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A Sui Generis Approach to 'Insider' Status in Bankruptcy

On Feb. 8, 2016, in In re The Village at Lakeridge LLC,[1] the United States Court of Appeals for the Ninth Circuit held that a claim of an "insider," which is not counted for the purposes of creating an accepting impaired class for confirmation of a contested plan of reorganization, does not retain insider status once transferred to a third party that is not an insider. The ruling potentially creates an additional avenue for plan confirmation in small cases with few noninsider creditors. It also stands in contrast with rulings of several other courts regarding other Bankruptcy Code provisions that have held that a subsequent transfer to an innocent third party did not remove the negative treatment of such claim resulting from the prior holder's failure to return an avoidable transfer, or the prior holder's inequitable conduct.[2]

Facts

The debtor was a Nevada single-asset real estate company wholly owned by MBP, a limited liability company. MBP, in turn, was governed by a five-member board, including Kathie Bartlett. Bartlett had signed the debtor's Chapter 11 petition on behalf of MBP, as owner of the debtor. In addition to being its owner, MBP also held a $2.76 million intercompany claim against the debtor, which was the only significant claim other than a nearly $22 million undersecured claim filed by U.S. Bank, as trustee (the mortgage lender).[3]

Several months after commencing its Chapter 11 case, the debtor filed a plan of reorganization, providing treatment for the mortgage lender to which the mortgage lender took strong exception. After filing the plan, Bartlett, on behalf of MBP, sold MBP's $2.76 million claim for $5,000, to Robert Rabkin, an individual with whom she had a "close personal and business relationship." Rabkin later admitted he knew little about the debtor and stated that he did not know until much later that the plan proposed to make a $30,000 distribution on the claim. Bartlett testified that MBP's board voted to sell the claim because, as an insider claim that would not be counted for voting purposes, it was "useless" to MBP, and also because the board perceived potential tax advantages in selling the claim.

The mortgage lender, after an unsuccessful attempt to buy the claim from Rabkin for as much as $60,000 (12 times Rabkin's purchase price), then challenged Rabkin's vote in favor of the plan. Two key issues emerged in the resulting litigation. First, whether Rabkin was a "statutory" insider and, if not, whether he was, at a minimum, a "nonstatutory" insider under 11 U.S.C. § 101(31). While the law would be the same in either case (i.e., his vote would not be counted in a contested plan process) "statutory" insiders are persons who are defined as insiders under the explicit terms of Section 101(31) (for example, an officer or director of a debtor, or a relative of an officer or director), while "nonstatutory" insiders are persons with relationships that are not identified in Section 101(31), but whom courts consider to be their functional equivalents.

At the plenary level, the bankruptcy court found that Rabkin was not rendered a nonstatutory insider of the debtor despite his personal relationship with Bartlett. Nonetheless, it held that because Rabkin had purchased his claim from a statutory insider (i.e., the debtor's owner, MBP), as a matter of law Rabkin himself had succeeded to statutory insider status, even in the absence of relationship with the debtor personally. Rabkin, accordingly, was not entitled to vote his claim.

On appeal to the bankruptcy appellate panel, the panel affirmed the bankruptcy court's holding that Rabkin was not himself an insider of the debtor (among other things, it pointed out that Rabkin was not living together with Bartlett, nor was he exercising control over the debtor), but disagreed with the bankruptcy court's conclusion that by purchasing the claim from MBP which, as the debtor's owner, was an insider under the express terms of Section 101(31), Rabkin was automatically rendered a statutory insider. And because Rabkin's claim was no longer one of an insider (whether statutory or nonstatutory), it could be voted in favor of the debtor's plan, which would now have an "accepting impaired class" and be capable of confirmation. An appeal to the Ninth Circuit ensued.

The Ninth Circuit's Majority Opinion

On appeal to the Ninth Circuit, the panel began it's analysis, as had the lower courts, with the distinction between a statutory insider, which the court alternatively referred to as a "per se" insider, and a nonstatutory insider, whose status is determined by reference to the surrounding facts and circumstances.

The Ninth Circuit panel disagreed with the bankruptcy court (and agreed with the appellate panel), and held that the purchase by Rabkin of his claim from a statutory insider did not render the claim an insider claim. According to the court, this was because the state of being an insider is not a property associated with a claim, but rather a characteristic of a claimant. Therefore, the general rule that an assignee takes a claim subject to any benefits and defects of the claim did not apply, because the claim itself was not defective. And while the court was conscious of the potential for abuse that would inhere in the ability of a voting-ineligible insider to transfer its claim to a voting-eligible noninsider, it held that the requirement of Section 1129(a)(3) of the Bankruptcy Code that a plan be proposed in good faith, as well as the bankruptcy court's ability to designate the vote of claimant whose claim was not procured in good faith, afforded sufficient protection against abuse.

The Ninth Circuit then agreed with the lower courts' findings that Rabkin was not a nonstatutory insider, either. In order to be a nonstatutory insider, Rabkin would have had to have a relationship to the debtor that was "comparable to those listed in section 101(31)." The court held this was not the case here. Rabkin did not know any of the other four members of MBP, did not influence their control of the debtor and, with respect to Bartlett, while he had a close relationship with her, they "kept separate finances, lived separately, and conducted their business separately." Accordingly, Rabkin was entitled to vote his claim.

The Dissent

Not all of the Ninth Circuit panel agreed that Rabkin should have been allowed to vote. In partial dissent, Judge Richard Clifton agreed that insider status is a function of the claim holder, and not the claim itself. Therefore, the fact that a prior holder of a claim was an insider does not impose a residual defect on the claim once transferred to a noninsider.

However, Judge Clifton strenuously disagreed with the majority's conclusion that Rabkin was not a nonstatutory insider. Judge Clifton noted that one hallmark of insider status is the negotiation of a transaction at less than arm's length. According to Judge Clifton, the mere fact that Rabkin's transaction with MBP stood to be mutually beneficial did not mean that it was conducted at arm's length. As colorfully explained by Judge Clifton:

> [I]t is clear that the transaction cannot be understood as a primarily economic proposition on [Rabkin's] part. There was no evidence that he had a habit of making blind bets, say by helping out Nigerian princes or buying the Brooklyn Bridge. There is an alternative explanation that makes a lot more sense. As the majority opinion acknowledges, Rabkin had a "close business and personal relationship" with Bartlett, the person who proposed this transaction to him. I don't have to know the precise details of the relationship between Rabkin and Bartlett to conclude that it offers the only logical explanation for Rabkin's actions here. He did a favor for a friend, and if it made some money for himself, so much the better.

Moreover, Judge Clifton was less than assuaged by the notion that Sections 1129(a) and 1126(e) could serve as sufficient protection against abuse. In Judge Clifton's view, abuse was occurring right here in the case before the court, yet those sections were proving themselves useless as a means of stopping it.

Analysis

The Ninth Circuit's statutory analysis of the claimant-focused, rather than claim-focused, nature of insider status seems sound. Section 1129(a)(10) of the Bankruptcy Code instructs a court to disregard the acceptance of a plan of reorganization "by any insider," and Section 101(31) defines insider by reference to the identity of a particular entity or individual (e.g., a relative, a partnership, a director, an officer, a general partner...), rather than by reference to any particular claim that such entity or individual may hold.

And yet, as Judge Clifton points out, the facts of the case make it very difficult for one to reasonably conclude that MBP sold the claim to Rabkin for any purpose other than to facilitate the creation of an accepting impaired class under its reorganization plan. This is particularly the case because Rabkin's claim was classified separately from the mortgage lender's deficiency claim under the debtor's plan, which would have otherwise carried the unsecured class.[4] Indeed, MBP itself admitted that the claim was "useless" in its own hands due to its inability to vote the claim. The upshot is that the Ninth Circuit seems to have created another vehicle for single-asset real estate debtors to solve a problem that frequently emerges when they attempt to propose a reorganization plan, which is the frequent absence of noninsider claims that can be voted in favor of a reorganization plan against the opposition of the plan-rejecting secured lender.

The case is also notable because of the contrasts that it presents with the transfer of claims that are subject to disallowance or subordination under Sections 502(d) or 510(c) of the Bankruptcy Code. Under Section 502(d), an otherwise valid claim may be disallowed if its holder received a preferential or fraudulent transfer and has not restored the transferred funds back to the estate. Additionally, under Section 510(c), an otherwise valid claim may be subordinated to otherwise similar claims based on the inequitable conduct of the creditor holding the claim. Under these circumstances, when the otherwise valid claim is sold to a nonculpable third party, those third parties have argued that the combination of the claim's validity and their innocence should render their purchased claim free of any subordination or disallowance.

Several courts, prominent among them the Third Circuit Court of Appeals, have rejected this argument. In In re KB Toys Inc., the Third Circuit held that susceptibility to disallowance under Section 502(d) is a defect that runs with the claim even after it is sold to a third party.[5] There, the court seemed much more concerned than the Ninth Circuit was in Village at Lakeridge at the prospect of deliberate "claims washing," which would "undermine" the statutory goals of Section 502(d). One can only speculate as to whether the Third Circuit would have the same concerns in a plan voting case under Section 1129(a)(10) about undermining its purpose in disregarding insider voting, or whether it would concur with the Ninth Circuit's sui generis approach to the interpretation of "insider" based on its textual analysis of that defined term. The potential reach of the Ninth Circuit's decision to the potential negative treatment under Sections 502(d) and 510(c) when such claims are transferred to innocent third parties is therefore questionable.

1 2016 U.S. App. LEXIS 2124 (9th Cir. Feb. 8, 2016)

2 See 11 U.S.C. §§ 502(d), 510(c)

3 The stipulated value of the property securing the mortgage lender's claim was $10.8 million.

4 The issue of separate classification appears to have been mooted when the mortgage lender elected to have its entire claim classified as secured, pursuant to Section 1111(b) of the Bankruptcy Code.

5 In re KB Toys Inc., 736 F.3d 247 (3d Cir. 2013)

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