WHAT CAN I DO?

"Insider" treatment in bankruptcy? What does that mean?

Summary

In today's environment, lenders are frequently receiving additional benefits or incentives (including board representation or observation rights, or issuance of new equity interests/warrants) in connection with special situations investments and distressed workouts. Although these non-traditional forms of consideration are often important components of the transaction, lenders need to be mindful that such additional rights or benefits may result in a lender being considered an "insider" under the Bankruptcy Code.

What is an "Insider?"

In bankruptcy, there are two types of insiders: *statutory insiders* and *non-statutory insiders*.

- *Statutory Insiders*. Statutory insiders are individuals or entities that meet a specific definition under the Bankruptcy Code. For example, if the borrower is a corporation, the Bankruptcy Code defines an insider as, among other things, directors, officers, persons in control, partnerships in which the borrower is a general partner, a general partner of the borrower, and all of the foregoing's relatives (including individuals or entities that would meet the definition of an "affiliate," i.e., an entity that holds at least 20% of the voting securities of the debtor).
- *Non-Statutory Insiders*. The Bankruptcy Code's definition of "insider" is intentionally nonexclusive, meaning that a lender may be considered an insider even if it would not be a statutory insider. ***That said, the bar here is fairly high, and courts have generally found that unless a lender dominates or controls the debtor, merely exercising greater control over a debtor's affairs pursuant to rights granted under the loan documents is insufficient, by itself, to render a lender a non-statutory insider***.

"Insider" treatment in bankruptcy (cont'd)

Effects of Being Considered an Insider

- **Longer Challenge Period for Potential Preferences**. If a lender is considered an insider, then payments the lender received from the debtor that would potentially constitute preferences under the Bankruptcy Code are subject to a longer challenge period (one-year for insiders, as opposed to a 90-day period for non-insiders).
- **UVTA Claims**. In certain states that have adopted the Uniform Voidable Transfer Act (like New York) , transfers to insiders may be voidable if made while the debtor was insolvent and the insider had reasonable cause to believe the debtor was insolvent.
- **Votes Not Counted Toward Plan Acceptance**. To confirm a plan of reorganization, at least one impaired class of creditors has to vote in favor of the plan. However, if a lender within an impaired class of creditors is considered an insider, such lender's vote would not count towards the impaired-acceptance requirement, and the debtor would need either sufficient support from non-insider lenders within the same class, or a separate impaired class to accept the plan.
- **Enhanced Scrutiny of Transactions**. Insider status will also lead to greater court scrutiny for transactions between the insider-lender and the debtor For example, secured lenders that are also insiders who credit bid for their collateral in a bankruptcy sale will have the transaction more closely reviewed with close attention paid to (i) the fairness of the sale process and (ii) any special benefits received by the insider-lender. Insider status can also be an important building block for a challenge to a lender's claim on equitable subordination grounds or to recharacterize the lender's loan as equity.

Practical Considerations for Lenders Confronting Insider Issues

- Consider whether a lender board seat is critical, given resulting statutory insider status.
- Resignation from the board prior to the borrower approaching distress may ameliorate, but not necessarily cleanse, the insider issue (depending on the transaction being scrutinized).
- Lenders should consider whether the right to appoint an independent representative, coupled with a board observer right, is sufficient protection. This formulation, without more, generally will not lead to insider status.
- Lenders on a board should always be sensitive to conflicts issues. Actions taken will often be questioned as to whether the lender acted with its "lender hat" on as compared to complying with its fiduciary duties as a corporate insider.
- Although special committees created without lender participation may mitigate claims regarding conflicts issues, such committees will not absolve a lender of insider status.

Recent Examples of Potential Insider Transactions

- As noted in AMC Entertainment 2020 Bond Exchange, a component of AMC's recent bond exchange transaction involved the exchange by Silverlake of certain unsecured bonds into secured bonds. As part of an earlier investment, Silverlake obtained a significant equity position and received a seat on AMC's board and, in so doing, is now likely to be considered an "insider" in the event of a subsequent bankruptcy proceeding.