LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 35, Number 7 • May 2018

SCOTUS Recap: What Lies Ahead For the Lower Courts' Tests for 'Non-Statutory Insiders'

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In *U.S. Bank Nat'l Ass'n v. Village at Lakeridge, LLC*, 200 L.Ed.2d 218 (U.S. 2018) (http://bit.ly/2H7G5JU), the U.S. Supreme Court laid out the standard of review for appellate courts to apply when reviewing a bankruptcy court's determination of a "mixed question" of law and fact. No doubt the decision provides valuable guidance for the lower courts and practitioners, but resolution of this technical procedural issue has garnered little excitement: as one commentator put it, the majority opinion authored by Justice Kagan represents "the smallest change in the law of any opinion the Supreme Court hand[ed] down this year." Ronald Mann, *Opinion Analysis: Justices Approve Deferential Review of Bankruptcy-Court Determinations on "Insider" Status*, SCOTUSblog (Mar. 5, 2018, 4:34 PM), https://bit.ly/2IqGcAr.

Ultimately, though, *Village at Lakeridge* is noteworthy for what the Court did not decide. The case concerned the bankruptcy judge's determination that an investor who cast the critical vote for confirmation of a cramdown plan was not a "non-statutory insider." In granting *certiorari*, the Supreme Court declined to address whether the lower courts' various "non-statutory insider" tests should be refined. As concurrences from Justices Sotomayor and Kennedy emphasized, though, that issue is ripe for increased scrutiny. The test used by the Ninth Circuit in *Village at Lakeridge* is particularly problematic and should be reconsidered in light of the Code's intent and legislative history.

Background

Beneath this case's dull exterior lies a tale of corporate intrigue and romance (or, at least, as much as one can expect from a bankruptcy appeal). The debtor, Village at Lakeridge, LLC (Lakeridge), is a commercial real estate development in Reno, NV, wholly owned by MBP Equity Partners (MBP). Saddled with debt, Lakeridge tried to reorganize under Chapter 11. It had two major debts: over $17 million due to U.S. Bank for the balance on a loan, and $2.76 million owed to MBP. Both creditors were impaired under Lakeridge's proposed plan. U.S. Bank aggressively opposed Lakeridge's reorganization efforts.

After failing at consensual confirmation, Lakeridge sought to achieve plan confirmation through the Code's cramdown provision, 11 U.S.C. §1129(b). Lakeridge needed the consent of at least one class of impaired creditors that was not an insider. *See*, 11 U.S.C. §1129(a)(10). That posed a problem. U.S. Bank refused to consent to the cramdown plan, and MBP could not provide the necessary consent because, as Lakeridge's parent company, it was an insider. *See*, 11 U.S.C. §101(31)(B)(i)–(iii) (defining "insider" to include director, officer, or "person in control" of an entity).

To circumvent this problem, Lakeridge arranged to transfer MBP's claim to another party. Kathleen Bartlett, who both served on MBP's board and was an officer of Lakeridge, persuaded her boyfriend, Robert Rabkin, to purchase MBP's $2.76 million dollar claim for $5,000. As the new holder of the claim, Rabkin then consented to Lakeridge's cramdown plan.

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Before the bankruptcy court, U.S. Bank objected that Rabkin should be considered an insider for plan confirmation purposes. U.S. Bank argued that, even though Rabkin was not formally affiliated with MBP or Lakeview, his romantic relationship with Bartlett meant that he should be regarded as a "non-statutory insider" and thus could not provide the necessary consent for the cramdown plan.

At an evidentiary hearing, both Rabkin and Bartlett conceded that they were romantically involved. The testimony also established, *inter alia*, that MBP did not offer or market its claim to anyone other than Rabkin; that Rabkin did not perform any due diligence or other investigation on the debtor before he purchased his claim; and that, after purchasing the claim for $5,000, Rabkin subsequently rejected U.S. Bank's offer to purchase the claim for up to $60,000. *See*, Brief for Petitioner at 9-12, *U.S. Bank Nat'l Ass'n v. Village at Lakeridge, LLC*, No. 15-1509 (U.S. June 12, 2017).

Despite that evidence, the bankruptcy court held Rabkin was not a non-statutory insider. In reaching this conclusion, the bankruptcy judge emphasized that Rabkin did not exercise control over the Debtor and did not co-habit or mingle finances with Bartlett.

The subsequent appeals focused on how the appellate courts should review the bankruptcy court's determination on whether Rabkin was a non-statutory insider. The Ninth Circuit ultimately affirmed, applying clear-error review and holding that the bankruptcy court's conclusions could not be invalidated under that deferential standard.

In doing so, the Ninth Circuit held that a creditor could not be deemed a non-statutory insider unless *both*: 1) the creditor's relationship with the debtor is so close as to be comparable to the enumerated insider classifications set forth in 11 U.S.C. §101(31); and 2) the relevant transaction was not negotiated at arm's length. *See*, 814 F.3d 993, 996, 1001 (9th Cir. 2016).

In this case, the Ninth Circuit held, Rabkin had no relationship with Lakeridge comparable to the enumerated insider categories listed in §101(31); indeed, the evidence showed the opposite — that Rabkin had no relationship with the debtor. *Id*. at 1002. The Ninth Circuit also held that Rabkin's relationship with Bartlett was not sufficiently comparable to the §101(31) categories, and concluded that there was not sufficient evidence to show that Rabkin's purchase of the claim was not a speculative arm's-length investment. *Id*. at 1002-03.

The Majority's Holding

U.S. Bank asked the Supreme Court to review the case to determine the sufficiency of the Ninth Circuit's non-statutory insider analysis. Instead, the Court granted *certiorari* solely on the issue of the standard of review.

In a unanimous opinion written by Justice Kagan, the Court held that the standard of review applicable to a bankruptcy court's determination whether a creditor is a non-statutory insider depends on the analysis conducted in three separate steps:

First, the bankruptcy court must decide which legal test to apply. (As the Court recognized, various circuits have developed similar, but not identical, tests for identifying non-statutory insiders. See, 200 L.Ed.2d at 223-24.) The bankruptcy court's selection of the appropriate test is a "purely legal" question that is subject to *de novo* review.

Second, the bankruptcy court must make findings of "historical facts" to evaluate a creditor's insider status. These factual findings are reviewed for clear error.

Third, the bankruptcy court must determine whether the historical facts satisfy the chosen legal test. This is a "mixed question" of law and fact.

The parties in *Village at Lakeridge* disagreed about the standard of review for the third step (mixed questions), and the bulk of the Court's decision focused on this point. The Court held that, because "[m]ixed questions are not all alike," the standard of review depends on the nature of the mixed question the bankruptcy court is answering. If the bankruptcy court is "developing auxiliary legal principles of use in other cases," then the determination should be reviewed *de novo*. On the other hand, if the bankruptcy court is examining "case-specific factual issues," then review should be for clear error. *Id*. at 227. "In short," *Village at Lakeridge* holds, "the standard of review for a mixed question all depends — on whether answering it entails primarily legal or factual work." *Id*. at 227-28.

In this instance, the bankruptcy court considered whether the facts about Rabkin's relationship and subjective intent in purchasing the MBP claim showed that the transaction at issue was conducted at arm's length. That determination, the Supreme Court concluded, was "about as factual sounding as any mixed question gets" — and, accordingly,

the Ninth Circuit was correct to apply clear-error review. *Id*. at 228.

The Non-Statutory Insider Analysis After *Village at Lakeridge*

As the majority opinion stressed, the Supreme Court did not opine on whether the Ninth Circuit's test for assessing non-statutory insiders was correct. *See*, *id*. at 225 & 224 n.1. But concurrences by both Justices Sotomayor and Kennedy suggest that it is far from clear whether the Ninth Circuit applied the correct test in determining whether Rabkin was a non-statutory insider. *Id*., at 230 (Sotomayor, J., concurring) (expressing "concerns with the Ninth Circuit's test" and inviting the lower courts to engage in "additional consideration" of the correct standard for evaluating non-statutory insiders); *id*. at 229 (Kennedy, J., concurring) (encouraging courts of appeals to "elaborate in more detail" the legal test for assessing non-statutory insiders).

According to the Ninth Circuit, Rabkin could be a non-statutory insider only if his relationship with the debtor was similar to the categories listed in §101(31) *and* his purchase of the claim was not at arm's length. *See*, 814 F.3d at 1001. As Justice Sotomayor pointed out, because the Ninth Circuit formulated this test in the conjunctive ("and"), a finding of non-statutory insider status is automatically defeated if the bankruptcy court concluded the transaction was conducted at arm's length, regardless of whether or not the creditor was closely connected with the debtor. That formulation is problematic, since the plain meaning of the term "insider" in the Bankruptcy Code "generally rests on the presumption that a person or entity alleged to be an insider is so connected with the debtor that any business conducted between them necessarily cannot be conducted at arm's length." 200 L.Ed.2d at 231. *See also*, H.R. No. 95-595, at 312 (1977); S. Rep. No. 95-989, at 25 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5810.

Thus, there is good reason to question the correctness of the Ninth Circuit's test and similar tests used by other circuits. *See*, *e.g.*, *Anstine v. Carl Zeiss Meditec AG* (*In re U.S. Med., Inc.*), 531 F.3d 1272, 1277 (10th Cir. 2008) ("The inquiry then is whether there is a close relationship *and* whether there is anything other than closeness to suggest that any transactions were not conducted at arm's length.") (emphasis in original).

A more flexible approach is needed. Although courts should examine the closeness of the relationship between the debtor and the transferee and whether the transaction was conducted at arm's length, they should regard these as factors to be considered, rather than disjointed prongs that both must be met. A flexible approach better honors the purpose and context of the non-statutory insider inquiry. As courts have "uniformly held," the definition of "insider" in Bankruptcy Code §101(31) is "merely illustrative" and not determinative of the analysis. *Vargas Realty Enters. v. CFA W. 111 St., L.L.C.* (*In re Vargas Realty Enters.*), 440 B.R. 224, 241 n.7 (S.D.N.Y. 2010) (analyzing the Code's definition of "insider" in the context of equitable subordination).

Thus, it makes sense for courts to consider the wider context of the case in reaching a determination on non-statutory insider status, rather than artificially confining their analysis to a rigid multipronged test. *See generally*, *Nisselson v. Softbank AM Corp.* (*In re MarketXT Holdings Corp.*), 361 B.R. 369, 387 (Bankr. S.D.N.Y. 2007) (in equitable subordination context, noting that because the Code's definition of "insider" is not exhaustive, "a court must consider all the facts of a given case" in determining whether an entity should be considered an insider).

In engaging in this fact-intensive analysis, courts may find it useful to consider the variety of factual considerations earmarked as significant by prior cases. Such considerations include whether the creditor received information not available to others, had special access to the debtor and its personnel, attempted to influence the debtor's decisions, selected new management for the debtor, was the debtor's sole source of financial support, or generally acted as a joint venturer or prospective partner with the debtor. *See*, *e.g.*, *Vargas Realty*, 440 B.R. at 241 n.7; *Official Unsecured Creditors' Comm. of Broadstripe, LLC v. Highland Capital Mgmt., L.P.* (*In re Broadstripe, LLC*), 444 B.R. 51, 80 (Bankr. D. Del. 2010).

Conclusion

The Ninth Circuit's rigid, two-pronged formulation has an unnecessarily restrictive effect on the analysis of who is, and who is not, a non-statutory insider. Although the Supreme Court declined to consider the issue in *Village at Lakeridge*, in the wake of this decision courts should adopt a more flexible analysis for non-statutory insiders.

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