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Feature

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The Appellate Standard of Review in Attempting to Spot an Insider

Lakeridge Creates More Questions Than Answers

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In *U.S. Bank Nat. Ass'n v. Village at Lakeridge LLC*,[1] the U.S. Supreme Court addressed the narrow legal question of whether the Ninth Circuit Court of Appeals applied the proper standard of appellate review in analyzing a bankruptcy court's decision regarding whether a creditor fell within the status of a "nonstatutory insider" under the Bankruptcy Code. In unanimously affirming the Ninth Circuit, the Supreme Court determined that while the issue involved a so-called "mixed question" of law and fact, the mixed question primarily involved a factual determination, and therefore the proper standard of review to apply was a "clear-error" standard.

While the Supreme Court's opinion provides a helpful reminder with respect to the proper standard of appellate review in connection with a mixed question of law and fact, the most interesting discussion in the opinion occurs in the concurrences, which are simply *dicta* but discuss the need to establish an appropriate legal test for determining nonstatutory insider status under the Code. While the Court's opinion is interesting, the opinion fails to decide the question of how to spot a nonstatutory insider under the Code.

Who Is an "Insider" Under the Code?

Under the Bankruptcy Code, an "insider" is a person or entity whose close relationship with the debtor subjects certain transactions made between the parties to additional scrutiny.[2] In determining insider status, courts uniformly recognize two types of insiders: "statutory" and "nonstatutory."

A "statutory insider" is one that falls within the express definition set forth in § 101(31) of the Bankruptcy Code.[3] In the case of a debtor that is a corporation, this includes, among other things, the debtor's directors, officers, persons in control of the debtor, partnerships in which the debtor is a general partner, general partners of the debtor, and relatives of a general partner, director, officer or person in control of the debtor.[4] Since the Code states that an insider of a corporate debtor expressly "includes" people like corporate directors or officers, courts have viewed the Code's list of examples of insiders as non-exhaustive.

As a result, courts have developed various tests for determining nonstatutory insider status under the Bankruptcy Code.[5] For example, certain courts apply a "closeness" approach, which considers "whether there is a close relationship [between debtor and creditor] and ... anything other than closeness to suggest that any transactions were not conducted at arm's length."[6] Other courts have applied a "control" approach, which considers whether the alleged insider exercised "sufficient authority over the debtor so as to unqualifiably dictate corporate policy and disposition of corporate assets."[7] Some courts apply a "similarity" approach, which examines whether the "the alleged insider holds a position substantially similar to the position specified in [§ 101(31)]."[8] The Supreme Court has yet to specifically consider or endorse any of these tests.

The determination of whether a party is an insider impacts a number of issues in a chapter 11

1 138 S. Ct. 960, 2018 WL 1143822 (2018).
2 2 *Collier on Bankruptcy* ¶ 101.31 (16th ed.).
3 11 U.S.C. § 101(31).
4 11 U.S.C. § 101(31)(B).
5 G. David Dean and Amanda Bassen, "Absence of References to LLCs in the Code: An 'Insider' Problem," XXXI *ABI Journal* 7, 48-49, 89, August 2012, *available at* abi.org/abi-journal (providing insightful discussion of different approaches for identifying nonstatutory insiders).
6 *See, e.g., Schubert v. Lucent Techs. Inc. (In re Winstar Commc'ns Inc.)*, 554 F.3d 382, 396-97 (3d Cir. 2009).
7 *See, e.g., Butler v. David Shaw Inc.*, 72 F.3d 437, 443 (4th Cir. 1996); *but see In re Broumas*, Nos. 97-1183, 97-1182, 135 F.3d 769 (4th Cir. Feb. 24, 1998) (unpublished).
8 *See, e.g., In re Longview Aluminum LLC*, 657 F.3d 507, 509 (7th Cir. 2011).

case, including the confirmation process. For example, in order to confirm a chapter 11 plan, a debtor must have "at least one class of claims that is impaired under the plan ... accept ... the plan, *determined without including any acceptance of the plan by any insider*."[9] As a result, if a claim in an impaired class is cast by an "insider," that creditor's vote should be excluded when tabulating voting results, which might significantly impact a debtor's ability to achieve confirmation of its plan.

Factual Background: *U.S. Bank Nat. Ass'n v. Village at Lakeridge LLC*

At the time Lakeridge filed for chapter 11 relief, it owed more than $10 million to U.S. Bank and $2.76 million to MBP Equity Partners, its corporate parent.[10] Lakeridge subsequently filed a chapter 11 plan, which contained two separate impaired classes of claims, one including those of U.S. Bank, and the other including those of MBP.[11] U.S. Bank refused the offer, thereby potentially blocking confirmation unless MBP voted in favor of the proposed plan. However, MBP, as the sole owner of Lakeridge, was a statutory insider pursuant to § 101(31) and therefore was not entitled to have its vote considered for purposes of § 1129(a)(10) of the Bankruptcy Code.

Consequently, in a creative move designed to obtain an impaired accepting class, Kathleen Bartlett, a board member and officer of Lakeridge, facilitated the transfer of MBP's $2.76 million claim to Robert Rabkin, an individual unaffiliated with Lakeridge (but with whom Bartlett had a personal romantic relationship) in exchange for $5,000.[12] Rabkin, as the new holder of MBP's claim, subsequently accepted to Lakeridge's proposed plan.

In turn, U.S. Bank filed a motion to, among other things, disallow Rabkin's claim for plan-voting purposes on the basis that Rabkin was an insider.[13] U.S. Bank argued that Rabkin was both a statutory and nonstatutory insider under the Bankruptcy Code, pointing to the close business and personal relationship between Bartlett and Rabkin.[14] The evidence presented at the hearing showed that Rabkin had no pre-existing relationship with Lakeridge or MBP before he acquired MBP's claim, that Rabkin understood that purchasing the claim was a risky investment, and that Rabkin did not know the distribution that he would receive for the claim under the plan.[15]

The Lower Court Decisions

After an evidentiary hearing, the bankruptcy court held that Rabkin did not qualify as a "nonstatutory insider," citing to the lack of control that Rabkin exercised over Lakeridge and the particulars of the relationship between Rabkin and Bartlett.[16] Despite these findings, the bankruptcy court disallowed Rabkin's claim for plan voting, determining that Rabkin became a statutory insider by virtue of acquiring the claim from MBP.[17]

Both parties appealed, and the U.S. Bankruptcy Appellate Panel for the Ninth Circuit (BAP) affirmed in part and reversed in part.[18] The BAP reversed the bankruptcy court's finding that Rabkin was a statutory insider merely because it acquired MBP's claim, holding that insider status cannot be assigned and must be determined for each individual "on a case-by-case basis, after the consideration of various factors."[19] However, the BAP affirmed the bankruptcy court's determination that Rabkin did not qualify as a nonstatutory insider, and therefore determined that Rabkin's vote on the plan should be included.[20]

> **[T]he standard of appellate review for any court applying the two-prong closeness test adopted by the Ninth Circuit is primarily fact-based and is therefore a clear-error standard.**

On further appeal, the Ninth Circuit affirmed, again finding that Rabkin did not become a statutory insider solely by acquiring the MBP claim.[21] In analyzing whether Rabkin was a nonstatutory insider, the Ninth Circuit applied a two-part closeness test: (1) whether the closeness of its relationship with the debtor was comparable to that of the enumerated insider classifications in § 101(31), and (2) whether the relevant transaction was negotiated at less than arm's length.[22] The Ninth Circuit noted that application of this test involved a "purely factual inquiry," and therefore, the bankruptcy court's determination should be reviewed under a clear-error standard of review.[23]

Applying this standard, the Ninth Circuit ultimately held that the bankruptcy court's finding regarding nonstatutory insider status was not clear error.[24] The court reasoned that while Rabkin and Bartlett had a personal relationship, they had no control over one another, and their relationship was not sufficiently close to compare with any category listed in § 103(31).[25] The court also found that the bankruptcy court did not clearly err in determining that the transaction was made at arm's length because Rabkin understood that purchasing the claim was a risky investment and he did not know the value of the claim under the plan at the time he purchased it.[26]

The Supreme Court's Opinion

Despite the many issues raised, the sole question presented to and addressed by the Supreme Court was

9 11 U.S.C. § 1129(a)(10) (emphasis added).
10 *In re Village at Lakeridge LLC*, 814 F.3d 993, 996-97 (9th Cir. 2016).
11 *Id.* at 997.
12 *Id.* Ultimately, the proposed distribution on the claim under the plan was $30,000; however, Rabkin testified that this was unknown to him at the time he purchased the claim. *Id.*
13 *Id.* at 997-98.
14 *Id.*
15 *Id.*
16 *Lakeridge*, 814 F.3d at 998. The court was not persuaded by the romantic nature of the relationship and cited to a number of other facts, including that Rabkin and Barlett did not (1) cohabitate, (2) pay each other's bills or living expenses, or (3) purchase expensive gifts for each other. *Id.*
17 *Id.* The bankruptcy court held that when a statutory insider sells or assigns the claim to a noninsider, the noninsider becomes a statutory insider. *Id.*
18 *Id.*
19 *Id.*
20 *Id.*
21 *Id.* at 999-1000.
22 *Id.* at 1001 (citing *In re Winstar Commc'ns Inc.*, 554 F.3d at 395; *Anstine v. Carl Zeiss Meditec AG (In re U.S. Med. Inc.)*, 531 F.3d 1272, 1277 (10th Cir. 2008)).
23 *Lakeridge*, 814 F.3d at 1002, n.13.
24 *Id.* at 1002-03.
25 *Id.* at 1003.
26 *Id.*

"[w]hether the Ninth Circuit was right to review for clear error (rather than *de novo*) the Bankruptcy Court's determination that Rabkin [did] not qualify as a nonstatutory insider because he purchased MBP's claim in an arm's-length transaction."[27] Justice Elena Kagan, writing for a unanimous Supreme Court, made it clear that the Court's opinion was not addressing the "correctness of the Ninth Circuit's legal test."[28]

In its decision, the Supreme Court repeated the well-known legal principle regarding the standard of appellate review that should be applied with respect to mixed questions of law and fact. The Court stated that appellate courts should address questions requiring a legal analysis under a *de novo* standard of review, while trial courts, as finders of fact, should be given greater deference where mixed questions rely on factual issues, thereby warranting a clear-error standard.[29] In light of the fact that in *Lakeridge*, the mixed question primarily involved whether Rabkin's purchase of MBP's claim was an arm's-length transaction, which was predominantly factual, the Supreme Court determined that the clear-error standard applied by the Ninth Circuit was the correct standard and therefore affirmed the Ninth Circuit's decision.[30]

The Concurring Opinions

While joining in the unanimous decision, Justices Anthony Kennedy and Sonia Sotomayor each wrote concurring opinions that highlight the lack of clarity on the proper test for determining nonstatutory insider status under the Bankruptcy Code. Justice Kennedy's concurring opinion expressly cautioned that the Supreme Court's unanimous decision did not endorse the Ninth Circuit's two-part test for determining nonstatutory insider status, specifically stating that "ongoing elaboration of the principles that underlie nonstatutory insider status seems necessary to ensure uniform and accurate adjudication in this area."[31]

In her concurring opinion, Justice Sotomayor — joined by Justices Kennedy, Clarence Thomas and Neil Gorsuch — voiced more specific concerns with the Ninth Circuit's two-part test. Noting that the two prongs of the Ninth Circuit's test are conjunctive, Justice Sotomayor pointed out that a bankruptcy court's finding that the relevant transaction was conducted at arm's length necessarily defeats a finding of nonstatutory insider status, regardless of the closeness of a person's relationship with the debtor or whether the relationship is comparable to a statutorily enumerated noninsider.[32]

Justice Sotomayor further stated that this result is inconsistent with the plain meaning of the term "insider" under § 101(31), highlighting the fact that the concept of "insider" status generally rests on the presumption that the alleged insider is so connected with the debtor that any business conducted between them necessarily cannot be conducted at arm's length, and she suggested two possible alternative tests.[33] First, Justice Sotomayor suggested eliminating the arm's-length prong and instead focusing solely on a comparison between the characteristics of the alleged nonstatutory insider and the statutory insider to determine whether they are sufficiently similar.[34] Alternatively, Justice Sotomayor suggested utilizing a test that focuses only on the circumstances surrounding any relevant transaction to determine insider status.[35] Finally, she pointed out that if a different test were to be applied, the standard of appellate review might also change, thus potentially unwinding the entire holding of the Supreme Court's *Lakeridge* opinion.[36]

The Impact of *Lakeridge*

Given the narrow holding by the Supreme Court and the criticisms in the concurring opinions, what are some takeaways from the *Lakeridge* decision? First, and most obvious, the standard of appellate review for any court applying the two-prong closeness test adopted by the Ninth Circuit is primarily fact-based and is therefore a clear-error standard. However, the standard of review might be different to the extent another test is applied. Second, and more significantly, in light of the criticism of the Ninth Circuit's test for determining nonstatutory insider status, particularly in the concurrences, lower courts have an opportunity to continue to develop and establish a more viable standard for determining nonstatutory insider status under the Bankruptcy Code.

While it seems likely that the Supreme Court will take this issue up in the future, for now practitioners should be wary of placing too much reliance on the Supreme Court's *Lakeridge* decision, as it is still unclear how the Court will ultimately choose to spot a nonstatutory insider. **abi**

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27 *Lakeridge*, 138 S. Ct. at 965.
28 *Id.*
29 *Id.* at 967.
30 *Id.* at 968-69.
31 *Id.* at 969 (Kennedy, J., concurring).
32 *Id.* at 970 (Sotomayor, J., concurring).
33 *Id.* at 970-72.
34 *Id.* at 971.
35 *Id.* at 971-72.
36 *Id.* at 972.