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EXHIBIT

Problems in the Code

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Absence of Reference to LLCs in the Code: An "Insider" Problem

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A limited liability company (LLC) is neither a corporation nor a partnership, but rather a hybrid entity having common characteristics of both. LLCs have become popular in recent years because they provide protections of limited liability similar to shareholders of a corporation, as well as the tax benefits of a partnership.[1] When the Bankruptcy Code was enacted in 1978, the use of LLCs as business entities was in its infancy and there was no specific reference to LLCs in the Code.[2]

As LLCs have become frequent participants in bankruptcy, uncertainties regarding their treatment in bankruptcy have arisen. Courts have resolved most of these issues without serious debate. For example, an LLC unquestionably qualifies as a "person" eligible to be a debtor, even though the Code's definition of "person" expressly includes only individuals, partnerships and corporations.[3] Additionally, courts permit creditors to file involuntary petitions against LLCs, as with corporations, but there is no reported decision authorizing a member of an LLC to file an involuntary case against an LLC, as general partners are permitted to do against partnerships.[4]

One important issue regarding the treatment of LLCs in bankruptcy, however, has eluded consensus: When the debtor is an LLC, what causes entities associated with the LLC to be considered insiders? The answer is not clear due to a lack of any express reference to LLCs in the Code's definition of an "insider," and also due to differing judicial standards for establishing nonstatutory insider status. With a modest amendment to the Bankruptcy Code, Congress could provide clarity as to which entities associated with debtor LLCs are or are not insiders of the debtor.

The Importance of Insider Status and the Code Definition

The determination of whether an entity is an insider is meaningful in a number of bankruptcy contexts. Insider status is most germane in preference litigation. Preferential transfers made to insiders within one year of the bankruptcy filing can be avoided under § 547(b), while transfers made to noninsiders can be avoided as preferential transfers only if made within 90 days of the filing.[5]

In chapter 11 confirmation proceedings, the insider status of voting creditors could determine whether a plan satisfies the elements of confirmation, as § 1129(a)(10) requires the plan proponent to obtain the vote of at least one impaired class of creditors, *excluding insiders*.[6] In litigation involving subordination or recharacterization of claims, insider status is important to the applicable burden of proof and often the ultimate outcome of the proceeding.[7] It has also been held that insiders are barred from asserting *in pari delicto* as a defense to claims brought against them by a bankruptcy estate.[8]

In determining insider status, courts start with the definition of an "insider" in § 101(31):

> (A) if the debtor is an individual—
> (i) relative of the debtor or of a general partner of the debtor;
> (ii) partnership in which the debtor is a general partner;

1 *See, e.g., Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65, 74 (Bankr. E.D. Va. 1996) (internal quotation and citation omitted).
2 Wyoming was the first state to permit the formation of LLCs in 1977. *Lieberman v. Wyoming.com LLC*, 11 P.3d 353, 356-57 (Wyo. 2000).
3 11 U.S.C. § 101(41). *See, e.g., In re 4 Whip LLC*, 332 B.R. 670, 672 (Bankr. D. Conn. 2005); *In re ICLNDS Notes Acquisition LLC*, 259 B.R. 289, 293 (Bankr. N.D. Ohio 2001); *In re DeLuca*, 194 B.R. at 74.
4 *See generally In re Green Hills Dev. Co. LLC*, 445 B.R. 647, 666 (Bankr. S.D. Miss. 2011); *In re AMC Investors LLC*, 406 B.R. 478, 483 (Bankr. D. Del. 2009).
5 *In re Longview Aluminum LLC*, 657 F.3d 507, 509 (7th Cir. 2011) (citing 11 U.S.C. § 547(b)(4)(B)).
6 11 U.S.C. § 1129(a)(10).
7 *See, e.g., Shubert v. Lucent Techs. Inc. (In re Winstar Communications Inc.)*, 554 F.3d 382, 412 (3d Cir. 2009).
8 *See, e.g., In re Student Finance Corp.*, 335 B.R. 539, 547 (D. Del. 2005).

(iii) general partner of the debtor; or
(iv) corporation of which the debtor is a director, officer, or person in control;
(B) if the debtor is a corporation—
(i) director of the debtor;
(ii) officer of the 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;
(C) if the debtor is a partnership—
(vii) general partner in the debtor;
(viii) relative of a general partner in, general partner of or person in control of the debtor;
(ix) partnership in which the debtor is a general partner;
(x) general partner of the debtor; or
(xi) person in control of the debtor;
(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;
(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and
(F) managing agent of the debtor.[9]

An entity fitting squarely within any of the insider definitions listed in § 101(31) is known as a "statutory" insider.[10] Section 101(31) is nonexhaustive, however, and an entity can qualify as what is known as a "nonstatutory" insider, even if not listed in the statute.[11]

Divergent Approaches

There is no substantive difference in the treatment of statutory and nonstatutory insiders.[12] The absence of specific statutory reference to LLCs in the Code, however, has led to uncertainty regarding what is required to establish insider status (statutory or nonstatutory) in cases involving debtor LLCs. A party advocating an insider finding in a case involving a debtor LLC could argue that an entity associated with an LLC may qualify as a statutory insider, eliminating the need to delve into the more subjective issue of nonstatutory insider status. In so arguing, the party seeking an insider finding could take the position that an LLC fits within the broad definition of a "corporation" as defined in § 101(9), either because an LLC qualifies as a "partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association," or that an LLC is an "unincorporated company or association."[13]

If a court were to accept that an LLC falls within the Code's definition of a "corporation," one could argue that it is therefore unnecessary to amend the insider definition to address LLC debtors specifically. Simply relying on the stated examples of corporate debtor insiders for debtor LLCs, however, would be insufficient in most cases to conclude that an entity associated with an LLC is a statutory insider. The same is true for partnerships, which is why § 101(31)(C) separately addresses them, even though partnerships (other than limited partnerships) also technically fall within the broad definition of corporations in § 101(9).

Like partnerships, LLCs are managed differently than corporations. It appears, for this reason, that Congress distinguished corporations and partnerships when establishing what categories of entities associated with corporations and partnerships qualify as insiders. Section 101(31)(C)(i) provides that general partners of partnerships are insiders, while § 101(31)(B)(i) and (ii) provide that officers and directors of corporations are insiders.

The absence of specific examples of entities that traditionally manage LLCs could result in members or managers of LLCs not being considered insiders under the current construction of the definition, despite what appears to be clear congressional intent to include those in similar positions with other corporate vehicles as insiders. Because such entities are not expressly listed, they should not be considered statutory insiders. As a result, for such entities to be considered insiders, one must rely on judicial interpretation of what is required to be considered a nonstatutory insider. Depending on the jurisdiction in which a case is pending, the answer could differ.

Three primary tests have emerged in determining the insider status of entities not expressly listed in the statute. One approach, adopted recently by the Seventh Circuit in *In re Longview Aluminum LLC*, is the "similarity" approach.[14] In *Longview*, a chapter 11 trustee brought an adversary proceeding to set aside pre-petition payments allegedly made by an LLC to one of its managing members as preferential transfers.[15] The court looked to Delaware corporate and LLC law in finding that an LLC's members can be properly analogized to directors of a corporation and thus be considered statutory insiders within the meaning of § 101(31)(B).[16] In reaching this conclusion, the court emphasized the importance of not only looking to the individual's title, but also to his or her relationship to the company.[17]

In arguing against an insider finding, the defendant in *Longview* posited that because an LLC is not mentioned in the Code, the plaintiff must prove that the defendant was a nonstatutory insider.[18] The defendant advocated for the adoption of a "control" approach in determining nonstatutory insider status.[19] Under the control approach, "the alleged insider must exercise sufficient authority over the debtor so as to unqualifiably dictate corporate policy and the disposition of corporate assets."[20] Other courts, including the Fourth Circuit in *Butler v. David Shaw Inc.*, have utilized this approach in determining nonstatutory insider status in other contexts.[21] The Seventh Circuit in *Longview* declined to adopt the control approach, holding that when deciding whether a manager or member of an LLC is a statutory insider, "the similarity approach yields a better interpreta-

9 11 U.S.C. § 101(31).
10 *See, e.g., Anstine v. Carl Zeiss Meditec AG (In re U.S. Med. Inc.)*, 531 F.3d 1272, 1276 (10th Cir. 2008).
11 *See, e.g., Solomon v. Barman (In re Barman)*, 237 B.R. 342, 348 (Bankr. E.D. Mich. 1999); *Jahn v. Economy Car Leasing Inc. (In re Henderson)*, 96 B.R. 820, 824-25 (Bankr. E.D. Tenn. 1989) (citation omitted); *see also In re U.S. Med. Inc.*, 531 F.3d 1272 at 1276.
12 *See, e.g., In re Bruno Mach. Corp.*, 435 B.R. 819, 833 (Bankr. N.D.N.Y. 2010).
13 *See, e.g., In re Longview Aluminum LLC*, 657 F.3d at 509 n. 1 (7th Cir. 2011); *In re QDN LLC*, 363 Fed. Appx. 873, 876 n. 4 (3d Cir. 2010) (citing 11 U.S.C. § 101(9)(A)(ii)); *In re ICLNDS Notes Acquisition LLC*, 259 B.R. at 293.
14 *In re Longview Aluminum LLC*, 657 F.3d at 509-10.
15 *Id.* at 508.
16 *Id.* at 510.
17 *Id.*
18 *Id.* at 509.
19 *Id.* at 510-11.
20 *Butler v. David Shaw Inc.*, 72 F.3d 437, 443 (4th Cir. 1996).
21 *Id.* at 443; *but see Three Flint Hill Ltd. P'ship v. Prudential Ins. Co. (In re Three Flint Hill Ltd. P'ship)*, 213 B.R. 292, 299-301 (D. Md. 1997).

tion of the statute."[22] Although not expressly articulated, it appears that the Seventh Circuit found the manager at issue to be a statutory insider based on the similarity approach as opposed to a nonstatutory insider, despite case law holding that insiders not expressly mentioned in the statute are to be considered nonstatutory insiders.[23] Regardless of whether the manager of the LLC was a nonstatutory or statutory insider, the Seventh Circuit affirmed the insider finding using the similarity approach and expressly rejected the control approach, highlighting the diverging views of other courts on the insider status of entities not expressly listed in the statute's definition.

Adding an additional wrinkle, the Seventh Circuit in *Longview* discussed another approach, known as the "closeness" approach, but neither relied on nor expressly rejected this approach.[24] The closeness approach was adopted by the Third Circuit in *In re Winstar Commc'n Inc.*, relying in part on the legislative history of the statute.[25] Like the Seventh Circuit in *Longview*, the *Winstar* court rejected the control approach, holding that the control approach improperly requires a finding of control for all nonstatutory insiders and that such a requirement is inconsistent with the statute, which provides that a "person in control" of a debtor is but one of many ways to establish the existence of insider status.[26] The court additionally explained that if actual control were required, Congress's decision to provide a nonexhaustive list of insiders in § 101(31)(B) would be meaningless because the "person-in-control" category already present in the Code would serve as the determinative test for nonstatutory insider status.[27] The court further explained that because not all statutory insiders possess actual control over a debtor, it is unnecessary for nonstatutory insiders to maintain actual control.[28] In rejecting the control approach, the *Winstar* court held that the pertinent inquiry in determining nonstatutory insider status "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."[29] These divergent judicially created approaches to nonstatutory insider status could lead to confusion and inconsistent results in evaluating whether an entity associated with an LLC debtor is an insider, while one in a similar managerial role of a corporation or partnership would unquestionably be an insider under the statute.

Conclusion

Although the Bankruptcy Code's definition of "insider" includes entities that typically manage debtor corporations and partnerships, no provision exists with respect to those in similar positions in debtor LLCs. Congress's intent in making the examples of insiders in the statute nonexhaustive and flexible is clear, yet creative litigants and judicial precedent have cast doubt over what is required for an entity associated with an LLC to qualify as an insider. Namely, application of the "similarity," "control" and "closeness" approaches could yield inconsistent results regarding whether an identical entity is an insider in a case where the debtor is an LLC.

Because LLCs are frequently debtors in bankruptcy cases, the Code should be amended to include another subsection in the insider definition, providing express examples of what category of entities associated with debtor LLCs are insiders, just as § 101(31)(B) and (C) does for corporations and partnerships. While such an amendment would not answer the question of who an insider is in every case, it would confirm that it is no more difficult to prove the insider status of those in management positions in LLCs than it is for those that manage corporations and partnerships. abi

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22 *In re Longview Aluminum LLC*, 657 F.3d at 511.
23 *See, e.g., In re U.S. Med. Inc.*, 531 F.3d at 1276.
24 *Id.* at 509.
25 *In re Winstar Commc'n Inc.*, 554 F.3d at 388.
26 *Id.* at 396-97.
27 *Id.* at 395-96.
28 *Id.* at 396.
29 *Id.* at 396-97 (citing *In re U.S. Med. Inc.*, 531 F.3d at 1277; S. Rep. No. 95-989, at 25 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5810).