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Learning From Recent Insider Preference Cases

Law360, New York (October 11, 2011, 1:09 PM ET) -- The continued vitality of preference litigation has led to an ever-growing body of case law, including decisions with regard to recoveries from "insiders," pursuant to Sections 547, 550 and 101(31) of the Bankruptcy Code. This article addresses three recent insider preference cases: one in which the Seventh Circuit establishes a framework to simplify the analysis undertaken by bankruptcy courts when the alleged insider has a role similar to one of the specifically enumerated persons and entities listed in section 101(31); one that illustrates the risks inherent for owners of nondebtor affiliates of debtor entities; and one that provides an example of the interaction between the Bankruptcy Code and state law in connection with determining whether a defendant is indeed an "insider."

In In re Longview Aluminum LLC, 2011 U.S. App., decided on Sept. 2. 2011, the Court of Appeals for the Seventh Circuit considered a case in which a board member who owned a membership interest in a limited liability company that became a debtor was sued by the trustee for recovery of a prepetition litigation settlement payment from the company. Ironically, the prepetition litigation had concerned, among other things, the member's allegation that he had been frozen out of the company's decision making, notwithstanding his status as a board member.

The court acknowledged that determination of insider status is a mixed question of law and fact, and one to be decided on a case-by-case basis. Following the lower courts, the Seventh Circuit also recognized that "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 … [w]e thus not only look to the individual's title but also his relationship to the company."

However, the court went on to rule that the necessary understanding of the relationship in question arises from the examining the formal rights the alleged insider held with regard to the company at the time of the challenged transfer. In Longview, the defendant had not resigned from the board of the debtor until after he had received his settlement payment. The court did not look to whether he had exercised rights available to him, but only to the existence of the rights. Practitioners should keep this decision in mind when settling inter-owner disputes, and draft agreements accordingly.

In In re James William Lull, 2011 Bankr., decided April 26, 2011, a case from the envied venue of Hawaii, a bankruptcy court meticulously applied the facts before it to a multistep legal analysis of the statutory definitions of "insider" and "affiliate" and ultimately ruled in favor of the trustee. The debtor, an individual, owned 50 percent of and was a director and officer of a corporation. The corporation owned more than 20 percent of an LLC. Finally, the defendant, along with his wife, owned two 12.5-percent joint interests the LLC.

There were no allegations of control. Much to the disappointment of the defendant, the joint tenancy brought him to an aggregate 25-percent ownership of an affiliate of an insider of the debtor, which placed him within a three-link chain leading to insider status. The lesson for practitioners is to apprise clients of indirect insider status risk where business considerations preclude using a structure or an ownership percentage that steers clear of that risk.

Finally, In re Harvey Goldman & Company, 2011 Bankr. decided on Aug. 24, 2011 by the United States Bankruptcy Court for the Eastern District of Michigan, concerned a claim asserted by a trustee against the second cousin of the debtor's president. Section 101(31) of the Bankruptcy Code employs the term "relative" among the list of insiders, and Section 101(45) further defines "relative" as meaning an "individual related by affinity or consanguinity with the third degree as determined by the common law, or individual in a step or adoptive relationship with such third degree."

The court first determined which state law provided the necessary guidance regarding he relationship and then applied the facts that had been adduced at trial. Based on Michigan law, the court ruled in favor of the defendant. Of particular note, however, is a footnote that only an attorney could love. It states in relevant part, "Both counsel for the Trustee and counsel for [defendant], representing other parties, previously took contrary positions [as to whether a second cousin was a relative] … and … both counsel made a point of noting the inconsistency between the other's earlier argument and their position in this adversary proceeding."

Mark Twain is quoted as having said, with a nod to Aesop, that "familiarity breeds contempt … and children." In connection with the Bankruptcy Code, it can breed insider preference litigation.

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