

A L E R T

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2009**Financial Services Litigation and Bankruptcy, Workout and Business Reorganization****THIRD CIRCUIT DEEMS CREDITOR AN “INSIDER” BASED ON ABUSE OF BUSINESS RELATIONSHIP WITH DEBTOR AND ORDERS RETURN OF \$188.2 MILLION TO TRUSTEE***By Jennifer A. Diamantis*

The Third Circuit Court of Appeals has adopted a broad interpretation of “insider” status for purposes of avoidance claims under the Bankruptcy Code. It recently ruled that Lucent Technologies, a creditor, vendor-supplier, and strategic partner of bankrupt Winstar Communications, must return to Winstar’s bankruptcy trustee approximately \$188.2 million in loan payments it received from Winstar within the year before Winstar’s bankruptcy filing. The Third Circuit’s decision, issued on February 3, 2009 in *In re Winstar Communications, Inc.*, No. 07-2569, hinged on its determination that Lucent was an “insider” of Winstar under bankruptcy law. As a result, debtor Winstar’s payments constituted a preference under the Bankruptcy Code and were required to be returned to Winstar’s trustee. The case is significant because it expands upon the definition of an “insider” under bankruptcy law for purposes of extending the time for recovery of preferential payments, and finds that a creditor with a “close relationship” to a debtor may be an insider of another debtor-company by overstepping or abusing its business relationship with the debtor.

Under federal bankruptcy law, a trustee may recover preferential payments made by the debtor within 90 days of the filing of its bankruptcy petition. However, section 547(b) of the Bankruptcy Code extends this reachback period and permits a trustee to recover transfers made within one year of bankruptcy if the

creditor meets the Code’s definition of an “insider.” Under section 101(31)(B) of the Code, if the debtor is a corporation, the term insider “includes”: a director, officer, and “person in control” of the debtor; a partnership in which the debtor is a general partner; a general partner of the debtor; and a relative of a general partner, director, officer, or person in control of the debtor. Because of the Code’s use of the word “includes” when setting forth the persons or entities that may be deemed insiders, courts may expand the definition of an “insider” beyond the specific categories listed in the Code and deem others “non-statutory” insiders.

In *Winstar*, the \$188.2 million in payments by Winstar to Lucent were made outside of the 90-day preference period but within one year of the bankruptcy filing. To recover these payments, Winstar’s trustee argued that Lucent was an “insider” of Winstar as either a “person in control” or a “non-statutory” insider. In considering the issue, the Third Circuit held that although actual control, or its “close equivalent,” was necessary for a person or entity to be deemed an insider as a “person in control” of the debtor under section 101(31)(B) of the Code, a finding of such control is not required for an entity to be deemed a non-statutory insider. Rather, in determining whether an entity is a non-statutory insider, the Third Circuit explained that “the question ‘is whether there is a close relationship [between

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debtor and creditor] and . . . anything other than closeness to suggest that any transactions were not conducted at arm's length.” To answer this question, courts must undertake a fact-specific inquiry and review the creditor-debtor relationship at issue.

After reviewing the Bankruptcy Court's factual findings, the Third Circuit concluded Lucent was an insider of Winstar because of its “ability to coerce Winstar into transactions not in Winstar's interest.” For example, the Court found that Lucent imposed demands on Winstar such as the purchase of unneeded goods from Lucent for the purpose of inflating Lucent's revenue, treated Winstar as a captive purchaser, exercised control over certain Winstar decisions related to the buildout of its network, exerted influence over Winstar employees in connection with transactions that benefitted Lucent, and manipulated the timing of a refinancing notice. The Third Circuit rejected

Lucent's claim that it was simply attempting to drive a hard bargain and exercise its contractual rights. Rather, the Court viewed the various transactions at issue as being one-sided, and found they were not arms-length dealings in the normal course of business by parties with independent interests.

The *Winstar* decision may motivate trustees and debtors to delve deeper into creditor-debtor relationships and dealings in order to discover and prove facts that show more than an ordinary, arm's length business relationship for the purpose of extending the preference period by establishing non-statutory insider status. Although not every “close relationship” between a creditor and debtor will give rise to a finding of insider status, creditors' dealings with debtors will likely be subject to increased scrutiny in future bankruptcy proceedings. ♦

For more information about Schnader's Financial Services Litigation and Bankruptcy, Workout and Business Reorganization Groups, or to request to speak with a member of the groups at a particular Schnader office location, please contact a group chair:

Financial Services Litigation
Theresa E. Loscalzo
tloscalzo@schnader.com, 215-751-2254

Bankruptcy, Workout and Business Reorganization
Nicholas J. LePore, III
nlepore@schnader.com, 215-751-2286

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