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Expert Analysis

Third Circuit Elaborates On Non-Statutory Insiders

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The U.S. Court of Appeals for the Third Circuit in *Schubert v. Lucent Technologies Inc.* (*In re Winstar Communications Inc.*)[1] recently elaborated on the standard for determining whether a creditor may be treated as a "non-statutory insider" for purposes of extending the time for recovering preferential transfers under the Bankruptcy Code. Specifically, the Third Circuit held that a showing of actual control of the debtor is not necessary to render a creditor an "insider" as defined in §101(31) of the Bankruptcy Code. Instead, it held that a creditor may constitute a "non-statutory insider" when it has a close relationship with a debtor and conduct other than closeness suggests that the transactions among them were not conducted at arm's length.

Preferences to Insiders

Pursuant to §547 of the Bankruptcy Code, a trustee may recover preferential transfers made within 90 days before the filing of the debtor's petition and, if the recipient is an "insider," preferences made up to a year before the petition date.[2] Accordingly, transfers made more than 90 days before the petition date can only be avoided under §547(b) if the trustee can establish that the creditor is an "insider."

Section 101(31) of the Bankruptcy Code enumerates a non-exclusive list of "insiders," which includes directors, officers, partners, and "persons in control" of the debtor and relatives of any of the foregoing.[3] In addition to the enumerated statutory insiders, courts also have established a catch-all category of "non-statutory insiders."

The legislative history of §101(31) indicates that the term "insider" is intended to apply to "one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms [sic] length with the debtor."[4] Thus, to ascertain a party's "insider" status, courts consider the closeness of the party's relationship with the debtor and whether the transaction in question was negotiated at arm's length.[5]

The 'Winstar' Decision

In October 1998, Winstar Communications Inc., a telecommunication services provider, entered into a strategic partnership with Lucent Technologies Inc. pursuant to which Lucent agreed to finance and build Winstar's global broadband network. Specifically, Lucent provided Winstar with a $2 billion secured line of credit to purchase products and services required for the buildout. The parties also entered into a supply agreement that required Winstar to purchase from Lucent the majority of the equipment and services needed for the network buildout and provided for surcharges in the event Winstar failed to meet these purchase requirements

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However, because Lucent did not have the core competencies necessary to perform the network buildout, it agreed to enter into a transition agreement pursuant to which Lucent subcontracted a portion of the work to a subsidiary of Winstar, Winstar Wireless Inc., until Lucent was capable of assuming responsibility for the buildout.

In May 2000, Winstar obtained from a lending syndicate a $1.15 billion revolving credit facility and term loan (the bank facility), which was used in part to refinance its existing $2 billion line of credit. Simultaneously, Winstar and Lucent entered into a second $2 billion credit facility (the second credit facility) secured by the assets of two Winstar subsidiaries and a senior lien on certain equipment financed by Lucent.

The second credit facility also contained financial covenants (i) prohibiting Winstar's total cash expenditures from exceeding $1.3 billion, (ii) permitting Lucent to serve a "refinance notice" on Winstar if the outstanding loans exceeded $500 million, and (iii) requiring the use of any increased availability under the bank facility to repay Lucent.

During the course of its dealings with Winstar, Lucent coerced Winstar into certain questionable transactions that were not in Winstar's best interests. Specifically, Lucent forced Winstar to purchase goods and services well before they were needed and at prices substantially above fair market value. Lucent undertook a pattern of demanding purchases toward the end of fiscal quarters so that it could disclose more profitable results in its quarterly public reports. These purchases eventually caused Winstar to breach the cash expenditure covenant and $500 million refinancing threshold under the second credit facility, thereby entitling Lucent to issue a refinancing notice. Lucent subsequently extracted payments from Winstar by threatening to issue the refinancing notice and stop payment of Wireless' invoices for services already performed.

In December 2000, Siemens, a competitor of Lucent, joined the bank facility and

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lent $200 million to Winstar to be used for general corporate purposes. However, Lucent demanded that the proceeds be applied to repay amounts owed to it. When Winstar did not immediately acquiesce, Lucent first put the transition agreement negotiations on hold and then threatened to prohibit further draws on the second credit facility, even though such a prohibition was not permitted under the agreement. Winstar submitted to the economic pressure exerted by Lucent and transferred approximately $188 million of the Siemens' loan proceeds to repay Lucent.

Over four months later, Winstar commenced its chapter 11 case in the U.S. Bankruptcy Court for the District of Delaware, which was converted in January 2002 to a case under chapter 7. Winstar's chapter 7 trustee sought the return of the $188 million payment to Lucent as a preferential transfer. Lucent contended that the trustee's claim was time-barred because Lucent was not an insider from which a preferential transfer made more than 90 days before the commencement of the case could be avoided.

The bankruptcy court held that Lucent was an insider because it was a "person in control" of Winstar as well as a non-statutory insider. Specifically, the bankruptcy court found that Lucent's coercive conduct rendered it an insider and, therefore, the $188 million payment to Lucent could be avoided as a preference. Lucent appealed the decision to the district court, which affirmed, and then filed an appeal to the Third Circuit.

The Third Circuit first addressed the legal standard for determining whether a creditor is an insider, acknowledging that §101(31) of the Bankruptcy Code provides for both statutory insiders, such as "persons in control," as well as non-statutory insiders.

However, the appellate court held that these two types of insiders are subject to different legal standards. The court held that actual control is required for an entity to constitute a "person in control," but such a showing is not a prerequisite to finding that an entity is a "non-statutory insider." The court reasoned that utilizing the "person in control" test for all other insider types would render meaningless Congress' decision to provide a non-exhaustive list of "insiders" in §101(31)(B). Nonetheless, the court agreed with Lucent that the catch-all non-statutory category "must be reserved for persons and entities that are functionally equivalent of the types of insider enumerated in the statute."[6] According to the Third Circuit, the test for whether a party is a non-statutory insider is "whether there is a close relationship [between the debtor and creditor] and…anything other than closeness to suggest that any transactions were not conducted at arm's length."[7]

Lucent argued that its conduct fell short of the type that would satisfy the relevant insider tests and that it was merely exercising its contractual rights and utilizing its superior position to drive a hard bargain. Further, Lucent identified certain alleged concessions obtained by both parties that evidenced arm's-length dealings.

However, the Third Circuit was persuaded that Lucent was an insider based on the bankruptcy court's findings that Lucent controlled many of Winstar's decisions relating to the buildout of Winstar's network and forced Winstar to buy goods well before they were needed, which goods often never left Lucent's facilities.

The circuit agreed with the bankruptcy court that Lucent effectively treated Winstar as a captive buyer for Lucent's goods and improperly used Winstar as a means for Lucent to disclose inflated earnings in its public filings. The court also emphasized that Lucent's ability to involve Winstar's employees in these improper transactions was further evidence of Lucent's control.

The Third Circuit noted that Lucent's conduct was not limited to the permissible compulsion of payment or other concessions incidental to the second credit facility. Instead, it found that Lucent's coercion of Winstar to make unnecessary purchases reduced Winstar to a "mere instrumentality" of Lucent.

Additionally, the Third Circuit held that, even if Lucent was not a "person in control" of Winstar, it certainly constituted a non-statutory insider.[8] On the basis of this ruling, the *Winstar* court upheld the trustee's right to recover from Lucent the $188 million that Winstar made over four months before the commencement of its bankruptcy case.

Analysis

The Third Circuit's decision in Winstar expounds on the type of egregious misconduct that would be necessary to render a creditor an insider for purposes of extending the clawback period for preferential transfers. Prior to *Winstar,* it was well-established that the exercise of financial control by a creditor over a debtor, which is incident to the creditor-debtor relationship, does not make a creditor an "insider."[9]

Indeed, a creditor may permissibly leverage its superior bargaining position in dealing with a debtor so long as the parties transact their business at arm's length. However, courts have drawn the line and found that a creditor may be characterized as an insider if it exerts such control over a debtor that it "unqualifiably dictate[s] corporate policy and the disposition of corporate assets."[10]

The *Winsta*r court emphasizes that the touchstone for "insider" status is whether the parties are dealing at arm's length, which is traditionally defined as any transaction negotiated in good faith in the ordinary course of business by parties, each with independent interests and acting in its own best interests. Although creditors may attempt to compel payment of debts and exercise other contractual rights incidental to the creditor-debtor relationship, *Winstar* demonstrates that there is a limit on creditor conduct in a given business relationship. The facts in *Winstar* were highly atypical and extreme, exemplifying the sort of domineering conduct that will influence a court to deem a creditor an insider and thus enlarge the clawback period for preferences from the usual ninety days to one year.

Conclusion

The decision in *Winstar* should not come as an alarming development for the vast majority of creditors. Because most business relationships are not fraught with the degree of entanglement and coercion that marked the Lucent-Winstar relationship, creditors acting within reasonable bounds will run no risk of being treated as an insider. The decision is instructive as a clear example of the degree of conduct that will subject a creditor to a finding that it is no longer dealing at arm's length and thus may be deemed an insider.

Further, *Winstar* is a reminder that bankruptcy courts are courts of equity and have been established by Congress to carry out the critical Bankruptcy Code policy of equitable treatment of creditors, which includes crafting remedies that obviate any unfair advantage that one creditor may have over its peers through acts of undue coercion and other unreasonable behavior.

1. Case No. 07-2569, 2009 WL 235676 (3d Cir. Feb. 3, 2009).
2. 11 U.S.C. §547(b).
3. 11 U.S.C. §101(31).
4. *Hirsch v. Tarricone* (*In re A. Tarricone Inc.*), 286 B.R. 256, 262 (Bankr. S.D.N.Y. 2002).
5. See id.; see also *In re Krehl,* 86 F.3d 737, 742 (7th Cir. 1996); *Schreiber v. Stephenson* (*In re Emerson*), 235 B.R. 702, 707 (Bankr. D.N.H. 1999).
6. Id.
7. Id.
8. Id. at *10.
9. *Johnson v. NBD Park Ridge Bank* (*In re Octagon Roofing*), 124 B.R. 522, 530 (Bankr. N.D. Ill. 1991).
10. *Badger Freightways Inc. v. Continental Il. Nat'l Bank & Trust Co. of Chicago* (*In re Badger Freightways Inc.*), 106 B.R. 971, 982 (Bankr. N.D. Ill. 1989).