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Alert

Update on Insider Litigation

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The U.S. Bankruptcy Court for the Northern District of Illinois ordered the "equitable subordination" of insider secured claims against a Chapter 11 debtor on Nov. 30, 2015 because the insiders left "the company and its unsecured creditors unprotected against a sharp market decline" in the debtor's business; failed to make an equity infusion "when a sharp market decline [in the debtor's business operations] did in fact occur … immediately after [the insiders received a cash] distribution"; caused the debtor to lose its "equity cushion" with the distribution they received and "replaced" it with their secured loans, thereby "diminishing the funds available to support the trade creditors"; and kept the debtor's finances "completely confidential from its trade creditors," making it "impossible for any … trade creditors to know about its shareholder distributions … or its decision to substitute secured debt." *In re SGK Ventures, LLC*, 2015 WL 7755525, at *22 (Bankr. N.D. Ill. Nov. 30, 2015). Because of the trustee's broad attack on the debtor's insiders here, the court's decision provides a helpful update to the current state of insider litigation.

The court made its findings after trial. It rejected the trustee's attempt to (1) recover distributions to the insiders as fraudulent transfers; (2) avoid a lien granted to an insider as a preference; (3) recharacterize the insiders' loans as equity; and (4) recover damages for the insiders' alleged breach of fiduciary duty. Able to rely solely on the equitable subordination remedy, the court found that the trustee had failed to prove the elements of the other theories of recovery. Moreover, as a practical matter, because the claims of "the [insider] lending entities are subordinated, they are not entitled to enforcement of their rights as secured creditors until the claims of all other creditors are paid in full." *Id.* at *1.

Relevance
Insiders are common targets in bankruptcy cases. Recent cases like *SGK* show that trustees and creditors' committees regularly sue insiders for preferences, fraudulent transfers, equitable subordination, recharacterization of insider claims as equity, liability for the debtor's obligations, and other harm caused to the debtor's financial well-being (and, indirectly, to creditors of the debtor):

- *U.S. Bank Nat'l Ass'n v. Verizon Communications, Inc.*, 761 F.3d 409 (5th Cir. 2014) (affirming district court's dismissal of $2.5-billion fraudulent transfer suit against debtor's corporate parent when debtor found to be solvent);
- *In re Adamson Apparel, Inc.*, 785 F.3d 1285 (9th Cir. 2015) (2-1) (corporate insider who personally guaranteed debtor's loan not liable on bankruptcy trustee's preference claim when corporate debtor repaid its lender);

- *In re Alternate Fuels, Inc.*, 789 F.3d 1139 (10th Cir. 2015) (2-1) (claim of insider lender who invested in "venture with substantial risk" and who made secured "rescue" loans to salvage business should not be recharacterized as equity or subordinated on equitable grounds).
- *Capmark Fin. Group Inc. v. Goldman Sachs Credit Partners L.P.*, 491 B.R. 335 (S.D.N.Y. 2013) (asserted insider preference complaint dismissed; complaint failed to show defendants were insiders despite affiliates' (1) equity position in debtor; (2) management services contract with debtor; and (3) seat on debtor's board of directors).
- *In re Sentinel Management Group, Inc.*, 728 F.3d 660 (7th Cir. 2013) (debtor investment manager's "failure to keep client funds properly segregated" and subsequent pledge of those funds "to secure an overnight loan" from defendant bank to stay in business may have constituted (1) a fraudulent transfer; and (2) grounds for equitably subordinating bank's $312-million secured claim; case remanded for further litigation); *on remand*, *In re Sentinel Management Group, Inc.*, 2014 WL 6990322 (N.D. Ill. Dec. 10, 2014) (bank did not engage in "egregious conduct" sufficient to subordinate its lien on equitable grounds; because of bank's "good faith," corrupt borrower's fraudulent pledging of customer funds to bank to secure $312-million rescue loan "cannot be avoided").
- *In re Winstar Communications, Inc.*, 554 F.3d 382 (3d Cir. 2009) (affirming preference judgment against insider, "actual control not required"; rather, question was whether close relationship existed between debtor and creditor).
- *In re Adam Aircraft Industries, Inc.*, 2015 U.S. App. LEXIS 17930 (10th Cir. Oct. 15, 2015) (terminated officer of corporate debtor, who bargained for "18 months of severance … to ensure that his firing not disrupt [debtor's] negotiations for $80 million" of financing and who gave debtor "reasonably equivalent value" found not liable; affirmed dismissal of trustee's fraudulent transfer claims against officer as purported insider; officer not an insider and "did not end up getting what he bargained for," but debtor did get entire benefit of "a truly good trade"), distinguishing *In re Trans Texas Gas Corp.*, 597 F.3d 298 (5th Cir. 2010) (former chief executive officer's severance payments held to be insider fraudulent transfers) and *In re TSIC, Inc.*, 428 B.R. 103 (Bankr. Del. 2010) (same).
- *In re Autterson*, 2015 WL 6789168 (10th Cir. BAP, Nov. 6, 2015) (insider creditors "waived … right to charge default interest on" their claims and "failed to prove" their claim for non-default interest, but claims not equitably subordinated because insiders were "separate legal entities"; pre-bankruptcy dealings with debtor had been "carefully and appropriately documented" and their cash transfers to debtor had "always been treated as loans").

As this sampling also shows, insider litigation is fact-intensive, often requiring a trial like the one in *SGK*.

Facts in *SGK* Case

The debtor limited liability company ("LLC") was in the volatile metal recycling business, buying scrap, processing it and reselling it to producers. 2015 WL 7755525, at *4. There was no public market for trading stainless steel, one of the debtor's essential products. The prices of nickel and stainless steel affected the debtor's profitability. The effect of changes in nickel price was substantial, resulting in the debtor realizing large profits when nickel/stainless prices were rapidly increasing, but also sustaining losses when prices fell. *Id.* at *6.

To maintain its business, the debtor maintained a revolving line of credit with a bank, secured by all of its assets. It kept only a small amount of its current assets in cash, relying on the collection of accounts receivable from prior scrap sales to purchase new scrap and to cover its operating expenses and distributions. The debtor's operating agreement provided for distributions from available cash to the two insider members of the LLC so that they could pay their income tax liabilities. The debtor treated the tax distributions as mandatory, regularly making distributions to its members in an amount equal to 45 percent of the debtor's taxable income. *Id.* at *7.

When the debtor had generated substantial income in 2005 and 2007, the debtor made two large special non-tax distributions to the insiders rather than retaining the income in cash. Those distributions "resulted in … minimal members' equity." After distributing $50 million in 2006 to its members, the debtor made another special distribution of $40 million to them in 2007. The trustee's expert conceded that during this time period, the value of the debtor's assets exceeded its liabilities even after a later tax distribution in 2008. In fact, the debtor made $29.3 million of distributions in 2008, consistent with its "practice of paying tax distributions automatically," even after nickel prices had fallen sharply, with a negative effect on the debtor's net profits, although the debtor "remained profitable." *Id.*

The debtor's chief financial officer, in an October 2009 memorandum, criticized the tax distributions, noting the "significant financial stress created by recent capital expenditures and the timing of shareholder distributions," causing the company "to be significantly under-capitalized." *Id.* at *9. Although the debtor "had sufficient capital to do business," the court found its "level of capitalization … would have been insufficient under the [Dun & Bradstreet] benchmarks" for public companies in the same line of business as the debtor.

The debtor's financial condition "plummeted" after the 2008 tax distributions. *Id.* The debtor had breached one of the covenants in its bank loan agreement, causing the debtor's chief executive officer to direct substantial cost reductions and to seek additional capital to sustain the business and reassure its bank. In a December 2008 memorandum, however, the debtor's chief financial officer expressed concern about a new capital infusion and the ability to protect it in any subsequent bankruptcy. *Id.* at *10.

The debtor first decided to raise capital from its members in a preferred stock offering, but was concerned about "keeping the contributed cash at least temporarily separate from [the debtor] and its creditors." *Id.* at *11. After getting advice from bankruptcy counsel to "forget equity," the debtor decided to "discard the preferred share approach and replace it with a corporate restructuring that would not involve adding equity." *Id.* at *12-13.

The insiders eventually decided to lend new funds to the debtor on a secured basis. They also ordered the destruction of all documents related to a preferred stock offering "to prevent confidential information being disseminated outside the [debtor]." *Id.* at *13.

The new loan from the insiders would "be secured by a second lien on [the debtor's] assets." According to the court, "[i]nstead of sharing equally with unsecured creditors, the [insider] loan would now be payable in full before unsecured creditors had any right to payment." *Id.* at *14. The debtor's auditors delayed issuing a report until an appropriate amendment was made to the debtor's loan agreement with its bank and the insider loan was documented.

The debtor later generated income but, by 2012, "again went into default under its [bank] loan agreement." *Id.* at *15. In late 2011, insiders had made a second $5 million loan to the debtor on an emergency basis. *Id.* at *16. Although this loan "prevented a complete lack of cash, [it] did not improve [the debtor's] overall financial situation." *Id.* By early 2013, the debtor's bank cut off any further availability under the pre-existing revolving credit agreement. One insider had to make an emergency short-term $1 million bridge loan to the debtor on a secured basis. By 2013, the debtor "continued to experience negative financial results, … with net … losses each month until its bankruptcy filing in September." *Id.* at *17.

The debtor hired bankruptcy counsel in late March 2013. The debtor's insiders asked their general counsel about their subordinated secured loans to the debtors, and in a March 26, 2013 email the lawyer noted that "there is a very good chance that any trade creditors who do not get paid are going to file a motion to have [the loans] equitably subordinated." But the insiders and their counsel figured the risk "was worth a shot," noting that "because the debt has actually been in place for a while, … we could argue that any creditors today were not prejudiced and in fact benefitted from the debt being in place." *Id.* at *18. Between the insiders' approval of a bankruptcy filing in June 2013 and the Sept. 24, 2013 bankruptcy filing, other than the bank, "no other [creditor had been informed of [the debtor's] intention to file." Instead, the debtor closed three of its facilities and suspended "payments for all goods received on or before June 26, but would continue to do business and make payments for goods received after June 26 … . Operating in this mode, and liquidating unnecessary assets, [the debtor] generated enough cash to pay all of its indebtedness to [the bank]." *Id.*

Decision

No Fraudulent Transfer. The court rejected the trustee's attempt to recover under applicable state law the distributions that the debtor made to its insiders in 2007 and 2008. Because the distributions "were not contractually required, and no other value was given by" the insiders, "the only issue for determination [was] whether the distributions left [the debtor] with inadequate assets." *Id.* at *19. According to the court, " [The debtor] was not known to be insolvent or unable to pay its debts after either of the distributions." The debtor, moreover, remained solvent "even after the 2008 tax distribution," and "[t]he trustee presented no evidence of insolvency in connection with either of the distributions." *Id.* The trustee also failed to prove that the debtor made these cash transfers with actual "intent to hinder, delay, or defraud" creditors.

The trustee's expert opined that the debtor was inadequately capitalized because it had an equity cushion of only 4.7 percent. His opinion, however, was "not supported by any further analysis, by reference to particular prior experiences of the expert, or by citation to any authority on capital adequacy." Nor did the expert show what would be an adequate equity cushion. Because there was no evidence of the debtor's "financial distress shortly after the tax distribution," the trustee failed to show that the debtor's cash transfers were "either constructively or actually fraudulent." *Id.*

No Recharacterization. The court rejected the trustee's attempt to recharacterize the insider loans as equity contributions under federal and state law. First, a recharacterization claim "can only be considered under state law." *Id.* Because the Seventh Circuit had not ruled on the specific issue, the court relied on recent decisions from other circuits, holding that recharacterization is available only under applicable state law. *In re Lothian Oil, Inc.*, 650 F.3d 539, 544 (5th Cir. 2011) (applying Texas law); *In re Fitness Holdings Int'l Inc.*, 714 F.3d 1141, 1147-50 (9th Cir. 2013) (remanding for consideration under applicable state law).

Illinois law "allows courts to determine whether a transaction asserted to be a loan should instead be treated as an equity contribution." 2015 WL 7755525, at *20. According to the court, "deficiencies in loan documentation and treatment" are essential to the recharacterization analysis. When there are "no promissory notes, no fixed payment dates, no specification of interest," an equity contribution is apparent, but those facts were "not present here." First, the insider loans here "were thoroughly documented, with detailed interest and payment terms and with the full expectation that they would be paid interest." Consistent with the note terms, the debtor paid the interest. *Id.*

Equitable Subordination. The court granted the trustee's request for equitable subordination of the insider claims, "which would allow those claims to be paid only after full payment of other creditor claims." *Id.* at *21. First, because the debtor made no fraudulent transfers to the insiders, their making a secured loan to the undercapitalized debtor was hardly inequitable when viewed in isolation. *Id.* at *22, quoting *In re Lifschultz Fast Freight*, 132 F.3d 339, 345 (7th Cir. 1997) ("[W]hile undercapitalization may indicate inequitable conduct, undercapitalization is not in itself inequitable conduct.")

Other facts, however, made the insider loans inequitable. Not only did the holders' receipt of large cash distributions leave the debtor "and its unsecured creditors unprotected against a sharp market decline," but the insiders deliberately declined to make the necessary equity infusion. Concerned "that the funds paid for the stock would be lost," the insiders "contacted bankruptcy counsel precisely to address that concern." On the basis of that advice, the insiders decided to "forget equity and make a secured loan instead," thus reducing "the funds available to support the trade creditors." *Id.*

Most important, the insiders kept "every aspect of [the debtor's] finances … completely confidential from … trade creditors." *Id.* These creditors were thus prevented from learning about the shareholder distributions and the insiders' decision "to substitute secured debt" for a needed capital infusion.

No Breach of Fiduciary Duty. According to the court, the trustee proved no breach of fiduciary duty by insiders involved in the management of the debtor. The trustee also failed to show that the distributions in 2007 and 2008 were improper. As to the trustee's claim that the insiders should have placed the debtor "into bankruptcy sooner," the trustee failed to show "when the filing should have taken place and what additional recovery the estate could have … realized." *Id.* at *23.

No Insider Preference. Finally, the court rejected the trustee's attack on the debtor's granting of a lien to one insider and repayment of the third emergency insider bridge loan as a preference. Although the debtor had not signed a security agreement "until two days after the execution of a promissory note and payment of the loan proceeds to [the debtor]," the so-called "contemporaneous exchange" defense contained in Bankruptcy Code Section 547(c)(1) insulated the payment. "[T]he note itself stated the intent of the parties that it be secured, complying with the first condition of the defense, and the actual security agreement was executed two days later — and so substantially contemporaneous." *Id.*, citing *Pine Top Ins. Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 969 F.2d 321, 328 (7th Cir. 1992) (finding a much longer gap to be contemporaneous). In short, the insider's lien was valid, insulating the later payment to him.

Comment

SGK is consistent with appellate decisions authorizing equitable subordination. *Lifschultz*, 132 F.3d at 344, 354 ("A loan from a corporate insider muddles [the] conceptual clarity [distinguishing debt from equity] … . Any misconduct by an insider may be invoked to subordinate" insider's claim; insiders may have been guilty of misconduct by inflating salaries with “retroactive raises”); *In re Herby’s Foods, Inc.*, 2 F.3d 128, 134-35 (5th Cir. 1983) (debtor undercapitalized; insider’s loans “neither accurately nor timely reflected” on debtor’s records; trade creditors unknowingly increased debt; inequitable conduct warranted equitable subordination of insider claims). The *SGK* court’s thorough analysis thus provides an excellent guide to the current state of fact-intensive bankruptcy litigation.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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