

“Nonstatutory” Insiders Under Bankruptcy Code § 101(31): An “Arm’s-Length” Test Is Not a Proper Test

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On July 15, 2008, the Tenth Circuit in *In re U.S. Medical, Inc.* became one of the few circuit courts to establish a test to determine who constitutes a “nonstatutory” insider under Bankruptcy Code § 101(31).¹ Bankruptcy Code § 547 allows a trustee to avoid preferential transfers made within one year, rather than only during 90 days, before bankruptcy, if the creditor was then an “insider.” Section 101(31) provides that an “insider” in the case of a corporation “includes” directors, officers of the debtor, and several others. If creditors fall into one of the specifically enumerated categories, they constitute “statutory” insiders. However, by adding the word “includes,” Congress did not intend the list of enumerated insiders to be exhaustive. Rather, Congress intended the list to be illustrative only and to include other insiders as well, who are commonly referred to as “nonstatutory insiders.” In *U.S. Medical*, the Tenth Circuit, affirming the Bankruptcy Appellate Panel which reversed the bankruptcy court, held that “a creditor may only be a non-statutory insider of a debtor when the creditor’s transaction of business with the debtor is not at arm’s length.”² The holding reflects an extraordinary standard that lacks a supporting analysis.

The debtor in *U.S. Medical* distributed new and used medical equipment via the Internet. On June 15, 2000, the debtor entered into a distribution agreement with a creditor, a German producer of surgical and aesthetic lasers. The agreement provided that the debtor was to be the exclusive distributor in North America, and the creditor was to be the debtor’s sole laser manufacturer. The agreement also provided that an executive of the creditor would serve on the board of directors of the debtor and that the creditor would acquire a 10.6% equity interest in

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the company for \$2 million in cash and a \$2 million inventory purchase credit. In 2001, the debtor began experiencing financial difficulties, and on June 24, 2002, the debtor filed a Chapter 7 petition.

In *U.S. Medical*, the trustee sought to recover a preference made after 90 days but within one year before the bankruptcy filing, which could be recovered under § 547 only if the creditor was an “insider.” The bankruptcy court held that the creditor constituted a “nonstatutory insider” because the creditor’s CEO served on the debtor’s Board of Directors and because of the creditor’s equity stake in the debtor. In finding the creditor to qualify as a nonstatutory insider, the bankruptcy court found to be determinative the extreme closeness of the relationship between the creditor and debtor. The Bankruptcy Appellate Panel (BAP) disagreed. The BAP stated: “If ‘closeness’ alone were enough, the category of non-statutory insiders would be impermissibly broadened.”³³ The BAP concluded that closeness alone does not establish insider status. Moreover, the BAP determined that a finding of nonstatutory insider status requires evidence that transactions between the creditor and debtor were not conducted at arm’s length. The trustee appealed the BAP’s decision to the Tenth Circuit, which affirmed the BAP’s decision.

In its appeal to the Tenth Circuit, the trustee argued that the closeness of the relationship between a creditor and debtor alone is enough to support a finding that a creditor is a nonstatutory insider of a debtor. The trustee further argued that the absence of control or of an arm’s-length relationship is not determinative and that access to inside information supported the bankruptcy court’s decision.

While the Tenth Circuit agreed with the trustee that the absence of control is not determinative of nonstatutory insider status, it disagreed with the trustee’s argument that access to inside information and the closeness of the relationship between the debtor and the creditor are alone sufficient to establish “nonstatutory” insider status. Instead, the Tenth Circuit held that the absence of an arm’s-length relationship is determinative, quoting the following legislative history: “An insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.”³⁴ Specifically, the court stated: “We hold here that a creditor may only be a non-statutory insider of a debtor when the creditor’s transaction of business with the debtor is not at arm’s length.”³⁵ The court defined an arm’s-length transaction as: “a transaction in good faith in the ordinary course of business by parties with independent interests... The standard under which unrelated parties, each acting in his or her own best interest, would carry out a particular transaction.”³⁶

The court relied on another Tenth Circuit case, *In re Kunz*, for the principle that there is a “conclusive presumption” that statutory insiders have

a closer than arm's-length relationship with the debtor but that, when it comes to nonstatutory insiders, the relationship must "compel the conclusion" that a creditor and debtor are "close enough to gain an advantage attributable simply to affinity rather than to the course of dealings between the parties."⁷ Using the *Kunz* rationale, the court determined that a finding that the creditor and debtor engaged in a challenged transaction not at arm's length necessarily is required in order to compel the conclusion that the creditor is a nonstatutory insider. The court decided that "to hold a creditor is a non-statutory insider in circumstances like these, a trustee must prove that the creditor and debtor did not operate at arm's length at the time of the challenged transaction."⁸

The court also dismissed the trustee's argument that access to insider information should be sufficient to establish nonstatutory insider status. Although the court did not dispute that the creditor had access to insider information, the court was persuaded by the fact that the creditor did not act in any way that suggested that it had any advantage over other creditors. The court noted, in particular, the creditor's sensitivity to potential conflicts of interest, the creditor's apparent arm's-length dealing with the debtor, and that the creditor did not take advantage of the inside information.⁹

Certainly under the circumstances present in the *U.S. Medical* case, the likelihood that the creditor would receive preferential treatment is much greater than that received by other creditors with less connection to the debtor. For example, the creditor's CEO was on the debtor's board of directors; the creditor's CEO had limitless access to inside information of the debtor; the creditor held 800,000 shares or 10.6% of the debtor's common stock; and the creditor and debtor were intertwined in a strategic alliance whereby the creditor made a multimillion dollar investment in the debtor and entered into an agreement for the debtor to purchase inventory from the creditor. Despite the overwhelming potential for preferential treatment based on access to insider information and stock ownership, the Tenth Circuit found that the creditor was not a "nonstatutory" insider because the creditor and debtor seemingly had an arm's-length relationship. Thus after the decision in *U.S. Medical*, the test to determine whether a creditor is a nonstatutory insider, at least in the Tenth Circuit, will be whether the transaction at issue was at arm's length.

An arm's-length test is the wrong test for many reasons. In light of the expansive term "including," Congress could not have intended insider status to be limited so as to cover only arm's-length transactions. To be sure, if Congress had deemed the lack of an arm's-length transaction to be the sole test for nonstatutory insider status, it could have easily said so in the statute.

In addition to creating a new test for nonstatutory insider status, the arm's-length test is also flawed because it changes the focus. Whereas

the focus in the case of a statutory insider should be on the course of dealings or relationships between debtors and creditors, according to *U.S. Medical*, the focus is on transactions.

The Tenth Circuit's adoption of an arm's-length test based on legislative history to determine insider status is also flawed because the U.S. Supreme Court has stated on numerous occasions that legislative history should be used cautiously.¹⁰ Indeed, when the legislative history fails to illuminate congressional intent, it should not be used.¹¹ In this regard, the congressional history of the term "insider" is anything but clear. As mentioned earlier, the legislative history for § 101(31) is found in the House Judiciary Committee Report, which states that the term "insider" "is not susceptible to precise specification" and "an insider is one who has a sufficiently close relationship with the debtor that its conduct is made subject to closer scrutiny than those dealing at arm's-length with the debtor."¹² That does not mean that there should be no scrutiny of the relationship even where there were arm's-length dealings between the parties.

Figuring out the correct test to determine who constitutes a nonstatutory insider is a difficult task and requires the consideration of many variables. For a fair evaluation, it is necessary to construe the ambiguous definition of "insider" in § 101(31), the legislative history, the use of statutory interpretive techniques, the section's relationship to other sections of the same Code, and policy implications. Even then, the intended test may prove elusive. Here, for the most part, the court neglected to consider any statutory interpretive technique other than inconclusive legislative history.

To be fair to the Tenth Circuit, the particular facts in *U.S. Medical* were compelling. Not only was there no evidence that the creditor used inside information, but the creditor took painstaking care not to exercise control over the debtor. Regardless, the court made the decision on the basis of appearance, which is not a good way to resolve a dispute because appearance is not substantive; it is just what it looks like but not necessarily what it is.

The Tenth Circuit has adopted an extraordinarily narrow standard for who constitutes a nonstatutory insider that is not supported by legislative history or any meaningful analysis.¹³

NOTES

1. In re *U.S. Medical, Inc.*, 531 F.3d 1272, 50 Bankr. Ct. Dec. (CRR) 57, Bankr. L. Rep. (CCH) P 81275 (10th Cir. 2008).

2. *U.S. Medical*, 531 F.3d at 1280.

3. In re *U.S. Medical, Inc.*, 370 B.R. 340, 345 (B.A.P. 10th Cir. 2007), judgment aff'd, 531 F.3d 1272, 50 Bankr. Ct. Dec. (CRR) 57, Bankr. L. Rep. (CCH) P 81275 (10th Cir. 2008).

4. *U.S. Medical*, 531 F.3d at 1277 (quoting S. rep. No. 95-989, at 25 (1978), 1978 U.S. Code Cong. & Admin News 5787, 5810; H.Rep. No. 95-595, at 312 (1977)).

5. U.S. Medical, 531 F.3d at 1280.
6. U.S. Medical, 531 F.3d at 1277 n.4 (quoting Black's Law Dictionary 109 (6th ed. 1990)).
7. U.S. Medical, 531 F.3d at 1280 (citing *In re Kunz*, 489 F.3d 1072, 1079, 48 Bankr. Ct. Dec. (CRR) 103, Bankr. L. Rep. (CCH) P 80958 (10th Cir. 2007)).
8. U.S. Medical, 531 F.3d at 1280.
9. Note that the court's result runs contrary to securities laws. In the securities law context, an insider is a person who has knowledge of facts not available to the general public. Black's Law Dictionary (8th Ed. 2004).
10. *Wisconsin Public Intervenor v. Mortier*, 501 U.S. 597, 617, 111 S. Ct. 2476, 115 L. Ed. 2d 532, 33 Env't. Rep. Cas. (BNA) 1265, 21 Env't. L. Rep. 21127 (1991) (SCALIA, J., concurring in judgment) (legislative history is "unreliable... as a genuine indicator of congressional intent"); *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 97 S. Ct. 926, 51 L. Ed. 2d 124, Fed. Sec. L. Rep. (CCH) P 95864 (1977) ("Reliance on legislative history in divining the intent of Congress is, as has often been observed, a step to be taken cautiously."); *Department of Air Force v. Rose*, 425 U.S. 352, 388-389, 96 S. Ct. 1592, 48 L. Ed. 2d 11, 1 Media L. Rep. (BNA) 2509 (1976) ("As is so often the case, the legislative history cuts both ways and is particularly confusing here").
11. *U.S. v. Gonzales*, 520 U.S. 1, 6, 117 S. Ct. 1032, 137 L. Ed. 2d 132 (1997) ("There is no reason to use the legislative history" and "far from clarifying the statute, the legislative history only muddies the waters").
12. H.R. Rep. No. 95-595, at 312, 314 (1978).
13. This article is intended only as a discussion of the *U.S. Medical* case. The author is in the process of writing an in-depth article addressing what should be the correct test to determine when a creditor constitutes a nonstatutory insider.