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The Long View Following In Re Longview Aluminum

Law360, New York (November 15, 2011, 11:32 AM ET) -- There has been a noticeable increase in bankruptcy preference lawsuits wherein the plaintiff alleges that the defendant is an "insider" of the debtor and should therefore be required to disgorge payments received within one year of the debtor's bankruptcy filing. Since the reach-back period for payments to non-insiders is only 90 days preceding the filing date, preference defendants strive to avoid the insider label, in the hopes of being able to retain payments received 91 to 365 days before the bankruptcy filing.[1]

The Bankruptcy Code provides a non-exhaustive list of entities that are deemed to be insiders of a partnership or corporate debtor, but it does not define who are the insiders of a debtor that is a limited liability company. There is further ambiguity because courts recognize a category of "nonstatutory insiders" that is not defined by the Bankruptcy Code.

Given the uncertainty surrounding who should be deemed to be an insider in preference actions, the Seventh Circuit Court of Appeals' decision in In re Longview Aluminum LLC[2] should raise some eyebrows. In Longview, the Seventh Circuit held that a minority member of an LLC who was feuding with the majority member and whose membership rights had been curtailed by the other members was nevertheless an insider of the LLC debtor.

This represents a second federal appellate court decision adopting an expansive view of the universe of insiders, following in the footsteps of the Third Circuit Court of Appeals' decision in 2009 in Schubert v. Lucent Technologies Inc. (In re Winstar Communications Inc.).[3] These cases illustrate that the determination of who constitutes an insider is fact-specific, and the results courts reach are sometimes counterintuitive.

Background of Longview

The debtor was a Delaware LLC having five members, who comprised its board of managers (the "board"). Dominic Forte held a 12 percent membership interest in the debtor. Before the debtor's bankruptcy, Forte's requests to inspect the debtor's financial records were repeatedly denied. He sued the debtor's majority member, alleging that this member used his controlling interest to prevent Forte from reviewing the debtor's business records, and to exclude Forte from participating in the management of the debtor.

Thereafter, the debtor's other members formally suspended Forte's right to access the debtor's records pending, among other things, an investigation into the propriety of Forte's requests. Forte subsequently settled the pending lawsuit by agreeing to accept $400,000 in exchange for his agreement to resign from the debtor's board. Upon execution of the settlement agreement, the debtor delivered to Forte a payment in the amount of $200,000.

Next, the debtor filed its bankruptcy case. The debtor's trustee sued Forte seeking a return of the $200,000, which Forte received four months before the bankruptcy filing, as an avoidable preference. Forte argued that the $200,000 payment was not a preference because he was not an insider of the debtor. The bankruptcy court held that Forte was an insider and avoided the $200,000 transfer. The district court affirmed, and Forte appealed to the Seventh Circuit.

The Seventh Circuit's Ruling

The court observed that "[t]he insider analysis is a case-by-case decision based on the totality of the circumstances, and bankruptcy courts have used a variety of factors in their determination. One approach focuses on the similarity of the alleged insider's position to the enumerated statutory categories, while another approach focuses on the alleged insider's control of the debtor."[4]

It further noted that the term "insider" includes one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor. Forte argued that the lower courts erred by using the similarity approach to analogize a director of a corporation to a member of an LLC in finding that he was an insider. The Seventh Circuit disagreed.

The court explained that "[w]hen 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 relationships."[5] It reasoned that, because under Delaware law, directors of corporations generally have the authority to manage a corporation while members of an LLC generally have authority to manage an LLC, LLC members are deemed to be analogous to corporate directors, and are therefore sufficiently similar to a statutory insider to be considered an insider of an LLC in bankruptcy.

The court also examined Forte's relationship to the debtor. Forte argued that he had no control over the debtor because he was prevented from managing or participating meaningfully in its affairs. The court rejected that argument, noting that his access to the LLC's books and records was only suspended temporarily, and that his membership status was not revoked.

According to the court, Forte retained meaningful rights and control, including voting rights in the company. Because Forte did not resign from the board until after he received the $200,000, the court held that he was still an insider when he received the payment.

Lastly, Forte argued that, because the Bankruptcy Code does not define insiders of an LLC, it was only possible for him to be deemed a nonstatutory insider. He argued he could not be a nonstatutory insider because his relationship was not sufficiently close to the debtor and he lacked sufficient control of the debtor in order for him to be deemed to be a nonstatutory insider.

Notably, the Seventh Circuit rejected that argument, stating that "in this situation, where the court is determining whether a member or manager of an LLC is a statutory insider, the similarity approach yields a better interpretation of the statute."[6]

What It Means

The Longview decision demonstrates that determination of insider status is an intensely factual exercise, and a court may take more than one approach in reaching its conclusion.

This case is reminiscent of the Third Circuit Court of Appeals' ruling in Winstar. There, Lucent Technologies Inc., a publicly traded company, was held to be an insider of the debtor Winstar Communications Inc., an unaffiliated public company. The Third Circuit held that, even though Lucent was not a "person in control of the debtor," Lucent was still an insider because it had a close relationship with Winstar and the ability to coerce Winstar into transactions that were not in its interest.

The Third Circuit found Lucent dominated the relationship with Winstar, and held sufficient control so as to be a nonstatutory insider of the debtor. Accordingly, Lucent was required to return a $188.2 million payment it received from Winstar over four months before Winstar's bankruptcy filing.

Cautionary Note

Taken together, Longview and Winstar demonstrate that there are several grounds upon which a creditor may be found to be an insider of a debtor. A creditor seeking to avoid insider status needs to be certain that it has relinquished its rights to control the potential debtor's activities, and must avoid using its superior position in its relationship with the debtor to coerce the debtor into acting to its own detriment. The creditor who ignores the lessons of these cases does so at its own peril.

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[1] There are additional reasons why a party may want to avoid the insider designation. For example, (i) claims of insiders are more easily susceptible to equitable subordination; see, In re Liberty Mutual Ins. Co., 226, B.R. 746, 756 (N.D.N.Y. 1998) (for the purposes of equitable subordination, "[t]he conduct of an insider is subject to more rigorous scrutiny"); (ii) transactions between a debtor and an insider are subject to heightened scrutiny; see, In re Enron, 335 B.R. 22, 28 (S.D.N.Y. 2005) ("Courts have held that transactions that benefit insiders must withstand heightened scrutiny before they can be approved under § 363(b)."); and (iii) the votes of insiders are not counted in determining whether a class of creditors has voted to a accept a plan of reorganization; see 11 U.S.C. § 1129(a)(10).

[2] 657 F.3d 507 (7th Cir., 2011).

[3] 554 F.3d 382 (3d Cir. 2009).

[4] In re Longview Aluminum LLC, 657 F.3d at 509.

[5] Id at 510.

[6] Id. at 511.