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Justice Deferred: What High Court Won't Review In Lakeridge

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On March 27, 2017, the U.S. Supreme Court granted certiorari in the case of In re the Village at Lakeridge LLC, under which the U.S. Court of Appeals for the Ninth Circuit held that a claim of an "insider," which is not counted for the purpose of creating an accepting impaired class for the purpose of "cramming down" a plan of reorganization over the opposition of a rejecting class, does not retain its status as a claim of an insider for that purpose once transferred to a noninsider third party. The Supreme Court granted certiorari, however, only as to the narrow question of "[w]hether the appropriate standard of review for determining non-statutory insider status is the de novo standard of review applied by the Third, Seventh and Tenth Circuit Courts of Appeal, or the clearly erroneous standard of review adopted for the first time by the Ninth Circuit Court of Appeals in [Lakeridge]."

Notably, the court declined to review two additional questions presented on appeal, "[w]hether 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 under 11 U.S.C. 1129(a)(10); [and] [w]hether the proper test for determining non-statutory insider status requires bankruptcy courts to conduct an "arm's-length" analysis as applied by the Third, Seventh and Tenth Circuits (i.e., to examine whether the debtor and a third party treated with each other at arm's length), or to apply a "functional equivalency" test, which looks to factors comparable to those enumerated for statutory insider classifications as the sole or primary basis for determining whether an entity is a nonstatutory insider, as the Ninth Circuit seems to have done.

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The court's determination not to address these further questions presented leaves open important questions for cases involving debtors with few noninsider creditors.

Background

The debtor was a Nevada single-asset real estate company wholly owned by MBP, a limited liability company. MBP also held a $2.76 million intercompany claim against the debtor, which was the only significant claim against the debtor's estate other than a nearly $22 million undersecured claim filed by U.S. Bank. No one disputed that in the hands of MBP, the $2.76 million intercompany claim was a claim of an "insider" for purposes of 11 U.S.C.   1129(a)(10).

Several months after commencing its Chapter 11 case, the debtor filed a plan of reorganization, to which U.S. Bank strongly objected. Thereafter, the debtor's parent, MBP, sold its $2.76 million claim for $5,000 to Robert Rabkin, an individual with whom one of MBP's board members, Kathie Bartlett, had a "close personal and business relationship." Bartlett testified in the bankruptcy court 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.

U.S. Bank, after an unsuccessful attempt to buy the claim from Rabkin for a significant premium, challenged Rabkin's vote in favor of the plan. U.S. Bank urged in the resulting litigation that Rabkin was a "statutory" insider and, if not, was at a minimum, a "nonstatutory" insider under 11 U.S.C.   101(31). Had Rabkin been either a statutory or nonstatutory insider, his vote would not have been counted and the plan would not have been confirmable, which was the bank's desired result. The bankruptcy court found that while Rabkin was not rendered a nonstatutory insider of the debtor despite his personal relationship with Bartlett, because Rabkin had purchased his claim from a statutory insider, as a matter of law Rabkin himself had succeeded to statutory insider status.

On appeal to the Bankruptcy Appellate Panel for the Ninth Circuit, the panel affirmed the bankruptcy court's holding that Rabkin was not himself an insider of the debtor, but disagreed with the bankruptcy court's conclusion that by purchasing the claim from an insider, Rabkin was automatically rendered a statutory insider.

On further appeal to the Ninth Circuit, the appeals court agreed with the appellate panel (disagreeing with the bankruptcy court), holding 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 court determined that 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. The appeals court also agreed with the lower courts' findings that Rabkin was not a nonstatutory insider, either. Importantly, in rendering these opinions, the circuit court stated that it was applying a "clearly erroneous" standard of review.

In a far-ranging dissent, Judge Richard Clifton urged, "the problem here is not with the facts as found by the bankruptcy court but with the legal test that the bankruptcy court applied." He went on: "[w]hat standard did the bankruptcy court apply to determine whether this transaction was conducted at arm's length, by the parties acting like they were strangers? We don't know, because the bankruptcy court order never discussed the concept. At a minimum, this makes Rabkin's status a mixed question of law and fact, subject to de novo review [rather than subject only to a clearly erroneous standard]. See In re Bammer, 131 F.3d 788, 792 (9th Cir. 1997) ('Mixed questions presumptively are reviewed by us de novo because they require consideration of legal concepts and the exercise of judgment about the values that animate legal principles.')"[1]

In the petitioner/appellant's petition for a writ of certiorari filed with the Supreme Court, counsel urged that three questions should be addressed by the Supreme Court: "1. 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 under 11 U.S.C. 1129(a)(10); 2. Whether the appropriate standard of review for determining non-statutory insider status is the de novo standard of review applied by the Third, Seventh and Tenth Circuit Courts of Appeal, or the clearly erroneous standard of review adopted for the first time by the Ninth Circuit Court of Appeal in this action; and 3. Whether the proper test for determining non-statutory insider status requires bankruptcy courts to conduct an "arm's length" analysis as applied by the Third, Seventh and Tenth Circuit Courts of Appeal, or to apply a "functional equivalent" test which looks to factors comparable to those enumerated for statutory insider classifications as erroneously applied for the first time by the Ninth Circuit Court of Appeal in this action."

The Supreme Court requested the opinion of the solicitor general as to whether certiorari should be granted and, if so, as to which issues. In response, the acting solicitor general suggested that none of the three issues raised on appeal warranted the Supreme Court's consideration. As to the question on which the Supreme Court finally determined to grant an order of certiorari, the acting solicitor general argued that "[t]o be sure, the court of appeals' opinion includes some imprecise language. The court stated, for example, that '[t]he bankruptcy court's finding that Rabkin does not qualify as a non-statutory insider is not clearly erroneous,' Pet. App. 16a — a statement that, viewed in isolation, appears to elide the separate factual and legal components of the bankruptcy court's ultimate conclusion as to Rabkin's insider status. But the court of appeals elsewhere made clear that it was applying clear-error review to the bankruptcy court's factual findings, and de novo review to the court's articulation of the legal standard."

On the other hand, the petitioner/appelant's petition urged that the circuit panel only applied a clearly erroneous standard of review, "afford[ing] complete deference to the Bankruptcy Court's findings." The petition went on to argue that the panel majority "implicitly acknowledged that [had it not applied a clearly erroneous standard] they would have joined Judge Clifton in in finding that Rabkin was a non-statutory insider." The petition points out that the Supreme Court has previously granted certiorari to resolve circuit splits involving applicable standards of review and suggested that the case at bar was therefore ripe for Supreme Court intervention.

The Supreme Court appears to have disagreed with the solicitor general's reading of the Ninth Circuit's decision and agreed with that presented by the petitioner/appellant, or at least determined that the issue was important enough to address, and is expected to hear the case in the court's 2017-2018 term. As is its practice, the Supreme Court made no comment as to why the review was granted only as to question 2 and not the other questions presented.

Analysis

The high court's decision not to consider questions 1 or 3 in the certiorari petition may be as interesting as the court's decision to consider question number 2. The issue of when and under what circumstances claims filed in bankruptcy are permanently tainted by their holders at any particular time is one that runs through the Bankruptcy Code, and has produced a host of difficult-to-reconcile decisions in the areas of, among others, equitable subordination under Section 510(c) (is the "bad actor's" claim subject to subordination even after it has been transferred to an innocent third party?) and Section 502(d), which generally disallows otherwise valid claims of recipients of preferential and fraudulent transfers until those are returned to the estate (does that apply even when the claim is assigned to a third party that received no such transfers?).[2]

A Supreme Court decision on whether "insider" status can travel with the claim potentially would have been useful for developing a coherent doctrine governing when a claim's infirmities that are based on the identity or actions of the holder do and do not travel with the claim after it has been transferred, and may have tipped the court's hand as to how it would address other infirmities in future cases. The court's decision not to address that issue in this context, however (rather than in the context of Sections 502(d) or 510(c)) may have been based on a unique aspect of a claim associated with insider status that might not apply in other situations — specifically, that the policy considerations that would have led the legislature to treat an insider's acceptance of a Chapter 11 plan with suspicion ostensibly go away once the right to vote that claim is being exercised by a true noninsider.

Similarly, the other question not addressed by the court, which sought to place some defining lines around the rather vague notion of a "nonstatutory insider," a term defined nowhere in the Bankruptcy Code (hence, the moniker "nonstatutory"), potentially would have had application wherever insider status is relevant in the Bankruptcy Code (including, for example, in the area of fraudulent transfer law). The court chose not to address this question either, perhaps believing that the petitioner had not demonstrated a genuine circuit split on this issue.

However, what the court was apparently concerned enough about to grant certiorari over was the concern that animated the dissenting judge in the case, which is that the specific facts in Village at Lakeridge were very difficult to reconcile with the notion that the transferred $2.6 million unsecured claim, which was sold to the transferee for $5,000 and which the transferee then refused to sell to the petitioner even for a high multiple of what he paid for it, was voted in any manner other than as a proxy for the insider transferor. In the words of the dissenting Ninth Circuit judge, "it is clear that the transaction cannot be understood as a primarily economic proposition on Rabkin's [the transferee'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. … I don't have to know the precise details of the relationship between Rabkin and Bartlett [the transferor's principal] 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."[3]

Given the facts here, the Supreme Court may have had concern about the level of deference required, and employed, by the two lower appellate courts to the findings of the bankruptcy court in order to permit the conclusion that the transferee was not a nonstatutory insider. Village at Lakeridge contains some back-and-forth between the majority and dissent about whether or not the case presented a "mixed question of law and fact" that could be subjected to de novo review, and it may be this point that the court wishes to clarify, with consequences that may, depending on how broadly or narrowly the case is decided, affect areas of the law beyond bankruptcy specifically, by implicating general principles of appellate review much more broadly.

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1. Village at Lakeridge, 814 F.3d at 1006 (J. Clifton, dissenting); (App. A, p. 24a).
2. Similar issues arise under Section 507(a), which deals with priority claims (e.g., employee wage claims), although the question presented there is somewhat different (courts generally assume that assigned priority claims are entitled to retain their priority, but often struggle to distinguish between assignment and subrogation for that purpose).
3. Village at Lakeridge, 814 F.3d at 1005 (J. Clifton, dissenting); (App. A., p. 21a).

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