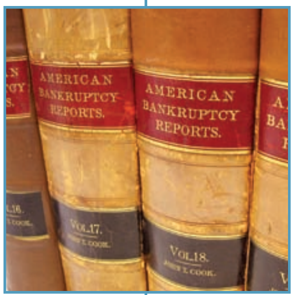
When being an insider is NOT a good thing

Normally, being an insider connotes a certain coolness. Not so in the complicated world of bankruptcy law, where being labeled an insider can come back to bite you.

QUICK TAKE

- Bankruptcy law treats creditors equally
- Penalties are stiff for those creditors demanding preferential treatment

First, a bit of background… During bankruptcy, a company may receive a preference demand from a debtor, or a trustee administering the debtor's assets. In essence, the debtor claims the company was "preferred" over other creditors in receiving payment for a pre-bankruptcy debt prior to the bankruptcy filing. The law allows the debtor or its trustee to recover any preferential payments received prior to bankruptcy, subject to a few conditions and defenses.



The typical creditor response: "What? You mean I got paid what they rightfully owed me—and now I have to give it back!?"

In a word, yes. One of the fundamental aspects of bankruptcy law is that it treats similarly situated creditors equally. If, on the eve of bankruptcy, one creditor receives a payment over others, a preference is created. Bankruptcy law abhors preferences, and the bankruptcy code provides a way to undo them.

Usually, for a debtor to recover pre-petition preferential payments, those payments must have occurred within 90 days of a bankruptcy filing. However, if the party receiving the preferential payment is found by the bankruptcy court to be an "insider" of the debtor, the look-back period for recovering payments is extended to one year prior to the bankruptcy filing. The rationale is that an "insider" would have better knowledge of the debtor's financial condition leading up to the filing, and therefore should have broader liability for receiving such preferential payments.

A recent Third Circuit case, *Schubert v. Lucent Techs. Inc. (In re Winstar Communications, Inc.)* emphasized the liability of being an "insider."

In its decision, the Third Circuit found that an insider relationship existed between Lucent and Winstar, the debtor, when an initial strategic partnership became greatly lopsided. After lending money to Winstar, Lucent—a much larger company—dictated business dealings and forced the smaller and financially distressed Winstar to purchase unneeded products from its bigger partner.

Tagging Lucent an "insider" due to its coercive influence over Winstar, the Court extended the preference reach-back period to one year. As a result, Lucent was forced to return $188 million that Winstar had repaid to Lucent several months prior to its bankruptcy, and was also equitably subordinated to all of Winstar's other creditors.

The lesson to be learned? Be careful when dealing with a financially distressed company—particularly when making demands for payment of outstanding debts, or using leverage to dictate business operations. You may be pegged an "insider" by the bankruptcy court. And that is not a good thing.

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Bankruptcy expert Bartolomei is back

After a respite practicing law in Dallas, José J. Bartolomei has returned to Miller Canfield, where he's now on board in our Ann Arbor office. José adds considerable experience in corporate finance and bankruptcy to our firm. He has represented both creditors and borrowers in structured finance and securitization transactions, distressed credit matters, commercial bankruptcy, and out-of-court workouts. Over the years, his clients have included those in the automotive, healthcare, real estate, oil and gas, swaps, derivatives, and securitization industries.

José earned his J.D. from The University of Michigan Law School and is admitted to the Bar in Michigan, Illinois, Minnesota, and Texas.