AMERICAN BANKRUPTCY INSTITUTE

JOURNAL

January 2014 • Vol. XXXIII, No. 1

The Essential Resource for Today's Busy Insolvency Professional

Capmark: Clarifying Insider Status for Market Participants page 12

By Marshall S. Huebner and Hilary A.E. Dengel

On the Inside

AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Feature

By Marshall S. Huebner and Hilary A.E. Dengel

Capmark: Clarifying Insider Status for Market Participants

Marshall S. Huebner
Davis Polk & Wardwell LLP; New York

Hilary A.E. Dengel
Davis Polk & Wardwell LLP; New York

Marshall Huebner is a partner and Hilary Dengel is an associate with Davis Polk & Wardwell LLP in New York.

Being deemed an "insider" has important ramifications for creditors in bankruptcy. For example, the otherwise-applicable 90-day preference period expands to one year for insiders. When facing equitable-subordination claims, special scrutiny applies to the conduct of an insider, and a lower burden of proof applies to proving that the insider engaged in inequitable conduct. Insider status is also relevant to determining a creditor's intent to defraud in a fraudulent-transfer proceeding. Moreover, under the laws of certain states, transfers to insiders, including transfers satisfying past debts, might be deemed constructively fraudulent. Thus, insider status can materially affect a creditor's risk and recovery profile in any case.

In *Capmark Financial Group Inc. v. Goldman Sachs Credit Partners LP (Capmark)*,[1] Hon. Robert W. Sweet of the U.S. District Court for the Southern District of New York made several rulings on key insider-status issues favorable to market participants who regularly find themselves, sometimes through affiliated entities, playing multiple roles with respect to a borrower counterparty (the "company"). The *Capmark* decision provides comfort and greater certainty to market participants who, absent falling into one of the expressly enumerated categories of insiders under the Bankruptcy Code, should not be deemed insiders if they neither control the company nor deal with it at less than arm's length.

Brief History of the *Capmark* Case

In 2006, a consortium of private-equity funds acquired an approximately 75 percent equity stake in Capmark through a limited liability company (LLC) holding company (GMACCH LLC). Funds managed by affiliates of the Goldman Sachs Group Inc. (the "PIA funds") held a 19.8 percent stake in GMACCH LLC 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 entered into two syndicated, unsecured credit facilities: a $5.5 billion senior unsecured credit facility and a $5.25 billion unsecured bridge loan. Four affiliates of Goldman Sachs (the "Goldman lenders") acquired positions in those credit facilities.

In late 2008, due to credit market turmoil and a related decline in the value of its mortgage-related holdings, Capmark found itself in a challenging financial position. Specifically, Capmark faced an $833 million maturity payment due on its bridge loan in March 2009, in which the Goldman lenders continued to be participants. After extensive negotiations, in May 2009 Capmark entered into a new $1.5 billion secured credit facility, proceeds of which were also used to pay down roughly a similar amount of the 2006 unsecured credit facilities. In this transaction, the Goldman lenders were alleged to have received approximately $139 million in the secured credit facility in exchange for a similar amount of the 2006 unsecured credit facilities, and approximately $5.5 million in cash.

On Oct. 25, 2009, Capmark and a number of its affiliates commenced bankruptcy proceedings before Hon. **Christopher S. Sontchi** of the U.S. Bankruptcy Court for the District of Delaware. As a step toward 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 percent payment in satisfaction of the secured credit facility claims (the "settlement"). The settlement was opposed by Capmark's unsecured creditors' committee.

1 No. 11 Civ. 7511 (RWS) (S.D.N.Y. April 9, 2013).

In October 2010, Judge Sontchi held a five-day hearing to evaluate the settlement under Rule 9019 of the Federal Rules of Bankruptcy Procedure. During this hearing, Capmark witnesses testified that the secured-credit-facility negotiations were "above board" and "arm's length," and the parties stipulated that the secured-credit-facility transaction was on "market terms." Capmark incorporated this testimony and the stipulation into proposed findings of fact and conclusions of law. 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 Sept. 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 approximately $145 million that Capmark alleged that the Goldman lenders had obtained in the secured credit facility transaction (through the transfer of both cash ($5.5 million) and collateral ($139 million)). 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. Capmark alleged that the Goldman lenders were both "statutory" and "non-statutory" insiders.

Insider Status under the Bankruptcy Code

Bankruptcy law broadly provides for two types of insiders: "statutory insiders" and "non-statutory insiders." Statutory insiders are persons that the Bankruptcy Code specifically enumerates as insiders because of their status (including directors and officers of corporations, general partners, persons in control, affiliates or insiders of affiliates)[2] and are *per se* insiders under the Code. Because the Code's definition of insider "*includes*" the specifically enumerated categories, courts have concluded that insider status is not limited to those categories and have developed a separate, unenumerated category of insider: a "non-statutory insider."

In developing this second category, courts have looked to legislative history, which provides that "an insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor." Courts in Delaware, New York and elsewhere have, in recent years, developed a two-prong test for non-statutory insider status, requiring both a "close relationship" between the debtor and the alleged insider and a non-arm's-length transaction.

Statutory Insider Allegations in *Capmark*

Capmark's primary statutory insider allegation rested on the theory that the PIA funds, and therefore the Goldman lenders, were "insiders of an affiliate" because the PIA funds were members of GMACCH LLC, an insider of Capmark by virtue of its affiliate status. Because the Bankruptcy Code does not expressly address insiders of an LLC, Capmark relied on case law providing that LLC members (and managing members) are akin to officers or directors of a corporation or general partners of a partnership, and should therefore be treated as *per se* insiders because applicable nonbankruptcy law in most states provides LLC members with management rights. While this line of case law has not explicitly addressed the insider status of an LLC member that has both relinquished its management rights through the LLC's charter documentation and did not in fact manage the company, logic dictates that such a person should be viewed as more akin to a shareholder than a *per se* insider.

The court did not find the PIA funds to be *per se* insiders by virtue of their holdings in GMACCH LLC. Rather, the *Capmark* court determined that Capmark's conclusory allegations that the PIA funds, by virtue of their holdings of LLC membership interests, extensively controlled GMACCH LLC were insufficient to sustain a statutory insider claim with respect to the "person in control" standard or otherwise. While the *Capmark* opinion does not directly address the point, the court's reference to an implied "control" requirement for finding an LLC member to be an insider supports the notion above that an LLC member without management or control rights is more properly compared to a corporate shareholder. Separately, the court rejected Capmark's argument that certain Securities Exchange Act rules should be applied in order to deem the PIA funds affiliates of Capmark.

Veil-Piercing Required to Attribute Insider Status

Even had Capmark been able to demonstrate that the PIA funds were statutory insiders, the facts would have remained insufficient to sustain statutory insider preference claims against the defendants — the Goldman lenders — because the facts alleged were insufficient to pierce the corporate veils separating these entities. Accepting the arguments advanced by the Goldman lenders, the *Capmark* opinion joins a number of recent cases requiring allegations sufficient to support veil-piercing in order to attribute the conduct of one corporate affiliate to another for purposes of determining insider status. Despite Capmark's attempts to sufficiently plead facts to support a piercing claim, the court characterized the facts alleged as describing nothing more than a typical majority shareholder or parent relationship among Goldman Sachs, the Goldman lenders and the PIA funds, and noted that there were no allegations that any Goldman lender or PIA fund was a sham entity or existed as a vehicle for fraud.

The court also held that where a plaintiff seeks to disregard corporate formalities separating horizontal affiliates, the corporate veils separating each entity from the corporate parent must be pierced. Additionally, the court rejected Capmark's argument that a veil-piercing requirement would allow investors to escape insider liability by simply creating a separate entity to make and receive loan payments — implying that if done for an improper purpose, a basis for veil-piercing might exist.

Non-Arm's-Length Transaction Required for Non-Statutory Insider Claim

The *Capmark* decision cited with approval recent case law requiring a non-arm's-length transaction for non-statutory insider liability to attach — a standard that plaintiffs were judicially estopped from satisfying because of their own

2 11 U.S.C. § 101(31).

statements made during the settlement litigation. This now-established pattern in the case law began with *Anstine v. Carl Zeiss Meditec AG (In re U.S. Medical Inc.)*, in which the U.S. Court of Appeals for the Tenth Circuit stated that "closeness alone does not give rise to insider status" and held that "a creditor may only be a non-statutory insider of a debtor when the creditor's transaction of business with the debtor is not at arm's length."[3] A year later, the Third Circuit echoed this sentiment, in *Shubert v. Lucent Techs. Inc. (In re Winstar Commc'ns Inc.)*, holding that two elements were necessary to establish non-statutory insider status: (1) a close relationship between the debtor and creditor and (2) something other than "closeness" to suggest that any transaction between the two was not conducted at arm's-length.[4]

Following the *Winstar* decision, recent cases in Delaware with facts similar to *Capmark* refused to tag counterparties as insiders where they dealt with a debtor at arm's-length. In *Official Committee of Unsecured Creditors v. Credit Suisse (In re Champion Enterprises Inc.)*, the U.S. Bankruptcy Court for the District of Delaware refused to find various Credit Suisse lending entities to be insiders where their access to information and influence stemmed from bargained-for rights under a credit agreement.[5] In *Clear Thinking Group LLC v. Brightstar US Inc. (In re KCMVNO Inc.)*, on facts *a fortiori* to those alleged in *Capmark*, the court opined that in order to "curtail the risk that Winstar is inopportunely used as a vehicle to allege that insider liability should attach to ordinary market participants that deal with the debtor," *Winstar* should not be construed "to permit application of insider status whenever a debtor has an [sic] unique relationship with an entity."[6] The *Capmark* opinion is entirely consistent with these cases and supports the proposition that the *Winstar* test should be applied in the Second Circuit.

In *Capmark*, the court found that the alleged relationship between the Goldman lenders and Capmark was no more than that of ordinary commercial lenders in a syndicated credit facility and did not suggest the existence of the "high level of control" required for non-statutory insider status to attach. Causing the claim to fail on the second prong of the *Winstar* test as well, judicial estoppel precluded Capmark from asserting a claim "that require[d] the Secured Credit Facility to have been a non-arm's-length transaction."

Timing Matters for Insider Status

The *Capmark* decision also holds that even in cases where a multi-year relationship exists (whether close or not) and where several transactions have occurred among the parties over time, the facts must support a claim of insider status *at the time of the specific transaction at issue*. It is therefore possible for a person or entity to shed its potential insider status over time. Alternatively, engaging in ordinary market transactions to sell down a position prior to a refinancing or other transfer from the debtor (thereby avoiding receipt of any such transfer) may limit a market participant's risk profile for avoidance or subordination claims.

Conclusion

The court's decision in *Capmark* is notable for the numerous points of law that it clarifies concerning both statutory and non-statutory insider status for market participants. This case should provide further clarity that insider liability should not attach to ordinary market participants who deal with a debtor — even in multiple capacities — at arm's length. abi

Reprinted with permission from the ABI Journal, Vol. XXXIII, No. 1, January 2014.

3 531 F.3d 1272, 1280 (10th Cir. 2008).
4 554 F.3d 382, 396-97 (3d Cir. 2009).
5 2010 Bankr. LEXIS 2720, at *18, 21-23 (Bankr. D. Del. Sept. 1, 2010).
6 2010 Bankr. LEXIS 3669, at *15 n.4 (Bankr. D. Del. Oct. 15, 2010).