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Update on Bankruptcy Preference Insider Liability

***Seventh Circuit Holds Minority Member of LLC Liable As Statutory Insider in* Longview Aluminum**

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The Seventh Circuit held, on Sept. 2, 2011, that a minority member of a limited liability company (LLC) was a "statutory insider" for purposes of bankruptcy preference liability. *In re Longview Aluminum Company, LLC*, 657 F.3d 507, 510 (7th Cir. 2011). As the court explained, it "not only look[ed] to the individual's title, but also his relationship to the company." *Id*. The facts of the case, however, undermine the court's legal analysis.

Facts

The insider here, Forte, held only a minority membership interest and lacked control of the debtor LLC. As one of five members of a member-managed Delaware LLC with only a 12% membership interest, Forte had repeatedly sought to inspect the debtor's books and records. When the LLC denied his request, Forte sued the 50% member, who joined with three other members in precluding Forte's access to the books and records during the pendency of the litigation. The parties eventually settled, with the debtor LLC agreeing to pay Forte $400,000 plus legal fees "in exchange for his agreement to leave the Board" of Managers. *Id*. at 508. During the year preceding the LLC's bankruptcy, the debtor paid Forte $200,000 of the agreed settlement amount (*i.e.*, 50%) plus $15,000 to reimburse him for his attorneys' fees. *Id*. at 508.

The LLC's bankruptcy trustee sued Forte, claiming that both payments were preferences under Bankruptcy Code § 547(b). Although conceding that the $15,000 paid within 90 days of bankruptcy was voidable, Forte denied that the $200,000 payment was a preference because he was not an insider when the debtor LLC paid him. *Id*. at 509. Forte argued that his LLC member status did not make him the equivalent of a business corporation's director. He cited his exclusion from management decisions and his lack of control. *Id*. at 509-10.

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Statutory Definition of Insider

Code § 101(31)(B) defines an insider of a corporate debtor to be a "(i) director of the [corporate] debtor; (ii) officer of the [corporate] debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor." [emphasis added] Moreover, the Code's definition of a corporation includes an LLC such as the debtor here: "unincorporated company." Code § 109(A)(iv).

Code § 101(31) defines "insider" inclusively so as to cover persons who have special relationships with the debtor and who would not ordinarily deal with it at arm's length. S. Rep. No. 989, 95th Cong., 2d Sess. 25 (1978). Directors and officers of a corporate debtor are, because specifically mentioned, statutory insiders per se. So, too, are persons who own, control or hold the power to vote 20% or more of a corporate debtor's outstanding voting securities. Code § 101(31)(E); § 101(2)(A) (affiliates defined as insiders per se). Moreover, "a person in control" of a corporate debtor is also an enumerated statutory insider. Code § 101(31((B)(vi) ("person in control of the debtor"). Most important, "the Code definition [of insider] is not exclusive. [Because] the definition [says] 'includes,' and [Code] § 102(3) … provides that the word 'includes' is not a word of limitation," the "litigator's skills are tested when the defendant [creditor] does not fit conveniently within one of the per se categories of Section 101(31) … ." A.S. Lurey, Bankruptcy Litigation Manual § 8.02[A] at 8-5, 8-6 (2011-12 rev. ed.).

Relevance of Insider Status

When the debtor pays an "insider" creditor, the Code enlarges the preference reach-back from 90 days to one year before the bankruptcy filing. Essentially, "insider" status turns on the defendant creditor's position during the earlier nine-month period. Because any preferential payment, however, regardless of insider status, is voidable under Code § 547(b) during the later 90-day period immediately preceding bankruptcy, Forte had "conceded" liability for the debtor's $15,000 payment during the basic preference and "returned the funds" to the Longview trustee. 1657 F.3d at 509.

Analysis

"Courts regularly treat [the statutory] definition [of "insider" in § 101(31)(B)] as illustrative of types of insider relationships and not as an exhaustive list." *Id*. According to the court in *Longview*, whether a defendant is an insider turns on "a case-by-case decision based on the totality of the circumstances … . If the alleged insider holds a position *substantially similar to the position specified* in the [statutory] definition, a court will often find that individual to be an insider … . [Under an alternative] approach, courts look to the closeness of the relationship between the parties." *Id*. (emphasis added).

The Seventh Circuit adopted the "similarity approach" used by the lower court, rejecting Forte's challenge and explaining that a member of an LLC should be treated like a director of a corporation:

> It is well established that the definition of insider is not an exhaustive list; the definition has been expanded by bankruptcy courts to include positions analogous to those enumerated, including in the LLC context. … When the position held by the alleged insider *is not enumerated in the statute*, the relevant inquiry for the court is to consider *whether the relationship at issue is similar* to or has characteristics of *any of the defined relationship*s.
>
> *Id*. at 509-10 (emphasis added).

Construing Delaware law, the court approved the district court's finding that Delaware law vested in the members of an LLC the same management authority as the directors of a Delaware corporation. *Id*. at 510. Indeed, according to the court, the LLC agreement here "specifically provided its members with authority analogous to that of a director of a corporation … ." *Id*.

The Seventh Circuit approvingly quoted the bankruptcy court's reasoning:

> It is not simply the title 'director' or 'officer' that renders an individual an insider; rather, it is the set of legal rights that a typical corporate director or officer holds.
>
> *Id*., quoting *In re Longview Aluminum, LLC*, 419 B.R. 351, 355 (Bankr. N.D. Ill. 2009). Thus, the individual's relationship, not his title, is key.

Forte argued, though, that he lacked any kind of control over the debtor's affairs because he had been "prevented from managing or participating in a meaningful way … ." *Id*. He cited his being denied access to the debtor's books and records and his exclusion by the other members. *Id*. But the Court of Appeals, like the district court, did not find this exclusion "to be enough to remove Forte's status as an insider … ." *Id*. at 511. In the court's view, the other members had not removed Forte as a member, and he still retained "meaningful rights and control given to members under" the debtor's LLC agreement. *Id*. Forte could still vote and still remained a member. It was not until after he had received funds from the debtor that he resigned. *Id*. Although courts often use a "control approach" (Code 10(1)(31)(B)(iii) in determining insider status, the court here was determining whether Forte was a director, a statutory insider per se. *Id*. Thus, by using a "similarity approach," the court held that Forte, as a member of the debtor LLC, was the equivalent of a corporate director.

Critique of *Longview*

Forte had no meaningful position in the debtor's management. Despite his 12% minority interest, the other members had improperly excluded him from management and from exercising his rights as a member. That misconduct was the basis for the debtor's agreement to pay Forte $400,000 plus legal fees in exchange for his departure. Forte could have convincingly argued on the facts that he was more like a minority shareholder in a closely held corporation, somebody who would not be an insider under the Code. The Seventh Circuit suggested, though, that Forte would not have been an insider had he resigned (" … surrendered all of his rights in the company before his formal resignation or departure."). *Id.* at 511. But withdrawal as a member of an LLC may be severely limited by applicable state law. *See, e.g.*, Del. LLC Act § 18-603 ("… unless [LLC operating] agreement provides otherwise, a member may not resign … prior to the dissolution and winding up of the [LLC]"); Maryland Statutes 4A-605 (withdrawal barred unless "6 months' prior written notice" given to other members or when "operating agreement" denies "right or power to withdraw."); NY Consol. Laws, LLC § 606(a)(same). Moreover, the debtor LLC in *Longview* had, in effect, already removed Forte as a member by causing him to leave the Board of Managers as part of his settlement. 657 F.3d at 508. Particularly unconvincing was the court's assertion that Forte "retained voting rights," "still held a *formal* position on the board on the Board and did not resign until after he received the settlement payment." *Id.* At 511 (emphasis added). Indeed, it was the debtor LLC's wrongful exclusion of Forte that forced him to sue almost two years prior to bankruptcy. *Id.* at 508.

Other Appellate Rulings

Longview Aluminum is inconsistent with at least one other appellate decision. The Tenth Circuit previously rejected a bankruptcy court's determination in a preference action that an individual debtor was a director of a corporation, simply because he held the title "director emeritus." *In re Kunz*, 489 F.3d 1072 (10th Cir. 2007). According to the court, holding that a "director emeritus" is a director without first looking to the level of control or decision making power "frustrate[s] legislative intent" and "def[ies] common sense." *Id.* at 1078.

The Chapter 7 trustee in *Kunz*, relying on Code § 101(31)(A)(iv), argued that the defendant bank was an insider because it was a "… corporation of which the [individual] debtor is a director, officer, or person in control … ." The bankruptcy court in *Kunz* agreed with the trustee that the debtor, in his capacity as a "director emeritus," was a director of the bank, reasoning that "emeritus" is simply an adjective having no effect on the debtor's status as a director. *Id.* at 1076-77.

The Tenth Circuit, relying on a standard dictionary definition, found that "emeritus" meant "holding [an honorary title] … after retirement … ." *Id.* at 1077. The individual debtor here "was not a director in the ordinary understanding of the term." *Id.* Rejecting the view of the bankruptcy court and the trustee, the court explained that "common sense" dictated its result. *Id.* Although the defendant bank in *Kunz* was not a statutory insider per se because of the debtor's director emeritus title, the lower court still had to determine on remand, as a factual matter, whether the bank was an insider: "Whether [the bank] is ultimately determined to be an insider, based on the specifics of their dealings, is left to the Bankruptcy Court to determine on remand." *Id.* at 1080. The Seventh Circuit had also held in another case, based on different facts, that an "insider relationship survived [an officer's] resignation and … [the] subsequent appointment of a receiver … ." I*n re Krehl*, 86 F.3d 737, 742-43 (7th Cir. 1996) (evidence showed that officer remained in control of corporate debtor).

Non-Statutory *De Facto* Insiders

Courts have established, based on a factual review of the record, another category of creditors who fall outside any of the enumerated categories of statutory insiders. *In re U.S. Med., Inc.*, 531 F.3d 1272, 1275 (10th Cir. 2008); *In re Winstar Communications, Inc.*, 554 F.3d 382, 395 (3d Cir. 2009). They note that the definition of "insider" in Code § 101(31) contains the term "includes," and because Code § 102(3) provides that this term is "not limiting," a party may be considered a *de facto* or non-statutory insider on an appropriate factual record.

For example, a major creditor in *U.S. Med.* had a designee on the debtor's board of directors plus a 10.6% equity interest. The creditor had some involvement, but no control over the debtor's business. Moreover, the defending creditor was sensitive to potential conflicts of interest and dealt with the debtor at arm's length. The court held that the creditor was not a statutory insider, and that it also lacked *de facto* insider status. *See Rubin Bros. Footwear Inc. v. Chemical Bank*, 73 B.R. 346. 354 (S.D.N.Y. 1987) (held, motion to dismiss denied; complaint alleged insider status; lender allegedly persuaded debtor not to file bankruptcy petition, but to hire particular turnaround consultant who was allegedly allied with lender and who intended to provide lender with more collateral; lender received liens during longer insider preference reachback period), later modified, 119 B.R. 416 (S.D.N.Y. 1990) (held, lender's motion for summary judgment dismissing preference claim granted; no proof that turnaround consultant was lender's agent; lender lacked sufficient control of debtor to be deemed *de facto* insider); *In re Radnor Holdings Corp.*, 353 B.R. 820, 833-35 (Bankr. D. Del. 2006) (held, after trial, investment fund secured lenders were not insiders for preference purposes despite: 1) holding equity in debtor; 2) having representative on debtor's board; and 3) access to debtor's performance reports and financial information with debtor's agreement to appointment of new CEO; lenders never exercised rights and never exercised control over debtor's operations); *In re Optical Techs, Inc.*, 246 F.3d 1332 (11th Cir. 2001) (held, to be insider, person must "control the company so as to dictate corporate policy and disposition of corporate assets without limits."); *In re Friedman*, 125 B.R. 63, 70-71 (9th Cir. B.A.P. 1991) (creditors "not in control of [debtor's] business affairs at any point … [Loan documents signed] in an adversary atmosphere and at arm's length.").

The Third Circuit in *Winstar* rejected the defendant creditor's argument that the definition of "insider" applied only to those who exercise day-to-day managerial control over the debtor's operations. 554 F.3d at 396. According to the court, "it is not necessary that a non-statutory insider have actual control; rather the question 'is whether there is a close relationship [between debtor and creditor] and … anything other than closeness to suggest that any transactions were not conducted at arm's length." *Id.*, citing *In re U.S. Med.*, 531 F.3d at 1277. Holding that the debtor's "strategic partnership" vendor was liable as a non-statutory insider, the Third Circuit relied on the bankruptcy court's post-trial "extensive findings" in *Winstar* to support its imposition of insider status, including the following:

- The defendant creditor "controlled many of Winstar's decisions relating to the build-out of the network";
- The creditor "forced the 'purchase' of its goods well before the equipment was needed and in many instances … never needed at all";
- The creditor "treated Winstar as a captive buyer for [the creditor's] goods";
- The creditor used Winstar as a "means for [the creditor] to inflate its own revenue"; and
- The creditor "involved Winstar's employees in [certain improper transactions that benefited the creditor] … ."

Id. at 397.

In sum, reasoned the court in *Winstar*, "actual control is unnecessary for an entity to be deemed a non-statutory insider." *Id.* at 399. Even if the creditor "was not a 'person in control' of Winstar, it was still a non-statutory or *de facto* insider of Winstar … ." *Id.* It was "both a major creditor and supplier of Winstar." *Id.* As such, it "had the ability to coerce Winstar into a series of transactions that were not in Winstar's best interest," thus refuting "any suggestion of arm's length dealing." *Id.*, citing *U.S. Med.*, 531 F.3d at 1277 n.4 ("An arm's length transaction is '[a] transaction in good faith in the ordinary course of business by parties with independent interests … [,] each acting in his or her own best interest' … ."), quoting Black's Law Dictionary, 109 (6th ed. 1999). Despite the creditor's argument in *Winstar* that it had been "engaging in arm's length dealings" with the debtor, the court affirmed the bankruptcy court's findings that the creditor "had come to dominate the parties' relationship" when the preferential transfer occurred, and that the parties were not engaged in arm's length dealings. *Id.* at 399.

Conclusion

The Seventh Circuit's *Longview* decision is aberrational. The court's facile legal analysis ignored hard facts to impose insider liability on an individual who was, at best, an insider in name only. Common sense should have dictated a different result. As Voltaire noted long ago, however "common sense is not so common." Dictionaire Philosophique (1764). And, as the Ninth Cirucit noted, "[l]aw can be stranger than fiction in the Preference Zone." *In re Powerine Oil Co.*, 59 F.3d 969, 971 (9th Cir. 1995)(2-1) (Kozinski, J.).