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How to Identify a Non-Statutory Insider

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There are distinct disadvantages to being an insider in bankruptcy litigation. A transfer of property of a debtor to a creditor who is an insider made within one year preceding the debtor's bankruptcy filing may be avoidable as a preference, whereas the preference window for transfers to non-insider creditors is limited to transfers made within 90 days preceding the bankruptcy filing. 11 U.S.C. § 547(b)(4). Moreover, the conduct of insiders toward a debtor is subjected to rigorous scrutiny such that the claims of insiders are more susceptible to equitable subordination than those of non-insiders. *See In re Fabricators*, 926 F.2d at 1458, 1465 (5th Cir. 1991).

It is well-established that the definition of an "insider" contained in § 101(31) of the Bankruptcy Code is not exhaustive and that there exists a category of insiders, commonly known as "non-statutory insiders," whose description is not set forth in the Bankruptcy Code itself. In *Schubert v. Lucent Techs., Inc.* (*In re Winstar Commc'ns, Inc.*), 554 F.3d 382 (3d Cir. 2009), the Third Circuit Court of Appeals affirmed the lower courts' rulings that a public company was an insider of another non-affiliated public company and was therefore required to return a $188.2 million payment made over four months before the debtor's bankruptcy filing. This decision, in which the Third Circuit clarified the standards for identifying a non-statutory insider, deserves special attention because it illustrates how critical it is for lenders and vendors to conform their conduct toward troubled companies so as to reduce their risk of being deemed non-statutory insiders.

Background

Winstar Communications, Inc. ("Winstar"), a publicly owned telecommunications services provider, and its wholly owned subsidiary, Winstar Wireless, Inc. ("Wireless"), commenced construction of a global broadband communications network in the

1990s. Lucent Technologies Inc. ("Lucent"), another publicly owned company, is a large telecommunications vendor. The companies entered into what they described as a "strategic partnership" in which Lucent agreed to help finance and construct Winstar’s network and Winstar agreed to become a major purchaser of Lucent products and services. In October 1998, under a credit agreement between the parties (the "First Credit Agreement"), Lucent provided Winstar a $2 billion line of credit secured by a lien granted to Lucent over nearly all of Winstar’s assets. Simultaneously, the companies entered into a supply agreement that required Winstar to purchase equipment from Lucent. In addition, Wireless subcontracted to perform much of the network buildout for Lucent.

In May 2000, Winstar was able to obtain a $1.15 billion revolving credit and term loan from a consortium of banks. With proceeds from the bank loan, as well as funds Winstar raised in equity and public debt, Winstar paid off approximately $1.2 billion that it had borrowed from Lucent under the First Credit Agreement, and Lucent released its lien. Simultaneously, Lucent and Winstar entered into a second loan agreement (the "Second Credit Agreement"), under which Winstar received a $2 billion line of credit. The terms of the Second Credit Agreement required Winstar to, among other things, use any increases in the new bank loan to repay Lucent, and permitted Lucent to issue a refinance notice requiring Winstar to repay it in full if the outstanding loans exceeded $500 million.

In November 2000, Siemens, a competitor of Lucent, agreed to join the bank consortium facility and to lend Winstar $200 million. Siemens’ loan document permitted the loan proceeds to be used for "general corporate purposes." But the Second Credit Agreement required Winstar to pay increases in the bank facility to Lucent. Winstar’s failure to do so would result in a default under the second credit agreement, and consequently, a default under the bank facility by virtue of a cross-default provision. Winstar requested permission from Lucent to retain all or half of the $200 million Siemens loan. Lucent not only denied that request, it threatened to withhold: 1) any further draws on the second credit agreement; and 2) the payment of Wireless’ invoices for services already performed for Lucent, unless Winstar paid it all of the proceeds of the Siemens loan, even though the debtors were contractually entitled to both. On Dec. 7, 2000, Winstar closed on the $200 million increase in the bank facility and paid Lucent approximately $188.2 million (the Siemens loan less fees and a refund).

In April 2001, Winstar and Wireless filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code. Lucent filed several proofs of claim totaling nearly $1 billion. The debtors' bankruptcy cases were subsequently converted to Chapter 7 liquidations. The Chapter 7 trustee (the "Trustee") appointed to administer the debtors' estates pursued an adversary proceeding against Lucent seeking, among other things, avoidance and recovery of the $188.2 million Siemens loan proceeds as a preferential transfer, and equitable subordination of Lucent's claims based on its conduct toward Winstar. The key issue became whether Lucent was an "insider" of Winstar.

The Trial Before the Bankruptcy Court

Following a 21-day bench trial, after hearing 39 witnesses and reviewing 1,400 exhibits, the Bankruptcy Court for the District of Delaware made extensive factual findings of Lucent's control over Winstar and its ability to coerce Winstar into transactions not in Winstar's interest. The Bankruptcy Court identified numerous facts demonstrating that the parties did not deal at arm's length, including the following: 1) Lucent forced Winstar to buy vast amounts of goods before they were needed; 2) Lucent required Winstar to enter into end-of-quarter transactions in order to inflate the revenues Lucent could report to its shareholders and the financial authorities; 3) Lucent controlled many of Winstar's decisions relating to the buildout of its network; 4) duplicate charges were assessed to Winstar; and 5) a purchase order that simply described as "miscellaneous" what Winstar purchased from Lucent for several million dollars. *Shubert v. Lucent Techs., Inc.* (*In re Winstar Commc'ns, Inc.*), 348 B.R. 234 (Bankr. D. Del. 2005); aff'd, No. 06-147-JJF, 2007 WL 1232185 (D. Del. Aug. 26, 2007).

The Bankruptcy Court found that Lucent used its superior position to ensure Winstar's cooperation by repeatedly threatening to halt both funding Winstar's draw requests and the payment of a Wireless' invoices for services already performed for Lucent [*i.e.*, Lucent threatened to breach its contractual commitments unless Winstar purchased the unneeded equipment]. The Bankruptcy Court characterized the relationship between Lucent and Winstar as one of domination: "[W]hat began as a 'strategic partnership' to benefit both parties quickly degenerated into a relationship in which the much larger company bullied and threatened the smaller into taking actions that were designed to benefit the larger at the expense of the smaller." *Id*. at 251.

The Bankruptcy Court held that Lucent was an insider of Winstar as a

"person in control" under Code Section 101(31)(B)(iii), and as a non-statutory insider, when it received the $188.2 million payment from the Siemens loan proceeds. After rejecting Lucent's preference defenses, the Bankruptcy Court held that this payment was avoidable as a preferential transfer, even though it was made more than 90 days before Winstar's bankruptcy filing. The Bankruptcy Court also awarded judgment to the Trustee for $62 million plus interest for Lucent's breach of the subcontract with Wireless, and held that Lucent's claims should be equitably subordinated.

Lucent appealed the Bankruptcy Court's decision to the District Court for the District of Delaware, which affirmed. Lucent thereafter filed an appeal with the Third Circuit Court of Appeals.

The Appeal

On appeal, the Third Circuit affirmed the judgment of the Bankruptcy Court with respect to the Trustee's preference claim, the breach of subcontract claim and in nearly all other respects, resulting in a judgment valued at over $340 million. Regarding the preference claim, the Circuit Court began its insider analysis by reviewing the relevant text of the Bankruptcy Code. The statute provides that "[t]he term "insider" includes- … (B) if the debtor is a corporation- (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor." 11 U.S.C. § 101(31)(B). The Circuit Court noted that, because Congress inserted the word "includes" into this definition, courts properly have held that certain persons and entities not enumerated in the statute still could constitute "non-statutory insiders." *In re Winstar Commc'ns, Inc.*, 554 F.3d at 395 (*citing Anstine v. Carl Zeiss Meditec AG* (*In re U.S. Med., Inc.*), 531 F.3d 1272, 1276 (10th Cir. 2008)).

The court agreed with Lucent's argument that "actual control (or its close equivalent) is necessary for a person or entity to constitute an insider under § 101(31)'s 'person in control' language," *Id*. at 396, but did not determine whether that standard had been met on the facts found below. Rather, the Third Circuit held that, for the purposes of non-statutory insiders, a finding of actual control was not necessary. The court reasoned that "[t]o hold otherwise would render meaningless Congress's decision to provide a non-exhaustive list of insiders in 11 U.S.C. § 101(31)(B) because the 'person in control' category would function as a determinative test." *Id*. It also observed that not all of the insiders delineated in the statute possess actual

control over the debtor, so Lucent's argument that the non-statutory catchall must be reserved for those who are functionally equivalent to the types of insiders enumerated in the statute could not prevail. Instead, guided by the legislative history of § 101(31), S. Rep. No. 95-989, 95th Cong. 2d Sess., reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5810, the Circuit Court held that "the question 'is whether there is a close relationship [between debtor and creditor] and … anything other than closeness to suggest that any transactions were not conducted at arm's length.'" *Id*. (quoting *In re U.S. Med.*, 531 F.3d at 1277) (alterations in original).

The court also held that "[t]he Bankruptcy Court's extensive findings regarding Lucent's ability to coerce Winstar into transactions not in Winstar's interest amply demonstrate Lucent's insider status." *Id*. at 397. For example, Lucent used Winstar to inflate its own quarterly revenues by making Winstar process massive last minute purchases of unneeded equipment near the end of quarters.

Notably, the Circuit Court rejected Lucent's argument that it was simply driving a hard bargain and exercising its contractual rights. While acknowledging that the exercise of financial control incident to the creditor-debtor relationship does not transform a creditor into an insider, the Third Circuit noted that Lucent did not merely compel payment of debts or other financial concessions, it coerced Winstar to make unnecessary purchases and used Winstar as a mere instrumentality to inflate Lucent's own revenues. *Id*. at 399. Lucent had the ability to coerce Winstar into a series of transactions that were not in Winstar's best interests. Such one-sided transactions refute any suggestions of arm's length dealings, according to the Circuit Court.

Lucent argued that the parties' dealings were arm's length, as each side obtained concessions from the other. The Third Circuit rejected this argument, noting that the Bankruptcy Court's findings that Lucent had come to dominate the relationship by Dec. 7, 2000 (the date of the transfer challenged as preferential) and held that the Bankruptcy Court's finding that the parties did not deal at arm's length was not clearly erroneous. *Id*. at 399-400.

Analysis

The Third Circuit held that the test of whether a creditor is an insider of a debtor is whether there was a close relationship between it and the debtor and anything other than closeness to suggest that their transactions were not conducted at arm's length. Lucent clearly had a close relationship with Winstar, one of its major customers, given the

extent and ongoing nature of the parties' interactions. But why were Lucent's dealings with Winstar found not to be at arm's length?

Most importantly, Lucent did not merely stand on its contractual rights to extract concessions from Winstar. Rather, Lucent threatened to breach agreements between the parties and to deny Winstar its contractual rights — by refusing to fund draws to which Winstar was entitled and withholding payment for services rendered — in order to compel Winstar to obey its demands. In addition, Lucent dominated the relationship to the extent of forcing Winstar into blatantly one-sided transactions that harmed Winstar and benefited Lucent. Winstar was forced to engage in transactions detrimental to it just so it could receive that to which it was already contractually entitled.

Lenders, major vendors, and all others having extensive relationships with debtors should be mindful that, although it is acceptable for them to enforce their contractual rights vigorously, threats to deny a party its contractual rights are illegitimate and may expose them to significantly longer reachback periods on preference claims and greater risk of having their claim against the debtor equitably subordinated. As Lucent learned, the consequences may be severe. So too, if they fail to deal at arms' length in what might otherwise be proper transactions.

Creditors in a position to influence strongly the conduct and business decisions of a debtor should consult with knowledgeable counsel to ensure that they do not cross over the line and make themselves vulnerable to claims that they are insiders.

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