Supreme Court Clarifies Standard of Appellate Review of Creditor's Insider Status

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In *U.S. Bank N.A. v. Village at Lakeridge, LLC*, the U.S. Supreme Court issued an important decision on standards of appellate review, holding that appellate courts should review a bankruptcy court's determination of whether a particular creditor is a "nonstatutory insider" for purposes of the Bankruptcy Code under the highly deferential "clearly erroneous" standard of review.

The holding of the unanimous *Lakeridge* opinion, issued on March 5, 2018, is narrow. The Court considered only the appropriate standard of appellate review and declined to review whether the substantive legal test for nonstatutory insider status that the U.S. Court of Appeals for the Ninth Circuit applied was proper. The opinion reinforces the importance and primacy of bankruptcy courts as finders of fact.

Significance of Insider Status

The issue of whether a party is an insider of a Chapter 11 debtor has numerous implications in bankruptcy cases, including whether debtor transfers to the party are subject to heightened scrutiny; whether prepetition transactions with alleged insiders are subject to longer avoidance periods; and whether the vote of an alleged insider counts as a creditor vote for purposes of determining if a creditor class has accepted a Chapter 11 plan and if that plan may be crammed down and confirmed over the rejection of another class of creditors. The Bankruptcy Code's statutory definition of "insider" is nonexhaustive and includes any officer, director or "person in control" of a debtor. Courts have crafted various tests to determine whether a party is a nonstatutory insider. Disputes about whether a particular party is an insider typically pose mixed questions of law and fact that require a bankruptcy court to make factual findings and then apply a judicially developed test for insider status to those findings.

Bankruptcy and Ninth Circuit Decisions

In *Lakeridge*, the debtor was a limited liability company with two substantial creditors: U.S. Bank and the debtor's sole equity owner, MBP Equity Partners (MBP). The debtor owed more than $10 million to U.S. Bank and another $2.76 million to its nondebtor owner, MBP. The MBP and U.S. Bank debt claims were classified separately in two different impaired classes under the debtor's proposed Chapter 11 plan. U.S. Bank opposed the plan and voted to reject it. MBP voted to accept it, but it was insufficient to confirm and cram down the plan on U.S. Bank because MBP, as 100 percent equity owner of the debtor, was an insider. MBP thus sold and transferred its $2.76 million claim to an alleged noninsider individual who paid $5,000 for the claim.

The sale of MBP's claim was arranged by an MBP director who also was an officer of the debtor and who further admitted to a romantic relationship with the claim buyer. The debtor took the position that the claim buyer's vote of acceptance of the plan should satisfy the Bankruptcy Code's requirements for confirmation of the debtors' cram-down plan because the claim buyer was not an insider.

U.S. Bank objected, asserting that the individual buyer of the MBP claim was a nonstatutory insider because of his ongoing romantic relationship with the debtor's director, who had arranged the sale without offering or marketing the MBP claim to other third parties. Based on the evidence presented, the bankruptcy court determined that despite the romantic relationship, the buyer was not an insider because the evidence showed he had purchased the MBP claim at arm's length, viewed the purchase of the claim as a speculative investment and conducted some diligence prior to the sale.

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U.S. Bank appealed that determination, and the Ninth Circuit affirmed. The court applied its nonstatutory insider test: A creditor qualifies as one only if "(1) the closeness of its relationship with the debtor is comparable to that of the enumerated insider classifications in [the Bankruptcy Code], and (2) the relevant transaction is negotiated at less than arm's length." The Ninth Circuit held that the bankruptcy court's determination was entitled to deference under the "clearly erroneous" standard of appellate review because the bankruptcy court was in the best position to consider and weigh the evidence that was implicated in the mixed question of law and fact presented by the nonstatutory insider test that the appeals court had applied.

Supreme Court's Affirmance

Writing for a unanimous Court, Justice Elena Kagan noted that insider status is relevant in a variety of circumstances under Chapter 11. Yet the Court decided only a single question: whether the Ninth Circuit was correct to review for clear error (rather than *de novo*) the bankruptcy court's determination that the MBP claim buyer did not qualify as a nonstatutory insider because he purchased MBP's claim in an arm's-length transaction. The Court did not consider or decide whether the Ninth Circuit applied the proper nonstatutory insider test; indeed, the Court specifically rejected U.S. Bank's request to include that question in the grant of *certiorari*.

The Court framed the specific issue it decided as follows: "What is the nature of the mixed question [of law and fact] here, and which kind of court (bankruptcy or appellate) is better suited to solve it?" The Court concluded that the standard of review for a mixed question of law and fact "all depends on whether answering it entails primarily legal or factual work." The Court held that the Ninth Circuit properly applied the "clearly erroneous" standard of review because the Ninth Circuit's nonstatutory insider test required the bankruptcy court to determine whether the facts it found showed an arm's-length transaction between MBP and the buyer of its claim. The Court said that particular mixed question of law and fact determination "is about as factual sounding as any mixed question gets."

Key Takeaways

The *Lakeridge* opinion indicates that a bankruptcy court is best positioned to decide many mixed questions of law and fact that require limited legal analysis. Parties and attorneys should therefore make strong and careful evidentiary records in bankruptcy matters, especially contested plan confirmation proceedings. Bankruptcy court decisions on mixed questions of law and fact, including questions concerning nonstatutory insider status, often are entitled to deference on appeal. Parties that must evaluate insider status in the context of a Chapter 11 case should take careful note of the Supreme Court's guidance on nonstatutory insider status and arm's-length transactions.

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