To: Ed Smith
Dan Kleinberger
From: Ken Kettering
Date: July 23, 2013 (Revised August 8, 2013)
Re: As used in the Uniform Fraudulent Transfer Act, should the definition of "insider" be revised in light of new and emerging forms of business organization?

At the Annual Meeting in Boston it was suggested that consideration be given to revising the definition of the term "insider" in UFTA § 1(7).[1] At present, the definition provides specific guidance (albeit non-exclusive guidance) on who qualifies as an "insider" of a debtor only in respect of a debtor that is an individual, corporation, or partnership. It thus does not provide specific guidance on who qualifies as an "insider" of a debtor that is an LLC, or that is organized in some other new or emerging form. The suggestion was to consider revising the definition to give specific guidance on who qualifies as an "insider" of a debtor that is so organized.

After doing some reading and thinking I have come to the conclusion that no change to the statutory text of that definition is desirable. I would favor only a modest addition to the official comment noting the potential applicability of "insider" status to, e.g., a member of an LLC, notwithstanding that LLCs are not expressly referred to in the definition. A couple of unrelated typographical errors in the definition of "affiliate" should probably also be fixed.

I thought it would be wise to let you know my thinking in advance of the September meeting. I would particularly like to have the benefit of Dan's lights, given his expertise in business organizations.

Use of the term "insider" (and the allied terms "affiliate" and "relative") in the UFTA. The term "insider" is used meaningfully in only one substantive provision of the UFTA. That is section 5(b), the so-called "insider preference" rule that is conceptually quite different from the other substantive rules of the UFTA. Under the UFTA, a preferential transfer – that is, a transfer of property by a debtor to a creditor in order to pay or secure a legitimate debt owed by the debtor to the creditor – cannot qualify as a fraudulent transfer under the ordinary rules of sections 4 and 5(a).[2] The special rule of section 5(b) renders a preferential transfer fraudulent if it is made to an "insider" of the debtor, and if the debtor was insolvent at the time of the transfer. The action to avoid the transfer must be brought within one year after the date of the transfer, per section 9(c).

Section 5(b) of the UFTA had no direct predecessor in the former UFCA. However, under the UFCA a transfer to pay or secure a debt was deemed to be given for "value," and hence immunized from attack under the UFCA's constructive fraud provisions, only if the

[1] The suggestion was made by David Walker, Commissioner from Iowa and chair of the committee that drafted the Revised Uniform Limited Liability Company Act.

[2] Specifically, a preferential transfer cannot be constructively fraudulent under the rules of Section 4(b) or 5(a) because a debtor is always deemed to receive "value" to the extent that he pays or secures a debt. See UFTA § 2(a). There is no explicit language that would exclude a preferential transfer from being deemed actually fraudulent under UFTA §4(a), but it is all but inconceivable that payment of or security for a genuine debt could be deemed actually fraudulent in modern practice.

transfer was made in "good faith." (UFCA § 3). A preferential transfer by an insolvent debtor to a controlling person, relative, affiliate, etc. thus was susceptible to attack as constructively fraudulent under the UFCA, on the theory that the debtor lacked "good faith" in making the transfer. However, the "good faith" requirement was not restricted to transfers to such persons, and courts applied it controversial ways. The drafters of the UFTA therefore deleted the fuzzy "good faith" requirement for "value," and compensated for that by adding section 5(b), which is narrowly addressed to a preferential transfer to an "insider" of the debtor.

Section 5(b) is very similar to the preference recapture provision of Bankruptcy Code § 547, except that section 5(b), unlike § 547, can be invoked even if the debtor does not go into bankruptcy. Section 547 generally permits avoidance of a preferential transfer made within 90 days before the debtor's bankruptcy, but § 547(b)(4) extends that reachback period from 90 days to a full year if the preferred creditor is an "insider," as defined in the Bankruptcy Code. The insider preference provision of the UFTA thus closely parallels (and was closely modeled on) the provisions of BC § 547 applicable to a transfer to an insider during the year before bankruptcy.[3]

Both UFTA § 5(b) and the one-year reachback applicable under BC § 547 apply only if the preferred creditor is an "insider" of the debtor. Both statutes contain almost identical definitions of "insider." The definition of "insider" in each statue uses two other terms, "affiliate" and "relative." Both statutes therefore also contain definitions of "affiliate" and "relative," and those definitions too are almost identical in both statutes. At least in the UFTA, the terms "affiliate" and "relative" are used only in the definition of "insider." The definition of "insider" in each statute also uses the terms "corporation" and "partnership." Those terms are not defined in the UFTA. The Bankruptcy Code does define "corporation," but not "partnership."

While § 5(b) is the only meaningful use of the term "insider" in the UFTA, it also appears in one other location. That is in the list of "badges of fraud" that are suggested for consideration when determining whether a transfer was made with actual intent to "hinder, delay, or defraud" creditors under § 4(a). Specifically, § 4(b)(1) provides that when determining whether a transfer or obligation was made with actual intent to "hinder, delay or defraud" creditors, "consideration may be given, among other factors, to whether….the transfer or obligation was to an insider." Because the badges of fraud are merely precatory and indicative, the precise definition of "insider" is not really meaningful as applied to § 4(b)(1).

Four states (Arizona, California, Indiana and Pennsylvania) did not enact § 5(b). Those states take the position that it doesn't make sense to provide for an action to recover a preferential transfer outside a collective insolvency proceeding in which the recovery can be shared among all creditors. If an action under § 5(b) is brought outside of bankruptcy, the

[3] The most significant difference between Bankruptcy Code § 547 as applied to insiders and UFTA § 5(b), aside from the fact that the latter provision can be invoked outside of bankruptcy, is that UFTA § 5(b) renders a transfer avoidable only if "the insider had reasonable cause to believe that the debtor was insolvent." There is no parallel requirement in BC § 547. If a debtor files for bankruptcy, BC § 544(b) would enable the trustee to use UFTA § 5(b) to attack an insider preference made within a year before bankruptcy filing. But it is not evident that UFTA § 5(b) would ever add anything to the trustee's rights under § 547, given that the one-year reachback period is the same under both statutes and the §5(b) action requires a showing of "reasonable cause to believe" that is not required under § 547.

recovery inures only to the plaintiff creditor who brought the action. Hence the result of an action under § 5(b) is not to undo the preferential transfer, but merely to shift its benefit to a different creditor (namely, the plaintiff creditor who brings the action). Hence those states perceived no good reason for § 5(b). The states that did not enact § 5(b) did not enact the definitions of "insider," "affiliate" or "relative."

"Insider" is used in various places in the Bankruptcy Code in addition to BC § 547, but § 547 is the most prominent use of the term.

Comparing the UFTA and Bankruptcy Code Definitions of "Insider," "Affiliate" and "Relative." Enclosed herewith is a separate document setting forth the definitions of "insider," "affiliate" and "relative" as they appear in the UFTA, blacklined to show the slight differences from the language of the Bankruptcy Code, and with my editorial comments on those differences. For convenience, the document also includes (a) a clean copy of those three definitions as they appear in the UFTA, together with the Official Comments thereto, and (b) a clean copy of those definitions as they appear in the Bankruptcy Code, plus the Bankruptcy Code's definition of "corporation."

A result of that exercise is to identify two places in which the UFTA definition of "affiliate" uses slightly different language in different clauses that obviously should be identical, evidently a result of typographical error. Those typos do not appear in the Bankruptcy Code's definition of "affiliate," and they should be corrected in the UFTA's definition. They are as follows: (a) in § 1(1)(i)(B), add "in fact" before "exercised", and (b) in § 1(1)(ii)(A), add "discretionary" before "power".

Given the close and intentional similarity of these definitions, it is certain that courts construing the UFTA definitions will be strongly influenced by precedent construing the Bankruptcy Code definitions, and *vice versa*. *Uniform Laws Annotated* today notes fewer than ten cases that construe the UFTA definition of "insider" in any context, and none of those construes that term in connection with its meaning as applied to an LLC or other novel form of business organization. The case law under the Bankruptcy Code definition is somewhat more extensive, and one Court of Appeals has considered the question of who constitutes an "insider" of an LLC under the Bankruptcy Code definition. That case is *In re Longview Aluminum, L.L.C.*, 657 F.3d 507 (7th Cir. 2011) (hereinafter "*Longview*"). I enclose a copy of that case, which is devoted solely to that issue.

Should we be concerned that the UFTA definition of "insider" lacks a reference to LLCs or other new and emerging forms of business organization? In this memorandum I focus on the definition of "insider" as it relates to LLCs. If we do not change the definition of "insider" in respect of LLCs, there is no point in changing it as to more exotic new forms of business organization.

Nonuniform amendments to the definition of "insider" relating to additional forms of business organization. Five uniform law jurisdictions (Nebraska, North Dakota, Utah, Vermont, Wisconsin) have amended their definitions of "insider" to refer to LLCs. Two other uniform law jurisdiction (District of Columbia and Wyoming) have amended their definition to refer to "unincorporated business organizations," a term that would appear to include LLCs and other new forms of business organization. No uniform law jurisdiction has amended its definition of "insider" to refer specifically to any new form of business organization other than LLCs.

These nonuniform amendments are quite diverse. They all define differently the relationship between entity X and an LLC that is necessary to make X an insider of the LLC. For instance, Nebraska takes the position that each "member" and "person in control of the debtor" of an LLC is an insider of the LLC. Utah likewise makes each "member" and "person in control of the debtor" an insider of an LLC, and also includes each "manager." By contrast, North Dakota does not take the position that each "member" of an LLC is an insider; rather, the basic insiders of an LLC are "a governor of the debtor, a manager of the debtor, [and] a person in control of the debtor." Wisconsin likewise does not make a "member" an insider of an LLC; the basic insiders are only a "manager" or "person in control of the debtor." Vermont provides that the basic insiders of an LLC are (i) a member of a "member-managed LLC," (ii) a manager of a "manager-managed LLC," and (iii) a "person in control of the debtor."

Nonexclusivity of the statutory definition. In both the UFTA and the Bankruptcy Code, the definition of "insider" given in the statute is merely indicative and is not exclusive. That follows from the fact that in both statutes the definition is worded to say that the term "insider" "includes" the persons listed below; it does not say that the word "means" the persons listed below. Bankruptcy Code § 102(3) specifically says that "includes" is not limiting. The UFTA has no similar express rule of construction, but Official Comment 7 to UFTA § 1 makes the same point.

Cases construing both definitions have taken this point to heart, and treat the statutory definition as no more than indicative guidance. (At least in the sense that courts have been quite willing to deem an "insider" a person not designated as such by the statutory list. The statutory language does not give a court power to exclude from "insider" status a person who is designated as such by the statutory list. Reported cases do not suggest that courts have applied the statute otherwise.)

The following passage from *Collier on Bankruptcy* ¶101.31 (16th ed) (footnotes omitted) illustrates courts' willingness to deem an "insider" a person who is not designated as such by the statutory list:

> Because the definition of an insider is nonexclusive, courts have worked to refine the category of "nonstatutory insiders." The category includes those individuals or entities whose relationship with the debtor is so close that their conduct should be subject to closer scrutiny that than those dealing with the debtor at arm's length. Thus, "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." Comparing two court of appeals decisions on this issue is instructive. In *Anstine v. Carl Zeiss Meditec AG (In re U.S. Medical, Inc.),* [531 F.3d 1272 (10th Cir. 2008),] the court found that the creditor was in a position to exert the type and level of control that would make one a nonstatutory insider but the court also found that the record was devoid of evidence of the exercise of any of such control and likewise devoid of any evidence that the transactions between the debtor and creditor were other than arms length. On the other hand in *Shubert v. Lucent Technologies Inc. (In re Winstar Communications, Inc.),* [554 F.3d 382 (10th Cir. 2009),] the court found that the creditor had the same type of access and potential for mischief as in U.S. Medical, and the record was full of evidence that the creditor had

> exercised its control in a way that took the transactions between debtor and creditor out of the category of "arms length." Thus the court in *Winstar* affirmed the well-documented determination by the bankruptcy court that the creditor was a nonstatutory insider.

The *Longview* case cited earlier, a bankruptcy case which considered whether a given individual qualified as an "insider" of an LLC, had no difficulty in concluding that an LLC can have "insiders," because the court concluded (with little analysis), that an LLC qualifies as a "corporation" under the Bankruptcy Code's definition of that term. See 657 F.3d at 509 n.1. Nevertheless, the court also recognized the nonexclusivity of the statutory definition:

> The 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 determinations. 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. If the alleged insider holds a position substantially similar to the position specified in the definition, a court will often find that individual to be an insider. But, based on the legislative history of the statute, our case law has also held that the term insider can also encompass anyone with 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." *Id.* at 741–42 (citing S.Rep. No. 989, 95th Cong.2d Sess., *reprinted in* 1978 U.S.C.C.A.N. 5787, 5810). For this second approach, courts look to the closeness of the relationship between the parties. *Id.*

657 F.3d at 509.

Longview held to be an "insider" of an LLC a member of the LLC who was on its Board of Managers and owned a 12% economic interest, but who was, at the time of the preferential payment, at war with the other participants in the LLC, and the payment was a settlement in exchange for his agreement to leave the Board of Managers. Because the LLC in question had a Board of Managers one might be tempted to call it "manager-managed," but it appears that all five members of the LLC were members of the Board, so the distinction between "manager-managed" and "member-managed" is slender as applied to that LLC. Indeed. the court quoted the LLC's organic documents as providing that power to manage the LLC is "vested in the Board of Managers and the Members," a puzzling formulation that leaves me wondering who actually was in charge. But as both groups appear to have consisted of the same individuals perhaps clarity on this point wasn't necessary. To my eye the court's analysis was sensible in essentials, in that the court evaluated whether the member in question really was able to deal with the LLC on an arm's length basis.

One might debate whether *Longview* reached the right result on the given facts. The payment in question was made to a member who, it seems, didn't have any actual power to manage the business at the time, given his war with the other members. But the same issue would arise in the case of a director and substantial stockholder of a close corporation who is at war with the other directors/stockholders. Such a director would be an insider of the corporation, per UFTA § 7(ii)(A). If there is a problem with the result reached in *Longview*, it is not one that arises out of the fact that the debtor was an LLC.

Conclusion: Should the UFTA definition be amended? As noted at the outset, I do not favor amending the UFTA definition of "insider" to deal specifically with LLCs or other newfangled organizations.

One reason is that I am skeptical that it is possible to lay down sound fixed rules defining "insider" as to an LLC. LLCs by their nature are a hybrid of a partnership and a corporation, and the organizers have great flexibility to define internal governance and economic interests. Determining insider status should depend on the particular arrangements applicable to the particular LLC in question. Some LLCs may resemble most closely a corporation; others may resemble a traditional partnership; still others may be *sui generis*.

The differences between the approaches taken by states that have already adopted nonuniform amendments on the subject is indicative of the problem of creating a sound fixed rule. To take just one point, consider that those states are divided on whether a member of an LLC should be an insider *per se*. It would seem to me indefensible to say, as have some those states, that a member is an insider *per se*. An LLC might be a manager-managed outfit in which a given member owns a very small interest, and such a member ought not be an "insider." Vermont provides that a member is an insider *per se* of a member-managed LLC, which seems reasonable at least intuitively. (Of course that approach requires "member-managed LLC" to be adequately defined, and *Longview* shows that that may not be easy.) However, the Vermont language would make a member an insider of a manager-managed LLC only if the member were in "control" of the LLC. That doesn't seem to me right. An owner of 20% of the voting stock of a corporation is an "affiliate" and hence an "insider," even if not in control of the corporation. It would be inconsistent to say that a holder of a substantial economic interest in an LLC is not an insider unless he is in control. Proceeding down the Vermont path thus would call for changes to the definition of "affiliate" to pick up substantial members of a manager-managed LLC. I do not think it would be wise to try to draft such detailed provisions in the absence of more experience in the cases than exists at present.

Furthermore, I do not think that the courts need further guidance in this area. They have been reasoning sensibly about who should constitute an "insider".

Finally, a certain fuzziness in the definition of "insider" is arguably a good thing, not a bad thing. People who are arguable insiders don't have an overwhelming need to be told exactly how far they can go without triggering extended preference risk. In any case such fuzziness is inevitable, given the nonexclusivity of the statutory definition. (Of course in theory one might consider completely junking the statutory definition and seek to write a complete and closed definition of "insider," but I think that would be highly inadvisable and only doubtfully possible.)

As a result, I favor leaving the statutory definition of "insider" alone (except for correction of the typos noted earlier in the related definition of "affiliate"). It probably would be useful, though I don't think absolutely necessary, to revise the official comment in order (a) to emphasize the nonexclusive nature of the definition, and (b) to note the potential applicability of "insider" status to LLCs and other creatures not listed in the statutory definition.

KCK

Enclosures