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SUPREME COURT APPROVES DEFERENTIAL REVIEW OF BANKRUPTCY-COURT DETERMINATIONS ON "INSIDER" STATUS

To Our Clients and Friends:

On March 5, 2018, the U.S. Supreme Court issued a decision in *U.S. Bank N.A. Trustee, By and Through CWCapital Asset Management LLC v. Village at Lakeridge, LLC* (No. 15-1509), approving the application of the clear error standard of review in a case determining whether someone was a "non-statutory" insider under the Bankruptcy Code. We note that the Court's narrow holding only addressed the appropriate standard of review, leaving for another day the question of whether the specific test that the Ninth Circuit used to determine whether the individual was a "non-statutory" insider was correct. The ruling is significant, however, because without the prospect of *de novo* review, a bankruptcy court's ruling on whether a person is a "non-statutory" insider will be very difficult to overturn on appeal—which may have significant impact on case outcomes.

The Bankruptcy Code "Insider"

The Bankruptcy Code's definition of an insider includes any director, officer, or "person in control" of the entity.[1] This definition is non-exhaustive, so courts have devised tests for identifying other, so-called "non-statutory" insiders, focusing, in whole or in part, on whether a person's transactions with the debtor were at arm's length.

Background

In this case, the debtor (Lakeridge) owed money to two main entities, its sole owner MBP Equity Partners for $2.76 million, and U.S. Bank for $10 million. Lakeridge submitted a plan of reorganization, but it was rejected by U.S. Bank. Lakeridge then turned to the "cramdown" option for imposing a plan impairing the interests of non-consenting creditors. This option requires that at least one impaired class of creditors vote to accept the plan, excluding the votes of all insiders. As the debtor's sole owner, MBP plainly was an insider of the debtor, within the statutory definition of Bankruptcy Code §101(31)(B)(i)–(iii), so its vote would not count. Therefore, to gain the consent of the MBP voting block to pass the cramdown plan, Kathleen Bartlett (an MPB board member and Lakeridge officer), sold MPB's claim of $2.76 million to a retired surgeon named Robert Rabkin, for $5,000. Rabkin agreed to buy the debt owed to MBP for $5,000 and proceeded to vote in favor of the proposed plan as a non-insider creditor.

U.S. Bank, the other large creditor, objected, arguing that the transaction was a sham and pointing to a pre-existing romantic relationship between Rabkin and Bartlett. If Rabkin were an officer or director of the debtor, Rabkin's status as an insider would have been undisputed. But because Rabkin had no formal relationship with the debtor, the bankruptcy court had to consider whether the particular relationship was

close enough to make him a "non-statutory" insider. The bankruptcy court held an evidentiary hearing and concluded that Rabkin was not an insider, based on its finding that Rabkin and Bartlett negotiated the transaction at arm's length. Because of this decision, the Debtor was able to confirm a cramdown plan over the objection of the senior secured lender.

The Ninth Circuit affirmed the bankruptcy court's ruling, holding that that the finding was entitled to clear-error review, and therefore would not be reversed.

The Supreme Court Holds That the Standard of Review Is Clear Error

On certiorari, the Supreme Court, in a unanimous opinion, took pains to emphasize that the sole issue on appeal was the appropriate standard of review, and not any determination of the merits of the "non-statutory" insider test that the Ninth Circuit had applied to determine whether Rabkin was an insider. The Supreme Court held that the Ninth Circuit was correct to review the bankruptcy court's determination for "clear error" (rather than *de novo*).

The Court discussed the difference between findings of law—which are reviewed *de novo*—and findings of fact—which are reviewed for clear error. The question in this case—whether Rabkin met the legal test for a non-statutory insider—was a "mixed" question of law and fact. Courts often review mixed questions *de novo* when they "require courts to expound on the law, particularly by amplifying or elaborating on a broad legal standard."[2] Conversely, courts use the clearly erroneous standard for mixed questions that "immerse courts in case-specific factual issues."[3] In sum, the Court explained, "the standard of review for a mixed question all depends on whether answering it entails primarily legal or factual work."[4]

Choosing between those two characterizations, the Court chose the latter. The basic question in this case was whether "[g]iven all the basic facts found, Rabkin's purchase of MBP's claim [was] conducted as if the two were strangers to each other."[5] Because "[t]hat is about as factual sounding as any mixed question gets,"[6] the Court held that the clear error standard applied.

The Supreme Court Avoids Adjudicating a Potentially Significant Circuit Split on Tests Used to Determine Non-Statutory Insiders

All nine of the justices joined Justice Kagan's opinion. However, the concurring opinion from Justice Sonia Sotomayor (joined by Justices Anthony Kennedy, Clarence Thomas and Neil Gorsuch) suggests grave doubts about the coherence of the Ninth Circuit's standard for assessing non-statutory-insider status. Nevertheless, Justice Sotomayor agreed that resolving the propriety of that standard is not a task that warranted the Supreme Court's attention.

Impact of *US Bank*

While this case does not break new ground, it firmly establishes the bankruptcy courts' authority to make these determinations and limits appellate review. This opinion may embolden appellants (and bankruptcy courts) to push the envelope in the future. Debtors may be emboldened to seek to use a

variety of affiliate-transaction structures as they seek the keys to confirming cramdown plans over the objections of senior lenders.

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[1] 11 U.S.C. § 101(31)(B)(i)–(iii).

[2] Decision at p. 8.

[3] *Ibid.*

[4] *Id.* at p. 2.

[5] *Id.* at p. 10.

[6] *Ibid*.

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization practice group, or the following authors:

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