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Johnathan D. Green

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AVERTING AN INSIDE JOB: A PROPOSAL TO CHANGE HOW INSIDERS ARE DEFINED IN THE BANKRUPTCY CODE

ABSTRACT

Are you a business debtor with massive unsecured debts and need your cramdown plan approved? Just sell the claims to a friend at a massive discount and have him vote to approve your plan over other creditors' objections. While this sounds absurd, under current insider jurisprudence in chapter 11 bankruptcies, this happens.

In most situations, the Bankruptcy Code prohibits insiders of businesses from seeking preferential treatment from a bankrupt debtor. One way the Code does this is through excluding an insider's vote from the plan approval process in a chapter 11 bankruptcy cramdown. But, if an insider can find a way to escape the narrow statutory insider definition in the Code, then the usual prohibitions on insider conduct may not apply.

In addition to the narrow, specified list of statutory insiders in the Code, courts have crafted various definitions of non-statutory insiders as well. This lack of uniform and predictable application has thwarted one of bankruptcy's main goals: the equitable treatment of creditors. This Comment examines courts' conflicting applications of insider rules, with a focus on chapter 11, and recommends a change to how insiders are defined in the Code to prevent inequitable outcomes for creditors.

I. INTRODUCTION TO CHAPTER 11 AND INSIDERS

A. *A Need for a Change*

The chapter 11 bankruptcy process allows debtors to retain their assets, reorganize their debts, and pay off their creditors according to a plan of reorganization.¹ Chapter 11 is utilized primarily by business debtors to maintain and preserve a functioning company, while modifying otherwise overwhelming debts, by spreading payments out over a repayment period or changing the terms of various debts according to a plan.² Congress has crafted the Bankruptcy Code (the Code) to ensure that creditors and debtors receive equitable treatment and to minimize abusive use of Code provisions.³ One area of potential abuse that Congress addresses through the Code is the area of insiders.

Insiders are persons (which the Code defines broadly as including individuals and entities)⁴ who have clear self-interest in the outcome of a bankruptcy proceeding, such as directors, officers, or persons in control of a corporate debtor.⁵ Because of their close affiliation and personal stake in the reorganization, insiders are specifically prevented, among other things, from voting to approve a reorganization plan if they are also creditors holding any voting claims.⁶ Under the current statutory scheme, some individuals who appear to be insiders, but technically do not meet the statutory criteria, are permitted to vote on a reorganization plan and potentially force an otherwise non-confirmable plan upon dissenting creditors.⁷ This Comment will argue that this practice is abusive and thwarts Congress's intent to draft a Code that treats similarly situated creditors equitably.

To address this problem, Congress should amend the Code by changing how the Code defines "insider." Rather than the current *inclusive* list that allows courts to interpret whether a person fits the strict insider definition (thereby becoming statutory insiders), or is similar enough to be considered a non-statutory insider, Congress should define "insider" exclusively. This

¹ See U.S. COURTS, BANKRUPTCY BASICS 3 (2d ed. 1998).

² *Id.*

³ See Bankruptcy Abuse Prevention and Consumer Protection Act, 109 P.L. 8, 119 Stat. 23, 109 P.L. 8, 2005 Enacted S. 256, 109 Enacted S. 256, drafted primarily to prevent abuse.

⁴ 11 U.S.C. § 101(41) (2012).

⁵ See *id.* § 101(31).

⁶ See *id.* § 1129(a)(10).

⁷ See U.S. Bank N.A. v. Vill. at Lakeridge, LLC (*In re Vill. at Lakeridge, LLC*), 814 F.3d 993, 998 (9th Cir. 2016).

exclusive definition will improve predictability, prevent abusive claim selling by debtors, and better meet Congress's goals for chapter 11 bankruptcy.

This Comment proceeds by detailing the chapter 11 process, continues with an examination of the Code's current definition of "insider," and then explains the background and purposes of chapter 11 bankruptcy. Next, this Comment will set up the conflict between courts in defining non-statutory insiders, with some courts taking a liberal view of insiders and others taking a narrow view, and examine how commentators and courts alike have predicted future litigation and possible abuse. In the final section, this Comment will propose a solution that modifies how the Code defines insider so as to prevent these conflicting interpretations and potential abuses. This Comment will conclude with an explanation of the mechanics of the new definition's application, an examination of the benefits and potential drawbacks of a new definition, and the issues that will continue to inevitably arise with insider determinations.

B. The Chapter 11 Bankruptcy Process

1. Restructuring and the Automatic Stay

Chapter 11 bankruptcy provides for debt restructuring of businesses under a court confirmed plan of reorganization to repay creditors.⁸ While a chapter 7 bankruptcy proceeding is also available for business debtors, a chapter 11 bankruptcy allows a company to continue to operate during and (hopefully) after bankruptcy, thus avoiding asset liquidation and closing of the business.⁹ In a chapter 7, there is no chance of saving the business because all of the debtor company's assets are liquidated to satisfy its debts.¹⁰ Under a chapter 11, the debtor maintains the business and its assets and "may seek an adjustment of debts, either by reducing the debt or by extending the time for repayment, or may seek a more comprehensive reorganization."¹¹ Even if a debtor is not able to emerge successfully from a chapter 11 bankruptcy, the debtor is nonetheless protected by the automatic stay¹² from the time the debtor

⁸ 11 U.S.C. § 1129 (2012).

⁹ See BANKRUPTCY BASICS, *supra* note 1, at 3.

¹⁰ See *id.* at 11.

¹¹ *Id.*

¹² 11 U.S.C. § 362(a) (2012). Other than an ultimate discharge, the automatic stay is the greatest protection provided by bankruptcy and a major objective in and of itself for debtors. The automatic stay prevents creditors from taking many actions, including attempting to collect debts from the debtor, repossessing property from a debtor, and enforcing liens against any of the creditor's property.

files the petition until discharge, dismissal, or conversion to chapter 7.¹³ This at least gives the debtor a significant amount of time¹⁴ to try to save the business by providing a “breathing spell . . . during which negotiations can take place to try to resolve the difficulties in the debtor’s financial situation.”¹⁵ Ultimately, if a business is insolvent, but management is determined to continue operating in order to eventually salvage the company, chapter 11 is likely the proper choice.

2. *Classifying Claims, Impairment, and Voting*

The chapter 11 process involves preparing a reorganization plan, identifying creditor claims, determining if claims are impaired, and claim voting to approve or disapprove the plan. To begin a chapter 11 bankruptcy, a business files a petition with the bankruptcy court where the business is domiciled.¹⁶ A chapter 11 debtor, known as a debtor in possession,¹⁷ must file a number of additional documents and schedules that give creditors and the courts an understanding of the business’s financial situation.¹⁸ One critical document that the debtor in possession must file is a plan of reorganization, which specifically proposes how the debtor intends to modify its debts based on the type of each creditor’s claims.¹⁹ The debtor’s plan must assemble each creditor’s claim, defined broadly in the Code as a “right to payment,²⁰” into a class.²¹ Each claim represents a creditor’s right to vote in the ultimate acceptance or rejection of a plan,²² so each creditor may have a number of claims based on distinct rights to payment.

¹³ 11 U.S.C. §§ 362(c)(2)(A)–(C) (2012).

¹⁴ *See id.* § 1121. From the time a debtor files a chapter 11 petition they have an exclusive 120-day period to file a plan of reorganization, which under certain circumstances may be extended by a court to up to 18 months.

¹⁵ BANKRUPTCY BASICS, *supra* note 1, at 27.

¹⁶ *Id.* at 2.

¹⁷ *Id.* at 25.; 11 U.S.C. § 1107(a) (2012). A “debtor in possession” under chapter 11 is the term used to describe the debtor who is performing the requirements of bankruptcy while also retaining possession of property of the estate and other assets. This is in contrast with other chapters, such as chapter 7, where a trustee is assigned to manage the process on behalf of the debtor as a disinterested third party.

¹⁸ *See* BANKRUPTCY BASICS, *supra* note 1, at 25.; 11 U.S.C. § 1121(a) (2012). The debtor files a plan. 11 U.S.C. § 1125 (2012). The debtor must also provide a written disclosure statement that provides “adequate information” of the debtor’s financial situation.

¹⁹ BANKRUPTCY BASICS, *supra* note 1, at 25.

²⁰ 11 U.S.C. § 101(5)(A) (2012). The Code uses a broad definition of claim which encompasses almost any right to payment, “whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured;”

²¹ *Id.* § 1123(a)(1).

²² *See id.* § 1129(a) (describing that each “holder of a claim or interest” gets to vote to accept a plan of reorganization).

In addition to classifying claims, the Code specifies that a plan must provide for equal treatment of each class of claims and provide “adequate means for the plan’s implementation.”²³ The plan must also specify each class of claims as either impaired or unimpaired.²⁴ In essence, impaired claims are those claims held by creditors who are getting a proposed amount that is less than what was initially bargained for.²⁵ As § 1124(a)(1) puts it, a creditor’s claim under the plan is not impaired if the plan “leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest,”²⁶ or otherwise restores the claim to its unaltered state.²⁷ Therefore, depending on the treatment of each creditor’s claim, it will be classified in the debtor’s plan as either impaired or unimpaired.²⁸

The Code specifies that unimpaired claims are presumed to have accepted the plan because these creditors are getting the full benefit of their bargain.²⁹ Thus, unimpaired claims are not entitled to vote on the plan.³⁰ Claims that receive no payment are likewise presumed to have rejected the plan, and these claims are also not entitled to vote.³¹ Under the plan, any claim holder who gets more than nothing but less than the full amount of its claim is considered to have an impaired claim and must vote on the plan with the other claim holders within their class.³² Impaired claims, therefore, are the target audience of the debtor’s plan of reorganization because, as we will see, the votes of these impaired claim holders can ultimately decide whether the business can successfully reorganize.

²³ *Id.* § 1123(a)(5). The “adequate means” may be almost any disposition of the debtor’s assets, up to and including complete liquidation. The Code provides a non-exclusive list of these “adequate means” including retention of property by the debtor, transfer of property by the debtor, merger of the debtor with another entity, sale of property, satisfaction of a lien, and others.

²⁴ *Id.* § 1123(a)(2).

²⁵ *See id.* § 1124.

²⁶ *Id.* § 1124(1). For example, if a creditor holds an unsecured claim of \$5,000 with an interest rate of 5%, payable in 5 years, then this claim will be unimpaired if the debtor’s plan leaves that claim exactly at the same terms as of the effective date of the plan. Any modification of the contractual rights of that creditor’s claim, even more favorable adjustment, will make the claim impaired.

²⁷ *Id.* §§ 1124(2)(A)–(E). This provision generally deals with situations where a debt has been accelerated due to a debtor default. If the default is cured (A) the maturity is reinstated as it originally existed; (B) any damages as result of the claim holder’s reliance on the acceleration are compensated; (C) any nonmonetary obligations are compensated; (D) and the claim is not otherwise modified; (E) then the claim will be deemed to be unimpaired.

²⁸ *Id.* § 1124.

²⁹ *Id.* § 1126(f).

³⁰ *See id.*

³¹ *See id.* § 1126(g).

³² *Id.* § 1126(a).

Once a claim has been labeled as impaired or unimpaired under § 1124, titled “Impairment of claims or interest,” the claim will be put into a class according to § 1122, titled “Classification of claims or interests.”³³ Section 1122 requires that a plan “may place a claim . . . in a particular class only if such claim . . . is substantially similar to the other claims” within the same class.³⁴ Because the substantially similar requirement is not defined in the Code, the bankruptcy courts have been left to interpret its meaning; the courts have “broad discretion in matters of classification.”³⁵

Generally, courts interpret the substantially similar requirement by evaluating “the legal attributes of the claims, not who holds them,” focusing on how the “legal character of claim relates to debtor’s assets and whether claims exhibit similar effect on the bankruptcy estate.”³⁶ While all claims in a class must be substantially similar, not all claims that are substantially similar are required to be placed in the same class.³⁷ Debtors are given some latitude to classify similar claims in different classes, so long as the purpose for the different classification is not manipulation of voting.³⁸

Once claims have been classified based on their nature, the class must then vote on the plan.³⁹ This voting proceeds under § 1126, titled “Acceptance of plan” which governs the requirements of voting to approve or reject a plan.⁴⁰ For a class to accept a plan, two conditions must be met. First, two-thirds or more of the value of the class must approve the plan.⁴¹ Second, more than one-half in number of claims in the class who are impaired must approve the plan.⁴² If both the value (two-thirds) of the “yes” votes and number (one-half) of “yes” votes meets these conditions, the class will be deemed to have accepted the

³³ *Id.* §§ 1122(a)–(b).

³⁴ *Id.* § 1122(a).

³⁵ *Hanson v. First Bank of S.D., N.A.*, 828 F.2d 1310, 1313 (8th Cir. 1987).

³⁶ *In re Tribune Co.*, 476 B.R. 843, 855 (Bankr. D. Del. 2012) (citing *W.R. Grace & Co.*, 475 B.R. 34 (D. Del. 2012)).

³⁷ *Hanson*, 828 F.2d at 1313.

³⁸ *See id.* The Court in *Hanson* noted that debtors’ discretion is not unlimited. A debtor cannot manipulate the classes to create one class of approving claims to force overall approval of a plan through a cramdown proceeding.

³⁹ *See* 11 U.S.C. § 1126(a) (2012).

⁴⁰ *Id.* § 1126.

⁴¹ *Id.*

⁴² *Id.*

plan.⁴³ Only those claims that actually cast a vote count toward the requisite one-half and two-thirds calculation.⁴⁴

Once all claims have been voted, the next step is plan confirmation under § 1129, titled “Confirmation of plan.”⁴⁵ This section states that for the overall plan to be confirmed, all of the impaired classes must accept the plan under § 1129(a)(8).⁴⁶ Once the classes of impaired claims have accepted the plan, a bankruptcy judge must evaluate the plan and confirm it as long as it meets the other requirements of § 1129(a).⁴⁷ This subsection has fifteen requirements for plan confirmation, only one of which is plan acceptance by the impaired classes.⁴⁸ The other significant requirements include that the plan and the proponent comply with applicable provisions of the Code, that the plan has been proposed in good faith, that the debtor has disclosed the identities and affiliations of any individuals proposed to serve in key management positions after confirmation, and that each impaired class receive a certain minimum amount of payment in the plan, among others.⁴⁹

Of these many requirements, the key provision for the purposes of this Comment, in addition to § 1129(a)(8) requiring class acceptance, is under subsection (a)(10), which states “[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.”⁵⁰ Ultimately, under a § 1129(a) confirmation, the court will approve a plan if, in addition to the technical and statutory requirements, the debtor can create a restructured debt situation that is financially acceptable to a majority of its creditors, as evidenced by each class’s approval of the plan under § 1129(a)(8).⁵¹

⁴³ *Id.*

⁴⁴ *See id.* If a class has ten claims, each valued at \$100, and each claim holder casts a vote, then at least six must approve of the plan and the value of the approval votes must equal at least \$700. Practically then, the plan must garner seven approval votes in that class to be accepted. However, if only three claim holders cast a vote, then only two yes votes are required to approve a plan for that class.

⁴⁵ *See id.* § 1129. This section governs how the bankruptcy court confirms a plan. If all the requirements of subsection (a) or (b) are met, then the court “shall” confirm the plan.

⁴⁶ *Id.* § 1129(a)(8)(A).

⁴⁷ *Id.* § 1129(b)(1).

⁴⁸ *Id.* §§ 1129(a)(1)–(16).

⁴⁹ *See id.*

⁵⁰ *Id.* § 1129(a)(10).

⁵¹ *Id.* § 1129(a). The statute states that a court “shall” confirm the plan if the requirements of subsection (a) are met, this removes any discretion of the court.

3. *The Cramdown*

If all classes do not approve the plan, the debtor is not out of luck; a cramdown is possible. So long as one class of creditors approves a plan, a court may confirm a plan as a “cramdown”⁵² under § 1129(b). In a cramdown, the Code removes the requirement of § 1129(a)(8)—requiring the approval of *all* classes—leaving only § 1129(a)(10) as the class voting standard. This alternate approval standard requires only *one* impaired class to accept a plan to move on to confirmation so long as the plan meets two additional “fairness” requirement.⁵³ All other requirements of the typical confirmation proceeding under § 1129(a) remain, but the proponent must show compliance with the additional provisions of § 1129(b).⁵⁴

These additional provisions set a higher standard for the treatment of the non-accepting classes.⁵⁵ Where under subsection (a) the plan was required to only have a good faith standard and meet the additional statutory minimums, subsection (b) requires that, with respect to the non-approving classes, the plan “does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”⁵⁶ Subsection (b) imposes these additional requirements on the debtor to ensure that a cramdown plan treats secured claim holders, unsecured claim holders, and interest holders in a more favorable manner based on their type of claim.⁵⁷

This higher standard of favorable treatment proposed in the plan is that the plan must be (1) fair and equitable and (2) must not discriminate unfairly with regard to the classes being crammed down against.⁵⁸ The Code specifically defines what it considers fair and equitable treatment, but does not define how courts are to evaluate whether the plan discriminates unfairly.⁵⁹ For example, if a secured claim holder is being crammed down against, to be considered fair and equitable under § 1129(b)(2)(A) the plan must provide:

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the

⁵² *See id.* § 1129(a)(8); H.R. 95-595, 95th Cong., 1st Sess. (1977).

⁵³ *Id.* § 1129(a)(8).

⁵⁴ *Id.* § 1129(b).

⁵⁵ *See id.*

⁵⁶ *Id.* § 1129(b)(1).

⁵⁷ *See id.* §§ 1129(b)(2)(A)–(C).

⁵⁸ *Id.*

⁵⁹ *Id.*

debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, or any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.⁶⁰

This high standard of fair and equitable, although relatively complicated, ensures that holders of claims being crammed down against receive at least a minimum amount of their claim (for secured claims) or receive some amount at the expense of junior claim holders (for unsecured claims).⁶¹

When it comes to the requirement that the plan must not discriminate unfairly against a class being crammed down against, the Code provides no definition and has left it up to the courts to define.⁶² One bankruptcy court in the Southern District of Texas has adopted a popular definition from well renowned bankruptcy scholar Bruce Markell.⁶³ This test was described in *In re Sentry Operating Co of Tex. Inc.* as follows:

. . . a [c]hapter 11 plan is presumptively subject to denial of confirmation on the basis of unfair discrimination, even though it provides fair and equitable treatment for all classes, when there is (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of

⁶⁰ *Id.* § 1129(b)(2)(A).

⁶¹ *See id.* § 1129(b)(2)(A)–(C).

⁶² *See In re Sentry Operating Co. of Tex., Inc.*, 264 B.R. 850, 863–64 (Bankr. S.D. Tex. 2001) (noting that “fair and equitable” is defined, but “discriminates unfairly” is not).

⁶³ *See id.* at 863.

materially greater risk to the dissenting class in connection with its proposed distribution.⁶⁴

Ultimately, a debtor is not required to craft a plan that every class accepts.⁶⁵ However, a plan that is rejected by a class must meet both the higher cramdown standards examined above⁶⁶ and every other requirement of § 1129(a) to be confirmed.⁶⁷ In many single asset bankruptcy proceedings (i.e., where a debtor owns one large asset, such as an office building), these higher standards have less practical effect on plan confirmation because there will usually be only one impaired secured creditor class and one unsecured impaired class.⁶⁸

Regardless of the type of debtor, in every cramdown proceeding, as well as in a regular § 1129(a) proceeding, all claim holders in a class may vote on the plan except those creditors classified as “insiders.”⁶⁹ This point becomes more important under a cramdown because in a typical approval process, where all classes accept the plan, there is not necessarily a requirement that there be no insiders in any class, but that only one of the (potentially many) impaired classes be free of insider votes.⁷⁰ Thus, being labeled an insider can have a significant effect on whether a plan is confirmed by the court in a cramdown proceeding.

C. *Insiders and their Difficulties*

Currently, the definition of insiders is based on the type of entity of the debtor and the entity’s relationship to the creditor.⁷¹ Insiders are defined in

⁶⁴ *Id.* (quoting Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227 (1998)).

⁶⁵ 11 U.S.C. § 1129(b)(1) (2012).

⁶⁶ *Id.*

⁶⁷ *Id.* § 1129(a).

⁶⁸ *Cf. Fichter Ltd. v. Teachers Ins. & Annuity Ass’n of Am. (In re Fichter Ltd.)*, 118 F.3d 635 (9th Cir. 1997). Where the major secured creditor (Teachers) had a \$17 million claim in its class and the only other impaired class was unsecured with a value of only about \$22,500. Here the “fair and equitable” requirement would require that Teachers retain a lien on the property until paid, which was already part of the debtor’s plan, while the “unfair discrimination” requirement did not apply because there were no other classes within the same priority.

⁶⁹ 11 U.S.C. § 1129(a)(10) (2012).

⁷⁰ Compare 11 U.S.C. § 1129(a)(10) (2012), and 11 U.S.C. § 1129(b) (2012), with 11 U.S.C. § 1129(a)(8) (2012). Under a normal approval process, a plan may contain, for example, four impaired classes of claims. Assuming all four classes reach the required approval levels, there still only must be one of those four that approves without counting the insider vote. This is different in a cramdown, where the debtor is forcing the plan onto (potentially many) disapproving creditors. Here the one and only accepting class, must also be the class that is free of insider votes.

⁷¹ 11 U.S.C. § 101(31) (2012).

§ 101(31) by listing examples of insiders based on the kind of legal entity of the debtor.⁷² If the debtor is an individual, an insider is defined as a “(i) relative of the debtor or a general partner of the debtor; (2) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer or person in control.”⁷³ The Code continues by defining an insider of a corporation as a “(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of a debtor; (iv) partnership in which the debtor is a general partnership; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer or person in control of the debtor.”⁷⁴ The Code continues with similar definitions if the debtor is a partnership, a municipality, an affiliate, or managing agent of the debtor.⁷⁵

The Code defines insiders in a non-exclusive way by using the word “includes” in the definition.⁷⁶ The use of “includes” means that the list of insiders outlined above is not exclusive, but rather only examples, thus leaving the courts with discretion to interpret into the Code additional examples that sufficiently meet the statute’s intent.⁷⁷ As a result, insiders are generally grouped as “statutory” if they clearly fit into the defined categories listed in the Code and as “non-statutory” if they do not neatly fit into a specified category.⁷⁸

There has been significant debate about what constitutes non-statutory insiders, with some courts using a limited definition and some a more expansive definition.⁷⁹ For example in *Butler v. Shaw*, which is examined more in depth later, the Fourth Circuit crafted a limited definition requiring a party have significant control of the debtor to be considered an insider for voting purposes.⁸⁰ This narrow view is contrasted with *In re Three Flint Hill*, where a friend and business associate of a partnership was deemed to be an insider for voting purposes despite not fitting neatly into the statutory definition.⁸¹ These conflicting interpretations raise confusion and arguably thwart Congress’s

⁷² *Id.*

⁷³ *Id.* § 101(31)(A).

⁷⁴ *Id.* § 101(31)(B).

⁷⁵ *Id.* § 101(31).

⁷⁶ *Id.*

⁷⁷ *Rupp v. United Sec. Bank (In re Kunz)*, 489 F.3d 1072, 1078 (10th Cir. 2007).

⁷⁸ Holly Estes, *Transfer of a Claim Held by Insider Does Not an Insider Make*, 35 AM. BANKR. INST. J. 106, Apr. 2016 at 34, 106.

⁷⁹ See Michael Lichtenstein, *Who Is an Insider For Voting Purposes in a Single Asset Chapter 11?*, 10 J. BANKR. L & PRAC. 279, 281 (2001).

⁸⁰ See *id.*

⁸¹ *Id.* at 286.

goals of having a well-crafted and equitable chapter 11 process because it creates a lack of predictability and uniformity in reorganizations.

D. A Solution to the Insider Problem

Congress should change how an insider is defined in the Code. Specifically, § 101(31) should be amended by removing the word “includes” and adding a provision that defines an insider as “any individual with close personal or financial relationships with the debtor that, as a result of a less than arm’s length transaction, raises a presumption that the individual is beholden to the debtor.” This presumption should be rebuttable, thereby shifting the burden to the would-be insider to present evidence that the transaction was legitimate. This combination of changes will result in an exclusive definition which eliminates the need for courts to classify some insiders as “non-statutory” but still provides flexibility for courts to make a fact-intensive inquiry.⁸² The proposed change will also cast a wider net by having a statutorily set definition, and will reduce the potential for abusive claim sales while furthering Congress’s broad intent of treating similarly situated creditors similarly.⁸³

II. BACKGROUND LEGAL DOCTRINES AND CURRENT STATE OF CASE LAW

A. Equitable Distribution and Claim Selling

There are two fundamental background legal doctrines and a series of cases that will help frame this issue and establish the current legal situation regarding bankruptcy insiders. These overarching principles are (1) equitable distribution⁸⁴ and (2) the buying and selling of creditor claims.⁸⁵ Both are interwoven into most insider cases.

The first, equitable distribution, is a fundamental principle of bankruptcy with specific salience in chapter 11 contexts. This is because the definitive goal of a restructuring is to “provide fair remedies to creditors generally,” which includes an equitable distribution of debtor’s assets to creditors through a valid

⁸² See *In re Vill. at Lakeridge, LLC*, 814 F.3d at 1000. The court noted that whether a creditor is an insider is factual inquiry that courts must conduct each time there is a claim that a party is a non-statutory insider. This fact intensive inquiry cannot be bypassed as a matter of law under the current definition.

⁸³ See *In re Kunz*, 489 F.3d at 1079.

⁸⁴ *Id.* at 1074.

⁸⁵ See *In re Figter Ltd.*, 118 F.3d 635 (describing the acceptability of claims buying and selling under certain conditions).

plan of debt restructuring and payments.⁸⁶ The Tenth Circuit, in *Rupp v. United Security Bank (In re Kunz)*, explained that a goal of adherence to the equitable distribution principle is to “prevent, within limits, a debtor from giving preferred treatment to some creditors in derogation of the interests of other, similarly situated creditors.”⁸⁷ The Code specifically requires this equal treatment in a chapter 11 context in § 1123, which, in part, requires that a plan “provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such claim or interest.”⁸⁸ Thus, without an acceptably fair and equitable distribution of a debtor’s assets under a chapter 11 plan, no creditors will vote to accept the plan and it is unlikely to be confirmed.⁸⁹

The second essential background doctrine is claim buying and selling.⁹⁰ Claim buying occurs when a creditor or third party purchases the claims of other creditors to secure the voting rights of those claims under a chapter 11 bankruptcy.⁹¹ In *Figter Ltd. v. Teachers Ins. Annuity Ass’n of Am (In re Figter)*, the Ninth Circuit clearly authorized these purchases for legitimate purposes.⁹² In *Figter*, the owner of an apartment development filed for chapter 11 bankruptcy and as part of its restructuring plan sought to convert the apartments into condominiums against Teachers Insurance Annuity Association of America’s (Teachers) wishes.⁹³ Despite their objections, Figter intended to cramdown against Teachers (which held a \$17.9 million secured claim) by gaining approval of the remaining creditors.⁹⁴

If these remaining creditors approved the plan, regardless of the amount of their collective claims, the plan could be crammed down against Teachers.⁹⁵ These creditors all held comparatively small unsecured claims, and the value of these claims in total was approximately \$22,500.⁹⁶ To prevent Figter’s

⁸⁶ *In re Kunz*, 489 F.3d at 1074–75.

⁸⁷ *Id.* at 1075.

⁸⁸ 11 U.S.C. § 1123(a)(4) (2012).

⁸⁹ *See id.* § 1129 (listing the requirements for a confirmable plan, including acceptance by creditors).

⁹⁰ *See generally In re Figter Ltd.*, 118 F.3d 635.

⁹¹ *Cf. id.* (Teachers Insurance and Annuity Association of America purchased unsecured claims of other creditors to increase its voting stake in Figter’s chapter 11 reorganization.).

⁹² *Id.* at 639.

⁹³ *Id.* at 637.

⁹⁴ *Id.*

⁹⁵ *See* 11 U.S.C. § 1129 (2012) (allowing a plan to be confirmed in the face of a disapproving creditor if at least one impaired class votes to approve the plan).

⁹⁶ *In re Figter Ltd.*, 118 F.3d at 637. Here, Teachers purchased twenty-one of thirty-four claims (after offering to buy all of them) valued at approximately \$15,000, making the total amount of all thirty-four claims somewhere in the range of \$15,000 to \$22,500.

cramdown against them, Teachers offered to purchase all of these unsecured claims (at a higher price than in Figter’s chapter 11 plan) and thereby obtain the votes of each claim to vote against Figter’s plan.⁹⁷ Teachers was able to purchase twenty-one of the thirty-four unsecured claims,⁹⁸ which was enough in number and value to prevent Figter’s cramdown.⁹⁹

The *Figter* court allowed Teachers to block this cramdown plan so long as the claims were not purchased in “bad faith” or for an “ulterior motive.”¹⁰⁰ Figter argued that the mere fact that Teachers purchased the unsecured claims for the express purpose of preventing the plan’s confirmation was evidence of bad faith.¹⁰¹ The court rejected this argument.¹⁰² Bad faith, the court reasoned, would be present if a debtor’s competitor or some other third party purchased these claims to block the confirmation, but in this case the purchasing party was already a creditor and was seeking to advance its own interests in its “fair share of the debtor’s estate.”¹⁰³

Figter also argued that Teachers should only be allowed one vote despite purchasing twenty-one claims.¹⁰⁴ This argument was similarly rejected because the Code specifically provides that votes are tallied by claims rather than by creditors, so the fact that one creditor held twenty-one claims did not preclude that creditor from voting twenty-one times.¹⁰⁵ Ultimately, the court approved claim selling and purchasing so long as the motive of the purchaser is not bad faith.¹⁰⁶ This decision paved the way for future claim selling and the concept is important in the context of insiders as discussed below in the *Lakeridge* case.¹⁰⁷

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ See 11 U.S.C. § 1126(c) (2012). As stated previously, this provision requires greater than one-half in number and at least two-thirds in dollar amount of a class to approve a plan. Teacher’s twenty-one purchased claims valued at nearly \$15,000 was sufficient to prevent this approval.

¹⁰⁰ *In re Figter Ltd.*, 118 F.3d at 639.

¹⁰¹ *Id.* at 638.

¹⁰² *Id.* at 641.

¹⁰³ *Id.* at 639.

¹⁰⁴ *Id.* at 641.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 640.

¹⁰⁷ See *In re Vill. at Lakeridge, LLC*, 814 F.3d at 999–1000. In this case, claims are validly purchased by a third-party.

B. Competing Interpretations of Insiders in the Courts

In addition to the principles of equitable distribution and claim selling, there are a significant number of cases (detailed below) that exemplify the competing and non-uniform interpretations among courts when resolving cases with insider issues.¹⁰⁸ Generally, courts either interpret the insider definition narrowly or broadly. Courts that narrowly define insiders tend to be more common in the chapter 11 context, such as the Ninth Circuit in *In re Lakeridge*.¹⁰⁹ However, a few courts, such as the bankruptcy court for Maryland, do not follow this trend. There the court, in a chapter 11 proceeding, interpreted the non-statutory insider definition broadly in *In re Three Flint Hill Ltd. P'ship*.¹¹⁰

Issues with insiders arise in areas of bankruptcy outside of the chapter 11 cramdown context as well.¹¹¹ Courts have similarly struggled with competing interpretations of non-statutory insiders, but in these non-chapter 11 contexts, courts tend to have a broader insider interpretation.¹¹² Examples of this more inclusive interpretation of insider include, *Schubert v. Lucent Tech. Inc. (In re Winstar Commc'n)*, and *Unencumbered Assets Trust v. JP Morgan Chase Bank (In re Nat'l Century Fin. Enters.)*,¹¹³ which both concern voiding asset transfers to insiders made on the verge of a bankruptcy filing.¹¹⁴ However, the Fourth and Tenth Circuits buck this trend as well, as exemplified in *Butler v. Shaw Inc.*, and in *Rupp. v. United Sec. Bank (In re Kunz)*.¹¹⁵ In these cases, the courts narrowly interpreted the insider definition.¹¹⁶ After an examination of

¹⁰⁸ Compare *In re Vill. at Lakeridge, LLC*, 814 F.3d at 999–1001, with *Schubert v. Lucent Tech., Inc. (In re Winstar Commc'n, Inc.)*, 2003 Bankr. LEXIS 766, at *24–27 (U.S. Bankr. D. Del. May 29, 2003).

¹⁰⁹ See generally *In re Vill. at Lakeridge, LLC*, 814 F.3d 993. This case is illustrative of courts that narrowly define non-statutory insiders in the chapter 11 context, finding that a purported insider who purchased claims in order to effectuate a cramdown was not an insider.

¹¹⁰ *Three Flint Hill Ltd. P'shp. v. Prudential Ins. Co. (In re Three Flint Hill Ltd. Pshp.)*, 213 B.R. 292, 299 (D. Md. 1997).

¹¹¹ 11 U.S.C. § 547 (2012); 11 U.S.C. § 548 (2012).

¹¹² See *Anistine v. Carl Zeiss Meditec AG (In re U.S. Medical, Inc.)*, 531 F.3d 1272, 1279 (10th Cir. 2008).

¹¹³ See Rich Mullen, *You Asked Your Buddy to Do What? Non-Statutory Insiders and Vote Designation*, THE WEIL BANKRUPTCY BLOG, <https://business-finance-restructuring.weil.com>; see also *Unencumbered Assets Trust v. JP Morgan Chase Bank (In re Nat'l Century Fin. Enters.)*, 604 F. Supp. 2d 1128, 1162 (So. Dist. OH 2009). This blog post examines a chapter 11 case citing support from non-chapter 11 cases, and *In re Nat'l* exemplifies a non-chapter 11 transfer voiding case, which will be further examined below.

¹¹⁴ See 11 U.S.C. § 547(b) (2012). This provision allows a trustee (the administrator of a chapter 7 liquidation) to void any transfer of property made to an insider within one year of the debtor's filing date.

¹¹⁵ *Butler v. David Shaw, Inc.*, 72 F.3d 437 (4th Cir. 1996); *In re Kunz*, 489 F.3d at 1074.

¹¹⁶ See *Butler*, 72 F.3d at 442; see also *In re Kunz*, 489 F.3d at 1079.

these cases, it will become clear that this body of law is unpredictable and not uniformly applied.

1. Lakeridge and Narrow Insider Definitions

The first case this Comment will examine is *U.S. Bank N.A. v. Vill. at Lakeridge, LLC (In re Vill. at Lakeridge, LLC)*.¹¹⁷ The 2016 *Lakeridge* decision is a prominent example of a court's narrow interpretation of the Code's definition of insider. In *Lakeridge*, the most recent case weighing in on the insider debate, the Ninth Circuit determined that a person with a close personal relationship with an insider who purchases a greatly discounted claim does not become a statutory or non-statutory insider as a result.¹¹⁸ The *Lakeridge* court also held that a claim-purchasing creditor does not become an insider solely by receiving a claim from an insider.¹¹⁹ This 2016 decision was significant because it established relatively clear rules for what a non-statutory insider (at least in the Ninth Circuit) is not, but the court did not clearly define what conduct it would consider worthy of an insider determination.¹²⁰

The Village at Lakeridge LLC was a company that owned and managed a commercial real estate development in Reno, Nevada.¹²¹ Lakeridge purchased the development in 2004 with a package of loans provided by Greenwich Financial Products and MBP Equity Partners.¹²² U.S. Bank subsequently acquired the promissory note, valued at approximately \$10 million, from Greenwich Financial.¹²³ MBP Equity Partners, LLC, the sole member of Villages at Lakeridge, LLC, financed and held the remaining debt valued at approximately \$2.76 million.¹²⁴ In June 2011, Lakeridge filed for chapter 11 bankruptcy disclosing both U.S. Bank and MBP as its only two creditors with U.S. Bank having a fully secured \$10 million claim and MBP having an unsecured \$2.76 million claim.¹²⁵ Months later, MBP sold their \$2.76 million claim for \$5,000.¹²⁶ MBP's board, knowing that it would be unable to vote to approve the Lakeridge chapter 11 plan as an insider, approved the sale of this

¹¹⁷ *In re Vill. at Lakeridge, LLC*, 814 F.3d 993.

¹¹⁸ *Id.* at 1003.

¹¹⁹ *See generally In re Vill. at Lakeridge, LLC*, 814 F.3d 993.

¹²⁰ *Id.* at 1001.

¹²¹ *Vill. at Lakeridge, LLC v. U.S. Bank N.A. (In re Vill. at Lakeridge, LLC)*, 2013 Bankr. LEXIS 2329, at *2 (U.S. B.A.P 9th Cir. 2013).

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.* at *2-3.

claim to a close friend of Katherine Bartlett, a board member of MBP.¹²⁷ This claim was sold to Dr. Rabkin, who had admittedly close personal and business relationships with Ms. Bartlett.¹²⁸ Interestingly, during Dr. Rabkin's deposition, U.S. Bank, through counsel, offered to purchase Dr. Rabkin's claim for \$50,000 and \$60,000; both offers were rejected.¹²⁹

U.S. Bank argued that this claim should be disallowed for voting purposes under the cramdown procedure of § 1129(a)(10) because Dr. Rabkin was either a non-statutory insider, became a statutory insider by purchasing the claim directly from an insider, or the claim was purchased in bad faith.¹³⁰ The bankruptcy court found that Rabkin was not a non-statutory insider because "(a) Dr. Rabkin does not exercise control over the Debtor; (b) Dr. Rabkin does not cohabit with Ms. Bartlett and does not pay Ms. Bartlett's bills or living expenses; (c) Dr. Rabkin has never purchased expensive gifts for Ms. Bartlett."¹³¹ The bankruptcy court further found the claim was not assigned to Rabkin in bad faith.¹³² Ultimately though, the bankruptcy judge ruled that the claim was not entitled to vote because by purchasing the claim from MBP, Rabkin acquired "the same status as a statutory insider when he purchased the claim."¹³³ Lakeridge and U.S. Bank appealed to the Ninth Circuit Bankruptcy Appellate Panel, which overturned the bankruptcy court's finding that Rabkin became a statutory insider solely by assignment of an insider claim.¹³⁴ U.S. Bank appealed to the Ninth Circuit.¹³⁵

The majority of the Ninth Circuit adopted the reasoning of the Bankruptcy Appellate Panel and held that: (a) Rabkin did not acquire insider status solely by purchasing the claim from an insider,¹³⁶ and (b) Rabkin was not a non-statutory insider because his relationship with Bartlett was not sufficiently close to "compare with any category listed in § 101(31)."¹³⁷ The factual examination of Bartlett and Rabkin's relationship, which is triggered by

¹²⁷ *Id.* at *2.

¹²⁸ *Id.* at *3-4.

¹²⁹ *Id.* at *4.

¹³⁰ *Id.* at *37.

¹³¹ *Id.* at *18. Although these factual findings seem odd, apparently these facts indicate that Rabkin and Bartlett were not in a relationship that resembles a marriage or other close family connection.

¹³² *Id.* at *26.

¹³³ *Id.* at *19.

¹³⁴ *Id.* at *23.

¹³⁵ *In re Vill.* at Lakeridge, LLC, 814 F.3d 993.

¹³⁶ *Id.* at 999.

¹³⁷ *Id.* at 1003.

Rabkin's potential non-statutory insider status, failed to raise enough concerns for the Ninth Circuit to deem Rabkin an insider.¹³⁸

Judge Clifton disagreed with the majority's refusal to classify Rabkin as an insider.¹³⁹ Judge Clifton accepted the legal conclusion that "a person does not necessarily become a statutory insider solely by acquiring a claim from a statutory insider," but disagreed with the majority's willingness to discharge Rabkin from the non-statutory category based on the facts presented.¹⁴⁰ Judge Clifton noted that Rabkin paid only \$5,000 for a \$2.76 million claim, there was no offer made to anyone but Rabkin, there was no negotiation over the price, and that Rabkin apparently knew nothing about the financial worthiness of the offer.¹⁴¹ To Judge Clifton, Rabkin should have been deemed an insider.¹⁴² He argued that because the claim sale between MBP and Rabkin met the requirement of a less than arm's length transaction and because Bartlett and Rabkin had a close personal relationship that there was clear concern about the legitimacy of the deal.¹⁴³ In the end, Rabkin's vote was allowed and Lakeridge successfully crammed down against U.S. Bank, thus paving the way for plan confirmation.¹⁴⁴

In addition to this recent case, there are other cases where courts have defined insiders narrowly. In *Butler v. Shaw Inc.*, the Fourth Circuit interpreted an insider definition narrowly, finding that to become a non-statutory insider, one must exercise "sufficient authority over the debtor to unqualifiedly dictate corporate policy and the disposition of corporate assets."¹⁴⁵ Butler sought to void a transfer of money he made to Shaw Inc.¹⁴⁶ Butler owned a struggling car dealership and as part of a deal to prevent failure of the business, Shaw (the former owner of the dealership and current owner of the real property) liquidated a portion of his ownership in the dealership to Butler.¹⁴⁷ Butler then used that cash to pay the arrearage of the rent and other payments that were due.¹⁴⁸

¹³⁸ *See id.* at 1002.

¹³⁹ *Id.* at 1003 (Clifton, J., dissenting).

¹⁴⁰ *Id.* at 1004 (Clifton, J., dissenting).

¹⁴¹ *Id.* (Clifton, J., dissenting).

¹⁴² *Id.* at 1006 (Clifton, J., dissenting).

¹⁴³ *Id.* at 1006–07.

¹⁴⁴ *Id.* at 1003.

¹⁴⁵ *Butler*, 72 F.3d at 442. (citing *In re Babcock Dairy Co.*, 70 Bankr. 662, 666 (Bankr. N.D. Ohio 1986)).

¹⁴⁶ *Id.* at 440.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 439.

Butler subsequently filed for bankruptcy and the trustee attempted to void the transfers to Shaw Inc. under a theory that Shaw was an insider of the debtor by being an affiliate of Butler or by having a close relationship with Butler as a former owner.¹⁴⁹ If found to be an insider, the court could have voided any transfer made within one year of the bankruptcy filing under § 547.¹⁵⁰ The court rejected the affiliate argument because, at the time of the transfer, Shaw was not an affiliate as defined in the Code because he had ceased to be an affiliate the day prior to the challenged transfers.¹⁵¹ The Fourth Circuit rejected Butler's second argument, that Shaw was an insider based on his close relationship with Butler, because the court believed that to be a non-statutory insider, the alleged creditor-insider must have a significant level of control over the debtor.¹⁵² Even though Shaw retained the title of manager at the car dealership,¹⁵³ the court believed that he did not exercise sufficient control over the company and was therefore not an insider.

Lakeridge and *Butler* are just two examples of courts' narrow construction of the non-statutory insider definition in §§ 1129 and 547, respectively. The final narrow interpretation case is *Rupp. v. United Security Bank (In re Kunz)*.¹⁵⁴ In this chapter 7 case, the Tenth Circuit determined that United Security Bank was not an insider of a former member (Mr. Kunz) of a bank's board of directors despite Kunz's title of "director emeritus."¹⁵⁵ Here, Mr. Kunz, a retired banker, filed for chapter 7 bankruptcy and the trustee attempted to void payments that Mr. Kunz had made to United as part of significant debts he owed.¹⁵⁶ In the year prior to Mr. Kunz's filing he paid United Bank approximately \$250,000.¹⁵⁷ The trustee moved to void these payments under § 547(b), which limits preferential transfers on the eve of bankruptcy, because Mr. Kunz was a director of the bank and therefore the bank was an insider to Mr. Kunz.¹⁵⁸ The Tenth Circuit rejected this argument on the grounds that Mr. Kunz was a "director emeritus" which was significantly different than a "director," and therefore did not meet the statutory criteria of an insider.¹⁵⁹ The

¹⁴⁹ *Id.* at 440.

¹⁵⁰ 11 U.S.C. § 547(b)(4)(B) (2012).

¹⁵¹ *Butler*, 72 F.3d at 440.

¹⁵² *Id.* at 442.

¹⁵³ *Id.* at 440.

¹⁵⁴ *In re Kunz*, 489 F.3d 1072.

¹⁵⁵ *Id.* at 1080.

¹⁵⁶ *Id.* at 1075.

¹⁵⁷ *Id.* at 1076.

¹⁵⁸ *Id.* at 1075.

¹⁵⁹ *Id.* at 1080.

court further argued that there was not the required element of control present in the facts to consider United a non-statutory insider.¹⁶⁰

2. Three Flint Hill and Broad Interpretations of Insider

While the Ninth, Fourth, and Tenth Circuit Courts issued rulings that narrowly define insiders, there are those that have rejected a narrow definition of a non-statutory insider. One significant case where a court broadly interpreted a claim transferee as an insider as part of its chapter 11 petition is *Three Flint Hill Ltd. P'Ship v. Prudential Ins. Co (In re Three Flint Hill Ltd. P'ship)*.¹⁶¹

In *Three Flint Hill*, the debtor limited partnership (Three Flint Hill) owned and operated an office building as its sole asset.¹⁶² Prudential made a nearly \$20 million loan to Three Flint Hill to finance the building.¹⁶³ After a few years, the office building's only tenant chose not to renew the lease and the owners were unable to secure a new tenant.¹⁶⁴ Three Flint Hill filed a petition for chapter 11 to prevent foreclosure, and eventually submitted a plan of reorganization.¹⁶⁵

Three Flint Hill's plan proposed to pay less than half of the amount owed on the Prudential loan while fully repaying its unsecured creditors within six months of plan confirmation.¹⁶⁶ Not surprisingly, Prudential voted not to approve this plan, thus requiring a cramdown vote for the unsecured impaired class of claims.¹⁶⁷ Prudential subsequently began the process of purchasing these remaining claims from the various unsecured creditors.¹⁶⁸ At the same time, Three Flint Hill representatives approached a friendly business associate, Mr. Bonderman of Tarrant Limited Partnerships (Tarrant), in order to have Tarrant purchase some of the unsecured claims as well.¹⁶⁹ Bonderman and Tarrant purchased forty-seven claims and voted to approve Three Flint Hill's reorganization plan in a cramdown.¹⁷⁰

¹⁶⁰ *Id.* at 1079.

¹⁶¹ *See In re Three Flint Hill Ltd. P'ship*, 213 B.R. 292.

¹⁶² *Id.* at 295.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 296.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

Prudential objected to Tarrant's vote, arguing that Tarrant and Bonderman were non-statutory insiders of Three Flint Hill.¹⁷¹ The bankruptcy court and, on appeal, the U.S. District Court for Maryland agreed that Tarrant was an insider of Three Flint Hill because Bonderman (as Tarrant's principal) purchased the forty-seven claims as a favor to Three Flint Hill and not because he was making "a carefully reasoned business decision."¹⁷² Thus, Bonderman's relationship with Three Flint Hill, when combined with the less than arm's length transaction, was sufficient to bring Tarrant within the scope of a non-statutory insider despite having no control over Three Flint Hill.¹⁷³

Three Flint Hill directly contrasts with *the Lakeridge* decision, where the court found that a similar transaction between a debtor and friendly business partner did not constitute an insider transaction.¹⁷⁴ It is unclear what caused these courts to come to divergent opinions, but it seems that the courts are left with significant discretion and a lack of a clear analytical structure when determining who is or is not an insider based on the Code's less-than ideal definition. Interestingly, both courts cite the same Code provision,¹⁷⁵ the same legislative history,¹⁷⁶ and even the same case,¹⁷⁷ yet came to different conclusions.

In situations that are outside the chapter 11 claim selling contexts, such as those that involve the voiding of transfers from debtors to insiders, courts appear more willing to broadly construe the definition to capture more insiders.¹⁷⁸ Most insider status litigation occurs in this non-chapter 11 arena.¹⁷⁹ This alternative instance of the Code's use of the term "insider" occurs in what is known as preferential transfer context under § 547(b)(4)(B).¹⁸⁰ This section provides that a trustee (under chapter 7) or debtor-in-possession (under chapter 11) may void a property transfer made within a certain time before the filing of a bankruptcy petition and bring that property back into the estate.¹⁸¹ Transfers made to persons other than insiders have a ninety-day reach back window

¹⁷¹ *Id.* at 297.

¹⁷² *Id.* at 298.

¹⁷³ *Id.* at 300.

¹⁷⁴ *See In re Vill. at Lakeridge, LLC*, 814 F.3d 993.

¹⁷⁵ *See* 11 U.S.C. § 101(31) (2012).

¹⁷⁶ *See* 11 U.S.C. § 101 (2012); *see also* S. REP. 95-989, at 25 (1978), *as reprinted in* U.S.C.C.A.N. 5787, 5810.

¹⁷⁷ *See In re Friedman*, 126 B.R. 63 (B.A.P. 9th Cir. Cal. 1991).

¹⁷⁸ *See id.*

¹⁷⁹ *See In re Gilbert*, 104 B.R. 206, 210 (Bankr. W.D. Mo. 1989).

¹⁸⁰ 11 U.S.C. § 547(b)(4)(B) (2012).

¹⁸¹ *Id.*

within which the trustee can void the transfer and bring the property back into the estate's possession.¹⁸² Alternatively, property transferred to an insider is recoverable as far back as one year prior to the debtor's filing.¹⁸³ The differing treatment is intended to prevent abuse and stop the debtor from giving, selling, or otherwise transferring debtor property to an insider on the eve of a bankruptcy filing.¹⁸⁴

The claim transfer avoidance body of law is generally more inclusive in defining non-statutory insiders and courts evaluate the facts of the debtor-claimholder transaction with a focus on "(1) the closeness of the relationship between the parties and (2) whether the transaction was negotiated at arm's length."¹⁸⁵ The Tenth Circuit has defined in detail the purpose of § 547 of the Code in *In re PERMA PAC. PROPS*, when it stated that:

It is the ultimate aim of the preference law in the Bankruptcy Code to ensure that all creditors receive an equal distribution from the available assets of the debtor Although the intent or state of mind of the parties is not materially dispositive of whether or not a transfer is a preference . . . we can see no impediment to allowing the bankruptcy court to look at the nature of the transaction and the relationship among the parties.¹⁸⁶

Cases that have a generally expansive interpretation of insider include *Schubert v. Lucent Tech. Inc. (In re Winstar Commc'n)*, and *Unencumbered Assets Trust v. JP Morgan Chase Bank (In re Nat'l Century Fin. Enters)*.¹⁸⁷

In *Schubert v. Lucent Tech. Inc. (In re Winstar Commc'n)*, the debtor Winstar attempted to recover \$194 million payment it made to Lucent Technologies as part of a financing package that was supposed to be used to expand Lucent's telecommunication network through a continuing strategic partnership.¹⁸⁸ Lucent quickly defaulted on their payments to Winstar.¹⁸⁹ Winstar was subsequently unable to pay its other existing debt obligations (unrelated to Lucent) and filed for bankruptcy approximately five months after its Lucent loan.¹⁹⁰ Winstar claimed that this transfer of \$194 million to Lucent

¹⁸² *Id.* § 547(b)(4)(A).

¹⁸³ *Id.* § 547(b)(4)(B).

¹⁸⁴ *See In re PERMA PAC. PROPS.*, 983 F.2d 964, 968 (10th Cir. 1992).

¹⁸⁵ Rich Mullen, *supra* note 113.

¹⁸⁶ *In re PERMA PAC. PROPS.*, 983 F.2d at 968.

¹⁸⁷ *See* Rich Mullen, *supra* note 113.

¹⁸⁸ *In re Winstar Commc'n, Inc.*, 2003 Bankr. LEXIS 766, at *24.

¹⁸⁹ *Id.* at *5–6.

¹⁹⁰ *Id.* at *6.

should be avoided as a preferential transfer to an insider.¹⁹¹ Winstar argued that their relationship with Lucent was sufficiently close and that Lucent maintained enough control over them financially, that Lucent should be considered an insider and have the \$194 million payment avoided under § 547(b)(4)(B).¹⁹²

Both the bankruptcy court for the District of Delaware and the U.S. District Court agreed that Lucent was an insider of Winstar under both a statutory and non-statutory analysis.¹⁹³ Under a statutory analysis, the bankruptcy court found that Lucent was a “person in control” of debtor under 101(31)(B)(iii).¹⁹⁴ Lucent was a “person in control” because it was able to dictate “Winstar’s purchasing decisions” and also induce Winstar to transfer the \$194 million or it “would terminate negotiations . . . and refuse further financing.”¹⁹⁵

Similarly, under a non-statutory analysis, the district court believed that Lucent was an insider of Winstar because the relationship was “more than a mere debtor-creditor relationship conducted at arm’s length,” and also was “sufficiently close.”¹⁹⁶ The district court, extracting this language directly from the legislative history of the definition of insider as described in *Butler v. Shaw*, applied this analysis to the Lucent-Winstar transaction and determined that Lucent should be considered a non-statutory insider as well.¹⁹⁷ This case is significant because it deemed a creditor, without actual control of the debtor, an “insider” by focusing on the parties’ relationship and the legitimacy of the transaction.¹⁹⁸ This is in contrast to *Lakeridge* and *Shaw* where the courts interpreted a narrower class of insiders while examining the same factors, finding the “control” requirement more important and the relationship-transaction requirement less important.

In *Unencumbered Assets Trust v. JP Morgan Chase Bank (In re Nat’l Century Fin. Enters.)*, the U.S. District Court for the Southern District of Ohio examined insiders under § 547 and found that a relatively liberal definition should apply in non-statutory insider situations.¹⁹⁹ In this case, the court sought

¹⁹¹ *Id.* at *25.

¹⁹² *Id.*

¹⁹³ *Lucent Techs., Inc. v. Shubert (In re Winstar Commc’n., Inc.)*, 2007 U.S. Dist. LEXIS 31137, at *7 (D. Del. Apr. 26, 2007).

¹⁹⁴ *Id.*

¹⁹⁵ *Id.* at *8.

¹⁹⁶ *Id.* at *7–8.

¹⁹⁷ *Id.* at *7.

¹⁹⁸ *See id.* at *7–8.

¹⁹⁹ *See In re Nat’l Century Fin. Enters.*, 604 F. Supp. 2d at 1160.

to invalidate certain cash transfers from a debtor²⁰⁰ under a § 547(b)(4)(B) argument similar to the claim in *Winstar*.²⁰¹ This court agreed that an insider is generally “one who does not deal at arm’s length with the debtor.”²⁰² The court went on to cite *In re Friedman*, which stated that:

insider status may be based on a professional or business relationship with the debtor ‘where such relationship compels the conclusion that the individual or entity has a relationship with the debtor, close enough to gain an advantage attributable simply to affinity rather than to the course of business dealings with the parties.’²⁰³

Due to such an affinity, the court in *In re Nat’l Century* voided a \$100 million transfer from a debtor to an insider, holding that this was “a situation that implicates the very reason why the Bankruptcy Code has a provision for avoiding transfers to insiders.”²⁰⁴

It seems clear that the competing interpretations of various courts’ construction of the non-statutory insider definition has led to starkly different outcomes. This imprecise term leads to especially unpredictable results when a potential insider does not meet the strict definition of a § 101(31) insider. Surely, this outcome is not Congress’s intent and has led to opportunities for abuse that further thwart bankruptcy’s policy goal of equitable distribution to creditors. Additionally, the varied outcomes from courts has the potential to lead to forum shopping.

III. A PROPOSAL: NEW STATUTORY DEFINITION OF INSIDER

This Comment argues for a new rule to be codified to address this split among jurisdictions that has arisen due to the inconsistent judicial interpretation of the term “insider” as defined in § 101(31). Congress should change how an insider is defined in the Code. Insider should be defined by removing the word “includes” from the Code²⁰⁵ and replacing it with “means,” thus making the definition exclusive. Next, the Code should include a catchall

²⁰⁰ *Id.*

²⁰¹ See 11 U.S.C. § 547(b)(4)(B) (2012). This Code provision provides that transfer from a debtor to an insider may be voided if that transfer occurred between ninety days and one year of the filing of the bankruptcy petition. Similar to the chapter 11 voting restriction on transferring claims to insiders, this provision is intended to prevent abuse by preventing a debtor, on the verge of bankruptcy, from transferring assets just prior to filing.

²⁰² *In re Nat’l Century Fin. Enters.*, 604 F. Supp. 2d at 1161.

²⁰³ *In re Friedman*, 126 B.R. at 70.

²⁰⁴ *In re Nat’l Century Fin. Enters.*, 604 F. Supp. 2d at 1161.

²⁰⁵ 11 U.S.C. § 101(31) (2012).

provision at the end of the definition. This new sub-paragraph “G” should state, “any person with a close personal or financial relationship with the debtor that, as a result of a less than arm’s length transaction, becomes beholden to the debtor, raises a presumption that the person is an insider.”²⁰⁶

This argument will advance in three stages. First, I will examine Congress’s intent in creating an insider rule by looking at the legislative history of the term when enacted under the 1978 Code. Next, I will explain the mechanics of this proposed rule and explain the two-step analysis courts should use when confronted with a chapter 11 claim transfer. Finally, I will address possible counterarguments and the continued issues that will inevitably arise with insider determinations.

A. Examination of “Insider” Legislative Intent

The definition and application of insiders throughout the Code should meet Congress’s intent when the term was initially adopted 1978. These intents include: (1) to prevent bankruptcy abuse; (2) to treat similar creditors similarly; and (3) to evenly distribute debtor assets. Courts and commentators have uneasiness with current state of insider interpretation.²⁰⁷ As mentioned above, the dissenting judge in *In re Lakeridge* disagreed with the majority’s application of the facts to law.²⁰⁸ In his dissent, Judge Clifton agreed that a non-statutory insider exists when there is a comparably close debtor-creditor relationship to those enumerated in § 101(31), and the “relevant transaction is negotiated at less than arm’s length.”²⁰⁹ He believed that the facts supported a finding that there was a close Rabkin-Bartlett relationship and the transaction was not arm’s length, thus Rabkin was an insider.

Many commentators have recommended a change, predicted abuse, or anticipated litigation based on the conflicting interpretations issued by courts and the non-exclusive nature of 101(31).²¹⁰ In one law firm alert article titled *Ninth Circuit Issues Controversial Opinion Limiting Insider Status for Purposes of Voting on a Chapter 11 Plan of Reorganization*, the authors note that the *Lakeridge* decision has “arguably provide[d] a roadmap for debtors to circumvent the requirement in § 1129(a)(10).”²¹¹ The path for these potentially unscrupulous debtors, according to the author, is to “simply sell their unsecured claims for a nominal amount to friendly third parties that will vote in favor of the plan.”²¹² It seems apparent that this end-run around the

²⁰⁶ *Id.* This Code section currently states that “[t]he term ‘insider’ includes—” and ends at subparagraph F. This modified definition would add an additional subparagraph “G” as a catchall.

requirements of chapter 11's finely crafted cramdown procedure was likely not Congress's intent when enacting the Code.

A leading treatise on bankruptcy, *Collier on Bankruptcy*, describes insiders, not by enumerating specific insider relationships (as does the Code), but by focusing on the closeness of the relationship and the existence of a less than arm's length transaction.²¹³ Accordingly, Congress should codify this descriptive definition rather than attempting to narrowly define specific examples of insiders as it currently does in the Code.²¹⁴

An examination of the legislative history of the enactment of this provision reveals support for a modified definition. Insiders are defined in § 101(31) of the Code using the word "includes" followed by a list.²¹⁵ Using rules of statutory construction, courts have determined that the list is not exclusive²¹⁶ but only illustrative, thus giving rise to statutory, or per se, insiders and non-statutory insiders.²¹⁷

The term "insider" was enacted with the 1978 Code.²¹⁸ Legislative intent of the "insider" term is relatively sparse and less than satisfactory,²¹⁹ but the Senate Report that accompanied the 1978 enactment of the Code does state a guiding principle that an insider "is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny

²⁰⁷ See Sarah Borders, Jeffrey Dutson, *Ninth Circuit Issues Controversial Opinion Limiting Insider Status for Purposes of Voting on a Chapter 11 Plan of Reorganization*, King and Spalding: Client Alert, Feb. 16, 2016.

²⁰⁸ *In re Vill. at Lakeridge, LLC*, 814 F.3d at 1003.

²⁰⁹ *Id.*

²¹⁰ See Rebecca Revich, *The KERP Revolution*, 81 AM. BANKR. L.J. 87, 2007.

²¹¹ Sarah Borders, Jeffrey Dutson, *Ninth Circuit Issues Controversial Opinion Limiting Insider Status for Purposes of Voting on a Chapter 11 Plan of Reorganization*, King and Spalding: Client Alert, Feb. 16, 2016.

²¹² *Id.*

²¹³ *In re U.S. Medical, Inc.*, 531 F.3d at 1277 (citing 5 COLLIER ON BANKRUPTCY, ¶ 547.03[6] (Allen N. Resnick & Henry J. Sommer eds., 15th rev. ed. 2008)).

²¹⁴ 11 U.S.C. § 101(31) (2012).

²¹⁵ *Id.*

²¹⁶ Borders, *supra* note 211.

²¹⁷ *In re Kunz*, 489 F.3d 1072 (quoting *Miller Avenue Professional & Promotional Serv. v. Brady (In re Enterprise Acquisition Partners)*, 319 B.R. 626, 631 (B.A.P. 9th Cir. 2004)).

²¹⁸ See 11 U.S.C. § 101(31) (2012); see also S. REP. 95-989 at 25 (stating that the term "insider" is new for the 1978 enactment of the Code). This year saw the codification the Code largely as it is today, and with such a large Code, the legislative reports accompanying its enactment for the most part give only basic background information and intent.

²¹⁹ Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 DEPAUL L. REV. 941, 959-60 (1978).

than those dealing at arm's length with the debtor."²²⁰ Although Congress chose to define insiders in this way in their committee report, Congress chose to enact the Code provision differently.²²¹

Rather than using a descriptive definition, Congress instead defined insider using an inclusive list as examples, explaining later in the Senate Report that some provisions are "open-ended because the term[s] [are] not susceptible of precise specification."²²² Thus, Congress intentionally left the courts with the ability to determine what relationships are sufficient to meet the insider status by "us[ing] the characterization provided in this definition."²²³

Congress's purpose of including insiders in the Code was to reach a broad scope of persons who are not true creditors of the debtor, but are instead "alter egos" of the creditor and therefore will not act in the best interest of other similarly situated creditors.²²⁴ Congress defined insiders in such a way that left significant discretion for the courts to craft and develop the body of insider law.²²⁵ Courts have significantly departed from Congress's intent and thereby created a confusing and non-uniform body of law that may only be corrected by modifying the Code.²²⁶

B. Mechanics of Proposed Definition's Application

Accordingly, § 101(31) should be changed in two ways. First, Congress should remove the "includes" language from the definition of insiders to make the definition exclusive, thus removing all "non-statutory" discussion. Second, the Code should include a catch-all provision at the end of the definition that provides a statutory analytical framework for determining if a person is an insider.

1. An Exclusive Insider Definition

Much of the litigation surrounding insider determination occurs because the Code is defined using an inclusive rather than an exclusive definition,

²²⁰ See 11 U.S.C. § 101(31) (2012); see also S. REP. 95-989 at 25.

²²¹ See 11 U.S.C. § 101(31) (defining "insiders" differently than they described "insiders.").

²²² S. REP. 95-989 at 35 (explaining that there are a number of Code provisions that are left open-ended, such as "security," "entity," "insider," and "person.").

²²³ *Id.*

²²⁴ *In re Blaine Richards & Co.*, 10 B.R. 424, 432 (Bankr. E.D.N.Y. 1981).

²²⁵ See 11 U.S.C. § 101(31) (2012) (Congress's use of the words "includes" created this discretion).

²²⁶ Compare *In re Vill. at Lakeridge, LLC*, 814 F.3d 993, with *In re Three Flint Hill Ltd. P'ship*, 213 B.R. 292 (two courts come to opposite conclusions based on very similar facts).

which creates two categories of insiders.²²⁷ Much of the debate and uncertainty that goes along with non-statutory insiders would be avoided by making the definition exclusive and thereby eliminating the non-statutory distinction altogether. Under this proposed modification, this change would remove some of this uncertainty by making every would-be insider a “statutory” insider and focus the courts on examining the relationship of the parties and the nature of the transaction, which more aligns with Congress’s original intent.²²⁸ This change can be effectuated by changing the word “includes” to “means.”²²⁹

2. *The Statutory Catchall and its Application*

The second, and more significant, change is to add a catchall provision (becoming subsection “G”) at the end of the definition, which should state: “any person with close personal or financial relationships with the debtor that, as a result of a less than arm’s length transaction, becomes beholden to the debtor, raises a presumption that the person is an insider.” This portion of the definition can be divided into three subparts and applied in three steps.

a. *The Close Relationship Test*

The first step of analysis under this Comment’s proposed Code definition is showing evidence of a close personal or financial relationship creating a creditor that is beholden to the debtor. The fact-intensive inquiry would allow courts some flexibility to determine what type of financial and personal relationship should be sufficient to raise a concern about a potential insider status. This inquiry should focus on the nature of the relationship—whether business, personal, or mixed—between the creditor and debtor, the length of the relationship, and the course of dealings between the parties, amongst others. This inquiry should be relatively inclusive and broad in order to catch as many purported insiders as possible.

This notion that the suspect relationship could be broad is supported in *In re Locke Mill Partners*, where the court noted that insider status should apply to a potentially broad range of parties.²³⁰ Keeping this inquiry relatively broad in scope is appropriate because Congress intended a relatively broad scope when enacting this definition in the 1978 Code.²³¹ Casting a wide net at this

²²⁷ *In re Kunz*, 489 F.3d at 1075.

²²⁸ See 11 U.S.C. § 101(31) (2012); see also S. REP. 95-989 at 25.

²²⁹ See 11 U.S.C. § 101(31) (2012).

²³⁰ *In re Locke Mill Partners*, 178 B.R. 697, 702 (Bankr. M.D.N.C. 1995).

²³¹ See S. REP. 95-989 at 35.

step will also allow the courts to move on to steps two and three of the analysis where the real substance of the test lies. Furthermore, this is appropriate because the initial burden will be on the party challenging the transaction (most often the creditor) and thus that party will have to provide evidence that this pre-existing relationship legitimately raises some kind of conflict of interest.

Another key requirement at this step is that the relationship and the transaction in question must combine to make the claim holding creditor beholden to the debtor. If a person with this pre-existing relationship accepts a claim from a debtor that is akin to what the *Lakeridge* dissent considered “doing a favor for a friend,” then they must be deemed to be beholden to the debtor.²³² This analysis overlaps with the next step and will provide the court with a link between the relationship of the parties and the specific transaction being challenged.

b. The Less Than Arm’s Length Transaction Test

Part two of the rule requires the party claiming that an insider should exist provide a factual basis to support a finding that a less than arm’s length transaction took place. The *Lakeridge* dissent looked to Black’s Law Dictionary and defined an arm’s length transaction as “1. A transaction between two unrelated and unaffiliated parties. 2. A transaction between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises.”²³³ This fact-intensive inquiry is indeed the main crux of the new definition because the prevention of abuse, through fraudulent claim selling to a friendly third-party, is the primary goal of this change. A less than arm’s length transaction in an insider context would be any transaction between a debtor and a claim-purchasing creditor where a potential conflict of interest arises. To determine whether a conflict of interest arises in an insider context, courts examine the motives of the parties when entering into the transaction²³⁴ and the price paid for the claim.²³⁵

Bankruptcy courts have considered non-arm’s length transactions in the insider context and have developed one relatively straightforward definition.²³⁶

²³² *In re Vill. at Lakeridge, LLC*, 814 F.3d at 1003–04.

²³³ *Id.* at 1005 (citing *Black’s Law Dictionary* (10th ed. 2014)).

²³⁴ *See In re Three Flint Hill L.P.*, 213 B.R. at 301.

²³⁵ *See In re Vill. at Lakeridge, LLC*, 813 F.3d 993 (dissent states that \$5,000 paid for a claim worth over \$2 million raised a concern about the legitimacy of the transaction).

²³⁶ *In re Three Flint Hill L.P.*, 213 B.R. at 299.

In *In re Three Flint Hill L.P.*, the Maryland bankruptcy court defined an arm's length transaction as "one entered into in good faith in the ordinary course of business by unrelated parties with independent interests."²³⁷ In *In re Three Flint Hill*, a business associate (Tarrant) of the debtor (Three Flint Hill) purchased \$123,000 of debt claims to help the debtor get their chapter 11 plan approved.²³⁸ The bankruptcy court and the district court found that Tarrant was an insider of Three Flint Hill because the claims were purchased to help out a friend rather than as a "carefully reasoned business decision."²³⁹ When facts like these are present, they indicate that the motives of the parties are self-seeking, rather than seeking to maximize the distribution of the debtor's estate, and thus not arm's length.

c. The Rebuttable Presumption of Insider Status

Part three of this new catchall insider definition is the creation of a rebuttable presumption of insider status. Under this proposed definition, once a transfer meets the two-part (relationship and transaction) test laid out above, there would be a presumption of insider status. This presumption (that the transferee is an insider) would shift the burden to the debtor to show sufficient evidence of: (1) a lack of a sufficiently close relationship; (2) that the transaction was conducted at arm's length; or (3) other evidence to remove the taint of the transaction. Currently, the burden rests with the party challenging the transaction (usually a creditor), to show that the alleged insider deal was less than arm's length.²⁴⁰ Ideally, the party with the best ability to prove or disprove a claim (i.e., the one with the best access to the evidence) should logically have the burden of proof.

This proposed burden shifting is appropriate because in bankruptcy cases like these, specifically in the claim selling and voidable transfer contexts, the party transferring a claim to a purported insider has the best knowledge of whether that individual is an insider, so it stands to reason that the burden of disproving insider status should remain with that party.²⁴¹ Such evidence could include information about the nature of the relationship between the parties, the conduct of the transaction, or any other evidence that could prevent a court

²³⁷ *Id.* at 300 (quoting *In re Valley Steel Corp.*, 182 B.R. 728, 735 (W.D.Va.1995)).

²³⁸ *Id.* at 296.

²³⁹ *Id.* at 299.

²⁴⁰ See *In re Vill. at Lakeridge, LLC*, 814 F.3d at 1003 (where the court stated that U.S. Bank did not present enough evidence to show that Rabkin was a non-statutory insider).

²⁴¹ See *id.* at 1005 (where MBP had all of the information regarding the relationship between Bartett and Rabkin, yet U.S. Bank had the burden of proving that Rabkin was an insider).

from finding that the parties' relationship and transaction "compels the conclusion that the individual or entity has a relationship with the debtor, close enough to gain an advantage attributable simply to affinity rather than to the course of business dealings between the parties."²⁴²

IV. BENEFITS OF PROPOSED DEFINITION AND COUNTERARGUMENTS

This Code modification will better meet Congress's goals of reducing bankruptcy abuse, providing equitable distribution of the debtor's assets, and reducing the possibility of forum shopping by debtors.

A. *Prevention of Chapter 11 Abuse*

This modified definition should make it easier for courts to identify and prevent bankruptcy abuse. The dissenting opinion by Judge Clifton in *Lakeridge* laid bare a clear example of an abusive transfer intended to assure plan confirmation: sell the voting power to a friendly third party for less than fair value in exchange for a "yes" vote.²⁴³ An article published by bankruptcy practitioners Sarah Borders and Jeffery Dutson also noted serious concerns that debtors could "circumvent the requirements in [§] 1120(a)(10)" of the Code.²⁴⁴ The authors argued that the "roadmap" to securing an approval in a cramdown was clearly laid out by the *Lakeridge* decision.²⁴⁵ They note that under the current system insiders can "simply sell their unsecured claims for a nominal amount to friendly third parties that will vote in favor of the plan."²⁴⁶ Clearly this scheming conduct violates Congress's goals of maximizing the equitable distribution of the debtor's estate. Furthermore, this change will provide bankruptcy courts with another tool to police the current system and fulfill their role as supervisor of unwarranted preferential treatment.²⁴⁷

This definition brings every insider into the statute and gives courts a concrete, statutorily mandated framework to determine if insider transfers are being made. The transfer that occurred in *Lakeridge* would likely have been deemed an insider transaction because it met both parts of the initial insider test because the claim holder, Rabkin, had a significant personal and financial relationship with Bartlett and also purchased the more than \$2,000,000 claim

²⁴² *In re* Friedman, 125 B.R. at 70.

²⁴³ *In re* Vill. at Lakeridge, LLC, 814 F.3d at 1005 (Clifton, J., dissenting).

²⁴⁴ Borders, *supra* note 211.

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ *In re* U.S. Medical, 531 F.3d at 1275 (quoting *In re* Kunz, 489 F.3d at 1077).

for a nominal value.²⁴⁸ This new provision will provide a concrete tool to enable the courts to recognize abuses and empower them to prevent similar abuses in the future. One court has said that “the purpose of this inquiry is to guard against collusive approval of plans by persons whose dealing with the debtor are “at less than arm’s length.”²⁴⁹ This modified insider definition will enable the courts to do this.

B. Improving Equitable Distribution

The improved definition will also ensure equitable distribution among creditors. A major goal of the enactment of the Code, beginning as far back as the first enactment of a national bankruptcy statute in 1898, was to protect debtors and prevent hardships and injustices to creditors²⁵⁰ by providing for equal distribution to similarly situated creditors.²⁵¹ The sale of economically unjustified claims to insider-like persons for the purpose of foisting a plan upon other creditors defeats this longstanding goal. As the court stated in *In re U.S. Medical*, one of the goals of bankruptcy law is to “prevent, within limits, a debtor from giving preferred treatment to some creditors in derogation of the interests of other, similarly situated creditors.”²⁵²

The proposed definition of insider will better meet these goals of equitable distribution and equitable creditor treatment by providing a more concrete and broad definition. A court can then better fulfill its role as supervisor to prevent potential “unwarranted preferential treatment.”²⁵³ By analyzing the debtor’s relationship to the claim holder the court will learn if there is an unwarranted affinity, then by further examining the transaction itself to figure out if it was conducted at arm’s length, the court can confirm or deny that affinity and presume the claim holder is an insider. The initial burden of proof is appropriately on the other claim holding creditors, as theirs is the interest being harmed by the insider-debtor collusion. Once the presumption is triggered, the debtor is best situated to rebut this presumption to the satisfaction of the court, ensuring that any initial misgivings about the relationship and the transaction were unwarranted, thereby ensuring that all creditors are being treated equitably, thus meeting Congress’s intent.²⁵⁴

²⁴⁸ See *In re Vill. at Lakeridge, LLC*, 814 F.3d at 1003.

²⁴⁹ *In re Three Flint Hill Ltd. P’ship*, 213 B.R. at 299.

²⁵⁰ *In re Nash*, 249 F. 375, 377 (S.D.W.Va. 1918).

²⁵¹ *Begier v. IRS*, 496 U.S. 53, 58 (1990).

²⁵² *In re U.S. Medical*, 531 F.3d at 1275 (quoting *In re Kunz*, 489 F.3d at 1074–75).

²⁵³ *Id.* at 1275 (quoting *In re Kunz*, 489 F.3d at 1074–75).

²⁵⁴ See *id.* (citing *In re Kunz*, 489 F.3d at 1074–75 (discussing the purpose of bankruptcy law)).

C. *Prevention of Forum Shopping*

The Code alteration also has the potential to prevent forum shopping by unprincipled debtors. The Central District of California, when examining the merits of a bankruptcy related motion,²⁵⁵ defined forum shopping as “a party attempt[ing] to manipulate an action to have it heard before a forum it deems more favorable, charitable, or sympathetic toward its point of view.”²⁵⁶ Assuming a debtor may have more than one choice for forum when contemplating bankruptcy, the debtor may seek a forum with a narrow insider definition to gain a favorable advantage.²⁵⁷ For example, a court that follows the *Lakeridge* precedent may determine that a close friend of an insider is not a non-statutory insider and allow that friend to purchase an unsecured claim for a nominal value in order to force approval other claim holders. If this hypothetical debtor intends to use a cramdown as part of a chapter 11 proceeding, they may choose the more favorable forum to manipulate an advantage over other creditors. Under the proposed modified definition of insider, courts will not have the same variance in their categorization of non-statutory insiders as they do now and the effect of forum shopping for an insider favorable court would be reduced.

All things considered, the benefits of the proposed change are potentially significant. The change will diminish abuse of the chapter 11 bankruptcy process by preventing less than arm’s length claim sales between friendly parties, afford more equitable distribution of a debtor’s assets by casting a wider insider net and thereby maximizing estate values, and reducing the incentive for debtors to forum shop bankruptcy courts for those with favorable interpretation of non-statutory insiders. A final benefit flowing from this change is greater economic value to creditors. For example, in *Lakeridge*, Rabkin stood to earn \$55,000 on the claims he purchased from MBP if he had sold them to U.S. Bank.²⁵⁸ This is considerably more than he stood to make if he held the claims as an investment and hoped to make money as part of *Lakeridge*’s plan.

²⁵⁵ See *Gottlieb v. Landau (In re KSL Media, Inc.)*, No. CV 15-08748-AB, 2016 U.S. Dist. LEXIS 1917, at *6 (C.D. Cal. Jan. 6, 2016).

²⁵⁶ *Id.* at *28 (quoting *Calvert v. Berg*, No. C13-1019, 2013 U.S. Dist. LEXIS 94874, at *5 (W.D. Wash. July 8, 2013)).

²⁵⁷ Compare *In re Vill. at Lakeridge, LLC*, 814 F.3d at 1003–04 (where the court applied a narrow definition of insider), with *In re Three Flint Hill Ltd. Pshp.*, 213 B.R. 2 at 299.

²⁵⁸ *In re Vill. at Lakeridge, LLC*, 814 F.3d at 998 (Rabkin was offered \$50,000 and then \$60,000 by U.S. Bank for the claims he purchased for \$5,000.).

D. Counterarguments

There are three potential counterarguments for the proposed definition change. The first is that the definition does not address the “control” aspect identified by many courts as an important factor in determining a party’s insider status. The second is that the change does not allow courts to have an in-depth factual inquiry, but instead requires them to make determinations as a matter of law, which could lead to unreasonable results. The final counterargument is that the scope of the new definition is too broad and will unduly harm debtors’ legitimate reorganization efforts.

Many courts have inquired into the level of “control” of the insider over the debtor, but under this new definition such an inquiry would not be required to classify a person or individual as a non-statutory insider.²⁵⁹ The Fourth Circuit, in *In re Gilbert* has argued, “the alleged insider must exercise sufficient authority over the debtor so as to unqualifiedly dictate corporate policy and the disposition of corporate assets.”²⁶⁰ Other courts have disagreed with this analysis, arguing that control is not dispositive.²⁶¹ Even the *Lakeridge* court believed that “[h]aving—or being subject to—some degree of control is one of many indications that creditor may be a non-statutory insider.”²⁶² Control should be “probative of an insider relationship,” but under the current system and the improved definition, a finding of some level of control would not be dispositive of insider status.²⁶³ This has generally been only one of many factors a court will examine to bring a person into the non-statutory category.²⁶⁴

The inquiry would still be enlightening under the proposed rule because the Code will retain the “person in control of debtor” definition of insider that applies to partnerships and corporations,²⁶⁵ but the “control” inquiry would not be necessary for other entities because the existence of a personal or financial relationship would suffice to trigger the arm’s length transaction inquiry. Furthermore, because many courts find the level of control to be probative²⁶⁶

²⁵⁹ *In re Locke Mill Partners*, 178 B.R. at 701.

²⁶⁰ *Butler*, 72 F.3d at 443 (quoting *Hunter v. Babcock (In re Babcock Dairy Co.)*, 70 Bankr. 662, 666 (Bankr. N.D. Ohio 1986)).

²⁶¹ *In re Three Flint Hill Ltd. P’shp.*, 213 B.R. at 299.

²⁶² *In re Vill. at Lakeridge, LLC*, 814 F.3d at 1001.

²⁶³ *In re Three Flint Hill Ltd. P’shp.*, 213 B.R. at 299.

²⁶⁴ *In re Locke Mill Partners*, 178 B.R. at 701.

²⁶⁵ 11 U.S.C. §§ 101(31)(b)(iii), (c)(v) (2012) (a person in control of debtor is included as a specific enumerated definition of insider under both partnerships and corporations under the current definition).

²⁶⁶ *In re Three Flint Hill Ltd. P’shp.*, 213 B.R. at 299.

of the relationship of the parties, this analysis would similarly apply under the proposed relationship prong. Finally, because the insider status is initially a rebuttable presumption, the purported insider may present evidence that concedes control, but still shows that the transaction was negotiated “as if the parties were strangers” and that no conflict of interest arose from the transaction.²⁶⁷

A second argument against the definition change is that a court will have less discretion to conduct a fact-intensive inquiry due to the strict statutory criteria in the Code. The Ninth Circuit noted in *Lakeridge* that courts “must conduct a fact-intensive analysis to determine if a creditor and debtor share a close relationship and negotiated at arm’s length.”²⁶⁸ The court also mused that creating statutory insider status as a matter of law could prevent a proper factual analysis on a case-by-case basis.²⁶⁹ Under the proposed system, a court will have the same factual debate over whether to include these would-be insiders into the statutory definition, as they would non-statutory insiders. There will still be a fact-based examination of the parties’ relationship and the nature of the transaction with enough discretion left to the court to conclude at either of these steps that an insider determination is unwarranted. Ultimately, there will always be a factual debate over insider statuses, but this proposed Code change will more clearly settle the legal debate by providing a uniform analytical tool that will exclude a greater number of creditors if they meet the insider catchall test.

Another counterargument is that the test will unduly harm debtors who are legitimately trying to reorganize by limiting the pool of non-insiders. In *Lakeridge*, the court worried that “a third-party assignee could be foreclosed from voting a claim acquired from an insider, even if the entire transaction was conducted at arm’s length.”²⁷⁰ This concern could stem from the fact that the proposed definition has a relatively broad scope initially. This concern is unjustified, however, because as the court stated in *In re Friedman* that, “not every creditor-debtor relationship attended by a degree of personal interaction between the parties rises to the level of an insider relationship.”²⁷¹ Under the new definition the courts will retain the same discretion to determine what relationships are worthy of an insider determination. Furthermore, even if a

²⁶⁷ *In re Vill.* at *Lakeridge, LLC*, 814 F.3d at 1003–04 (citing *Black’s Law Dictionary* (10th ed. 2014)).

²⁶⁸ *Id.* at 1001.

²⁶⁹ *Id.* at 1000.

²⁷⁰ *Id.*

²⁷¹ *In re Friedman*, 126 B.R. at 70.

court finds a close creditor-debtor relationship, if the parties negotiated the transaction at arm's length, then the insider analysis will end at this step.

The concern of harming legitimate debtors will be minimal under the new framework. This Comment's proposed definitional change should only affect a relatively small set of creditors because the change is designed to affect chapter 11 insiders who have a pre-existing personal or financial relationship and conduct a less than arm's length transaction. Without both elements of (1) a pre-existing close relationship and (2) a subsequent transfer, there is no trigger of this definitional provision. And even if the insider definition fits initially, the would-be insider may rebut the presumption by presenting any evidence it has that the deal was legitimate. The *Lakeridge* court's anxiety, that a party could statutorily become an insider without a less than arm's length claim sale, would be negated under the proposed definition.²⁷² Any debtor trying to legitimately reorganize can sell the claim to another unrelated entity, sell the claim for full and fair consideration, or maintain the sale to the insider and exclude that insider's vote under the cramdown rules.²⁷³

The definitional change is designed to catch insiders such as Rabkin in *Lakeridge*, who purchased claims under questionable circumstances after his long standing relationship with a Bartlett had been established.²⁷⁴ This modification will leave out the common unsecured creditor who still associates with a debtor, including accountants, lawyers, and other professionals who have not engaged in such transactions.²⁷⁵ The definitional change would not cast a net so large that it deems any person with a preexisting relationship to be an insider. Much like in *In re Blaine Richards & Co.*, where an accountant of a debtor was not considered to be an insider, the relationship itself does not establish insider status, but rather triggers a closer look when there is a subsequent transaction.²⁷⁶

CONCLUSION

In conclusion, this Comment argues for a change in how the Code defines an "insider" in § 101(31).²⁷⁷ This Comment proposes that the Code be modified from its current inclusive definition to one that is exclusive. The new

²⁷² *In re* Vill. at *Lakeridge*, LLC, 814 F.3d at 1000.

²⁷³ 11 U.S.C. § 1129(a) (2012).

²⁷⁴ *In re* Vill. at *Lakeridge*, LLC, 814 F.3d at 997.

²⁷⁵ *In re* Blaine Richards & Co., 10 B.R. at 432.

²⁷⁶ *Id.*

²⁷⁷ 11 U.S.C. § 101(31) (2012).

definition should conclude with a final catchall provision that is designed to reach and examine a broad spectrum of insiders. This catchall should read as follows: “insider means . . . any person with close personal or financial relationships with the debtor that, as a result of a less than arm’s length transaction, becomes beholden to the debtor, raises a presumption that the person is an insider.”

The modified Code provision will settle the disagreement among courts between broad and narrow definitions of non-statutory insiders by bringing many non-statutory insiders into the statutory frame. Currently the state of insider law is confusing, non-uniform, and subject to significant abuse. Some courts apply a narrow construction of the current definition, thus allowing persons who intuitively should be insiders to vote to approve plans that force unwanted cramdown restructuring plans on unwilling creditors.²⁷⁸ Other courts however, apply a broad interpretation to insiders, thus bringing more individuals into the statutory scope and limiting the voting power of these insiders for plan approval.²⁷⁹

This broad interpretation is more appropriate to properly meet Congress’s intent and bankruptcy’s greater goals. Many courts have recognized the importance of the Code’s goal of equitable distribution, which in large part requires that similarly situated creditors receive fair treatment and that debtors are prevented from “giving preferred treatment to some creditors in derogation of the interests other[s].”²⁸⁰ The proposed definition includes a relatively broad insider definition to meet these goals, while also maintaining safeguards, such as the required two part analysis and rebuttable presumption, to prevent unnecessary insider determinations.

The new definition will provide the courts with a uniform statutory framework for analyzing chapter 11 claim transfers that will provide bankruptcy judges and businesses with better guidance when considering potential insider transfers such as the one in *Lakeridge*.²⁸¹ Also, the new provision will prevent economically unjustified transfers of claims to any parties that have a pre-existing close relationship with a debtor. Congress has made clear its intention to prevent closely related parties from making deals

²⁷⁸ *In re Vill. at Lakeridge, LLC*, 814 F.3d 993.

²⁷⁹ *See In re Three Flint Hill Ltd. P’ship*, 213 B.R. 292.

²⁸⁰ *In re Kunz*, 489 F.3d at 1075.

²⁸¹ *See In re Vill. at Lakeridge, LLC*, 813 F.3d 993. This definition of “insider” would have prevented MBP from selling their insider claim to Rabkin with a guaranteed approval vote on the reorganization plan. At the very least, this new definition would have forced MBP’s board to negotiate a fair price for the claim and prevented the sale of a \$2.76 million claim for only \$5,000.

that undercut legitimate creditors in chapter 11 cases, just because a debtor's insider does not clearly fall within the current statutory frame should not allow these persons to force restructuring plans on unwilling creditors.²⁸²

JOHNATHAN D. GREEN*

²⁸² *In re Nash*, 249 F. at 377.

* Editor-in-Chief, *Emory Bankruptcy Developments Journal*; J.D. Candidate, Emory University School of Law (2018); B.S., United States Military Academy (2009). I would like to thank my faculty advisor, Dean James Hughes, for his advice throughout the writing process. Thanks to my wife Kate Davis Green for her love and for supporting my many endeavors.