ALERTS

District Court Dismisses Insider Preference Claim Despite Affiliates Holding Equity and Board Seats

April 19, 2013

The United States District Court for the Southern District of New York dismissed an insider preference complaint by Capmark Financial Group Inc. and its affiliates ("Capmark") seeking to recover a $145 million pre-bankruptcy payment from a lender group. *Capmark Financial Group Inc. v. Goldman Sachs Credit Partners L.P.*, __ F. Supp. 2d __, 2013 WL 1420243 (S.D.N.Y. Apr. 9, 2013) (Sweet, J.).[1] According to the court, the complaint failed to show that the defendants were insiders despite their affiliates' (a) equity position in the debtor; (b) management services contract with the debtor; and (c) seat on the debtor's board of directors. Nor could Capmark offer facts to support the court's disregarding ("veil-piercing") the corporate form between the defendant lenders and their affiliates.

Facts

Capmark financed a 2006 leveraged buyout with $8.7 billion of unsecured debt from various lenders, including the defendants (the "Lender Defendants"). *Id.* at *1. In the transaction, all the LBO lenders formed a limited liability company (the "LLC") to hold 74 percent of the equity of the debtor's parent company. *Id.* Affiliates of the Lender Defendants (collectively, the "Affiliates") collectively owned 19.8 percent of the LLC's equity. *Id.* at *3. As indirect equity owners, the Affiliates also had a representative on Capmark's board of directors. *Id.* at *3. Additionally, another affiliate of the Lender Defendants agreed with Capmark to provide "management monitoring and advisory services." *Id.* at *4.

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising

In 2009, Capmark entered into a $1.5 billion secured credit facility with new lenders, including the Lender Defendants. *Id.* at *1. Capmark used the new secured loan proceeds, in part, to repay $145 million owed to the Lender Defendants on their existing unsecured claims. By obtaining secured claims, Capmark alleged that the Lender Defendants "were better positioned to receive payment in full when the Plaintiff's predecessor entity declared bankruptcy in October 2009." *Id.* at *1. After emerging from bankruptcy in 2011, the reorganized debtors (the "Plaintiffs") sued the Lender Defendants (but *not* the Affiliates) to avoid and recover the $145 million payment as an insider preference.[2] The Lender Defendants moved to dismiss the complaint, arguing that the payment was not a preference because (a) it was paid more than five months prior to bankruptcy; (b) they were not "insiders"; and because of (c) the parties' corporate separateness. For the court, the main issue was whether the Lender Defendants were "insiders," which, if true, would extend the normal 90-day preference period to a year.

No Statutory Insider Claim

The court first addressed whether the Lender Defendants were "statutory insiders" under the Bankruptcy Code ("Code"). Code § 101(31)(B), (E) defines the term "insider" of a corporate debtor to include a (a) director; (b) officer; (c) "person in control"; (d) general partner of the debtor; (e) relative of one of those; or (f) an "affiliate, or insider of an affiliate as if such affiliate were the debtor." An "affiliate" is an "entity that directly or indirectly owns, controls or holds the power to vote 20 percent or more of the voting securities *of the debtor* …" Code § 101(32)(2)(A) (emphasis added).

Capmark alleged that the Lender Defendants were statutory insiders because of the Affiliates' "extensive control" over the LLC (as opposed to the Debtor), which held 74 percent of the Debtor's equity. *Id.* at *7. This allegation, the court found, was insufficient to show that the Affiliates had "actual authority or control" over the Debtor (as opposed to the LLC). *Id.* Citing Second Circuit precedent, the court held that control must be "substantial" and "extensive" for a party to be considered an insider. *Id.*, *citing In re 455 CPW Assocs.*, 225 F.3d 645, at *5 (2d Cir. 2000) (". . . required evidence of extensive control before finding insider status. . . .").

Capmark also alleged that the Affiliates were statutory insiders because their indirect equity interest (19.8 percent of the LLC's 74 percent) in the

Copyright © 2024 Schulte Roth & Zabel LLP

debtors should be aggregated with the equity holdings of the other LLC members under Rules 13d-3 and 13d-5 of the Securities Exchange Act of 1934. *Id.* at *8. According to Capmark, because the Affiliates and other LLC members acted together to acquire the Debtor's equity, they were part of a Rule 13(d) "group," resulting in all members of the group being "deemed," pursuant to Rule 13d-5, to be the beneficial owner of all equity securities of that issuer beneficially owned by the group members (in this case, 74 percent). *Id.* The court rejected this argument. Although "courts have recognized Rule 13d in the bankruptcy context," Rule 13d cannot "supplant the definition of 'insider' set out in the Bankruptcy Code." *Id.* "[T]he Second Circuit has rejected similar attempts to supplant definitions set out in the Bankruptcy Code with dissimilar definitions from the Exchange Act." *Id.* at *8 citing *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d. Cir. 2011).

Capmark also sought to disregard the corporate separateness of the Affiliates and the Lender Defendants. *Id.* at *8-9. Given the strong presumption of limited liability with separate entities, the court reiterated that "the standard for veil-piercing is very demanding" and warranted "only in extraordinary circumstances." *Id.* at *10. Conclusory allegations of "domination and control," without more, are insufficient to hold a parent company liable for the acts of its subsidiary. Although "domination and control" are elements of the veil-piercing analysis, the analysis does not stop there, and more must be shown (e.g., how the control was abused or caused an injustice). *Id.* at *10. Here, the court rejected Capmark's attempted veil-piercing because the complaint failed to allege that the "corporate formalities separating" the entities "were in any way disrespected." *Id.* at *12. There were no allegations that (a) "funds were commingled"; (b) the entities "were inadequately capitalized"; or that (c) "any other corporate formalities (such as maintaining separate books and records, or maintaining a functioning board of directors for each entity) were not respected." *Id.*

No De Facto Insider Claim

The court also rejected Capmark's assertion that the Lender Defendants were non-statutory, de facto insiders. Like other courts, it examined "(1) the closeness of the relationship between the debtor and the transferee, and (2) whether the transactions between the debtor and transferee were conducted at arm's length." *Id.* at *14; *See alsoShubert v. Lucent Tech. (In re Winstar Communc's, Inc.)* 554 F.3d 382, 296-97 (3d Cir. 2009). The

Copyright © 2024 Schulte Roth & Zabel LLP
Attorney Advertising

court cited the legislative history of the Code's insider definition, noting that "Congress was concerned with situations in which '[a]n insider … has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms-length with the debtor.'" *Id.* (citations omitted). Here, Capmark's allegations never suggested that the Lender Defendants had a "close" relationship with the debtors, or that the Lender Defendants "exercised anything resembling the high level of control required for non-statutory insider status." *Id.* There were no allegations of domination and control, and no allegations showing that lenders dictated day-to-day management or made decisions regarding replacement of management. The court also rejected Capmark's attempt to impute to the Lender Defendants the Affiliates' "closeness" to the debtors (by virtue of a board seat and management consulting agreement). Capmark had also failed to "adequately allege veil-piercing claims that would attribute the [Affiliates'] conduct to the [Lender Defendants.]" *Id.* at *15.[3]

Comments

The *Capmark* decision is important for lenders. It confirms that bankruptcy trustees face significant pleading hurdles and proof requirements when relying on a defendant's purported insider status. Superficial allegations of control will not suffice. Instead, a plaintiff must allege particular facts showing that the lender actually controlled the debtor.

The court also recognized the corporate separateness of related entities in the absence of concrete and particularized evidence showing (a) complete domination and control *and* (b) the misuse of the corporate entity to perpetrate some form of injustice or fraud. Lenders may now be more comfortable when their affiliates merely hold debt and equity of their borrowers.

Authored by David M. Hillman, Eleazer Klein, Howard O. Godnick and Michael L. Cook.

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

---

[1] Click here to view the decision. The district court was the trial court in this matter.

Copyright © 2024 Schulte Roth & Zabel LLP

[2] A transfer is voidable as a preference if it was (a) the debtor's property; (b) to or for the benefit of a creditor; (c) on account of an antecedent debt; (d) made while the debtor was insolvent; and (e) made within *90 days* of bankruptcy *or* between 90 days and *one year of bankruptcy if the defendant creditor was an "insider*." *See* 11 U.S.C. § 547(b).

[3] The court also rejected Capmark's attempt at arguing that the transaction was not negotiated at arms-length. During the bankruptcy case, Capmark's predecessor in interest conceded that the transaction had in fact been negotiated at arms-length. *Id*. at *16-17.

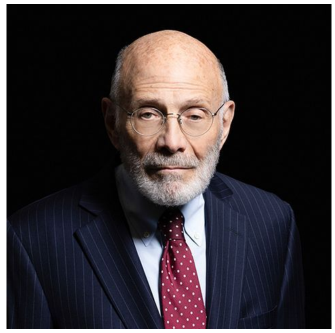
This information has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty as to its accuracy, completeness or timeliness. Transmission or receipt of this information does not create an attorney-client relationship with SRZ. Electronic mail or other communications with SRZ cannot be guaranteed to be confidential and will not (without SRZ agreement) create an attorney-client relationship with SRZ. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. The contents of these materials may constitute attorney advertising under the regulations of various jurisdictions.

Related People

Ele Klein

Partner

New York



Michael Cook

Of Counsel

New York

Practices

BUSINESS REORGANIZATION

COMPLEX COMMERCIAL LITIGATION

LITIGATION

Attachments

Download Alert

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising