Is a Bankruptcy Court's Determination of Insider Status Reviewed Under the Rigorous *De Novo* Standard or the More Deferential Clear-Error Standard?

CASE AT A GLANCE

The Bankruptcy Code has special rules and requirements that apply to insiders of the debtor. For example, unlike ordinary creditors, insiders are subject to an extended preference reachback period of one year instead of ninety days. Another provision bars severance payments to insiders unless certain narrow exceptions are met. Under the statutory definition of an insider, various enumerated persons and entities are deemed *per se* insiders based on their relationship to the debtor. A family relative of an individual debtor, for instance, is an insider. Or, if the debtor is a corporation, an officer or director is deemed an insider. The definition, however, is nonexclusive, meaning that a court may determine that a party nonetheless qualifies as a "non-statutory insider" based on the particular facts and circumstances of the case. Courts principally focus on whether the debtor and the third party have such a close relationship that their transactions are not conducted at arm's length. The issue presented by this appeal is certainly rather arcane. Should a court's assessment of arm's-length conduct be treated as a factual finding, subject to review for clear error, or as a matter of statutory interpretation, subject to *de novo* review? Alternatively, is the task a mixed question of law and fact? The standard for identifying such mixed questions is not especially well settled, and even the Supreme Court has adopted divergent factors to establish the proper scope of review.

U.S. Bank v. The Village at Lakeridge
Docket No. 15-1509

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INTRODUCTION

The goal of every Chapter 11 case is the confirmation of a plan of reorganization. The plan will specify the treatment of creditors and the means for the debtor's rehabilitation. A plan can be confirmed in one of two ways—either the plan meets the 16 statutory elements under Section 1129 of the Bankruptcy Code and each impaired class votes to accept the plan, or the plan is not accepted by all impaired classes but the debtor invokes the so-called cramdown option. Under this alternative, a plan may be confirmed over the rejection of a nonaccepting class so long as at least one impaired class of creditors has accepted the plan *and* the plan is "fair and equitable." But that impaired class may not include the assent of an insider. The purpose of excluding insider votes in this context is to avoid collusion between the insider and the debtor to the detriment of disinterested creditors. Thus, whether a party is or is not an insider can sometimes be critical to the debtor's ability to reorganize.

If the plan cannot be confirmed, usually the debtor's only realistic choice is to convert the Chapter 11 case to a case under Chapter 7. There, a trustee is appointed to "collect and reduce to money" all property of the estate. The proceeds of the liquidation are distributed to creditors according to strict statutory ranking, and the surplus, if any, is remitted to the debtor. The outcome in such a liquidation is often inferior to the potential recoveries under a confirmed plan. A debtor's ability to manufacture an impaired accepting class, thus, can have a significant effect on its reorganization prospects. If insider status can be transmuted, either because an assignment cleanses the claim or because the compliant assignee is factually distinguishable from the enumerated categories of statutory insiders, debtors will have a powerful incentive to propose otherwise unconfirmable cramdown plans.

ISSUE

What is the appropriate standard of appellate review for a bankruptcy court's determination that a party is or is not a non-statutory insider—clearly erroneous or *de novo*?

FACTS

The Village at Lakeridge filed its Chapter 11 case to stop the impending appointment of a receiver at the request of U.S. Bank, its secured lender (and the petitioner in this case). Lakeridge was organized as a single-member limited liability company. It owned a

commercial real estate complex in Reno, Nevada. The sole member of the LLC, MBP Equity Partners, was itself an LLC. MBP, in turn, was managed by a five-person board of directors. Under the statutory definition of an insider, MBP and each of its directors qualified as an insider of the debtor. At the time the debtor filed its Chapter 11 case, it had only two creditors. One of them, U.S. Bank, was owed $17.6 million under a loan used by the debtor to acquire its real property assets. The second creditor, MBP, held an unsecured claim in the amount of $2.7 million.

MBP sold its claim to Robert Rabkin, a local, retired doctor, for $5,000. Rabkin was romantically involved with Kathleen Bartlett, one of MBP's five directors. Bartlett had signed the debtor's bankruptcy petition and other related court documents. The debtor's plan classified the U.S. Bank claim and the MBP claim, now held by Rabkin, in separate classes. The plan offered a $30,000 recovery on the MBP claim. Rabkin believed that the plan would eventually be modified to increase that distribution to $60,000. The reason Rabkin thought the debtor would increase its payout was because, during Rabkin's deposition, an attorney for the bank offered to purchase the claim for $50,000 or $60,000 if he accepted the offer immediately, during the deposition itself. The bankruptcy court was not amused by these shenanigans, calling the attorney's conduct "appalling."

Under the proposed plan, the U.S. Bank claim was significantly impaired. The debt was converted to a ten-year balloon note with a present value equal to the value of the underlying collateral (stipulated to be $10.8 million). The new note called for monthly payments amortized over a 30-year term. As a result, the note was negatively amortized because each monthly payment was insufficient to cover the accrued interest, leading to a progressively increased principal balance.

U.S. Bank rejected this lowly treatment. In response, the debtor invoked the alternate cramdown path to confirmation. Rabkin's friendly vote for the plan, as MBP's assignee, meant the debtor theoretically satisfied the requirement of an impaired accepting class. But U.S. Bank challenged Rabkin's vote, claiming he was an insider of the debtor—as indicated above, for purposes of determining whether the debtor has met the requirement of an impaired accepting class, insider votes are not counted. Without an impaired accepting class, the debtor could not employ the cramdown route. If MBP had not traded its claim, it indisputably would have been ineligible to vote on the plan. Having sold the claim to Rabkin, however, MBP evaded its *per se* status as an insider. U.S. Bank, however, was not content with this apparent gerrymandering and argued that Rabkin was still a non-statutory insider—a person with such a close relationship to the debtor that his conduct was based on affinity not business.

The bankruptcy court decided that, although Rabkin did not factually qualify as a non-statutory insider, he became a statutory insider by virtue of his acquisition of the MBP claim. The court found that Rabkin and Bartlett did not cohabitate, did not pay each other's bills or living expenses, did not purchase lavish gifts for each other, and did not exercise control over one another. As a result, Rabkin did not meet the bankruptcy court's test for a non-statutory insider. The court articulated a test that required cohabitation, longer periods of association or associations where the parties become "economically entwined." Absent these characteristics, according to the bankruptcy court, Rabkin's intimate relationship with Bartlett did not make him an insider.

But the bankruptcy court also held that, as a legal consequence of the assignment of the MBP claim, Rabkin acquired the same status as a statutory insider. Rabkin had "stepped into MBP's shoes" and inherited its insider mantle. As a result, since Rabkin's insider vote would no longer count, the debtor's plan lacked an impaired accepting class and could not be confirmed. (U.S. Bank had also objected to Rabkin's vote on the grounds that it was made in bad faith. Although this dispute was addressed by the bankruptcy court and later on appeal, it is not part of the Supreme Court's review and is not further discussed herein.)

Lakeridge (the respondent) and U.S. Bank each appealed the bankruptcy court's decision to the bankruptcy appellate panel (BAP), which issued its opinion in April 2013. The BAP first concluded that the bankruptcy court's determination that Rabkin did not qualify as a non-statutory insider was not clearly erroneous. According to the BAP, this finding was a pure question of fact requiring a case-by-case assessment of the closeness of the relationship and the degree of control. Having heard the testimony of witnesses and weighed other evidence, the bankruptcy court was best situated to evaluate the existence of an insider relationship. Yet, the BAP reversed the bankruptcy court's ruling that insider status traveled with the claim on the grounds that insider traits apply to creditors not to claims. Based on these holdings, the BAP vacated the order denying confirmation of the plan.

Three years later, in February 2016, the Court of Appeals for the Ninth Circuit affirmed. First, the court (unanimously) confirmed that the transfer of the MBP claim to Rabkin did not convert him into a statutory insider. The court agreed with the BAP that insider status is an attribute of a claimant, not a claim. Thus, the general principle of assignment law under which the benefits and burdens of a claim flow to an assignee did not apply. According to the court, "bankruptcy law would contain a procedural inconsistency wherein a claim would retain its insider status when assigned from an insider to a non-insider, but would drop its non-insider status when assigned from a non-insider to an insider." Second, using a clear-error standard, a majority of the court also agreed that the bankruptcy court had properly concluded Rabkin was not an insider. The court held that whether a person qualifies as a non-statutory insider is a purely factual investigation. The majority rejected the dissenting argument that insider status was a mixed question of law and fact, viewing that argument merely as a proxy for an appellate court to engage in a reassessment of the facts, something it should eschew.

After a motion for rehearing *en banc* was denied, U.S. Bank filed a petition for a writ of *certiorari* in June 2016, which the Supreme Court partially granted on March 27, 2017. The question presented was limited to the standard of appellate review for a determination of non-statutory insider status. *Certiorari* had also been sought on two other, perhaps more interesting, questions, but the Court declined to consider either of them. One of these was whether "an assignee of an insider claim acquires the original claimant's insider

status, such that his or her vote to confirm a cramdown plan cannot be counted." This issue has broad bankruptcy ramifications in light of the flourishing claims-trading industry. U.S. Bank had also sought review of the proper legal standard for determining whether a creditor is a statutory or non-statutory insider, asking the Court to choose between the "arm's length" analysis adopted by three other circuits or the "functional equivalent" test employed by the Ninth Circuit (incorrectly, it believes).

CASE ANALYSIS

The Constitution authorizes Congress to formulate "uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const., art. I, § 8, cl. 4. At bottom, this case concerns whether court-issued legal standards under the Bankruptcy Code should be uniform or may permissibly vary by jurisdiction. As noted, the Bankruptcy Code expressly enumerates certain relationships that unambiguously identify a party as an insider to the debtor. But the list is merely illustrative, and the statute thus permits courts to decide whether a nonlisted party's relationship with a debtor might also render that party an insider. If the courts can develop idiosyncratic tests for insider status, then a creditor that is an insider in one venue might escape that label in another. The consequences for that creditor and the debtor's overall reorganization process therefore might differ significantly by jurisdiction.

The standard of appellate review would directly impact the goal of uniformity. If the insider determination is reviewed *de novo,* then, presumably, the appellate process could gradually synthesize the normative standards that may have been adopted in different jurisdictions. If, however, a trial court's decision is considered a purely factual task, implicating the credibility of witnesses and the balancing of evidence, an appellate court's ability to mold a uniform rule of law would be undermined by the customary deference given to factual findings.

Congress added the term *insider* to the Bankruptcy Code as part of the comprehensive 1978 amendments. It left the definition somewhat open-ended because, according to the legislative history, "the term is not susceptible of precise specification." Courts have since framed various tests for making the non-statutory insider determination. The legislative history indicates that a key benchmark is whether the debtor and the third party have such a close relationship that their transactions are not conducted at arm's length. Although courts have habitually relied on this legislative guidance, the specific relevant factors used to gauge insider status sometimes vary by jurisdiction. In this case in particular, the bankruptcy court emphasized cohabitation, the purchase of expensive gifts, and the payment of living expenses as persuasive indicators of insider status. Petitioner U.S. Bank derides the seeming arbitrariness of these factors, wondering why the closeness of the individual's personal relationship with the debtor should matter less than "whether they share the same roof."

The Supreme Court, thus, is asked to decide whether the application of a non-statutory rule (that is, a rule developed by courts as opposed to a definitive statutory mandate) to the particular circumstances of a case is either a question of ultimate fact or a mixed question of law and fact. It appears that both parties generally acknowledge that the bankruptcy court did not confront a pure issue of law, which would admittedly be subject to *de novo* review. Indeed, the respondent debtor conceded that the legal standard employed by the bankruptcy court would properly be subject to *de novo* review. (As noted above, U.S. Bank had sought *certiorari* to challenge the rule of law applied by the Ninth Circuit, but review was not granted for this issue.) Thus, if the court had veered into new territory in the course of announcing the legal standard, this deviation would be separately reviewable *de novo.*

On the one hand, the respondent debtor argues that, once the legal standard is resolved, the application of that standard to the particular case-specific details of the factual record is strictly and solely a factual exercise. The court's role, under this paradigm, is simply to decide whether the established facts satisfy the legal rule. This comparative exercise is entitled to deference on review. In response, U.S. Bank asserts that the legal standard for the non-statutory insider determination is not fixed (in the sense that it is left to the courts to develop). Although called a *non-statutory* insider, the determination of which persons resemble the enumerated *statutory* examples is still a question of statutory interpretation. As a result, the exercise is a tangled interplay between legal judgments and factual findings.

Under this rationale, an appellate court should apply heightened scrutiny to a trial court's rulings because the applicable law and the established facts are intertwined. According to U.S. Bank, since the determination of non-statutory insider status triggers both an inquiry into the proper legal standard as well as intensive fact-finding, the outcome deserves a different standard of review than mere clear error. Put another way, when a court is called upon to both develop the legal standard and apply the facts to that standard, this becomes a predominantly normative process. In order to promote doctrinal coherence under the Bankruptcy Code, the appellate courts should review these rulings under a *de novo* standard.

U.S. Bank insists that the determination of non-statutory insider status is a mixed question of law and fact. Given that the statute accommodates flexibility in the assessment of insider status, courts are necessarily engaged in both an interpretive task (specifying the legal factors to be used) and a traditional fact-finding mission. According to the bank, this type of analysis is "substantially legal or quasi-legal and presents a classic mixed question of law and fact." Under various Supreme Court precedents, mixed questions are entitled to *de novo* review if (a) they are predominantly legal, (b) historical practice supports such review, (c) they meet functional considerations, or (d) they resolve the ultimate issue in the case. Absent *de novo* review, the bank argues, the determination of insider status would be left to the predilections, views, values, and "even caprice" of individual bankruptcy judges. As framed by the bank, the question is "whether bankruptcy judges should be accorded virtually plenary discretion to determine the specific tests to apply when analyzing the facts."

Turning to its core argument, the bank distinguishes the "neat" comparison of historical facts to a governing rule of law (admittedly subject to minimal, clear-error review) from the bankruptcy court's *creation* of a legal standard by its adoption of certain indicators and its omission of others. As an example, the bank points to the court's choice of cohabitation as a critical factor. For petitioner, the

court's selection of relevant filters and factors "is a quintessential legal judgment, not a factual determination." Thus, the exercise of "standard-making" (that is, which facts are pertinent, or dispositive or entitled to greater weight, or simply immaterial) is a legal judgment. The court is fashioning a test for "*how* to decide" whether a party is an insider, not simply applying a legal principle to established facts. Insofar as this task might depend on the "vagaries of a bankruptcy court's own views," it should be reviewed under the searching, *de novo* standard of review.

The petitioner also criticizes the Ninth Circuit for its failure to closely analyze the applicable standard of review and, more importantly, for ignoring the possibility that the question presented might raise a mixed question of law and fact. This was especially glaring because four other circuit courts treat insider status as a mixed question subject to *de novo* review. According to the bank, because the Bankruptcy Code definition of an insider offers only vague guidance, the establishment of a test for non-statutory insider status has "potential broader impact than the individual case at hand." Thus, *de novo* review would aid "consistency of decision, uniformity of legal standards, and sound policy." A clearly erroneous standard, as used by the Ninth Circuit, permits the trial courts to develop idiosyncratic legal tests without meaningful oversight. And since classification as an insider has material consequences under many aspects of bankruptcy law, a "judicial process under which someone might be considered an insider in one courtroom and a stranger to the transaction in another courtroom" despite analogous facts would be "an open invitation for forum-shopping."

The respondent debtor does not see the same risk of a "wide disparity" in rulings. To the contrary, it argues that, from a functional perspective, the bankruptcy court (that is, the trial court) is the best-positioned judicial actor to decide the issue. Although the petitioner bank claims that the facts regarding Rabkin and Bartlett's relationship were not disputed, nor was witness credibility at stake, the respondent points out that the use of a *de novo* standard would require each appellate court to "redo the bankruptcy court's work, using scarce judicial resources to mine the record anew and examine transcripts of events that the bankruptcy judge witnessed in person." Thus, the competing policy of judicial economy should override the need for consistent outcomes.

The respondent maintains that insider status is a pure question of fact subject to clear-error review. Even if it is deemed a mixed question, respondent asserts the clear-error standard should still apply. Merely because courts must define a legal standard as part of their overall analysis does not convert any underlying factual findings into legal conclusions. For the respondent, insider status is highly fact intensive and must be analyzed on a case-by-case basis. As if to accentuate this point, it devotes almost a third of its brief to the underlying factual record developed by the bankruptcy court (whereas, to bolster its argument for *de novo* review, the petitioner had posited that the historical facts were undisputed). These facts showed that the bankruptcy court carefully inquired as to whether Rabkin's purchase was made at arm's length. Ultimately, the answer was a matter of intent: Were Rabkin and Bartlett "truly negotiating in their own self-interest or motivated instead by a connection to the other side"? If these types of fact-bound determinations are made the subject of *de novo* review, institutional costs will increase at each level of appeal and bankruptcy cases will correspondingly be delayed, at the direct expense of creditors. Contrary to the petitioner's claim that the standard for non-statutory insider status is vague and open-ended (arguably leading to normative judgments that might vary by venue and, hence, demanding *de novo* scrutiny), the respondent claims the test is facile: Was the transaction conducted at arm's length or not? That question "involves precisely the kind of 'who, when, what, and where' inquiries typical of pure fact-finding." This function, in turn, is entitled to deferential review.

As the respondent rather eloquently puts it, clear-error review is not earmarked solely for "standards with *ex ante* encyclopedic definitions exhausting every possible factual scenario that might arise in the universe of human activity." A settled, comprehensive understanding of arm's-length conduct is not necessary; instead, the court need only decide what actually happened. And merely because a finding of insider status would resolve the ultimate legal question in the case (here, rendering the plan unconfirmable for lack of an accepting class), that did not convert the task into a purely legal inquiry. Supreme Court precedent makes clear that an issue does not lose its factual character merely because its resolution would be legally dispositive.

Even if the bankruptcy court's determination was viewed as a mixed question of law and fact, respondent insists the standard of review would not change. That is because, under the Supreme Court's functional test, the bankruptcy court is unquestionably better positioned to decide the matter. Moreover, as the debtor points out, under the bankruptcy regime, "litigants have a right to *two* appeals, not one." If an appeal was initially taken to the BAP, that would entail "two three-judge panels (six judges in total) to devote substantial time and energy to re-creating an intense factual record." As there is no single mode of arm's-length transaction, the respondent claims that *de novo* review would not yield any useful, uniform guidance for future cases, contrary to the bank's policy pitch. Last, as a practical matter, the effect of insider status on the debtor-creditor adjustment process in a particular case is best reserved to the institutional expertise of bankruptcy judges. *De novo* review would only interfere with the strong goal of bankruptcy finality and expeditious administration. The Ninth Circuit's deferential analysis should thus be affirmed.

SIGNIFICANCE

The more interesting issue presented by this case is precisely the one not reviewed by the Court: Does insider status flow with the assignment of a claim? Claims trading in bankruptcy cases has become increasingly prevalent in recent years, but it is sometimes unclear whether disabilities attributable to the seller of the claim, or to the claim itself, will travel to the buyer. For example, the Bankruptcy Code permits an objection to the allowance of a claim on the grounds that the creditor is the recipient of an avoidable transfer. If that creditor, however, assigns its claim to another party, does the potential infirmity in the claim apply to the buyer (which was not the recipient of the avoidable transfer)? Similar questions apply to other claim disabilities under the Bankruptcy Code, such as subordination for inequitable misconduct.

Conversely, the Bankruptcy Code permits a creditor to object to the discharge of a claim that is based on fraud or a false representation. Plainly, this remedy is based on acts or omissions of the debtor that are directed toward a particular creditor. Yet, several courts,

including the Ninth Circuit, have permitted the assignee of a claim based on the debtor's false financial statements to assert that the claim should not be discharged even though the assignee did not itself rely on the debtor's false statements, either when the original debt was incurred or when it purchased the claim. Thus, in this situation, the defect in the claim travels with the assignment.

Returning to the context of this case (and putting aside the question of whether a party might independently qualify as a non-statutory insider), should a claim transfer by an insider to an otherwise arm's-length—but "agreeable"—buyer enable the debtor to recruit positive votes? This claim-laundering loophole might nullify the important safeguard under the cramdown path of obtaining at least one impaired accepting class of creditors. But, as noted, the Court declined to consider this structural question.

The dispute over the proper standard of review for the non-statutory insider determination does not seem as closely tied to the goals and objectives of bankruptcy administration. But the case may present an opportunity for the Court to clarify the framework for appellate review more generally, especially when a so-called mixed question is presented. The fact that the parties to this appeal could view the bankruptcy court's decision in such radically opposing ways—the bank claims it was a normative, value-driven, and arbitrary outcome, while the debtor claims it was a routine fact-finding mission—suggests the Court could helpfully illuminate this rather murky field.

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PREVIEW of United States Supreme Court Cases, pages 42–46.

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Tracking the Term*

9 – Number of oral arguments

34 – Days of oral argument remaining

47 – Number of cases granted to date

*As of October 17, 2017