No. 07-2569

IN THE

United States Court of Appeals for the Third Circuit

IN RE: WINSTAR COMMUNICATIONS, INC., *ET AL.*,

Debtors.

CHRISTINE C. SHUBERT,

Plaintiff-Appellee,

v.

LUCENT TECHNOLOGIES INC.,

Defendant-Appellant.

On Appeal from the United States District Court for the District of Delaware

---

REPLY BRIEF FOR DEFENDANT-APPELLANT

Philip D. Anker
Janet R. Carter
Michelle Goldis
WILMER CUTLER PICKERING
HALE AND DORR LLP
399 Park Avenue
New York, NY 10022
(212) 230-8800

Seth P. Waxman
Craig Goldblatt
Danielle Spinelli
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

Counsel for Defendant-Appellant

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES iii

INTRODUCTION 1

ARGUMENT 4

I. LUCENT WAS NOT AN INSIDER OF WINSTAR 4

A. A Commercial Creditor Can Be an "Insider" Only If It Exercises Managerial Control 4

B. Lucent Did Not Exercise Actual Managerial Control 12

1. Purchases of Lucent Equipment 12

2. Threatened Breaches 14

3. The Fifth Amendment Inference 16

C. Even If Less Than Managerial Control Were Sufficient, the Conclusion That Lucent Was an Insider Must Be Reversed 17

II. THE PAYMENT TO LUCENT WAS "EARMARKED" 20

A. Siemens and Winstar Agreed That the Siemens Proceeds Would Be Paid to Lucent 20

B. The Transfer Did Not Diminish the Estate 25

C. Lucent Did Not Waive Earmarking 27

III. LUCENT PROVIDED $90.7 MILLION IN NEW VALUE 29

A. Lucent Provided $28.4 Million in Unsecured New Value for Equipment and Related Services 29

B. Lucent Provided $62.3 Million in Unsecured New Value Under the Second Credit Agreement 30

C. Lucent's Loan Was Undersecured 31

IV. THE SUBCONTRACT JUDGMENT SHOULD BE REVERSED 32

A. The Subcontract Was Not Modified 32

B. Any Attempted Modification Would Be Ineffective Because of the Clause Requiring Modifications To Be in Writing 36

C. Lucent Did Not Breach the Allegedly Modified Terms 38

D. The Bankruptcy Court Erred in Entering Final Judgment for Winstar on the Subcontract Claim 40

V. THE EQUITABLE SUBORDINATION RULING IS ERRONEOUS 42

A. Lucent's Conduct Did Not Merit Equitable Subordination 42

B. The Bankruptcy Court Failed To Tailor Its Remedy 42

C. Subordination of Claims to Equity Interests Is Unlawful 44

CONCLUSION 45

TABLE OF AUTHORITIES

CASES

Page(s)

Beacon Terminal Corp. v. Chemprene, Inc., 429 N.Y.S.2d 715 (App. Div. 1980) 33

Butler v. David Shaw, Inc., 72 F.3d 437 (4th Cir. 1996) 4, 5, 12

Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351 (5th Cir. 1986) 22, 25

Dallas Aerospace, Inc. v. CIS Air Corp., 352 F.3d 775 (2d Cir. 2003) 36

Gray v. Giant Wholesale Corp., 758 F.2d 1000 (4th Cir. 1985) 5

Halper v. Halper, 164 F.3d 830 (3d Cir. 1999) 41

In re 455 CPW Associates, No. 99-5068, 2000 WL 1340569 (2d Cir. Sept. 14, 2000) 6

In re Adbox, Inc., 488 F.3d 836 (9th Cir. 2007) 24

In re Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990) 8

In re AmeriServe Food Distribution, Inc., 315 B.R. 24 (Bankr. D. Del. 2004) 28

In re Badger Freightways, Inc., 106 B.R. 971 (Bankr. N.D. Ill. 1989) 5

In re Bohlen Enterprises, Ltd., 859 F.2d 561 (8th Cir. 1988) 25

In re Broumas, 203 B.R. 385 (D. Md. 1996) 7

In re Broumas, No. 97-1183, 1998 WL 77842 (4th Cir. Feb. 24, 1998) 7

In re Buckenmaier, 127 B.R. 233 (B.A.P. 9th Cir. 1991) 41

In re Congrove, 222 F. App'x 450 (6th Cir. Jan. 10, 2007) 6

In re First Alliance Mortgage Co., 471 F.3d 977 (9th Cir. 2006) 42

In re Flanagan, 503 F.3d 171 (2d Cir. 2007) 25

In re Freestate Management Services, Inc., 153 B.R. 972 (Bankr. D. Md. 1993) 28

In re Hedged-Investment Associates, Inc., 380 F.3d 1292 (10th Cir. 2004) 44

In re Heitkamp, 137 F.3d 1087 (8th Cir. 1998) 24

In re Henderson, 96 B.R. 820 (Bankr. E.D. Tenn. 1989) 17-18

In re Holloway, 955 F.2d 1008 (5th Cir. 1992) 7

In re Intercontinental Polymers, Inc., 359 B.R. 868 (Bankr. E.D. Tenn. 2005) 31

In re Krehl, 86 F.3d 737 (7th Cir. 1996) 6

In re Kunz, 489 F.3d 1072 (10th Cir. 2007) 6

In re Lifschultz Fast Freight, 132 F.3d 339 (7th Cir. 1997) 44

In re New York City Shoes, Inc., 880 F.2d 679 (3d Cir. 1989) 31

In re Newcomb, 744 F.2d 621 (8th Cir. 1984) 6

In re Octagon Roofing, 124 B.R. 522 (Bankr. N.D. Ill. 1991) 9

In re Safe-T-Brake, Inc., 162 B.R. 359 (Bankr. S.D. Fla. 1993) 22

In re Superior Stamp & Coin Co., 223 F.3d 1004 (9th Cir. 2000) 24-25

In re Three Flint Hill Ltd. Partnership, 213 B.R. 292 (D. Md. 1997) 7

In re University Medical Center, 973 F.2d 1065 (3d Cir. 1992) 41

In re Walt Disney Co. Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005) 10

John Street Leasehold LLC v. FDIC, 196 F.3d 379 (2d Cir. 1999) 37

Joseph Martin, Jr., Delicatessen, Inc. v. Schumacher, 417 N.E.2d 541 (N.Y. 1981) 15

Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) ... 3

L&B 57th Street, Inc. v. E.M. Blanchard, Inc., 143 F.3d 88 (2d Cir. 1998) ... 36

Leocal v. Ashcroft, 543 U.S. 1 (2004) ... 9

Maas v. Cornell University, 721 N.E.2d 966 (N.Y. 1999) ... 33

Madison Avenue Leasehold, LLC v. Madison Bentley Associates LLC, 811 N.Y.S.2d 47 (App. Div. 2006) ... 34

Nassau Trust Co. v. Montrose Concrete Products Corp., 436 N.E.2d 1265 (N.Y. 1982) ... 33

Prieto v. Paul Revere Life Insurance Co., 354 F.3d 1005 (9th Cir. 2004) ... 36

Rose v. Spa Realty Associates, 366 N.E.2d 1279 (N.Y. 1977) ... 36

United States v. Lyckman, 235 F.3d 234 (5th Cir. 2000) ... 11

Wilkie v. Robbins, 127 S. Ct. 2588 (2007) ... 2

STATUTES AND RULES

11 U.S.C. §101(31) ... 6, 10

11 U.S.C. §547(b) ... 20, 28

11 U.S.C. §547(c) ... 31

11 U.S.C. §553 ... 41

Fed. R. Bankr. P. 7012 ... 41

Fed. R. Civ. P. 8(c) ... 36

OTHER AUTHORITIES

Blanchard, Gerald L., *Lender Liability* (2007) ... 9, 10

5 *Collier on Bankruptcy* (15th rev. ed. 2007) ... 31

2 *Farnsworth on Contracts* (3d ed. 2004) 33

Fuller, Lon L., *The Morality of Law* (rev. ed. 1969) 1

Merriam-Webster's Collegiate Dictionary (11th ed. 2004) 8

3 *Norton Bankruptcy Law & Practice* 2d (2007) 18

4 White, James J. & Summers, Robert S., *Uniform Commercial Code* (5th ed. 2002) 31

INTRODUCTION

The "first and most obvious" way in which a system of legal rules may miscarry "lies in a failure to achieve rules at all, so that every issue must be decided on an ad hoc basis."[1] As to each of her principal arguments, the Trustee advocates precisely such an ad hoc, standardless approach—one that is as inconsistent with the statutory text and applicable caselaw as it is unsuited to the real world of commercial dealings from which this case arises.

The Trustee's defense of the preference judgment is illustrative. In her view, Lucent was an "insider" of Winstar because Lucent's efforts to serve its economic interests amounted to "bull[ying] and threaten[ing]." TB44.[2] Untroubled by the unprecedented nature of this position, the Trustee declares it "of no moment" that "to date no other public company has been deemed an insider by reason of using a close relationship with the debtor to engage in" what she characterizes as "overreaching and self-dealing." TB7. But while this "unfortunate first[]" gives the Trustee no pause, she supplies no workable guidepost for determining when the rough-and-tumble dealings of self-interested commercial actors cross the line into "too much" influence. Instead, she blithely asserts (TB42) that this line-drawing can be left to "the capabilities of the courts."

---

1 Lon L. Fuller, *The Morality of Law* 38-39 (rev. ed. 1969).

2 The Trustee's brief is cited as TB, Lucent's opening brief as LB, and Eric Brunstad's amicus brief as BB.

But, as the Supreme Court recently cautioned, a "judicial standard to identify illegitimate pressure going beyond legitimately hard bargaining would be endlessly knotty to work out." *Wilkie v. Robbins*, 127 S. Ct. 2588, 2604 (2007). The courts have understandably rejected such an approach, holding that, to be an insider, a commercial creditor must exercise actual managerial control. The bankruptcy court's findings cannot support that conclusion here.

Nor can the Trustee's efforts to paint Lucent as a bad actor substitute for the proper application of controlling legal standards. To the extent Lucent accounted improperly for its transactions, the remedy lies in the securities laws, not in the Bankruptcy Code. Indeed, Lucent reported its questionable accounting to the SEC and paid a substantial fine. The melodramatic claim that reversing the insider determination would somehow "shelter ... illicit conduct" (BB5) is thus wrong.

Even if Lucent were an insider, the preference judgment must be reversed because the allegedly preferential payment was earmarked for Lucent. The Trustee's response is insubstantial. Her position that there was no "agreement" to pay the Siemens proceeds to Lucent boils down to the unsupported assertion that such an agreement must be embodied in one, rather than two, documents. And her argument that the Winstar estate was diminished by swapping a debt to Lucent for a debt in the same amount to Siemens has no support in the record and contravenes her own expert testimony, which was expressly credited below.

The Trustee's position with regard to the Subcontract judgment is equally unconcerned with the clear legal rules governing commercial dealings. The Trustee claims that the parties abandoned the terms of the Subcontract and that Lucent agreed instead to write Wireless a blank check, paying for whatever work Wireless in its sole discretion chose to do. That claim is both wholly implausible on its face and inconsistent with the strict rules for contractual modification established by New York law. While Lucent had previously paid Wireless invoices without insisting on adherence to every condition in the contract, it made clear that it would require such adherence after September 2000. It is a basic tenet of contract law that a landlord who permits a tenant to make a late payment in January and February may still insist on timely payment in March. That simple principle is controlling here.

In Judge Easterbrook's oft-quoted formulation, the law cannot require "participants in commercial transactions not only to keep their contracts, but also to do 'more'—just how much more resting in the discretion of a bankruptcy judge assessing the situation years later."[3] The Trustee's brief is a head-long assault on this principle. The judgment below must be reversed.

---

3 *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7th Cir. 1990).

ARGUMENT

I. LUCENT WAS NOT AN INSIDER OF WINSTAR

In its opening brief, Lucent explained (LB30-38) that a commercial creditor can be an "insider" only if it exercises actual managerial control over the debtor. The Trustee's efforts to argue otherwise are unsuccessful. Nor does she propose any coherent alternative standard, instead proffering the vague and unworkable tests of "influence" for "person in control" and "arm's length" for "non-statutory" insiders. The bankruptcy court's factual findings cannot justify the conclusion that Lucent was an insider under a managerial-control standard or, indeed, any standard responsive to the purposes of the insider provision.

A. A Commercial Creditor Can Be an "Insider" Only If It Exercises Managerial Control

Lucent's opening brief (LB34-38) set out extensive authority establishing that a commercial creditor must exercise actual managerial control to be an insider, either as a "person in control" or as a "non-statutory" insider. In response, the Trustee misdescribes the holdings of the leading cases and quotes disconnected snippets from lower-court decisions, most of which are inapposite because they involve close personal relationships between individuals, not commercial dealings between unaffiliated public companies.

The Trustee's description of the first case on which Lucent relied, *Butler v. David Shaw, Inc.*, 72 F.3d 437 (4th Cir. 1996), is simply inaccurate. *Butler* declared in the plainest terms that "the alleged insider 'must exercise sufficient authority over the debtor so as to unqualifi[ed]ly dictate corporate policy and the disposition of corporate assets.'" *Id.* at 443. The Trustee ignores that, claiming instead (TB37) that the court "rejected an insider claim ... [because the creditor] lacked managerial authority and had no power to self deal (and no allegation of self-dealing was made)." But there is no mention of self-dealing anywhere in *Butler*.[4] The Trustee does not even attempt to show that Lucent "unqualifi[ed]ly dictate[d]" Winstar's "corporate policy and the disposition of [Winstar's] corporate assets"—what *Butler* actually holds is required to make a commercial creditor an insider. Holding Lucent to be an insider would thus require this Court to split from the Fourth Circuit.[5]

The Trustee's treatment of *Gray v. Giant Wholesale Corp.*, 758 F.2d 1000 (4th Cir. 1985), is equally inaccurate. She claims (TB37 n.8) that *Gray* concluded that the creditor was not a "person in control" because it "had no say over how much money the debtor placed into the account, and ... acted in a good-faith,

[4] The Trustee's attempt to deny *Butler*'s holding by relying on a district court decision referencing *Butler* and a subsequent unpublished panel decision (TB37) also fails. Neither case could supersede *Butler*, and both are inapposite because they involved close personal relationships. *See infra* p. 7.

[5] The Trustee also misreads (TB39) *In re Badger Freightways, Inc.*, 106 B.R. 971 (Bankr. N.D. Ill. 1989), which clearly rejected the argument she advances here, unequivocally holding that an insider must "unqualifi[ed]ly dictate corporate policy and the disposition of corporate assets." *Id.* at 981-983.

arms-length manner." Again, the Trustee has invented the second part of the "holding": the court never mentioned good faith or arm's length dealings.

The Trustee similarly misconstrues (TB38) Lucent's third appellate case, *In re 455 CPW Assocs.*, No. 99-5068, 2000 WL 1340569 (2d Cir. Sept. 14, 2000) (unpub.), contending that it turned on "whether there were arms-length dealings." To the contrary, the Second Circuit explained that "courts have required evidence of extensive control before finding insider status." *Id.* at *5. Although the alleged insider was the vice-president of the limited partnership with responsibility for the day-to-day functions of the debtor, the court found that he was not an insider because he merely exercised authority delegated to him and did not himself possess actual managerial control. *Id.*[6]

The Trustee not only misdescribes Lucent's cases, but fails to ground her own "influence" and "arm's length" standards in persuasive caselaw. She cites no

---

[6] The Trustee cites (TB38), without discussion, four other appellate decisions, contending they did not require managerial control. But each involved individual (not corporate) debtors (to whom the "person in control" language does not apply), and each is thus irrelevant to the interpretation of §101(31)(B). Moreover, none of their holdings adopts the Trustee's position. *In re Kunz*, 489 F.3d 1072, 1075, 1078-1080 (10th Cir. 2007) (fact that individual debtor held title "director emeritus" did not render creditor per se insider); *In re Congrove*, 222 F. App'x 450, 457 (6th Cir. Jan. 10, 2007) (unpub.) (franchisor/franchisee relationship insufficient to make McDonald's insider of individual debtor); *In re Krehl*, 86 F.3d 737, 739, 741-743 (7th Cir. 1996) (where individual debtor was "for all intents and purposes the [creditor] corporate entity itself," his subsequent "largely ministerial act of resignation" as president and director did not defeat insider status); *In re Newcomb*, 744 F.2d 621, 625 n.4 (8th Cir. 1984) (federal agency not insider of individual debtor).

case for the atextual proposition that "person in control" actually means "person with influence." And she cites only two court of appeals decisions in support of the "arm's length" standard she proffers for the "non-statutory" insider category. In one, *In re Holloway*, 955 F.2d 1008 (5th Cir. 1992), the pertinent discussion was dictum, and the other, *In re Broumas*, No. 97-1183, 1998 WL 77842 (4th Cir. Feb. 24, 1998), was an unpublished decision from the Fourth Circuit, which had already adopted the managerial-control test in *Butler*. More importantly, both involved close personal relationships between individuals, not commercial relationships between independent public companies. *Holloway*, 955 F.2d at 1014; *Broumas*, 1998 WL 77842, at *1.

The remaining decisions on which the Trustee relies for her "arm's length" standard, and from which she pulls her string of out-of-context phrases, are non-binding decisions of bankruptcy or district courts—and are, in any event, inapposite. For instance, the Trustee cites (TB33-34) three cases for the proposition that actual managerial control is not required. In two, however, there was a close personal relationship, and thus no need to demonstrate managerial control. *In re Three Flint Hill Ltd. P'ship*, 213 B.R. 292, 296-301 (D. Md. 1997); *In re Broumas*, 203 B.R. 385 (D. Md. 1996), *aff'd in part and rev'd in part*, 1998 WL 77842. The third found a plan proponent to be an insider on bizarre facts of manipulation and control during the bankruptcy process. *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 295-301 (Bankr. W.D. Pa. 1990).

Employing a managerial-control standard for commercial creditors is not only grounded in the caselaw, but the only approach faithful to the statutory text. To decide who is an insider, one must start with the meaning of the word itself. The Trustee does not deny this. In fact, she offers a dictionary definition of "insider" very similar to Lucent's: "a person recognized or accepted as a member of a group, category or organization." TB39-40 n.10 (quoting *Merriam-Webster's Collegiate Dictionary* 647 (11th ed. 2004)). This definition is indisputably not satisfied here: Lucent was never "recognized or accepted as a member of" Winstar, and the Trustee does not argue otherwise.[7]

Perhaps recognizing how problematic the definition of "insider" is for the Trustee's argument, her amicus contends (BB13) that the definition is "irrelevant in interpreting the meaning of 'person in control of the debtor'" because "the Code offers its own definition." Clear Supreme Court precedent dictates otherwise. In

---

[7] The Trustee points (TB40 n.10) to one example the dictionary provides to illustrate its definition: "one (as an officer or director) who is in a position to have special knowledge of the affairs of or to influence the decisions of a company." She contends that this "suggests that ... insiders include those with power or influence over the decisions of a company." But the dictionary explains that this example is a "subsense" that is "subsumed by the preceding definition." *Merriam-Webster's* 20a (explanatory notes for "Division of Senses"). That is, the example illustrates, but cannot *expand*, the definition itself—"a person recognized or accepted as a member of a group, category or organization."

Leocal v. Ashcroft, 543 U.S. 1 (2004), the Court considered whether a drunk-driving conviction could be a "crime of violence," a term defined by statute. While the statutory definition arguably could have encompassed drunk driving, the Court held otherwise, interpreting that definition in a more limited way in light of the ordinary meaning of the defined term, "crime of violence." *Id.* at 11. Likewise, the term "person in control" must be interpreted in light of the common-sense meaning of the defined term, "insider."

The Trustee next contends (TB40) that Lucent was a "person in control" because "control" means "not just direction, but influence." That cannot be correct: if anyone with "influence" over a debtor were an insider, any large lender or supplier would be an insider, as would anyone with contractual leverage. That would throw commercial dealings into turmoil. Fortunately, the law is resolutely to the contrary. "The fact that a debtor has a weak bargaining position and few choices does not indicate that the other party was an insider[.]" *In re Octagon Roofing*, 124 B.R. 522, 530 (Bankr. N.D. Ill. 1991) (citation omitted). Or, as one treatise puts it, "the cases where a court has found a creditor to be in control" of the debtor generally share "the common element of complete domination of the company's officers and directors by the creditor." Gerald L. Blanchard, *Lender Liability* §9.8 (2007) (discussing equitable subordination context). "Strong bargaining, and the use of leverage ... does not ... constitute sufficient control[.]" *Id.*

Next, the Trustee and her amicus argue (TB40-41; BB15-16) that not all "insiders" enumerated in §101(31)(B) exercise managerial control—specifically, that directors, partnerships in which a debtor is a general partner, and relatives of insiders do not. That is simply incorrect as to directors, who under state law typically have ultimate decision-making authority over a corporation's affairs. *See, e.g.*, *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 761 n.490 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). As to the inclusion of relatives and partnerships in which the debtor is a general partner, this simply recognizes that a director, officer, or person in control might prefer her own interests, and direct a transfer to herself, or she might prefer the interests of those with whom she has a close personal relationship (relatives) or shares a collective financial interest (partnerships), and direct a transfer to them.[8]

In place of actual managerial control, the Trustee and her amicus contend that a vague "arm's length" standard governs the "non-statutory" insider analysis. The Trustee refuses to provide any clarifying principle that might allow this

---

[8] The Trustee and her amicus also rely (TB41; BB18) on a separate provision addressing the insider status of affiliates, §101(31)(E). But its separation in the statute from §101(31)(B) makes it irrelevant to Lucent's explication, via *noscitur a sociis*, of "person in control." In any event, affiliates are another instance (like partnerships) of shared financial interests.

colloquialism to function as a legal test—she simply knows it when she sees it. Her amicus attempts a clarification, arguing (BB22) that the inquiry should be whether "the parties to a transaction are independent and on an equal footing." But that standard is just as overbroad as "influence": if "unequal footing" made a creditor an insider, any large company doing business with a smaller one would be an insider.

In any event, the bankruptcy court did not rely on the catch-all "non-statutory" insider category, and for good reason. As a matter of statutory interpretation, that catch-all category cannot function as a laxer version of the "person in control" test, which can be satisfied by some lesser showing of influence than is necessary to make a creditor a "person in control." Rather, to avoid turning the catch-all "non-statutory" category into an end-run around Congress's intent—making superfluous the specific, narrow categories Congress identified—that catch-all category must be reserved for persons and entities that are functionally equivalent to the types of insider enumerated in the statute. *See United States v. Lyckman*, 235 F.3d 234, 238 (5th Cir. 2000) ("*ejusdem generis* warns against expansive interpretations of broad" catch-all provisions accompanying "narrow and specific terms").

B. Lucent Did Not Exercise Actual Managerial Control

The Trustee does not contend that Lucent exercised managerial control in the sense of making Winstar's daily business decisions. The two grounds for finding control she proffers instead—Lucent's "control" of Winstar's decisions to purchase Lucent equipment, and Lucent's "threatening" breach of the parties' contracts—are neither sufficient to establish managerial control nor supported by the record. And the other basis on which the bankruptcy court relied—the adverse Fifth Amendment inference—is indefensible.

1. Purchases of Lucent Equipment

The Trustee argues that managerial control was established because, she contends, Lucent exercised control over one narrow category of Winstar's business decisions: Winstar's purchases from Lucent.[9] She provides no justification for her view that control over this single aspect of Winstar's decision-making could be enough to make Lucent an "insider." It is not. Rather, a creditor must "unqualifi[ed]ly dictate corporate policy and the disposition of corporate assets," *Butler*, 72 F.3d at 443—controlling the full range of business decision-making—to be an insider.

---

[9] The Trustee does not contend that Lucent exercised any control over Winstar's substantial purchases of *non-Lucent* equipment. Indeed, Winstar's massive purchases of non-Lucent equipment—dwarfing the Lucent equipment purchased—belie her claim that Lucent controlled Winstar. *See*, *e.g.*, JA2180 ($507 million in non-Lucent purchases).

In any event, the claim that Lucent commandeered Winstar's decision-making regarding purchases of Lucent equipment is not supported by the record. The Trustee's brief spends many pages (TB11-21) describing the end-of-quarter deals, bill-and-hold transactions, and software-pool agreement. But the mere existence of transactions that benefited Lucent and imposed costs on Winstar cannot establish that Lucent "unqualifiedly dictated" those transactions.

Businesses routinely accept short-term losses to promote long-term goals, and Winstar's CFO was unequivocal that preserving the Lucent relationship was critical. JA2966 (Winstar "needed the relationship with Lucent to continue" for marketplace credibility). Similarly, the Winstar executive with primary responsibility for the build-out of Winstar's network testified that Winstar would not do anything that would be bad for it on account of its partnership with Lucent. ROA 465 (Ackerman 423:16–424:21) (3/5/2004). And another Winstar executive responsible for building the network made clear that "Winstar didn't do things that it did not want to do." ROA 462 (Zlotnick 115:7-8). The evidence the Trustee musters in response—a long quotation from the testimony of Lisa Hicks (TB13-14), a low-level administrative employee who reported to the executives quoted above—was never even cited by the bankruptcy court and cannot be used to prop up the bankruptcy court's actual findings, which are insufficient as a matter of law to show that Lucent exercised managerial control.

Without evidence of actual control, this is nothing more than a case about leverage derived from the parties' strategic partnership. The Trustee's "mugger" analogy is thus hopelessly inapt: Lucent attained its bargaining position by virtue of Winstar's free choice to stake its future on their relationship, not because Lucent brandished a gun.

2. Threatened Breaches

The Trustee attempts (TB44-45) to salvage her argument that Lucent "controlled" Winstar by pointing to threats she claims Lucent made to breach the parties' agreements. Again, the Trustee provides no support for the premise that such threats constitute managerial control. As a matter of common sense, threatening to breach a contract is not unqualifiedly dictating a course of action; the other party can ignore the "threat" and collect expectation damages for any breach. Moreover, even if threats could take the place of control, Lucent never threatened to breach the parties' contracts. The Trustee's contrary arguments depend on misreading the contracts and misrepresenting the bankruptcy court's findings.

The Second Credit Agreement. The bankruptcy court asserted that Lucent "forced" Winstar to transfer the Siemens proceeds by threatening that otherwise "there would be no further draws under the Second Credit Agreement." JA82. As Lucent previously explained (LB41-42), however, this was not a threat to breach the parties' contract, but a description of the consequences if Winstar breached. The Trustee does not deny that Winstar was obligated to transfer the Siemens proceeds or suggest that it is improper to withhold performance when the other side materially breaches. Instead, she makes the outlandish claim (TB45) that Lucent breached the Second Credit Agreement by "cut[ting] off Winstar's draws *before* Winstar could even borrow the Siemens funds." That is false, and the bankruptcy court made no such finding. Lucent did not reject any Winstar draw request in the period leading to the Siemens transaction. The testimony the Trustee cites—merely indicating that one Lucent employee was instructed to obtain higher-level authorization before approving a Winstar draw—shows no such thing.

The Supply Agreement. The Trustee asserts (TB46) that Lucent breached the Supply Agreement in late 2000 by failing to complete negotiations toward a transition agreement. But as Lucent previously explained (LB8-9, 12), the Supply Agreement did not obligate Lucent to reach a transition agreement with Winstar. Rather, it required only that Lucent provide a draft transition plan within 45 days, and Lucent did so. JA1534. That the parties ultimately could not reach a transition agreement is not a breach of the Supply Agreement.[10]

[10] The Trustee elsewhere suggests (TB22-23) that Lucent undertook a new obligation to negotiate in a September 2000 letter. Even if that were so, "a mere agreement to agree, in which a material term is left for future negotiations, is unenforceable." *Joseph Martin, Jr., Delicatessen, Inc. v. Schumacher*, 417 N.E.2d 541, 543 (N.Y. 1981).

The Subcontract. The Trustee also relies extensively (*e.g.*, TB21-23) on the contention that Lucent "repeatedly threatened to breach" the Subcontract. That contention rests on Lucent's telling Winstar that it did not want to pass through Wireless-performed services. But as Lucent demonstrated in its opening brief (LB61-73), and explains further in Part IV below, because the services had not been performed pursuant to a prior-issued Task Order, Lucent was not required to pay for those services. Accordingly, Lucent's statements did not threaten breach.

3. The Fifth Amendment Inference

The only remaining support for the bankruptcy court's insider finding is the point to which it devoted most of its analysis (and which the Trustee, tellingly, largely ignores): the adverse inference drawn from two former Lucent employees' invocation of their Fifth Amendment rights. Lucent demonstrated in its opening brief (LB42-44) that the court committed clear legal error when it drew from the refusal to answer narrow, specific questions the massively broad inference that "[h]ad Plunkett and Harris answered truthfully about the nature of the relationship between the two companies, they would have acknowledged Lucent's control over Winstar and the lack of arms' length relationship between them." JA104.

The Trustee does not deny that the inference went far beyond the sum of adverse responses to individual questions, and thus effectively concedes legal error. She nevertheless asserts (TB47) that the inference was "properly drawn where the questions established the same underlying facts that the trial court had already found." But even if true, that assertion would do no more than satisfy the corroboration requirement. It cannot cure the much graver flaw in the court's reasoning—the complete disconnect between the questions asked and the inference drawn. To that point the Trustee has no response.

When the adverse Fifth Amendment inference falls away, the conclusion that Lucent was an "insider" must fall too. The bankruptcy court itself apparently did not believe that that conclusion could be drawn without the adverse inference: seven out of nine pages of its legal analysis on the insider question were spent on the Fifth Amendment inference—an odd approach if the court believed the small remainder of the analysis sufficient.

C. Even If Less Than Managerial Control Were Sufficient, the Conclusion That Lucent Was an Insider Must Be Reversed

The Trustee and her amicus would have bankruptcy courts engage in a standardless inquiry to identify the point at which a commercial creditor exercising financial leverage crosses the line into "bullying" and "self-dealing." Even if such an ad hoc inquiry were appropriate—and, as demonstrated above, it is not—it would at the very least need to be guided by the purposes of the insider provision's extended reach-back period.

That purpose is to ensure that insiders cannot manipulate the timing of the payment and the bankruptcy to evade the 90-day window. *See, e.g.*, *In re*

Henderson, 96 B.R. 820, 825 (Bankr. E.D. Tenn. 1989); 3 *Norton Bankruptcy Law & Practice* 2d, §57:34 (2007). To hold a commercial creditor who has exercised financial leverage over the debtor to be an insider based on the Trustee's inchoate approach—absent evidence that the creditor forced the debtor to make the challenged payment or dictated the timing of the bankruptcy—would contravene this purpose.

The Trustee contends (TB45) that "Lucent forced Winstar to increase the bank facility and borrow the Siemens funds as soon as possible, whether Winstar wanted to or not." But Lucent obviously did not want one of its principal competitors, Siemens, to supplant it as Winstar's strategic partner. The Siemens deal meant that Winstar was required to purchase a significant portion of its equipment from Siemens, rather than Lucent. JA2040. The deal was thus highly disadvantageous to Lucent. *See* JA580-583.

Nor did Lucent have any control over the timing or structure of the Siemens loan. Siemens and Winstar began negotiating toward their new partnership in early 2000 and structured the deal without input from Lucent. Lucent did not learn about the Siemens loan—or know that it had been structured in a way that gave Lucent a contractual right to the proceeds—until November 2000, a month before the deal closed. JA81. To be sure, once the transaction occurred, the relevant agreements required that the proceeds be paid to Lucent. Knowing this, Winstar asked Lucent to waive that requirement, and Lucent refused.[11] By doing so, Lucent exerted no control over the timing or receipt of the payment; it simply stood on its contractual rights.

Likewise, whatever leverage Lucent had over Winstar by virtue of its standing in the industry and the parties' contracts did not give it the power to decide when Winstar filed for bankruptcy. The Trustee's entire argument as to the timing of the bankruptcy turns on the bankruptcy court's unsupported assertion that a refinancing notice Lucent sent Winstar in late December 2000 was a financial "death knell" for Winstar. JA108. Not so. The effects of the refinancing notice were far less significant: if the period expired without Winstar's refinancing, the interest rates on the loans would increase, and Lucent would be entitled to sell the loans. JA1663-1666. The notice did not entitle Lucent to accelerate the principal or demand a large payment from Winstar. *Id.*

Moreover, even if, contrary to fact, the refinancing notice were a financial "death knell," Winstar could have filed for bankruptcy at any time during the 105-

---

[11] Prior to the consummation of the Siemens transaction, when Winstar mistakenly believed that Lucent's consent to the transaction was required, Lucent sent Winstar a letter stating that it would consent on several conditions, including that Winstar draw down the funds immediately, triggering Winstar's obligation to pay those funds to Lucent. JA1079-1081. Winstar subsequently realized it did not need Lucent's consent and did not fulfill all the conditions in Lucent's letter. While Winstar drew down the full $200 million, the record is clear that it had intended to do so all along. *See* ROA 1190, 1198 (September 2000 Winstar emails).

day refinancing period, keeping the Siemens transfer well within the 90-day window. The Trustee's allegation of a tactical "delay" would make sense only if Lucent delayed 90 days before sending the notice—which it did not.

If any more proof that Lucent did not control Winstar were needed, Winstar provided it when it filed for bankruptcy—accompanying its petition with a $10 billion suit against Lucent. Even under the ad hoc approach advocated by the Trustee, the only conclusion true to the purposes of the preference statute is that Lucent was not an insider.

II. THE PAYMENT TO LUCENT WAS "EARMARKED"

In its opening brief, Lucent demonstrated that the proceeds of the Siemens loan were earmarked for Lucent, and that the transfer of those proceeds thus did not constitute a "transfer of an interest of the debtor in property." 11 U.S.C. §547(b). The Trustee's failure to prove this element requires reversal of the preference judgment.

A. Siemens and Winstar Agreed That the Siemens Proceeds Would Be Paid to Lucent

The Trustee concedes (TB48) that the question whether the Siemens funds were earmarked turns on "whether [Winstar] had the right to disburse the [Siemens] funds to whomever it wished, or whether the disbursement was limited to a particular old creditor or creditors." The plain language of the agreements shows that Winstar was required to pay the Siemens funds to Lucent. The funds were therefore earmarked.

When Siemens agreed to lend to Winstar, they structured the transaction by having Siemens join Winstar's existing bank facility. The facility's terms provided that a default by Winstar on any material loan, such as Winstar's $1 billion loan from Lucent, would also constitute a default under the bank agreement. LB51. The Lucent loan agreement, in turn, provided (as the bankruptcy court found) that "100% of the proceeds of any increase" to the bank facility must be used to repay any outstanding loan from Lucent. JA81. Accordingly, Winstar's agreement with Siemens expressly obligated it to honor the terms of its agreement with Lucent and pay over to Lucent any increase in the bank facility. The failure to do so would be a default under both the Lucent loan and the bank facility. The Trustee disputes none of this.

None of the Trustee's arguments can alter the unambiguous terms of the governing documents. She cites the testimony of a Siemens employee and the amendment to the bank facility as evidence that Siemens understood that its loan was for "general corporate purposes." TB49-50; JA2849. But, although the provision she cites did not require Winstar to use the Siemens proceeds to repay Lucent, the cross-default provision *did* so require, and the Trustee offers no justification for disregarding that specific obligation. Nor can the post-hoc testimony of a Siemens employee vary the plain terms of the documents.

The Trustee contends (TB50) that an obligation arising "through a cross-default provision" cannot constitute earmarking. But she offers no explanation for, or authority supporting, that conclusion—and it makes no sense. The fact that Siemens' and Winstar's agreement that the funds be paid to Lucent is embodied in two documents, rather than one, makes no legal difference. As the caselaw makes clear, the relevant inquiry is simply whether there is such an agreement. *See, e.g.*, *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351 (5th Cir. 1986) (analyzing several related agreements to discern whether objective of transaction as a whole was to transfer proceeds from new lender to old lender); *In re Safe-T-Brake, Inc.*, 162 B.R. 359 (Bankr. S.D. Fla. 1993).

Here, not only did the documents obligate Winstar to pay the Siemens proceeds to Lucent, but the evidence was uncontested that Siemens—a party to the bank facility—joined that facility knowing what it required. After Lucent rejected Winstar's request for a waiver of the requirement that Lucent receive those proceeds, the agent bank for the facility sent a memorandum to all the lenders, including Siemens, notifying them that Winstar "intends on utilizing up to $200 million of proceeds from the Additional Capital," including the Siemens loan, "to repay outstandings under the credit agreement with Lucent." JA2052. Siemens was thus aware that, as the agreements required, the proceeds would be paid to Lucent.[12]

The Trustee's remaining arguments are meritless. First, she speculates (TB50-51) that Winstar might not have been required to transfer the Siemens loan proceeds to Lucent, because it could have negotiated a waiver of that requirement from Lucent or the bank lenders. But that is irrelevant. The agreements that actually existed required Winstar to pay the funds to Lucent. Every earmarking case arises from an agreement whose terms could conceivably be renegotiated. If that were enough to defeat earmarking, there would be no earmarking doctrine.

The Trustee next hypothesizes (TB51 n.14) that perhaps Winstar breached its agreement with Lucent by transferring funds other than the Siemens proceeds. But the Trustee stipulated that Winstar's December 7, 2000 payment to Lucent "represented a payment of the … net proceeds of the Siemens loan" minus a set-off. JA248. She now attempts to wriggle out of the stipulation, claiming that she "stipulated only that Winstar wired funds that 'represented' a payment of the net

[12] The Trustee argues (TB52) that the memorandum is ambiguous because it defines "Additional Capital" as including not only the Siemens loan, but also other new funds, including a $270 million equity infusion. But Winstar was required under its agreement with Lucent to use any increase in the bank facility—not new equity or other new funds—to pay down its loan from Lucent. And it blinks reality to believe that a sophisticated investor such as Siemens, making a $200 million loan, would not have apprised itself of the terms of the $1 billion pre-existing loan from Lucent, which was publicly available in Winstar's SEC filings. Winstar Communications Inc., Current Report (Form 8-K), Ex.10.3 (June 1, 2000).

proceeds, rather than stipulating that Winstar wired the actual proceeds." But the Trustee offers no reading of this language other than the natural one—that Winstar transferred the Siemens proceeds to Lucent. She is bound by that stipulation.

In any event, the Trustee points to no evidence that Winstar transferred funds other than the specific funds it was obligated to pay, and the bankruptcy court made no such finding. In the absence of such evidence, the only reasonable inference is that when Winstar transferred $188,180,000 to Lucent, it transferred the proceeds of the Siemens loan.[13]

Finally, there is no merit to the contention of the Trustee's amicus (BB27-29) that where a debtor transfers funds from its own bank account, those funds cannot be earmarked. The caselaw is directly to the contrary. "[W]here a third party lends money to a debtor on the condition that it be used to pay a specific debt, the fact that ... the funds were advanced to the debtor rather than paid directly to the recipient creditor does not render the transfer outside the scope of the earmarking doctrine." *In re Superior Stamp & Coin Co.*, 223 F.3d 1004, 1005

---

[13] *In re Adbox, Inc.*, 488 F.3d 836 (9th Cir. 2007), is not to the contrary. While recognizing that the Trustee ultimately bears the burden to show all the elements of a preference claim, *Adbox* held that where funds are disbursed from a debtor's general account, a rebuttable presumption arises that the funds are not earmarked. Applying that rule, the Ninth Circuit found no earmarking because the debtor and the new lender had not agreed that the funds be used to pay the old lender. *Id.* at 843. Even if that burden-shifting approach were correct, *but see In re Heitkamp*, 137 F.3d 1087, 1089 (8th Cir. 1998), Lucent has met its burden here, both by virtue of the terms of the agreement and the Trustee's stipulation.

(9th Cir. 2000); *see also Coral Petroleum*, 797 F.2d at 1359; *In re Flanagan*, 503 F.3d 171, 185 (2d Cir. 2007).

Indeed, even the sole decision the amicus cites, *In re Bohlen Enterprises, Ltd.*, 859 F.2d 561, 565 (8th Cir. 1988), contradicts his theory. *Bohlen* expressly recognized that courts have *not* found it relevant whether the funds were transferred to the debtor before being transferred to the old creditor, instead holding that even when the "new funds are placed in the debtor's possession before payment to the old creditor, they are not within the debtor's 'control'" if the debtor is required to pay them to an old creditor. *Id.* at 565.[14]

B. The Transfer Did Not Diminish the Estate

The Trustee's argument (TB53-54) that the transfer diminished the Winstar estate is no more persuasive. Before the transfer, Winstar owed Lucent approximately $750 million (JA2180); afterward, Winstar owed Lucent and Siemens, collectively, the same amount. Siemens was merely substituted for Lucent as a creditor—with no new collateral given.

---

[14] *Bohlen* expressed skepticism about applying the earmarking doctrine where the new creditor did not guarantee the old debt, but ultimately adopted a test permitting its application in non-guarantor cases. *Id.* at 566 (earmarking requires (1) agreement between new lender and debtor that funds be used to pay specified antecedent debt; (2) performance of that agreement according to its terms, and (3) no diminution of the estate). The court found no earmarking because the debtor had not performed the agreement according to its terms, using the new funds for other purposes. *Id.* at 567. That did not occur here.

The Trustee surprisingly contends that the estate was diminished because the Lucent debt that Winstar repaid was undersecured,[15] whereas the $1.15 billion bank facility (secured by assets that ultimately sold for $42.5 million) was oversecured. The new Siemens debt thus, on this theory, encumbered previously unencumbered assets. And the Trustee accuses Lucent of "ignor[ing] findings of fact by the trial court" to that effect. TB53. But the court made no such findings.

The Trustee's claim is based solely on the bankruptcy court's conclusion that Winstar was insolvent by $1.6 billion at the time of the transfer—a finding she interprets as meaning (in light of Winstar's total outstanding debt of $4.8 billion) that Winstar's assets, which secured the bank facility, were then worth $3.2 billion. But the question the bankruptcy court addressed was only *whether* Winstar was insolvent, not by how much. Having found that it was, the court did not go on to value its assets—let alone the bank's collateral.

In support of its insolvency conclusion, the bankruptcy court credited the Trustee's expert's testimony that the book value of Winstar's assets should be reduced by $1.8 billion because of an asset-impairment charge. Since the assets' $5 billion book value exceeded Winstar's $4.8 billion in liabilities by only $200 million, that charge itself rendered Winstar insolvent by $1.6 billion. JA93-94; JA2629-2633 (Scherf). As the bankruptcy court observed, however, the Trustee's

---

[15] The Trustee reverses her position in her new-value argument (TB64-65), contending there that the Lucent debt was oversecured.

own expert testified that to determine the assets' fair-market value, one must also examine other factors demonstrating their depreciation, including the fact that they sold for $42.5 million—"less than 1% of the [book] value." JA93-94; JA2625-2630 (Scherf). The expert also testified that Winstar's bank debt was trading at a substantial discount—only 85 cents on the dollar (JA572)—powerful evidence that the market viewed Winstar's bank facility as undersecured.

Finally, the Trustee contends that Lucent submitted no evidence that the bank debt was undercollateralized, and notes that Lucent argued that Winstar was solvent. While Lucent did make that argument below, it also argued in the alternative that if the Trustee's expert were credited, it would logically follow that the bank debt was undersecured. JA572-573. The bankruptcy court rejected Lucent's solvency argument (a finding Lucent has not challenged on appeal), and credited the Trustee's expert. That expert's report and testimony contained more than sufficient evidence that the bank debt was undersecured, and thus that Winstar's estate was not diminished by the Siemens transaction. Lucent was not required to introduce anything further.

C. Lucent Did Not Waive Earmarking

The Trustee makes three half-hearted arguments (TB54-55) that Lucent waived earmarking. First, she contends that Lucent waived the issue through its stipulation, arguing that "Lucent could have expressly avoided stipulating to a 'transfer of an interest of the debtor in property' by stipulating only that 'the provisions of subdivision (1) of Section 547(b) have been satisfied.'" But Lucent stipulated that "Section 547(b)(1) ... has been satisfied." JA248. The Trustee does not explain the difference between what Lucent did and what she claims it ought to have done.

Second, the Trustee argues that Lucent waived earmarking by failing to identify it in the pretrial order. But Lucent specifically identified, as a disputed issue, whether the transfer of the Siemens funds was a preference under §547(b). JA221. Presumably for that reason, the bankruptcy court did not rely on that ground to find a waiver.

Third, the Trustee adheres to her position, rejected by every court of appeals and most lower courts to consider the issue, that earmarking is an affirmative defense. She relies on two unpersuasive bankruptcy court opinions. The first, *In re AmeriServe Food Distribution, Inc.*, 315 B.R. 24, 29-30 (Bankr. D. Del. 2004), merely assumes without comment that earmarking is an affirmative defense. The second, *In re Freestate Management Services, Inc.*, 153 B.R. 972, 979-980 (Bankr. D. Md. 1993), supports Lucent, acknowledging that "the trustee bears the burden of proving all the elements of a preference."

III. LUCENT PROVIDED $90.7 MILLION IN NEW VALUE

After the December 7, 2000 transfer, Lucent provided two types of unsecured new value to Winstar: $28.4 million in equipment and related services, and a $62.3 million loan.

A. Lucent Provided $28.4 Million in Unsecured New Value for Equipment and Related Services

In its opening brief (LB56-57), Lucent demonstrated that the $28.4 million in equipment and services were provided on an unsecured basis, because they never became the property of the special-purpose borrowers whose assets secured Lucent's loan.[16]

The Trustee cannot rebut that. She argues (TB58) that previous shipments of goods—financed under the Second Credit Agreement—were shipped to entities other than the special-purpose borrowers, and that title was subsequently transferred to the special-purpose borrowers, as required by the agreement. That is true, but irrelevant. The equipment at issue here was never financed, so there was no requirement that title be transferred, and the goods never became Lucent's collateral.[17]

---

[16] Contrary to the Trustee's suggestion (TB58 n.20), Lucent raised this argument at trial by presenting all the elements of its new-value claim to the court. JA679-684.

[17] Unable to point to a security agreement or other record evidence indicating that the $28.4 million in equipment was collateral securing a Lucent loan, the Trustee argues (TB56-57) that Lucent—in the early stages of the

The Trustee has abandoned the other ground on which the bankruptcy court ruled, no longer claiming that the $28.4 million in equipment was provided before the Siemens payment. She thus concedes the point.

B. Lucent Provided $62.3 Million in Unsecured New Value Under the Second Credit Agreement

The Trustee's arguments regarding the remaining new value—$62.3 million that Lucent lent to Winstar on December 29, 2000—fare no better. First, she claims (TB60) that the $62.3 million was not new credit Lucent extended on December 29, but services that Wireless (acting as Lucent's subcontractor) previously performed.[18] The Trustee contends (in a preview of her convoluted Subcontract theory) that the $62.3 million loan converted an "account payable by Winstar to Lucent for Subcontract services" into a debt Winstar owed Lucent under the credit agreement, "since the account payable had now been paid." But, as explained in Part IV.C, there was no "account payable" in the December 2000 quarter because Winstar did not order services from Lucent, and Lucent thus never instructed Wireless (as its subcontractor) to perform any services. Lucent thus

---

bankruptcy—checked the "secured by collateral" box on its proof of claim. The later-developed record makes plain, however, that this assertion was incorrect. Lucent's position in that early pleading cannot alter the facts of record, which establish that the $28.4 million extension of credit was unsecured.

[18] The Trustee also contends (TB60) that Lucent stated in its proposed findings that the $62.3 million "was for new services, not new credit." That is false. In fact, the page she cites said the opposite: "Lucent also provided Winstar with $62,324,930.00 *in additional financing* that Winstar used to pay for network buildout services." JA639 (emphasis added).

owed Wireless nothing for its services, and Winstar likewise owed Lucent nothing. And, crucially, Winstar never used the $62.3 million to pay Lucent for any such services. In sum, all the evidence points to one conclusion: the December 29, 2000 loan was a loan, and it was made on December 29, 2000.

Finally, the Trustee maintains (TB61-64) that if *any* collateral secures a loan, a subsequent draw is "secured" under §547(c)(4)(A). The great weight of authority is to the contrary:

> If the creditor is undersecured, the new advance, even though nominally secured, may satisfy 547(c)(4). Assume an outstanding debt of $1 million, collateral of $200,000. Creditor makes a new loan, bringing the total to $1,100,000. Although this loan was under the security agreement and was itself secured by the existing $200,000 of collateral, for this purpose it is not secured by an "otherwise unavoidable security interest[.]"

4 James J. White & Robert S. Summers, *Uniform Commercial Code* §32-5 (5th ed. 2002); *see also* 5 *Collier on Bankruptcy* ¶547.04[4] n.46 (15th ed. rev. 2007); *In re Intercontinental Polymers, Inc.*, 359 B.R. 868, 878-879 (Bankr. E.D. Tenn. 2005). That furthers the purpose of the new-value defense: to "treat fairly a creditor who has replenished the estate after having received a preference." *In re New York City Shoes, Inc.*, 880 F.2d 679, 681 (3d Cir. 1989) (citation omitted).

C. Lucent's Loan Was Undersecured

Finally, the Trustee contends (TB64) that Lucent failed to demonstrate that its loan to Winstar was undersecured, arguing that Winstar "had over $1.88 billion of assets to secure Lucent's approximately $800 million secured claim." But Lucent's loan was not secured by Winstar's assets, only by the assets of the special-purpose borrowers, which the Trustee stipulated sold for $21 million. JA1268, 1294, 1409. Those assets could not have oversecured Lucent's $800 million loan.

IV. THE SUBCONTRACT JUDGMENT SHOULD BE REVERSED

In its opening brief, Lucent demonstrated that the Subcontract judgment should be reversed for four independent reasons. The Trustee overcomes none of them.

A. The Subcontract Was Not Modified

It is undisputed that Lucent did not breach the Subcontract as written. By its terms, the Subcontract required Lucent to pay Wireless only if Lucent first issued Wireless a Task Order. Lucent issued no Task Order for the March 2001 quarter. The bankruptcy court, however, held that Lucent agreed to modify the Subcontract because, beginning in the June 1999 quarter, the parties engaged in a practice whereby Lucent passed Wireless-performed services through its books. According to the court, Lucent agreed permanently to abandon the Task Order requirement—the only mechanism by which Lucent could control the nature and extent of its obligations—and instead to pay for whatever services Wireless chose to perform.

The Trustee's evidence for this deeply unfavorable modification falls far short of the rigorous standard set by New York law. The Trustee bore the burden of demonstrating mutual assent to the claimed modification, *Beacon Terminal Corp. v. Chemprene, Inc.*, 429 N.Y.S.2d 715, 718 (App. Div. 1980), and a court may infer assent from a party's conduct only where it concludes "that the promise would have been explicitly made, had attention been drawn to it." *Maas v. Cornell Univ.*, 721 N.E.2d 966, 970 (N.Y. 1999).

The Trustee does not deny that the lower courts failed to apply that standard. Instead, she argues (TB78-79) that a modification was established merely because the parties' conduct deviated from the written contractual terms. But New York law requires much more: a finding that, had the parties addressed the issue, Lucent would have expressly agreed to the modification. Neither lower court made such a finding, and the Trustee nowhere argues that it was warranted.

Instead, the evidence demonstrates only that Lucent *waived* the Task Order requirement for the six quarters from June 1999 to September 2000. *See* 2 *Farnsworth on Contracts* §8.5 (3d ed. 2004); *Nassau Trust Co. v. Montrose Concrete Prods. Corp.*, 436 N.E.2d 1265, 1269 (N.Y. 1982). And a waiver may be withdrawn unilaterally with sufficient notice, *id.* at 1270, as Lucent did in September 2000, stating that Wireless should perform work "only upon prior receipt of a mutually acceptable written purchase order from Lucent (and not at its sole initiative)." JA952.

The Trustee does not dispute that if Lucent's conduct was a waiver rather than a modification, the September 2000 announcement validly withdrew the waiver—in which case Lucent's actions in March 2001 could not be a breach. She offers three arguments in response to the waiver point; none is persuasive.

First, the Trustee contends (TB81) that there is no evidence the parties agreed to a waiver. She misunderstands waiver doctrine. Of course there was no affirmative evidence of an agreement, because "[w]aiver is unilateral." *Madison Ave. Leasehold, LLC v. Madison Bentley Assocs. LLC*, 811 N.Y.S.2d 47, 51 (App. Div. 2006). The evidence of waiver is simply that Lucent did not insist on compliance with the Task Order requirement from June 1999 to September 2000. What is missing is what is necessary for modification: evidence that Lucent agreed to remove that requirement permanently.

Second, the Trustee argues (TB82-84) that the record is inconsistent with waiver. She points to Winstar employees' self-serving testimony about their subjective beliefs, which cannot demonstrate that Lucent manifested assent to a permanent removal of the Task Order requirement. She also points to testimony of

Lucent employees that is entirely consistent with waiver.[19] Lucent's September 2000 letter is likewise consistent with waiver; indeed, that was the communication in which Lucent withdrew its waiver, and what the Trustee seeks to draw from its text is entirely unclear. Finally, the Trustee, like the bankruptcy court, draws completely unwarranted conclusions from the historical facts when she asserts that Lucent "pa[id]" Wireless for services in December 2000. On December 28, 2000, Winstar sent Lucent a request to borrow over $62 million. JA73-74, 1157. It never submitted a purchase order, and Wireless never submitted an invoice. And internal emails demonstrated that Lucent employees believed that Winstar was entitled to *borrow* under the Second Credit Agreement *to finance* the services Wireless had performed.[20] They nowhere suggest that Wireless was entitled to be *paid* by Lucent under the Subcontract for those services.

Finally, the Trustee's half-hearted argument (TB84) that Lucent failed to raise this issue below is meritless. She acknowledges that Lucent included its

[19] The testimony cited merely acknowledges that the Subcontract was a contract relating to services; it is unclear which passages the Trustee contends support her claim.

[20] JA74-76 (quoting Montemarano email stating that Lucent could allow Winstar "to *use the credit facility* to *fund* services"; Hopkins email stating "We have already said no to the services *funding*"; Verwaayen email stating "Winstar can *draw down upon the credit facility*.... [T]hey have an *open line* and that is what we have to change"; Perricone email stating that, "given our agreement to *finance* services on 12/29/00," Lucent should write to Winstar "confirming *this was a borrowing under the Credit Agreement* as an accom[m]odation, and we reserve the right not to *make loans for any such purpose in the future*" (emphases added)).

waiver argument in its pre-trial statement, but insists that "waiver is a separate affirmative defense" that must be pleaded, citing Fed. R. Civ. P. 8(c). Lucent's waiver argument, however, is not an affirmative defense, but the explanation for Lucent's performing the pass-through without Task Orders for six quarters. By contrast, the affirmative defense of waiver arises when a defendant argues that it did not breach a contract because the *plaintiff* waived the contractual condition it claims was breached. *Prieto v. Paul Revere Life Ins. Co.*, 354 F.3d 1005, 1012 (9th Cir. 2004). Rule 8(c) is thus irrelevant.

B. Any Attempted Modification Would Be Ineffective Because of the Clause Requiring Modifications To Be in Writing

The Subcontract provided that "[n]o modification ... shall be binding ... unless made in writing and duly signed by both parties." §8.6, JA1558. This clause rendered ineffective any non-written modification, whether oral or inferred from conduct, *see Dallas Aerospace, Inc. v. CIS Air Corp.*, 352 F.3d 775, 783 (2d Cir. 2003). Under *Rose v. Spa Realty Assocs.*, 366 N.E.2d 1279, 1283 (N.Y. 1977), therefore, the claimed modification was ineffective unless Wireless engaged in partial performance or reliance that was "unequivocally referable" to the modification, meaning that "the only inference possible from [its] conduct is that an oral agreement" was reached. *L&B 57th St., Inc. v. E.M. Blanchard, Inc.*, 143 F.3d 88, 93 (2d Cir. 1998). Wireless' performing build-out services in the first quarter of 2001 does not meet this test. A modification is only one possible inference from that conduct; another, eminently reasonable inference is that Winstar wanted to continue building its network.

The Trustee does not take issue with this caselaw. Nor does she argue that the only inference possible from Wireless' performing services in early 2001 is that the parties modified the contract. Instead, she relies on the entire history of the parties' actions from 1999 onwards, claiming that Wireless' performing services "during every quarter in 1999, 2000 and into 2001," and Lucent's payment for services in most of those quarters, is "inexplicable absent the modification." But it is the "partial performance" or "reliance" that must be "unequivocally referable" to the claimed modification. *John Street Leasehold LLC v. FDIC*, 196 F.3d 379, 382 (2d Cir. 1999). The Trustee claims that Lucent breached its obligations only in the first quarter of 2001, and the only "partial performance" or "reliance" in that quarter was Wireless' building Winstar's network.

Even if the earlier conduct were relevant—a proposition for which the Trustee cites no support—she cannot prevail. Throughout, Wireless was building its parent's network, and Lucent was performing pass-through transactions that enabled Winstar to obtain favorable accounting treatment. JA57. Wireless' performance is explainable by Winstar's desire to have its network built regardless of the ultimate accounting treatment. Lucent's actions are explainable as quarter-by-quarter concessions to an important customer.

C. Lucent Did Not Breach the Allegedly Modified Terms

In a brief otherwise rife with assertions that the bankruptcy court's findings are entitled to deference, the Trustee affects blind denial as to the terms of the modification the court found:

> Generally Winstar sent a purchase order to Lucent [1] which, in turn, sent a purchase order to Wireless [2]. Wireless performed the services and then sent Lucent an invoice [3], with or without an accompanying spreadsheet showing the breakdown of services or goods. Lucent then invoiced Winstar in the same amount as Lucent was billed by Wireless [4]. Then, as described above, Winstar would draw down under the applicable Credit Agreement [5], [6], use the draw to pay Lucent [7] which would then pay its obligation to Wireless [8].

JA55; *see also* Fig. 1.

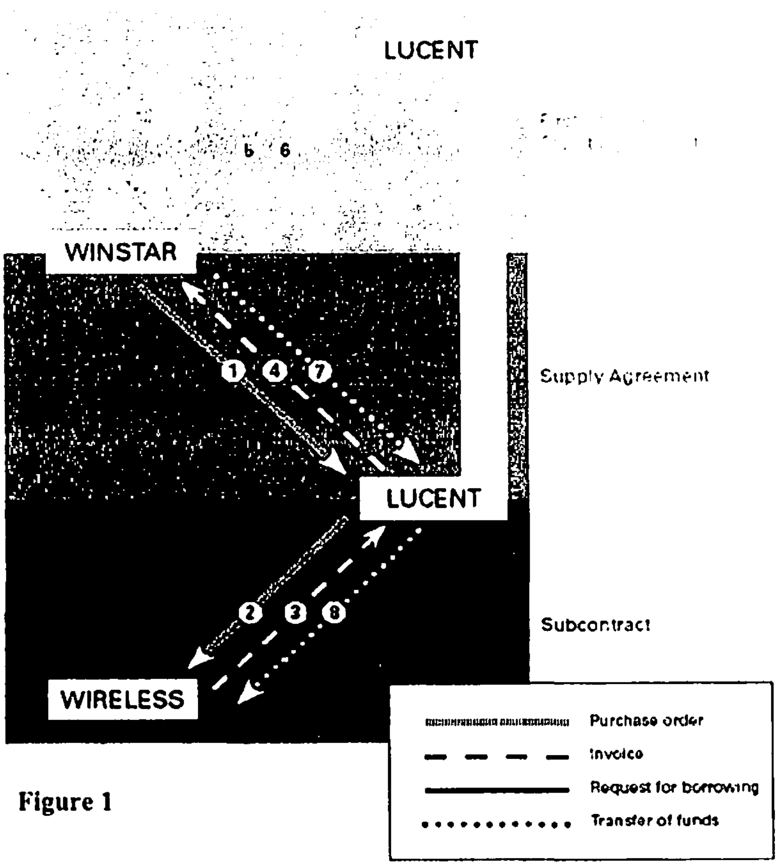

Figure 1

The Trustee does not dispute that the first step—Winstar issuing a purchase order to Lucent—never took place in December 2000 or March 2001. That step was crucial, because until it happened, Lucent had no obligation to provide services to Winstar under the Supply Agreement, and unless it happened, Lucent had no guarantee that Winstar would pay Lucent for the services Lucent subcontracted to Wireless. JA712 (Supply Agreement §4.1). Likewise, it is undisputed that steps two and three—the Lucent purchase order to Wireless and the Wireless invoice to Lucent—did not take place in those quarters. Accordingly, even under the bankruptcy court's theory of modification, Lucent's obligation to pay Wireless was never triggered.

Unable to contend that Lucent breached the modified terms found by the bankruptcy court, the Trustee concocts her own modified terms. She claims (TB85) that the bare fact that Wireless performed services on Winstar's network—tens of millions of dollars worth of services that Wireless itself chose to render—obligated Lucent to pay Wireless. That modification is not only untethered from the court's findings; it is preposterous. It amounts to saying that Lucent wrote Wireless a blank check—a theory that is not only implausible on its face, but also flatly contradicts the Trustee's contention that Lucent controlled Winstar.

The Trustee's only argument for such a modification is that "in December 2000, Lucent paid for the Wireless services without purchase orders or invoices."

That is false. In December 2000, Lucent permitted *Winstar* to *borrow* under the Second Credit Agreement; it did not *pay Wireless* for services. JA1157. Lucent did not breach the bankruptcy court's modified terms, and the Trustee cannot defend her invented modified terms. The Subcontract judgment must be reversed.

D. The Bankruptcy Court Erred in Entering Final Judgment for Winstar on the Subcontract Claim

In its opening brief (LB73-78), Lucent demonstrated that the Subcontract claim—a state-law contract claim by the estate against Lucent—was a non-core matter as to which the bankruptcy court could not constitutionally enter final judgment and as to which Lucent is entitled to a jury trial.[21] The Trustee's principal response is that Lucent rendered the Subcontract claim core—waiving its right to a jury—by filing proofs of claim, which the lower courts concluded were "directly related" to the Subcontract claim. But that conclusion was both unsupported and unsupportable. The proof of claim upon which the bankruptcy court relied sought to recover for unpaid goods and services provided under the Supply Agreement. The Subcontract was an entirely separate contract with a different party—Wireless. Whether Lucent owed Wireless money under the

[21] The Trustee is wrong to suggest (TB73) that if Lucent is entitled to a jury trial, this Court need not reach the legal defects in the Subcontract claim. Lucent contends that it was entitled to judgment on the Subcontract claim as a matter of law. If this Court agrees, there would be no need to reach the jury-trial question. If this Court were to disagree, it would nevertheless be required to remand so that disputed facts could be tried to the jury to which Lucent is entitled.

Subcontract has no bearing on whether Winstar owed Lucent money under the Supply Agreement. And the proof of claim's reference to "any and all related agreements" cannot create the needed "direct" relationship. The relevant inquiry is whether allowance of the proof of claim would affect the adjudication of the Subcontract dispute. *Halper v. Halper*, 164 F.3d 830, 837 (3d Cir. 1999). It would not.

The remainder of the Trustee's responses are no more convincing. *First*, the $6.3 million stipulated setoff against the Subcontract judgment does not render the claims related, because in an action by the debtor against a creditor, the creditor is entitled to set off any claim it has against the debtor, including an entirely unrelated one. 11 U.S.C. §553(a); *In re Univ. Med. Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992); *In re Buckenmaier*, 127 B.R. 233, 238 (B.A.P. 9th Cir. 1991). *Second*, the Trustee's assertion that Lucent waived its right to a determination that the Subcontract claim was non-core by asking the bankruptcy court to enter final judgment is incorrect, because a waiver of the right to an Article III tribunal for non-core claims must be express. Fed. R. Bankr. P. 7012(b). *Third*, the Trustee's claim that the non-core issue is moot because the district court reviewed the bankruptcy court's judgment *de novo* is belied by the court's opinion, which concluded that "the Bankruptcy Court's factual findings and conclusions of law ...

are ... not clearly erroneous." JA20. In any event, even *de novo* review would not cure the failure to provide a jury trial.

V. THE EQUITABLE SUBORDINATION RULING IS ERRONEOUS

A. Lucent's Conduct Did Not Merit Equitable Subordination

As Lucent has shown, it was *not* an insider under the Bankruptcy Code. Accordingly, the standard for equitably subordinating its claims is high: "gross and egregious conduct" is required. *In re First Alliance Mortgage Co.*, 471 F.3d 977, 1006 (9th Cir. 2006). As previously demonstrated (LB80-81), the lower courts wrongly found such conduct by faulting Lucent for exercising its contractual rights. The Trustee does not attempt to defend the contractual interpretation underlying the courts' account of threatened "breaches," instead relying on an embellished version of the bankruptcy court's findings and inferences. *Compare* TB67-68 (purporting to list "express" findings) *with* JA65, 77-80, 108-109 (actual findings). For the reasons set out in Lucent's opening brief, the actual findings are insufficient to support subordination.

B. The Bankruptcy Court Failed To Tailor Its Remedy

Even if equitable subordination were appropriate, it is well-established that equitable subordination is remedial, not penal, and should be applied only to the extent necessary to offset specific harm suffered by creditors on account of the inequitable conduct. The bankruptcy court failed to heed this standard.

Lucent's claim had two parts. *First*, Lucent had an unsecured claim for the $800 million in loans to Winstar, plus additional goods and services it provided on credit. *Second*, Lucent had a secured claim for the value of the equipment and other collateral held by the special-purpose borrowers—which the parties stipulated was approximately $21 million. The bankruptcy court not only subordinated Lucent's entire unsecured claim, providing that it would recover nothing on that claim, but also transferred the value of Lucent's lien to the estate, depriving Lucent of the $21 million in collateral.

In subordinating Lucent's claim, the bankruptcy court relied on Winstar's purchases of unneeded Lucent equipment. But Winstar never paid for most of that equipment. Accordingly, simply subordinating the portion of Lucent's unsecured claim arising out of the sale of unneeded equipment (ensuring that Lucent would never recover anything on account of that sale) would remedy any harm to the estate from Lucent's claim for such unpaid-for equipment. In order to justify any further remedy, such as the bankruptcy court's decision to transfer Lucent's lien to the estate, it would be necessary to quantify how much unneeded equipment the estate in fact paid for. The bankruptcy court did nothing of the sort.

The Trustee offers little response. While contending that the harm found by the court exceeded the full amount of Lucent's secured claim, she points to no specific findings that could justify that conclusion. The only concrete harm the court identified was interest, storage, and insurance costs associated with unneeded goods. But the bankruptcy court never quantified this harm, much less compared it to the value of Lucent's lien. These failures are fatal to the court's analysis.

C. Subordination of Claims to Equity Interests Is Unlawful

Lucent's brief explained (LB84) that the subordination of Lucent's claims to equity interests violated the plain language of the Bankruptcy Code. The Trustee's silence effectively concedes the point. She half-heartedly cites two cases that she suggests support the bankruptcy court's ruling. Neither does. As the Trustee's quotation itself makes clear, *In re Lifschultz Fast Freight*, 132 F.3d 339, 341-342 (7th Cir. 1997), addresses only the recharacterization of debt as equity, not equitable subordination of debt to equity. *See also In re Hedged-Invs. Assocs., Inc.*, 380 F.3d 1292, 1297 (10th Cir. 2004) (same). The equitable-subordination ruling cannot stand.

CONCLUSION

The judgment should be reversed.

Respectfully submitted,

Seth P. Waxman
Craig Goldblatt
Danielle Spinelli
WILMER CUTLER PICKERING HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

Philip D. Anker
Janet R. Carter
Michelle Goldis
WILMER CUTLER PICKERING HALE AND DORR LLP
399 Park Avenue
New York, NY 10022
(212) 230-8800

Counsel for Appellant

Dated: November 30, 2007

THIRD CIR. LAR 28.3(d) & 46.1(e)
CERTIFICATION OF BAR MEMBERSHIP

I, Craig Goldblatt, certify that I am a member in good standing of the Bar of the United States Court of Appeals for the Third Circuit.

Craig Goldblatt
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

Attorney for Appellant

Dated: November 30, 2007

FED. R. APP. P. 32(a)(7)(C) CERTIFICATION

1. On August 27, 2007, this Court granted the parties' Renewed Joint Motion for additional words, thereby extending the type-volume limitation for this brief to 10,500 words.

2. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) and this Court's order because this brief contains a total of 10,500 words—10,469 words in the main text, plus a graphic (on p. 38) containing an additional 31 words. This word count excludes the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

3. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5)(A) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2003 in 14-point Times New Roman type.

Craig Goldblatt
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

Attorney for Appellant

Dated: November 30, 2007

THIRD CIR. LAR 31.1 CERTIFICATION

Pursuant to Local Appellate Rule 31.1(c), the undersigned attorney hereby certifies that the text of the electronic brief is identical to the text of the paper copies. The undersigned further certifies that a virus detection program has been run on the file and that no virus was detected. The undersigned relies on the virus detection program Trend Micro OfficeScan, program version 7.3, scan engine version 8.500.1002, virus definition file version 4.711.00, in making this representation.

Craig Goldblatt
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

Attorney for Appellant

Dated: November 30, 2007

CERTIFICATE OF SERVICE

I, Craig Goldblatt, the attorney of record for Appellant Lucent Technologies Inc. hereby certify that I caused service of two copies of the foregoing Reply Brief for Defendant-Appellant to be made on the counsel listed below by overnight courier:

Stephen M. Rathkopf
Herrick, Feinstein LLP
2 Park Avenue
New York, NY 10016
212-592-1415

G. Eric Brunstad, Jr.
Bingham McCutchen LLP
One State Street
Hartford, CT 06103
860-240-2717

Robert K. Rasmussen
Gold School of Law
University of Southern California
699 Exposition Boulevard
Los Angeles, CA 90089
213-740-6473

I also certify that I caused service of an electronic copy, in .pdf format, of the foregoing Reply Brief for Defendant-Appellant to the following addresses: srathkopf@herrick.com; gebrunstad@bingham.com; and rrasmussen@law.usc.edu.

I also certify that ten bound copies of the foregoing Reply Brief for Defendant-Appellant were filed via overnight courier to:

Office of the Clerk
United States Court of Appeals for the Third Circuit
U.S. Courthouse
601 Market Street, Room No. 21400
Philadelphia, Pennsylvania 19106-1790
(215) 597-2995

I also certify that an electronic copy, in .pdf format, of the foregoing Reply Brief for Defendant-Appellant was filed with the Office of the Clerk by electronic mail at the address indicated:

electronic_briefs@ca3.uscourts.gov

Craig Goldblatt
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

Attorney for Appellant

Dated: November 30, 2007