Southern District of New York Dismisses Insider Preference Claims Against Affiliates of Goldman Sachs

April 15, 2013

Firms offering comprehensive financial services scored a significant victory on April 9, 2013, when Judge Robert Sweet of the United States District Court for the Southern District of New York dismissed Capmark Financial Group Inc.'s ("**Capmark**") insider preference action against four lender affiliates of The Goldman Sachs Group, Inc. ("**Goldman Sachs**"), which arose out of Capmark's 2009 bankruptcy.[1] Davis Polk represented the Goldman Sachs lender affiliates and advanced the arguments adopted by Judge Sweet. The court's opinion rejected Capmark's attempt to cast the lenders as "insiders" of Capmark based on an indirect equity interest in Capmark held by funds managed by affiliates of Goldman Sachs and Goldman Sachs's service as an advisor to Capmark. In doing so, Judge Sweet reaffirmed that corporate veils separating a lender from an affiliated entity holding equity positions or serving as advisor to the debtor will not lightly be disregarded, and that participation in an arm's-length transaction as an ordinary commercial lender will not give rise to insider status. Furthermore, Judge Sweet held that reorganized debtors are judicially estopped from making an about-face on key factual issues underlying relief secured in bankruptcy court. In sum, the *Capmark* decision should pose a substantial obstacle to claims alleging that a lender is an "insider" by virtue of affiliated entities' contacts with a debtor in the absence of evidence that the lender actually used the affiliates' contacts to influence the debtor's decisions.

Case Background

A brief history of the Capmark bankruptcy is essential to understanding Capmark's claims and the import of Judge Sweet's decision. In 2006, a consortium of private equity firms acquired an approximately 75% equity stake in Capmark through GMACCH LLC ("**GMACCH**"). Funds managed by affiliates of Goldman Sachs (the "**PIA Funds**") held a 19.8% stake in GMACCH and were permitted to appoint one designee to Capmark's board of directors. The PIA Funds selected a managing director of Goldman Sachs as their designee. In connection with this transaction, Capmark obtained two syndicated credit facilities, a $5.5 billion unsecured credit facility and a $5.25 billion unsecured bridge loan facility (the "**Bridge Loan**"). Four lender affiliates of Goldman Sachs (the "**Goldman Lenders**") acquired positions in those credit facilities.

In late 2008, because of credit market turmoil and a related decline in the value of its mortgage-related holdings, Capmark found itself in a challenging financial situation. In particular, Capmark faced an $833 million payment due in March 2009 to its Bridge Loan lenders, including, among others, the Goldman Lenders. After extensive negotiations, in May 2009 Capmark obtained a new $1.5 billion secured term loan facility (the "**Secured Credit Facility**"), which was used to pay down roughly the same amount from the 2006 unsecured credit facilities. Capmark also agreed to pay its Bridge Loan lenders about $75 million in cash. In this transaction, the Goldman Lenders allegedly received about $139 million in the Secured Credit Facility in exchange for a similar amount of the 2006 unsecured credit facilities, and about $5.5 million in cash.

On October 25, 2009, Capmark and a number of its affiliates commenced bankruptcy proceedings before Judge Sontchi of the United States Bankruptcy Court for the District of Delaware. As an intermediate

[1] *Capmark Fin. Grp. Inc., v. Goldman Sachs Credit Partners L.P.*, No. 11 Civ. 7511 (RWS) (S.D.N.Y. April 9, 2013).

step towards emergence, Capmark and the Secured Credit Facility lenders agreed to settle Capmark's potential claims arising out of the 2009 Secured Credit Facility—excluding potential preference claims against the Goldman Lenders—in exchange for a 91% payment in satisfaction of the Secured Credit Facility (the "**Settlement**"). The Settlement was opposed by Capmark's Official Committee of Unsecured Creditors.

A five-day hearing to evaluate the Settlement under Federal Rule of Bankruptcy Procedure 9019 was held before Judge Sontchi in October 2010. During this hearing, Capmark witnesses testified that the Secured Credit Facility negotiations were "above board" and "arm's length," and that the Secured Credit Facility had been offered at "market terms." Capmark incorporated this testimony into proposed findings of fact and conclusions of law submitted to Judge Sontchi.

In November 2010, Judge Sontchi approved the Settlement; his Findings of Fact and Conclusions of Law adopted verbatim Capmark's proposed findings that the Secured Credit Facility was negotiated at "arm's length."

Capmark emerged from bankruptcy on September 30, 2011. Less than one month later, reorganized Capmark commenced an action in the U.S. District Court for the Southern District of New York seeking to avoid as a preference the $145 million that the Goldman Lenders had obtained in the Secured Credit Facility transaction. Because the Secured Credit Facility transaction occurred more than 90 days before Capmark's bankruptcy filing, Capmark's preference claim depended on the Goldman Lenders being deemed "insiders" of Capmark.

Analysis of Insider Preference Claims

Under the Bankruptcy Code (the "**Code**"), a person qualifies as an "insider" of a debtor if that person is, among other things, (1) a director, (2) an officer, (3) a "person in control," (4) a general partner, or (5) a relative, affiliate, or insider of an affiliate of the debtor at the time of the transaction to be avoided.[2] A person falling under one of these categories is called a "statutory insider," because such a person is expressly defined as an insider by the Code. The Code's definition of "insider" states that an insider "*includes*" the above-enumerated categories. Courts have thus concluded that "insider" status is not limited to the enumerated categories, and have developed a separate, unenumerated category of "insider" dubbed the "non-statutory insider." If a person qualifies as either a statutory or non-statutory insider of a debtor, the debtor may recover any transfer of an interest in its property to such person within one year of the filing of its bankruptcy petition (while transfers to non-insiders may only be recovered as preferences if they occur within 90 days of the debtor's bankruptcy petition).[3]

In its suit, Capmark alleged that the Goldman Lenders were both statutory and non-statutory insiders of Capmark. According to Capmark, the Goldman Lenders were statutory insiders because the PIA Funds—holders of a 19.8% equity investment in GMACCH and rights to designate a board member—were statutory insiders, either as "directors," "general partners," or "persons in control" of Capmark. As for non-statutory insider status, Capmark alleged that the Goldman Lenders had a "close relationship" with Capmark because of the PIA Funds' equity holdings, service of a Goldman Sachs managing director as the PIA Funds' designee on the Capmark board and Goldman Sachs's role as financial advisor to Capmark in certain transactions. The complaint also alleged that transactions between the Goldman Lenders and Capmark were not at arm's length.

---

[2] *See* 11 U.S.C. § 101(31)(B), (E).

[3] 11 U.S.C. § 547(b)(4)(A), (B).

Judge Sweet's April 9 opinion dismissed both Capmark's statutory and non-statutory insider claims with prejudice.

With respect to the statutory insider claims, the court noted that Capmark had not alleged that the Goldman Lenders themselves fit any of the enumerated categories of insider. Instead, Capmark's statutory insider allegations related exclusively to the PIA Funds, whose alleged statutory-insider status Capmark argued was attributable to the Goldman Lenders.

Judge Sweet rejected even the initial step in Capmark's statutory claim, and held that Capmark failed to allege adequately that the PIA Funds were themselves statutory insiders. Quoting a decision of the Second Circuit, Judge Sweet held that an entity qualifies as a statutory insider under the "person in control" prong only if that entity exercises "extensive control," and that Capmark had failed to establish such control because the PIA Funds held only an approximately 15% indirect stake in Capmark. Even if Capmark had adequately alleged that the PIA Funds were statutory insiders, Judge Sweet held that Capmark's statutory insider claim would still fail because Capmark had not alleged facts sufficient to show the "extraordinary circumstances" necessary to pierce the veils separating the Goldman Lenders from the PIA Funds—which requires allegations sufficient to show both that Goldman Sachs exercised "complete domination and control" over both entities, and that the corporate form was used as a "sham" to perpetrate fraud or injustice.

Capmark's non-statutory insider claim failed on two independent grounds:

First, Judge Sweet held that Capmark alleged only that the Goldman Lenders acted as "ordinary commercial lenders that participated in a lending syndicate," which did not suffice to create the "close relationship" between the Goldman Lenders and the debtor necessary to establish non-statutory insider status. Because Capmark failed to plausibly allege facts supporting piercing the veils separating the Goldman Lenders and the PIA Funds, Judge Sweet determined that Capmark's non-statutory insider claim was subject to dismissal on this ground alone.

Second, Judge Sweet held that Capmark was judicially estopped from alleging that the Secured Credit Facility transaction was not at arm's length. The April 9 opinion quoted Capmark's prior representations to the bankruptcy court that the Secured Credit Facility was negotiated at "arm's length," and noted that the bankruptcy court accepted these representations in his approval of the Settlement. Since Capmark had benefitted by taking the position in bankruptcy court that the transaction *was* negotiated at arm's length, Judge Sweet, relying on the Second Circuit's decision in *In re Adelphia Recovery Trust*,[4] concluded that Capmark was judicially estopped from alleging that the transaction *was not* at arm's length.

Possible Effects of the Decision

Judge Sweet's ruling clarifies the law of insider preference liability and provides comfort that a lender should not be subject to insider preference liability based on a corporate affiliate's equity interest in the debtor in the absence of evidence that the lender had any ability to influence the debtor's decisions.

Fundamentally, the opinion rejects the notion—often advanced by plaintiffs in preference or equitable subordination actions—that a lender should be deemed an insider based on an aggregation of contacts across various entities affiliated with the lender's ultimate parent corporation. Indeed, Judge Sweet's opinion recognized that "these distinctions in form are relied upon by participants in structuring complex financial transactions"[5] and refused to disregard corporate separateness in the absence of allegations

[4] *Adelphia Recovery Trust v. HSBC Bank USA (In re Adelphia Recovery Trust)*, 634 F.3d 678, 697-99 (2d Cir. 2011).

[5] *Capmark Fin. Grp. Inc.*, slip op. at 2.

that would support veil piercing. The court synthesized case law showing that the level of corporate interrelatedness common to any parent-subsidiary relationship is not enough to pierce the veil. Judge Sweet reiterated that the standard for veil piercing is "very demanding" and requires a showing of "complete domination and control" and that the corporate form was used to perpetrate fraud or injustice. Moreover, the opinion clarifies that a plaintiff must make this showing to pierce the veil of each entity separating the affiliates in question.

In the specific context of preference liability, the opinion rejects a number of attempts to broaden the scope of statutory insider status, and confirms that a high level of control is required to find that an entity is a "person in control" under the Code. With regard to non-statutory insider status, the Third Circuit's decision in *Schubert v. Lucent Techs. Inc. (In re Winstar Commc'ns, Inc.)*, 554 F.3d 382, 396-97 (3d Cir. 2009) holds that a debtor seeking to establish non-statutory insider status must demonstrate *both* a close relationship between debtor and creditor *and* a non-arm's length transaction. By ruling that the absence of either a "close relationship" *or* a non-arm's length transaction is fatal to a claim, Judge Sweet's opinion suggests that the *Winstar* standard should be applied in the Second Circuit as well.

Finally, the opinion should also limit the ability of a reorganized debtor or litigation trust to whipsaw participants in bankruptcy proceedings by adopting diametrically opposed positions before and after emergence. Where ownership of a debtor or the influence of various creditor constituencies changes upon emergence, a reorganized debtor or post-emergence trust is often tempted to change positions that the debtor took when securing plan confirmation or the approval of a settlement. As applied here and in *In re Adelphia Recovery Trust*, judicial estoppel should prevent a reorganized debtor from attempting, in post-emergence litigation, to contradict representations made as a debtor in possession upon which the bankruptcy court relied in granting relief.

DavisPolk

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Litigation

Benjamin S. Kaminetzky	**212 450 4259**	**ben.kaminetzky@davispolk.com**
Elliot Moskowitz	**212 450 4241**	**elliot.moskowitz@davispolk.com**
Neal A. Potischman	**650 752 2021**	**neal.potischman@davispolk.com**
Jonathan D. Martin	**212 450 4530**	**jonathan.martin@davispolk.com**
Michael J. Russano	**212 450 4019**	**michael.russano@davispolk.com**

Insolvency and Restructuring

Donald S. Bernstein	**212 450 4092**	**donald.bernstein@davispolk.com**
Marshall S. Huebner	**212 450 4099**	**marshall.huebner@davispolk.com**
Damian S. Schaible	**212 450 4580**	**damian.schaible@davispolk.com**
Timothy Graulich	**212 450 4639**	**timothy.graulich@davispolk.com**
Brian M. Resnick	**212 450 4213**	**brian.resnick@davispolk.com**