U.S. Bank v. Village at Lakeridge

A Small Step for Bankruptcy, and A Slightly Bigger Step for Civil Procedure

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On March 5, 2018, the United States Supreme Court decided *U.S. Bank v. Village at Lakeridge*,[1] a case that, from a bankruptcy perspective at least, is notable more for what it didn't say than for what it did. The holding of the case is fairly straightforward: a clear-error standard is proper when appellate courts review a lower court's determination of whether a transaction is at arm's length.[2] Bankruptcy courts assess whether transactions are arm's length in part in order to determine whether parties are "insiders" of the debtor and thus subject to special rules and requirements. In this case, the Court took a cautious approach, sticking to the terrain of a relatively uncontroversial civil procedure question. Although the Court's reasoning may have broader application than its narrow holding, the Court in general ducked many of the more interesting bankruptcy questions and thus opened the door to more disagreement and uncertainty in the bankruptcy arena.

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[1] U.S. Bank Nat. Ass'n ex rel. CWCapital Asset Mgmt. LLC v. Vill. at Lakeridge, LLC, 138 S. Ct. 960 (2018) [hereinafter "Lakeridge"].

[2] *Id.* at 963.

I.
A Case with a Creative Debtor

The facts of *Lakeridge* involved a creative debtor, a determined bank, and a man with a mysterious identity. In 2011, Lakeridge, the owner and operator of a Nevada commercial real estate development, filed for chapter 11 bankruptcy, listing two significant creditors: U.S. Bank, to whom it owed approximately $10 million; and MBP Equity Partners, which also happened to be Lakeridge's sole owner.[3] As the owner of Lakeridge, MBP was an "insider" of the debtor.[4] This meant that, for bankruptcy purposes, different rules applied to MBP when it came to things like recovery of money and voting on the plan, which specified how MBP and other creditors would be paid.[5]

Lakeridge's plan of reorganization placed U.S. Bank and MBP in separate classes and proposed to pay each of them less than what they were owed.[6] U.S. Bank objected to this treatment, and Lakeridge sought to "cram down" the plan – to ask the bankruptcy court to confirm it anyway, despite U.S. Bank's objection.[7]

At this point, Lakeridge hit a snag. To cram down a plan under the Bankruptcy Code, Lakeridge needed the consent of a class of claims that (1) was impaired (for example, not paid in full) and (2) did not contain any insiders.[8] Of Lakeridge's two impaired creditors, one (U.S. Bank) had already rejected the plan, and the other (MBP) was an insider. So Lakeridge appeared to be out of luck.

Undeterred, Lakeridge got creative. Kathleen Bartlett, an officer of Lakeridge and a member of MBP's board, approached her friend and romantic partner Robert Rabkin, a retired surgeon, with an offer to sell

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[3] *Id.* at 964.

[4] 11 U.S.C.A. § 101(31)(B)(iii) (West 2016) ("The term 'insider' includes . . . person in control of the debtor.").

[5] *See, e.g.,* 11 U.S.C.A. § 547 (West) (providing a longer lookback period for a preferential transfer where insiders are involved).

[6] Lakeridge, *supra* note 1 at 964.

[7] *Id.*

[8] 11 U.S.C.A. § 1129(a)(10) (West).

MBP's claim.[9] MBP's claim was worth $2.76 million; Bartlett offered it to Rabkin for a mere $5,000.[10] Rabkin accepted Bartlett's offer. He bought the claim and then consented to Lakeridge's plan.[11] Lakeridge's theory for why this was appropriate was that because Rabkin *himself* had no connection to Lakeridge, his vote was not the vote of an insider and thus was sufficient to accomplish Lakeridge's cramdown objective.

U.S. Bank, of course, did not see things the same way. It conceded that Rabkin did not fall within the Bankruptcy Code's enumerated list of individuals qualifying as insiders. But U.S. Bank then argued that Rabkin nevertheless was a "non-statutory insider" whose vote should not count for cramdown purposes.[12] As the term suggests, a non-statutory insider is not listed in the Bankruptcy Code. But courts have long recognized that the Code's list of who qualifies as an insider is not meant to be exhaustive.[13] Individuals (and entities) that are similar to those listed in the Bankruptcy Code's definition can still qualify as insiders if they have sufficiently similar characteristics.

The bankruptcy court thus had to decide whether or not Robert Rabkin was an insider of Lakeridge. The bankruptcy court, located in the Ninth Circuit, naturally applied that circuit's test for determining whether a creditor qualifies as a non-statutory insider. This test says that a creditor is a non-statutory insider if "(1) the closeness of its relationship with the debtor is comparable to that of the enumerated insider classifications in [the Bankruptcy Code], *and* (2) the relevant transaction is negotiated at less than arm's length" (emphasis added).[14]

U.S. Bank argued that Rabkin should indeed be considered a non-statutory insider because of his relationship with Bartlett and because several factors indicated that the transaction was not arm's-length.[15] In addition to

[9] Lakeridge, *supra* note 1 at 964.

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.* at 963.

[14] *Id.* at 965.

[15] *Id.* at 964; *see also* U.S. Bank N.A. v. The Village at Lakeridge, LLC (In re the Village at Lakeridge, LLC), 814 F.3d 993, 997 (9th Cir. 2016) (describing U.S. Bank's offers to purchase Rabkin's claim for up to $60,000 and Rabkin's refusal to accept).

being in an intimate relationship with Bartlett, Rabkin had purchased a multi-million-dollar claim for a few thousand dollars and had done so with little to no diligence. The bankruptcy court disagreed with U.S. Bank, characterizing Rabkin's purchase as a "speculative investment" for which he had done sufficient due diligence.[16] The bankruptcy court ultimately concluded that the transaction had been conducted at arm's length, which was sufficient under the Ninth Circuit's test to take Rabkin out of the running for insider status.

On appeal, the Ninth Circuit affirmed the bankruptcy court's decision, concluding that it was properly based on a finding that the transaction in question was conducted at arm's length.[17] The Ninth Circuit also determined that this finding was entitled to clear-error review.[18]

II.
THE SUPREME COURT'S STRAIGHTFORWARD OPINION

The case reached the Supreme Court with three questions on the table – two narrower and one broader. First was a question about the Robert Rabkins of the world: do claimants who purchase or otherwise receive claims from insiders become insiders themselves, or does the sale or assignment automatically "cleanse" the claim and its recipient from insider status?[19] Second was a question sure to quicken the pulse of civil procedure buffs: what is the appropriate standard for reviewing a lower court's determination of non-statutory insider status?[20] Finally, there was a broader question: what is the proper test for determining non-statutory insider status?[21] The Supreme Court has never endorsed a specific test for determining who qualifies as a non-statutory insider, although the lower courts have come up with a healthy variety of their own tests. Notably, not all

[16] Lakeridge, *supra* note 1 at 964.

[17] *Id.* at 965.

[18] *Id.*

[19] Petition for Writ of Certiorari at i.

[20] *Id.*

[21] *Id.*

courts agree with the Ninth Circuit that a finding of an arm's-length transaction alone precludes a finding of insider status.[22]

This case thus presented two opportunities to clear up some nagging questions in bankruptcy law: the proper test for non-statutory insider status and the contested issue of whether otherwise non-insiders can become insiders by purchasing previously insider-owned claims. Unfortunately, the Court bypassed both of these exciting opportunities, choosing to grant cert only on the issue of the proper standard of review.[23] This meant that, for purposes of its decision, the Court took as a "given" the Ninth Circuit's test for determining non-statutory insider status and did not express an opinion on the correctness of that test.[24] In a 9-0 vote, the Court concluded that the Ninth Circuit had applied the correct standard in reviewing the bankruptcy court's application of its test for clear error.[25]

The Court reasoned that the Ninth Circuit's test dealt the bankruptcy court a "mixed question" of law and fact, requiring the bankruptcy court to determine whether the facts of the case satisfied the legal test for determination of non-statutory insider status.[26] Despite the "mixed" nature of the question, the Court concluded that it was primarily factual in nature and thus, the inquiry belonged primarily in the bankruptcy court.[27] The more deferential clear-error standard of review was therefore appropriate in this case.

Justice Sotomayor and Justice Kennedy each filed concurrences. To varying degrees, both hinted dissatisfaction with the Ninth Circuit's test. In her concurrence, Justice Sotomayor even articulated two alternative tests for the determination of non-statutory insider status.[28] Justice Sotomayor seemed disappointed at what she perceived to be the relatively limited use of the Court's opinion: she noted that if a different test were applied below, the correct standard of review might well have been different.[29]

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[22] *Id.* at 24-26.

[23] U.S. Bank Nat. Ass'n v. Vill. at Lakeridge, LLC, 137 S. Ct. 1372 (2017).

[24] Lakeridge, *supra* note 1 at 965-66.

[25] *Id.* at 969.

[26] *Id.* at 966.

[27] *Id.* at 968.

[28] *Id.* at 971-72 (Sotomayor, J., concurring).

[29] *Id.* at 972 (Sotomayor, J., concurring).

III.
A Safe and Limited Holding

From a bankruptcy perspective, the Court's holding is indeed quite limited. The standard of review that the Court affirmed seems primarily relevant to courts that use the Ninth Circuit's test, and the Court did not tackle the deeper circuit split about what the appropriate test should be.

The limitations of the Court's holding are exacerbated by the Justices' varying degrees of discomfort with the Ninth Circuit's test. Justice Kagan, who penned the majority opinion, was quick to distance the Court from any appearance of endorsement, stating "We do not address the correctness of the Ninth Circuit's legal test. . . . We simply take that test as a given in deciding the standard-of-review issue we chose to resolve."[30] Justice Kennedy took a similar approach in his concurrence, remarking that "The Court's holding should not be read as indicating that the non-statutory insider test as formulated by the Court of Appeals is the proper or complete standard to use in determining insider status."[31] Justice Sotomayor's approach was the most pointed: "I hope that courts will continue to grapple with the role that an arm's-length inquiry should play in a determination of insider status."[32] So viewing *Lakeridge* as an approval of the Ninth Circuit's test would be a stretch.

Yet while the Justices seemed to express disapproval of the Ninth Circuit's test, not enough Justices were comfortable endorsing an alternative test. That decision leaves the field open for more tests to develop, and possibly more splits to emerge, in the lower Courts. This also may help explain why the Justices decided to grant cert on this case. Although they may not have been ready or able to agree on a different test, they all seemed to want to send a message – of varying degrees of force – to the Ninth Circuit about the flaws in its test.

The Court's decision not to decide on how to determine non-statutory insider status may seem at first like a missed opportunity. It's important in bankruptcy to know who the insiders are. As in *Lakeridge*, confirmation of

[30] *Id.* at 965-66.

[31] *Id.* at 969 (Kennedy, J., concurring).

[32] *Id.* at 973 (Sotomayor, J., concurring).

a debtor's plan might turn on the question of insider status. Beyond *Lakeridge*, the debtor's ability to recover a preferential payment made to a creditor may also turn on insider status. It seems that the Court is not yet ready to articulate or endorse a definitive test. But the issue of non-statutory insider status is not going to go away and will likely continue to divide the courts.

The Court here may be taking baby steps when it comes to the bankruptcy issues, but *Lakeridge* represents perhaps a bigger step in the world of civil procedure. As others have pointed out, Justice Kagan's careful breakdown of the steps required to determine the proper standard of review in cases involving a mixed question of law and fact may well be useful in other cases, even if its use with respect to this particular bankruptcy issue is limited.[33] Justice Kagan distinguished between mixed questions that "require courts to expound on the law" and those that "immerse courts in case-specific factual issues."[34] The standard of review for a mixed question depends on which category it falls into. In *Lakeridge*, the predominant nature of the mixed question was fact-based: the lower court had to assess all of the facts to determine whether the transaction was conducted at arm's length.[35] Because of the fact-based nature of the inquiry, the court of appeals correctly used a more deferential clear error standard of review.[36]

IV.
CONCLUSION

The Court's decision in *Lakeridge* is likely to matter little to bankruptcy practitioners in the long run, but the Court's silence on the substantive issues in the case will keep these issues at the forefront of bankruptcy

[33] *See, e.g.,* Post of Ronald Mann, *Opinion Analysis: Justices Approve Deferential Review of Bankruptcy-Court Determinations on 'Insider' Status*, SCOTUSBLOG, Mar. 5, 2018, www.scotusblog.com/2018/03/opinion-analysis-justices-approve-deferential-review-bankruptcy-court-determinations-insider-status/; Alan B. Morrison, *U.S. Bank National Ass'n v. Village at Lakeridge: Reviewing Mixed Questions of Fact & Law*, GEO. WASH. L. REV. ON THE DOCKET (Oct. Term 2017).

[34] Lakeridge, *supra* note 1 at 967.

[35] *Id.* at 968.

[36] *Id.* at 969.

practice and litigation. Thus, *Lakeridge*, for better or for worse, is likely not to be the end of the story. Indeed, sticking to the "safer" issue in this instance may force lower courts to address, again and again, the issues the Court did not decide to resolve – and may set the stage for the Supreme Court to tackle them in the near future.