University of Minnesota Law School
Scholarship Repository

Minnesota Law Review

1991

Two Thoughts about Insider Preferences

Jay Lawrence Westbrook

Follow this and additional works at: https://scholarship.law.umn.edu/mlr

Part of the Law Commons

Recommended Citation

Westbrook, Jay Lawrence, "Two Thoughts about Insider Preferences" (1991). *Minnesota Law Review*. 1588.
https://scholarship.law.umn.edu/mlr/1588

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenzx009@umn.edu.

Two Thoughts About Insider Preferences

Jay Lawrence Westbrook*

With the benefit of time's remove, we begin to see that the decisions expanding insider-preference recoveries[1] will not lead to the demise of commercial lending in the United States, despite the river of criticism that has sprung from them.[2] I sus-

---

* Visiting Professor, Harvard Law School. Benno C. Schmidt Chair in Business Law, The University of Texas at Austin. J.D. 1968, The University of Texas at Austin. I am grateful to Jean Braucher, Douglas Laycock, Elizabeth Warren, and Zipporah Wiseman for comments on an earlier draft and for the research assistance provided by Lydia Kimble-Wright, J.D. 1991, The University of Texas at Austin.

1. *See, e.g.*, Levit v. Ingersoll Rand Financial Corp. (*In re* V.N. Deprizio Constr. Corp), 874 F.2d 1186, 1194-97, 1200-01 (7th Cir. 1989) (holding that the trustee may recover transfers from outside creditors made within one year when the payment produces a benefit for an inside creditor, including a guarantor); *In re* C-L Cartage Co., 899 F.2d 1490, 1494 (6th Cir. 1990) (holding that a literal reading of §§ 547 and 550 of the Bankruptcy Code "permits recovery from an outsider transferee for transfers made during the extended preference period when the beneficiary of the transfers is an inside creditor or an inside guarantor"); *In re* Robinson Bros. Drilling, Inc., 97 B.R. 77, 82-83 (Bankr. W.D. Okla. 1988) (holding that a debtor's transfer to a non-insider creditor who holds a guarantee from an insider of the debtor made more than 90 days before but within one year of the filing of the bankruptcy petition constitutes an avoidable preference recoverable by the trustee from the non-insider creditor), *aff'd*, 892 F.2d 850 (10th Cir. 1989); *In re* AEG Acquisition Corp., 127 B.R. 34, 44 (Bankr. C.D. Cal. 1991) (endorsing application of the *Levit* rule).

2. *See, e.g.*, Donald W. Baker, *Repayments of Loans Guaranteed by Insiders as Avoidable Preferences in Bankruptcy:* Deprizio *and Its Aftermath*, 23 U.C.C. L.J. 115 (1990) (arguing that the *Levit* rule is unsound and should be reconsidered); Robert F. Higgins & David E. Peterson, *Is There a One-Year Preference Period for Non-Insiders?*, 64 AM. BANKR. L.J. 383 (1990) (discussing the risks *Levit* raises for non-insider creditors and criticizing *Levit* and similar cases for mechanically applying the Bankruptcy Code rather than considering the substance and effect of the transaction in each case); Henk J. Brands, Note, *The Interplay Between Sections 547(b) and 550 of the Bankruptcy Code*, 89 COLUM. L. REV. 530 (1989) (arguing that recovery of a transfer from an initial transferee who did not satisfy the avoidance requirements of § 547(b) should be based on § 550(a)(2) rather than § 550(a)(1)); John Stephen Cullina, Comment, *Recharacterizing Insider Preferences As Fraudulent Conveyances: A Different View of* Levit v. Ingersoll Rand, 77 VA. L. REV. 149 (1991) (asserting that the Bankruptcy Code should be amended to recharacterize transactions that benefit insiders as fraudulent conveyances); Andrew J. Nussbaum,

pect that they will join a long line of bankruptcy cases that provoked cries of doom only to become part of the commercial landscape.[3] Yet the debate is likely to continue, because the courts' opinions have certain vulnerabilities[4] and because considerable litigation may be necessary to flesh out their holdings.[5]

I propose to add briefly to the clamor, because it seems to me that the commentary largely has missed two essential points:

a) the distinction between insider guarantees taken for their economic value, because the insider has the wherewithal to pay the debt, and those that are purely a matter of pressure on the insider to misdirect the debtor's funds; and

b) the explanation for the striking discontinuity between the technical operation of the creditor requirement as applied in these cases and the policies vindicated by the avoidance of indirect benefits to insiders.

Note, *Insider Preferences and the Problem of Self-Dealing Under the Bankruptcy Code*, 57 U. CHI. L. REV. 603 (1990) (criticizing the courts for failing to characterize transfers involving insiders according to their substantive impact and thereby violating the principles of the Bankruptcy Code); James A. Rodenberg, Note, *Indirect Preferences: Recovery Under Sections 547 and 550 of the Bankruptcy Code*, 55 MO. L. REV. 327 (1990) (asserting that the Bankruptcy Code does not require an extension of the preference-recovery period for outside creditors when there is an inside guarantor and suggesting a flexible alternative approach); Mark E. Toth, Comment, *The Impossible State of Preference Law Under the Bankruptcy Code:* Levit v. Ingersoll Rand *and the Problem of Insider-Guaranteed Debt*, 1990 WIS. L. REV. 1155 (contending that the preference sections as currently applied will not adequately deal with the insider-guaranteed debt problem); Bethaney J. Vazzana, Note, *Trustee Recovery of Indirect Benefits Under Section 547(b) of the Bankruptcy Code*, 6 BANKR. DEV. J. 403 (1989) (contending that § 547(b) can be read to reach indirect benefits received by creditors other than the direct transferee and that the time periods under § 547(b) should apply to the direct transfer and the indirect transfer). *But see* Thomas E. Pitts, Jr., *Insider Guarantees and the Law of Preferences*, 55 AM. BANKR. L.J. 343 (1981) (arguing that § 550(a)(1) should be read literally and that the financial community will adapt to this interpretation).

3. *See, e.g.*, Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 203-04 (5th Cir. 1980) (setting aside judicial sale as fraudulent conveyance).

4. *See, e.g.*, Baker, *supra* note 2, at 115-16, 130-34 (criticizing the holding in *Levit* and its subsequent adoption by the Sixth and Tenth Circuits and arguing that the *Levit* court violated several rules of statutory construction by construing § 550 to render § 547 hopelessly ambiguous).

5. *See, e.g.*, *id.* at 137-39 (outlining three distinct factual settings in which *Levit*, though applicable, requires further clarification); Higgins & Peterson, *supra* note 2, at 399-400 (suggesting five factual settings that implicate *Levit*'s holding.

The leading case, *Levit v. Ingersoll Rand Financial Corp.*,[6] serves as the best example. The facts in *Levit* are the usual dry, technical stuff of bankruptcy: the debtor's president assassinated in a parking lot and that sort of thing. The preference issues in the case arose from pre-petition payments made by the debtor to lenders, its pension funds, and the IRS, all between ninety days and one year before bankruptcy.[7] These payments could not be preferences unless made "to or for the benefit of"[8] a creditor who was an insider subject to the one-year preference period.[9] The court found that the one-year period applied to the payments to the lenders.[10] It reasoned that insiders had guaranteed the loans and therefore were creditors who received indirect benefits because the payments reduced the liabilities of the insiders as guarantors.[11] The insiders were creditors, the court reasoned, because they had contingent claims against the debtor for any amounts they might have to pay under the guarantees.[12] Even though the payments were preferential only because of the benefit to the insiders, the court permitted recovery of the payments from the lenders, not just from the insiders themselves.[13]

Despite a similar indirect benefit to insiders in the payments to the IRS, the court denied recovery against the IRS.[14] While the insiders might have been liable had the company not paid the taxes,[15] the court held that the insiders were not "creditors" of the company because they would not have had a right to recover from the company any payments they made on the company's taxes.[16] Because the insiders were not creditors of the company, the indirect benefit provision of section 547 of

6. 874 F.2d 1186 (7th Cir. 1989).

7. Section 547(b) provides that the trustee can avoid any transfer of an interest of the debtor made "between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider." 11 U.S.C. § 547(b)(4)(B) (1988).

8. Section 547(b)(1) provides that a trustee may avoid any transfer of an interest of the debtor "to or for the benefit of a creditor." 11 U.S.C. § 547(b)(1) (1988).

9. 11 U.S.C. § 547(b)(4)(B) (1988); *see also supra* note 7 (discussing the one-year period for inside creditors).

10. *Levit*, 874 F.2d at 1200-01.

11. *Id.* at 1190.

12. *Id.*

13. *Id.*

14. *Id.* at 1201.

15. *See* 26 U.S.C. § 6672(a) (1988).

16. *Levit*, 874 F.2d at 1191-92. The court reached the same result with respect to ERISA claims. *Id.* at 1192-94.

the Bankruptcy Code[17] did not apply to the IRS payments. Accordingly, tax payments made more than ninety days before bankruptcy could not be preferences.[18]

Levit presents many features of interest and contention, both technical and commercial, but my concern is the central policy issue: the use of preference law to reduce the attractiveness of insider guarantees. Judge Easterbrook's thoughtful opinion in *Levit* devotes considerable attention to preference policy as applied to insider guarantees.[19] He recognizes that preference policy rests on two bases, the traditional notion of equality of distribution and the modern idea of reducing the incentives for dismemberment of a financially troubled debtor.[20] Judge Easterbrook rightly emphasizes the anti-dismemberment policy as the more important in contemporary preference law.[21] The prospect of recovery of preferential transfers tends to deter creditors who might otherwise grab assets or force payment at the first hint of financial difficulty, perhaps ensuring a collapse that will seriously harm creditors generally.[22] It also pro-

---

17. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)) [hereinafter the "Code"].

18. *Levit*, 874 F.2d at 1192. The court allowed and disallowed preference actions as to the payments made to the pension funds, depending on the presence or absence of insider obligations. *Id.* at 1200. On remand, the *Levit* court directed the district court to address some of the specific pension fund questions. *Id.* at 1192-94.

19. *See id.* at 1194-95, 1197-1200.

20. For the history of preference law, see Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3 (1986); *see also* GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 378-81 (rev. ed. 1940) (discussing the history of preference law); Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713 (1985) (discussing in part the development of preference law).

21. *See* 874 F.2d at 1194; *see also* Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 727-31, 756-68 (1984) (stating that preference law is designed to prevent creditors from changing their positions vis-a-vis other creditors). *But see* 4 COLLIER ON BANKRUPTCY ¶ 547.01 at 11 (15th ed. 1991) [hereinafter "COLLIER"] (stating that equality of distribution is a policy more important than anti-dismemberment); GLENN, *supra* note 20, at § 384 ("Thus we have reduced the preference to a sporting proposition."); Countryman, *supra* note 20, at 748 (deterrence effect of preference law very weak); John C. McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 261-65 (1981) (same); Weisberg, *supra* note 20, at 136 nn.566-68 (same). Here, as elsewhere, Dean Jackson conceives the policy as purely for the collective benefit of creditors, *see* Jackson, *supra*, at 727-31, while I would argue it is meant to benefit a variety of bankruptcy constituencies, including the community generally. That difference, however, is not of great consequence for the present discussion.

22. Without this anti-dismemberment policy, outside lenders might propel

vides protection and comfort for creditors who are inclined to work with a financially troubled debtor, giving them some assurance that they will not be left behind in "the race of the diligent."

Because insiders pose a special risk to preference policies, section 547 provides an extended recovery period from insiders.[23] It would be hard to improve on Judge Easterbrook's summary of preference policy as it applies to insider guarantees:

> Insiders pose special problems. Insiders will be the first to recognize that the firm is in a downward spiral. If insiders and outsiders had the same preference-recovery period, insiders who lent money to the firm could use their knowledge to advantage by paying their own loans preferentially, then putting off filing the petition in bankruptcy until the preference period had passed. . . . An alternative device is to make the preference-recovery period for insiders longer than that for outsiders. With a long period for insiders, even the prescient managers who first see the end coming are unlikely to be able to prefer themselves in distribution.
>
> Loans from insiders to their firms are not the only, or even the most important, concern of outside creditors. Insiders frequently guarantee other loans. If the firm folds while these loans are outstanding, the insiders are personally liable. So insiders bent on serving their own interests (few managers hold outside lenders' interests of equal weight with their own!) could do so by inducing the firm to pay the guaranteed loans preferentially. . . . So an extended recovery period for payments to outside creditors that benefit insiders could contribute to the ability of the bankruptcy process to deter last-minute grabs of assets.[24]

The court's policy analysis is compelling. The enormous leverage generated by insider guarantees seriously threatens the anti-dismemberment policy.[25] Only recovery against the possessors of that leverage, the lenders themselves, will mitigate its undesirable effects.[26] Yet most of the commentary on *Levit* has been critical. I think that the debate over *Levit* and its siblings has failed to address adequately two essential issues, the distinction between economic and "pure-leverage" guaran-

a firm into bankruptcy at the slightest sign of trouble. Indiscriminate asset-grabbing would diminish the value of the company because firms generally are worth more as a single entity than in separate pieces. Recovering preferential transfers reduces the incentive for creditors to grab assets prematurely, thereby protecting both the value of the company and the interests of the creditors that refrain from acting. *Levit*, 874 F.2d at 1194-95.

23. 11 U.S.C. § 547(b)(4)(B) (1988).

24. 874 F.2d at 1195.

25. *See infra* notes 32-36 and accompanying text.

26. *See infra* notes 49-50 and accompanying text.

tees and the subtle role of the technical requirement that the insider be a "creditor" of the debtor. If, as I believe, the emerging rule is important to the prevention of insider abuse in business defaults, the clarification of these issues may help sustain its result and ensure the rule's proper application.

I. TRUE GUARANTEES VERSUS PURE-LEVERAGE GUARANTEES

A. THE CRITICISMS OF *LEVIT*

The two most prominent arguments against the result in *Levit* are that it surprises the innocent expectations of lenders and that it harms a normal and legitimate banking practice, the obtaining of insider guarantees. The expectation argument is not very persuasive, given the long-standing recognition of indirect preferences,[27] and in any event will have no force for post-*Levit* transactions. The more potent argument is that the obtaining of insider guarantees is a normal and proper lender practice that serves legitimate economic ends and therefore should not be hampered by a technical reading of the preference statute.[28] That argument has been successful in some of

---

27. *See* COLLIER, *supra* note 21, ¶ 548.01 n.2; Pitts, *supra* note 2, at 344-46.

28. Several commentators have suggested that a number of untoward and unexpected effects may arise from the *Levit* rule. Although it is useful and important to spin out the possible consequences of a new understanding of the law, I have the sense that these concerns are somewhat overstated. For example, one recent article expresses concern about an indirect preference to a fully secured creditor where there is an insider junior lienholder on the same collateral who benefits from the satisfaction of the senior's lien. Higgins & Peterson, *supra* note 2, at 400 n.56. These authors are worried that the senior lienholder might suffer a preference recovery even though it had not obtained the insider guarantee itself and may not have known about it. I am not convinced this example is problematic.

There would be an indirect preference recoverable from the senior lienholder, but as a practical matter, the recovery of the trustee-in-bankruptcy ("TIB") would be against the beneficiary, the insider. The TIB's relief would be to cancel all of the insider's gain in the collateral, which is by definition the entire benefit and therefore the entire preference. *See infra* note 91. Because the TIB can get only one satisfaction, there could be no further recovery against the senior. 11 U.S.C. § 550(c) (1988).

For example, take collateral worth $110,000 nine months before bankruptcy, a $100,000 senior note paid in full at that time, and a $50,000 junior note to an insider. If the value of the collateral remains the same, the benefit in bankruptcy to the junior (now senior) insider is $40,000, the difference between $10,000 of security and a full $50,000 of security, assuming no return for general unsecured creditors and ignoring subordination. By voiding the junior creditor's security to the extent of $40,000, the insider is returned to its prepayment position and the TIB has received a full recovery, leaving the TIB with no action against the senior under § 550. Even if we complicate matters

the courts that have not adopted the *Levit* analysis.[29]

Experience and a study of the literature suggest two legitimate reasons for insider guarantees. The first is greater protection for the lender. The insider may have additional personal assets of value. Exposing those assets to the debt provides more "equity" against the lender's investment and may induce a loan which would otherwise be refused. The insider is allowed, in effect, to segment investment in the business, putting some assets at risk as to only one of the company's creditors. Current conventional wisdom accepts this sort of arrangement as legitimate.[30]

The second legitimate reason is "commitment." Lenders are genuinely concerned that the principals of a borrower, especially a small borrower, be personally committed to the success of the business. That commitment guarantees hard work and sacrifice. An insider guarantee contributes powerfully to proving and sustaining such a commitment.[31]

The lenders are right that insider guarantees have legitimate business purposes. If *Levit* operated in the same way with regard to all insider guarantees, that fact would be a powerful

---

by assuming that the collateral declines in value to zero at the time of bankruptcy, the senior lienholder would not be hurt, because the insider's security interest would be worth nothing in bankruptcy, therefore no insider benefit, therefore no preference. (These relationships can no doubt be expressed by a high-school algebra equation, but I forebear.) The trustee might demand payment from the lender, forcing it to recover from the collateral sale, but that sort of maneuvering is regulated by the courts' equity powers under § 550(a). *See infra* note 91.

29. *See, e.g., In re* Performance Communications, Inc., 126 B.R. 473, 477 (Bankr. W.D. Pa. 1991) (inequitable to make bank suffer for its prudence); *In re* Aerco Metals, Inc., 60 B.R. 77, 82 (Bankr. N.D. Tex. 1985) (should not "punish the Bank for [its] prudence"); *In re* R.A. Beck Builder, Inc., 34 B.R. 888, 894 (Bankr. W.D. Pa. 1983) (inequitable to "penalize" bank for its prudence); *see also* COLLIER, *supra* note 21, ¶ 550.02; *In re* Arundel Housing Components, Inc., 126 B.R. 216, 219 (Bankr. D. Md. 1991); *In re* Midwestern Companies, Inc., 96 B.R. 224, 225-28 (Bankr. W.D. Mo. 1988), *aff'd*, 102 B.R. 169, 171-72 (W.D. Mo. 1989); *In re* Mercon Indus., Inc., 37 B.R. 549, 552 (Bankr. E.D. Pa. 1984).

30. Coupled with the easy availability of limited liability via the corporate form, the effect is to permit an owner to avoid exposing the entire equity investment in a firm to the risk of business failure. That is, the owner can protect a portion of the necessary investment in the firm from all creditors except those granted access to that portion through a guarantee, creating two capital pools and limiting access to one of them (for example, lenders but not tort victims). Whether that is always a proper result is a larger question for another day.

31. *Cf.* MARTIN MAYER, THE BANKERS 263-64 (1974) (explaining the role of security interest as "leverage" and one bank's requirement of a promise that home-sale proceeds would be applied to pay business loan).

countervailing consideration to be balanced against the anti-dismemberment policies served by *Levit*. That argument, however, ignores a crucial distinction among insider guarantees and obscures the fact that the *Levit* policy operates selectively: *Levit* has much greater force against guarantees that do not have a fully legitimate purpose than against those that do.

B. Two Different Types of Insider Guarantees

Insider guarantees may be divided into two categories: true guarantees and pure-leverage guarantees. By a "true" guarantee, I mean one which has value to the lender because the guarantor is financially capable of honoring the guarantee if the primary obligor, the company, does not pay. The ideal case is where the guarantor provides security for the guarantee and the value of the collateral is more than adequate to offset any shortfall in the debtor's performance.[32] A common example is a bank requirement that a small business person guarantee a loan to a closely held company and secure that guarantee with a mortgage on the guarantor's home.[33] If the recoverable equity at least equals the amount of the company's debt, then it is a true guarantee. Even where a guarantee is not secured, it is a true guarantee if the guarantor is judgment-worthy for the full amount of the debtor's obligation.

What I characterize as a "pure-leverage" guarantee is a guarantee given by an insider who is not likely to be able to offset any shortfall in the debtor's performance. Such a guarantee is unsecured, and the insider guarantor is someone without sufficient financial resources to serve as a meaningful alternative source of recovery if the debtor does not pay. The value of such a guarantee is primarily a matter of control over the debtor company through leverage on the insider.[34] The insider will be anxious to see the guaranteed debt paid and will be vulnerable to pressure to see that it is. Thus, the value of this sort of guarantee to the lender lies almost completely in the exercise of precisely the sort of pressure the anti-dismemberment policy is

32. *See, e.g., In re* Evanston Motor Co., Inc., 26 B.R. 998, 1002 (Bankr. N.D. Ill. 1983) (creditor "fully secured by collateral owned by third party guarantors"), *aff'd*, 735 F.2d 1029 (7th Cir. 1984).

33. *See, e.g., In re* Roberts, 54 B.R. 765, 767 (Bankr. D.N.D. 1985).

34. *See* Isaac Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1)*, 41 BUS. LAW. 175, 195-96 (1985) (discussing guarantees from insiders which are sought "not for their economic value, but for the indirect control of the debtor").

designed to prevent.[35] That pressure also is suspect under state corporate law, creating a conflict of interest for the insider fiduciary.[36]

Levit will not seriously harm the first legitimate goal of a guarantee, additional economic protection. The bank with a true guarantee may suffer a *Levit* recovery, but it will have a solvent guarantor (or, better still, adequate collateral) to salve its wounds. Indeed, it may have to pay nothing, because the bankruptcy trustee likely will seek recovery from the insider in the first place. At worst, modern joinder practice will give the bank a judgment against the guarantor at the same time it suffers one itself.[37] The bank will be left with the ultimate burden of enforcement against the insider, but with a true guarantee it should receive its full entitlement when all is said and done. Thus, a lender with a true guarantee will enjoy the legitimate benefit of additional economic protection.

The lender with a pure-leverage guarantee will feel the full effects of *Levit* because the lender will have to repay the trustee and will have no meaningful recovery against the insider. Because the primary value of its guarantee was leverage over the company, and because that leverage is the target of the anti-dismemberment policy, *Levit* will take away the main value for which it bargained.[38] The beneficiaries of true guarantees with independent economic value are largely protected, while those whose only entitlement is indirect pressure on a financially troubled debtor are denied that benefit. These results nicely distinguish legitimate and illegitimate insider guarantees and provide little basis for complaint by lenders.[39]

If the *Levit* decision provides a means to distinguish the

---

35. *See Levit*, 874 F.2d at 1194-96 (attempting to eliminate the "rush to dismember a firm" by removing the incentive to procure that result); *see also supra* notes 21-22 and accompanying text (discussing generally the anti-dismemberment policy).

36. A potential conflict of interest exists whenever a corporate decisionmaker is also a guarantor. *See, e.g.,* Cross v. Communication Channels, Inc., 456 N.Y.S.2d 971, 973-74 (Sup. Ct. 1982) (stating that going private eliminates the conflict of interest between the majority shareholder as personal guarantor and minority shareholder interests).

37. *See, e.g., In re* Art Shirt, Inc., 34 B.R. 918, 920-21 (Bankr. E.D. Pa., 1983) (joining third-party defendant alleged to be the guarantor of the debtor's obligations).

38. *See supra* notes 34-35 and accompanying text.

39. Most guarantees will, of course, partake to some extent of both types, especially as viewed prospectively. Nonetheless, the *Levit* rule will operate as indicated in the text to the extent that a guarantee is a true or a pure-leverage guarantee.

two types of guarantees as to economic protection, the situation is only a little less clear as to the second legitimate effect of an insider guarantee—commitment. Because a guarantee creates incentives through pressure on both types of insiders, the distinction is less obvious. Both give leverage over the insider. The difference is in the nature and the effect of that leverage.[40]

The leverage on the true guarantor is merely the inescapable consequence of the insider's decision to commit additional wealth to the business through the guarantee. In contrast, the leverage on the pure-leverage guarantor must consist of either the threat to seize assets of great personal value to the insider, but of little intrinsic value, or the threat of being forced into personal bankruptcy.[41] Both aspects of the pure-leverage guarantee are *in terrorem* pressures that are generally regarded as quasi-legitimate at best.[42] It is not clear that commitment obtained on such a basis has much claim to policy con-

40. *See supra* note 34 and accompanying text.

41. This threat would necessarily include collateral consequences such as the destruction of the insider's personal credit rating. The alternative to bankruptcy would be payment of the lender out of the insider's future income, but by dint of the definitions we are using, that payment would be over a long period of time at a low present value. If the insider could pay the lender reasonably soon out of ample future income, the guarantee would be to that extent a true guarantee, because the insider would be judgment-worthy. Only an insider who would go into bankruptcy or would be forced to pay over a long period would make a guarantee a pure-leverage guarantee. As noted earlier, these are not absolute categories, but ends of a spectrum. *See supra* note 39. To the extent the guarantee is in the pure-leverage category, the insider would be in the circumstances described in the text.

42. It is a commonplace in debtor-creditor law that rights have asymmetrical values. *See generally* Arthur A. Leff, *Injury, Ignorance, and Spite—The Dynamics of Coercive Collection*, 80 YALE L.J. 1 (1970) (discussing the ways in which costs and values vary depending on who is trying to collect from whom). One routine consequence is that rights resulting from a guarantee may have no economic value, but great leverage value. For example, a junior lienholder whose lien is "under water" may exert great leverage over a debtor by a threat to sell, even though the sale will yield no value to the junior lienholder because all the proceeds will go to the holder of the senior lien. In the terms used in this paper, the junior lienholder has a pure leverage lien, although the junior creditor's motivation may have included a hope that the lien would have economic value at some future time. The conclusion that this sort of leverage is illegitimate was an important factor in the adoption of § 522(f) of the Code. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 126-27 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6087-88. Commentators have noted that the Federal Trade Commission made a similar judgment in the adoption of its Credit Practices Rule. *See* Jean Braucher, *Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission*, 68 B.U. L. REV. 349, 422 (1988). Although these provisions were adopted in the context of consumer cases, and consumer ignorance was a factor in their adoption, they also reflect a conviction that *in terrorem* leverage is a less-than-legitimate creditor device.

sideration. It certainly should not be considered of sufficient value to counterbalance the anti-dismemberment policy.

The overall distinction between legitimate and illegitimate types of leverage is a large subject, beyond the scope of the present discussion. The key point for immediate purposes is that bankruptcy law generally regards as legitimate the leverage that arises from a threat to the wealth a party has committed to a transaction if the threat is incidental to a legitimate economic claim. Bankruptcy law is more skeptical of the leverage that arises solely from the harm threatened to the debtor. The true guarantee generates leverage from a threat to assets for the value of which the lender bargained. The pure-leverage guarantee operates solely *in terrorem*.

The two types of leverage also differ in effect because they create two distinct sorts of insider commitments, commitment to payment of the lender through the success of the business and commitment to preferential payment.[43] In either case, payment of the lender serves the insider's interest, but the first situation, payment through success of the business, is wholly consistent with bankruptcy policy, while the second is antithetical to it.[44]

The distinction comes into focus at the moment the lender pressures an insider for payment in a time of financial stress. If the payment threatens the survival of the business, the true guarantor is likely to resist. If making the payment destroys the business, the true guarantor will be an irresistible target for an indirect-benefit preference action by the trustee in bankruptcy. The guarantor's house and savings, or stream of separate income, will be seized for the benefit of the estate. The true guarantor's only hope to save these assets lies in resisting the lender's pressure and saving the business.

By contrast, the pure-leverage guarantor may face a different calculus. The insider may believe that a suit by the lender for nonpayment is more likely than an action by the bankruptcy trustee for an indirect preference. A Chapter 7 trustee operates with a severe shortage of resources and within a short time frame.[45] No bankruptcy trustee is likely to bring an action

43. *See supra* note 34 and accompanying text (distinguishing, in part, the incentives of the insider of a true guarantee versus a pure-leverage guarantee).

44. *See, e.g., Levit*, 874 F.2d at 1195 (discussing the desirabiliuty of eliminating the "special problems" posed by preferential treatment for insiders).

45. In Chapter 7 cases, the trustee must expeditiously close the estate with limited resources. *See, e.g., In re* Price Chopper Supermarkets, Inc., 19 B.R. 462, 466 (Bankr. S.D. Cal. 1982).

that will not result in fairly short-term collection, so an asset-poor guarantor may be safe. A lender is often in a different position. It will have ample resources to maintain an action, and it may have motives for action that transcend immediate collection—for example, *pour encourager les autres* or to placate regulatory authorities who may permit deferral of a write-off while the insider action is pending. The lender also may be in a position to threaten future credit for the insider, a threat not available to the bankruptcy trustee. Thus, it seems quite plausible that the pure-leverage guarantor will have more reason to react to lender pressure by preferential payment rather than by risking all on the success of the business. Clearly, both types of insiders will prefer to accomplish payment through business success, but as they weigh the risks and benefits of business-threatening repayments, their incentives likely will be different.

After *Levit*, the true guarantor will continue to have a strong commitment to the survival and success of the business—just the sort of nights-and-weekends commitment that it is legitimate for a lender to want demonstrated. The true-guarantee commitment will maximize the chances of the business' success, to the benefit of all concerned. The insider giving a true guarantee will hesitate to prefer the lender if that preference will threaten the survival of the business because, if the business fails, either the bankruptcy trustee or the lender will pursue the insider's personal assets. The true-guarantee insider will have more incentive to make all business decisions, including repayment to the lender, solely on the basis of the best interests of the economic enterprise.

Levit will not dilute the commitment of the pure-leverage guarantor to the business. It will weaken only the insider's commitment to the lender,[46] a commitment likely to stimulate illegitimate conduct that prefers the lender in violation of the

---

46. One example of an arguably legitimate commitment to the lender is the insider's incentive to assist an assets lender in obtaining maximum value in the liquidation of inventory following default. A knowledgeable commentator has used that commitment as an example of a legitimate purpose of insider guarantees that will be thwarted by *Levit*. *See* Baker, *supra* note 2, at 137. It is a good example of an economic benefit that flows to the lender from an insider guarantee even in the pure leverage situation. That benefit is legitimate as between lender and debtor. The insider's expertise may even benefit the other creditors as well, by reducing the lender's deficiency claim. The cost of this benefit, however, is the risk of serious prejudice to the general body of creditors because of the overall incentive to prefer the lender by making payments that are not in the best interest of the business. The cost to the collec-

insider's fiduciary duties. *Levit* will provide the pure-leverage guarantor with some insulation from pressure exerted by the lender, a desirable result from the perspective of creditors generally.[47]

The *Levit* rule will operate to permit the taking of true guarantees and to discourage the taking of pure-leverage guarantees, just as we should want.[48] At the point of the bargain, the lender with a solvent guarantor or a secured guarantee will be pleased to take the guarantee, because it will provide ultimate security against loss. The lender thinking of a pure-leverage guarantee will be advised by counsel that the game may not be worth the candle: payments that the lender could extract from the debtor using other standard sources of leverage—such as threats to cut-off credit or to foreclose—may have to be returned because of the link to the insider. It may be better to forego the additional leverage of an economically worthless guarantee than to risk having to return payments obtained by use of the lender's other sources of leverage.

At the point of default, the true guarantor will have every incentive to avoid preferential payments that might cripple the business. Because the guarantor's assets ultimately will answer for any shortfall, the company's success is the only answer for the insider. Of course, the insider might choose preferential payment, not knowing of the ultimate risk or betting that no preference action will be brought. But the first risk—ignorance—inheres in all law. The second risk—noncompliance in the face of legal risk—inheres in all preference law, because section 547 provides only a disincentive, not a counter-incentive, to preferential payments. If we penalized preferences, rather than merely demanding them back, the deterrent effect of preference law would be much greater.[49] As long as we do not,

---

tive is too high a price to pay for the benefit to the individual creditor or the incidental benefit to the collective.

Thus, Professor Baker is correct that loss of the benefit is a cost of *Levit*, but it seems to me it is a cost to one creditor in the interests of the collective, that is, a loss of a "preferential" benefit to that creditor. It also should be noted that the benefit could be obtained in other ways, including a contract with the insider requiring such assistance, the cost to be added to the debt owed by the company. That solution is not nearly as good from the lender's perspective, but the reduced benefit to the lender is the price of the collective benefit from the reduction of preference-creating leverage.

47. *See supra* notes 34-35 and accompanying text.

48. *See supra* notes 32-35 and accompanying text.

49. For a general discussion about the deterrent effect of preference law, see Countryman, *supra* note 20, at 748 (discussing the weak deterrent effect of

some creditors will continue to grab now and worry about a preference action later, and some true-guarantee insiders will take their chances on making preferential payments. For present purposes, the important point is that the *Levit* rule provides the right incentives, even though all preference incentives are fairly weak.

The courts that manipulate section 550 of the Code to permit recovery only against the insider have not served preference policy.[50] Such a rule operates effectively only as to true guarantors whom the bankruptcy trustee finds worth suing, but those are the very guarantees whose legitimate purposes will not be thwarted by *Levit*. The rule would leave the bankruptcy trustee with no effective remedy against a judgment-proof pure-leverage guarantor and would provide no disincentive for lender pressure on that guarantor to favor the lender at the expense of other creditors. That is, the rule would be inefficacious as to the only serious threat to preference policy in the realm of insider-guarantees. In an attempt to preserve the legitimate uses of such guarantees, it would serve only their illegitimate and quasi-legitimate uses.

The distinction between true guarantees and pure-leverage guarantees is important to understanding the policy justification for *Levit* and the weakness of the arguments made against it. *Levit* will permit lenders to continue to enjoy the legitimate benefits of insider guarantees while providing some measure of protection against abuse of those guarantees.

II. THE "NONCREDITOR" ANALYSIS

A. WAIVER

As the earlier summary indicated,[51] the *Levit* panel immunized the IRS from the one-year insider preference period.[52] It did so even though insiders would have had liability for tax payments not made and therefore were the indirect beneficiaries of payments made to the IRS more than ninety days, but less than one year, before bankruptcy. The rationale was that these officers would not have been able to obtain reimbursement from the company if they had made those payments.

preference law); McCoid, *supra* note 21, at 261-65 (same); Weisberg, *supra* note 20, at 136 nn.566-68 (same).

50. *See, e.g., In re* Aerco Metals, Inc., 60 B.R. 77, 81 (Bankr. N.D. Tex. 1985) (restricting recovery under § 550 on equitable grounds).

51. *See supra* notes 14-18 and accompaying text.

52. *Levit*, 874 F.2d at 1192.

They therefore were not creditors of the company, even contingently, and the indirect benefits to them were not benefits to "creditors" under section 547(b)(1).[53] Thus, the payments to the IRS were not preferences.

The importance of the *Levit* tax holding has been greatly reduced by the subsequent ruling of the Supreme Court in *Begier v. IRS*.[54] In *Begier*, the Court held that payment of "trust fund" taxes[55] are not preferences because the funds paid are held in trust for the government and therefore are not property of the debtor.[56] On that basis, no payment of trust funds can be a preference, whether or not it benefits an insider. This triumph for the fisc over bankruptcy policy swallows up the much smaller tax effects of *Levit*.[57] Nevertheless, the tax analysis in *Levit*—the effect of "noncreditor" status for the insider—has implications that go well beyond taxes.

The noncreditor analysis in *Levit* inferentially creates an immunity from the *Levit* rule for every well-lawyered commercial lender.[58] If the insider must be a creditor—must have an action for reimbursement from the company—for the *Levit* rule to apply, then a simple waiver of reimbursement by the insider could immunize commercial lenders from the effects of the *Levit* rule.[59]

The same economic leverage that enables lenders to obtain insider guarantees will enable them to get such waivers routinely. The insider's right of action against the company is likely to be virtually worthless in the only situation—default—

53. *Id.* at 1191-92.

54. 110 S. Ct. 2258 (1990).

55. "Trust fund" taxes, as defined in *Begier*, differ from common notions of trust funds. In *Begier*, the Court recognized that the IRS requires employers to withhold federal income taxes and to collect Federal Insurance Contributions Act taxes from its employees' wages. *See* 26 U.S.C. § 3402(a) (1988) (income taxes); 26 U.S.C. § 3102(a) (1988) (FICA taxes). The airline in *Begier* was required to collect excise taxes from its customers for payment to the IRS. 26 U.S.C. § 4291 (1988). Because the amount of these taxes is "held to be a special fund in trust for the United States," 26 U.S.C. § 7501 (1988), they are often referred to as "trust-fund taxes." *See Begier*, 110 S. Ct. at 2261. *See also* Slodov v. United States, 436 U.S. 238, 241 (1978).

56. *Begier*, 110 S. Ct. at 2267.

57. *Levit*, 874 F.2d at 1191-92.

58. *See, e.g.*, *In re* Kroh Bros. Dev. Co., 115 B.R. 1011, 1015-16 (Bankr. W.D. Mo. 1990) (finding that because partnership insider contractually disclaimed liability, no creditor status and no insider preference existed).

59. *See, e.g.*, Baker, *supra* note 2, at 145-47; Higgins & Peterson, *supra* note 2, at 399-401. *See generally* LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS § 2.4.2 (2d ed. 1991) (discussing various strategies for immunizing commercial lenders from the *Levit* rule).

in which it matters. The lender easily can persuade an insider that the insider's waiver is the sacrifice of a legal right that has no practical value. If *Levit* represents good policy, its routine evisceration is a troubling prospect.

The most straightforward response to this concern would be to hold such waivers void for preference purposes. Commentators have discussed this possibility, although not always with a full explanation of the likely rationale.[60]

An insider's waiver of company reimbursement at the insistence of a lender may strike the courts as odd. Absent the *Levit* application of section 547,[61] there is no commercial reason for the lender to seek such a waiver. Such a waiver is in substance exactly the same as a waiver of the application of section 547. That is its only function and purpose. Because it is self-evident that an insider cannot waive the rights of third parties, the courts are free to look through form to substance, as they so often do,[62] and hold the waiver invalid.

That analysis is simple and to the point. The judges may find it suffices for practical purposes. It leaves unresolved, however, a more fundamental issue that any student of bankruptcy law will want to understand.

Reflection upon the effects of waiver reveals an underlying anomaly in the operation of section 547 as applied in *Levit*. The noncreditor analysis makes the insider's creditor status crucial to the outcome, but that status has almost nothing to do with the policies the *Levit* rule serves[63] and the *Levit* opinion defends.[64] The lender with an insider guarantee has the same incentive to use its insider knowledge and control whether or not the insider has a reimbursement action against the company in case the lender calls the guarantee. If anything, the lender with a waiver of company reimbursement has more leverage, because the insider does not have even the possibility of recovering the economic loss from the company. When a circumstance is critical to a legal result, but seems irrelevant to the reason for that result, it can be inferred that either something

---

60. *See, e.g.*, Baker, *supra* note 2, at 145-46; Higgins & Peterson, *supra* note 2, at 401.

61. *See supra* notes 6-18 and accompanying text.

62. The most prominent instance in commercial law is, of course, the security lease. *See generally* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 21-3 (3d ed. 1988) (discussing leases claimed to be security interests).

63. *See* Cullina, *supra* note 2, at 151.

64. *See supra* text accompanying note 24.

is seriously wrong with the legal concept or the policy issues are more complex than at first appeared. Because creditor status is required for application of the *Levit* rule, but apparently irrelevant to its reason, something must be badly awry with the rule or the rule must serve some nonobvious purpose.

B. The Policy Gap

An understanding of the role of the creditor element in the operation of the *Levit* rule requires that we begin by putting preference law in context within the larger body of doctrine that aims to control insider abuses.

1. Insider Abuse Doctrines

Insofar as section 547 adopts a special rule for insiders, it is part of a complex web of bankruptcy rules that addresses the special risks to bankruptcy policy arising from insider abuses. In addition to insider-preference doctrine, these rules include several aspects of fraudulent conveyance law and the rules concerning breach of corporate fiduciary duties. Under both headings, the bankruptcy rules comprise both special federal rules stated in the Code and state law rules incorporated in bankruptcy law. Federal fraudulent conveyance law is found in section 548 of the Code[65] and state fraudulent conveyance law is incorporated through section 544(b).[66] The law governing breach of corporate fiduciary duties by insiders is primarily state law incorporated in bankruptcy through sections 541(a) and 544(b)[67] but includes some federal doctrines that have been developed in applications of section 510(c), which deals with eq-

---

65. Section 548, which addresses "fraudulent transfers and obligations," allows the trustee to "avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing" of bankruptcy, given the conditions enumerated in the Code. 11 U.S.C. § 548 (1988).

66. Section 544(a) addresses the trustee as lien creditor. 11 U.S.C. § 544(a) (1988). Subsection (b) provides that "[t]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim," provided that § 502's allowance of claims or interests requirements are met. 11 U.S.C. § 544(b) (1988). In those states that have adopted the recently promulgated Uniform Fraudulent Transfer Act, the state law insider-abuse rules now include a special insider-preference provision as well. *See* Uniform Fraudulent Transfer Act § 5(b), 7A U.L.A. 657 (1985).

67. *See* 11 U.S.C. § 541(a) (1988) (discussing property of the estate); 11 U.S.C. § 544(b) (1988) (permitting the trustee to exercise certain state law rights of unsecured creditors).

uitable subordination.[68]

Because of the multiplicity of state and federal rules that vindicate bankruptcy policy toward insider abuses, there is inevitably an overlap in their operation. Although some overlap is no doubt desirable, the strengths and weaknesses of each doctrinal tool make it appropriate to define and constrain the overlap so that each set of rules operates where it most efficiently and effectively serves bankruptcy and commercial policies generally. The lines courts draw in allocating insider-abuse problems to each category of doctrine should reflect the special characteristics of each.

Each of these legal tools can be placed on a spectrum that defines them as more "formulaic" or more "case specific." The term "formulaic" refers to legal standards that are at once more definite and more arbitrary, more predictable and more inflexible. Rules at the formulaic end of the spectrum are more mechanical, more quantified, narrower in application, and less related to scienter or fault; on the other hand, rules approaching the case-specific end are more flexible, more open-ended, broader in potential application, and more sensitive to state-of-mind and the balancing of competing values. Because of these characteristics, more formulaic rules are more predictable and require less litigation, while more case-specific rules are less arbitrary and more adaptable to new circumstances.[69] So considered, the preference rules, generally and as they relate to insiders, are near the formulaic end of the spectrum,[70] fraudulent conveyance rules lie along the spectrum from formulaic to case specific,[71] and fiduciary duty rules lie toward the

68. Section 510(c), which addresses subordination, provides that the court may "subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim" or may "order that any lien securing such a subordinated claim be transferred to the estate." 11 U.S.C. § 510(c) (1988).

69. This distinction evokes a long-standing debate about the distinction, if any, between rules and standards. *See, e.g.*, Pierre Schlag, *Rules and Standards*, 33 U.C.L.A. L. REV. 379 (1985). My usage derives from my conviction that there is a difference. That is, texts are more or less determinate, rather than determinate or indeterminate, and there is a distinction between a rule and a standard. In the specific context of preferences, Professor Weisberg has discussed a distinction that overlaps the one I suggest. He contrasts approaches that are "scientific" and "moral." *See* Weisberg, *supra* note 20, at 65-70. I have chosen "formulaic" and "case-specific" in an attempt to refer as broadly and neutrally as possible to the operation of two types of standards, putting to one side the various functions, normative and otherwise, that might be served by each.

70. *See Levit*, 874 F.2d at 1194.

71. That aspect of fraudulent conveyance law sometimes called "construc-

case-specific end.[72]

It is probably a fair generalization to say that rules tend to emerge at the case-specific end of the spectrum as new circumstances arise. Litigation then reveals recurring patterns of conduct and problems of procedure and proof, leading to the creation of more formulaic rules governing specific types of situations. Certainly that process describes the development of preference law[73] and the "constructive fraud" aspect of fraudulent conveyance law.[74] Federal preference law now has reached the point in its development where it has virtually no reference to state of mind or fault in a given transaction.[75]

The benefits of "formulization" are considerable when applied to core situations. "Core" situations are those that fairly often arise. Their frequency makes them well-understood and susceptible to routinization and also maximizes the benefits of a formulaic approach. Applied to core situations, more formulaic rules are more predictable in operation, a point of special importance in commercial law where parties routinely act with legal advice. Predictability reduces transaction costs for the large number of transactions that are never the subject of legal

---

tive fraud," *see* 11 U.S.C. § 548(a)(2)(B)(i) (1988); the Uniform Fraudulent Transfer Act § 5(a), 7A U.L.A. 657 (1985) is closer to the formulaic end, while "actual intent" fraudulent conveyance rules have more case-specific characteristics, *see* 11 U.S.C. § 548(a)(1) (1988); Uniform Fraudulent Transfer Act § 4(a), 7A U.L.A. 652 (1985).

72. *See In re* Mobile Steel Co., 563 F.2d 692, 698-702 (5th Cir. 1977) (oft-cited discussion of case-specific analysis of equitable subordination and fiduciary duties).

73. *See* Countryman, *supra* note 20, at 713-25. For example, the 1978 Code's presumption of insolvency during the normal ninety-day preference period, *see* 11 U.S.C. § 547(f) (1988), probably has reduced the amount of litigation on that very difficult factual issue. *See* Countryman, *supra* note 20, at 727-32.

74. *See* James A. McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404, 407-19 (1933).

75. The elimination of the "reasonable cause to believe" element, in 1978 as to creditors generally and in 1984 as to insiders, was the last step in this long process. *See* Countryman, *supra* note 20, at 726. Elements of scienter and fault remain at the margins, for example, in those cases under the ordinary course defense of § 547(c)(2) where pressure from the creditor has been viewed as tending to defeat the defense. *E.g., In re* Family Home Sales Center, Inc., 65 B.R. 176, 177-78 (Bankr. N.D. Ga. 1986). Professor Weisberg's thoughtful article questions this trend, suggesting that "scientific" and "moral" conceptions of preference will always remain in tension and that the latter repeatedly reemerge despite legislative efforts to apply mechanical rules. *See* Weisberg, *supra* note 20. His argument has considerable force, but I think it demonstrates a spiral rather than a circle, with preference law growing steadily more formulaic despite the strong pulls in the normative direction.

dispute and makes effective, through deterrence, the policy that the rule protects. Formulization also reduces litigation expense.

The benefits of formulization do not come without important costs, however. Formulization creates risks of mindless formalism, which in turn can lead to underground maneuvering by the courts, creating shadow rules that undermine predictability and swell litigation. At the margins, it may lead to results that are neither efficient nor fair in light of countervailing policies that cannot receive due weight from the application of a mechanical rule. For these reasons, a more formulaic rule best serves when applied to a fairly narrow range of recurring conduct, leaving marginal circumstances to case-specific standards.[76]

Because preference law is more formulaic, it usually makes sense to constrain it within the limits of its core circumstances, leaving other related rules to serve bankruptcy policy at the margins. Within the overall territory of insider abuse, the special preference rules for insiders should be directed at common abuses, leaving other potential abuses to other rules. Much of the appropriate constraint is found at the heart of preference law, section 547(b)(2), which requires that a transfer be "on account of" antecedent debt.[77] This requirement focuses preference law on a narrow range of insider abuses, but reflection may suggest that the focus should be narrower still. Therein we will find the function served by *Levit*'s requirement that the insider be a creditor.[78] That requirement does not support the preference policy precisely because it functions to constrain application of that policy rather than to vindicate it.

---

76. The fact that the avoiding powers are scattered along the spectrum from formulaic to case-specific has created a problem for those courts that have sought to avoid the *Levit* result by using their equitable powers under § 550. *See., e.g., In re* Arundel Housing Components, Inc. 126 B.R. 216, 218-19 (Bankr. D. Md. 1991). *See generally* COLLIER, *supra* note 21, ¶ 550.02. Section 550 is the common recovery provision for all the avoiding powers. Because the more formulaic rules are meant to operate mechanically, without much reference to equities, while the more case-specific rules have the equities built in, § 550, as a common provision for recovery, is not a good place to fit case-specific concerns. An attempt to fashion a broad rule in § 550 inevitably will operate inappropriately as to some of the avoiding powers, while a narrow rule simply will be an arbitrary "doing equity" in a given case by a given judge. The case-specific considerations that arise legitimately in § 550 are those that are directly related to relief as such. *See supra* note 28.

77. 11 U.S.C. § 547(b)(2) (1988).

78. *Levit*, 874 F.2d at 1189-92.

2. The Creditor Element at the Margin

Because the study of law is properly grounded in the concrete instance, we can best address the question before us through an example of an insider abuse that lies at the margin of preference law and policy. Suppose the president of H Corporation, Jane Hackman, an entrepreneur with several business interests, owns a large portion of the corporation. Because H Corporation suffers some financial difficulty, including a cash-flow problem, its bank lender becomes anxious about repayment. Hackman approaches the bank requesting financing of a shopping center, a new project in which H Corporation will have no part. The bank seeks to link the two ventures by demanding a guarantee of H Corporation's debt in exchange for financing for the new project, but Hackman refuses. The bank then informs her, somewhat inconsistently, that its policy against excessive exposure to the ventures of any one principal makes the new financing impossible unless H Corporation makes a substantial prepayment against its loan. Hackman causes H Corporation to make the payment and obtains the loan for the new project. Drained of cash following the repayment, H Corporation slowly expires, entering bankruptcy nine months later. Although this example is hardly a commonplace occurrence, those with commercial experience will view the scenario as comfortably realistic.[79]

If the new financing were the but-for cause of H Corporation's repayment, and the payment the but-for cause of its demise, conclusions that rarely would be clear,[80] most observers would regard this transaction as an insider abuse. Hackman has obtained a personal benefit by exploiting her control of the corporation to the detriment of the entity and its creditors, conduct we generally deplore in a fiduciary.[81] If the corporate trustee could overcome the substantial problems of proof of causation, a court likely would look for a doctrine that would permit the corporation's estate to obtain some sort of relief against Hackman. If the trustee also demanded relief against

79. *See, e.g., In re* Sharon Steel Corp., 871 F.2d 1217, 1221 (3d Cir. 1989) (noting that the debtor made repayment to facilitate loans to other enterprises controlled by its principal).

80. For example, the problem becomes more complicated if the payment was already past due, but the corporation would have postponed it until a later time absent Hackman's intervention.

81. *See, e.g.,* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 349 (1986) (attributing to a fiduciary the duty to "act in the best interests of the corporation and not of themselves as individuals").

the bank, the court would inquire into the bank's knowledge of the corporation's affairs and prospects before finding it responsible for the injury. On a proper showing, one can imagine that the bank could be found liable.

The Hackman example is designed to implicate precisely the same policy that was the central concern in *Levit*.[82] This hypothetical presents a corporation's demise caused by the prepayment of debt at the insistence of and for the benefit of an insider. The distinction from *Levit* lies in the indirect connection between the corporation's payment and the insider's benefit, unlike the insider-guarantee situation where payment often bears a dollar-for-dollar relationship to the insider's benefit. The technical, legal difference from *Levit* is that the insider possesses no rights against the corporation regarding the debt (*au contraire*) and therefore lacks creditor status for the purposes of section 547.[83] Under the *Levit* analysis, the payment fails to constitute a preference as to the insider or the bank.[84]

This example illustrates the useful role played by the requirement that an insider be a creditor if a payment is to be regarded as an insider preference, despite the somewhat artificial and indirect nature of that role. The creditor requirement distinguishes the example from the insider-guarantee case, notwithstanding the fact that both involve the same bankruptcy policy. That result is appropriate because the insider abuse in this example presents a marginal, idiosyncratic case that is ill-suited to the application of the more formulaic preference rules. This sort of insider abuse requires a more case-specific rule. In this instance, state law self-dealing doctrines are the obvious choice. On other facts, the actual-intent fraudulent conveyance doctrine may be a more useful approach.[85]

Two points are key to understanding the role that the creditor requirement plays in distinguishing the core preference

82. *See Levit*, 874 F.2d at 1194-95.

83. *See id.* at 1189-90.

84. *See id.*

85. An excellent student note advocates the use of fraudulent conveyance doctrine in the *Levit* situation. *See* Nussbaum, *supra* note 2, at 621-26. I disagree with the author's conclusion that fraudulent conveyance law, especially its *Dean v. Davis* actual-intent branch, provides the overall solution to the insider-preference problem. *See* Dean v. Davis, 242 U.S. 438, 440 (1917). The author's more fundamental point, however, is the analytical benefit derived from seeing the *Levit* problem in the larger context of insider-abuse doctrine generally. That insight makes the author's analysis enlightening. Another well-written student note reflects some of the same insights in a somewhat similar solution. *See* Cullina, *supra* note 2, at 158-162.

case of insider guarantees from marginal cases like the example just discussed. The first is negative. The creditor requirement does not serve to distinguish cases that implicate preference policy from those that do not. As the example demonstrates, the creditor requirement prevents the application of insider-preference law to some circumstances where preference policy is very much involved. That fact renders the requirement irrelevant, in any direct way, to the policy itself. Instead, within the universe of cases involving insider-preference policies, the creditor requirement makes preference law applicable to core cases and inapplicable to marginal ones.[86] Thus, the requirement relates to the policy factors weighing against preference policy and serves the function of constraining it.

The second point is that the creditor requirement operates only indirectly. It serves to include in the balance against enforcement of preference policy the costs that would arise from applying the more formulaic preference rules to marginal cases, costs that include confusion and expense in ordinary commercial transactions as well as procedural difficulties. Section 547 could address that balancing problem directly by identifying the competing concerns and requiring courts to balance them from case to case. By rendering preference law more case specific, however, that approach would decrease the benefits of predictability and increase litigation costs. The creditor requirement serves as a rough proxy for the balance between competing factors, acting in a more formulaic way that fits the structure of preference law generally.[87]

---

86. *See, e.g., Levit*, 874 F.2d at 1190.

87. On the other hand, the proxy nature of the creditor element requires some care in its application. *See In re* Octagon Roofing, 124 B.R. 522, 531-32 (Bankr. N.D. Ill. 1991). The facts in *Octagon* are not entirely clear from the opinion. The transfer under attack was the debtor's grant of a mortgage to a bank creditor more than ninety days before bankruptcy. *Id.* at 525. Although the debts covered by the mortgage formed a subject of dispute, for our purposes the debtor granted the mortgage to secure the debtor's own antecedent debt. *Id.* at 529. An affiliated company allegedly benefited from the granting of the mortgage because the bank creditor deferred collection of a second, unrelated debt from the affiliate. *Id.* at 532. The affiliate had not guaranteed the debtor's debt but was incidentally a creditor of the debtor on yet a third debt. Without discussion (and apparently without argument from the parties), the court implicitly permitted the incidental debt to satisfy the creditor requirement of *Levit* and explicitly accepted the collateral benefit allegation as sufficient to regard the transfer as being "for the benefit of" the affiliate. *Id.*; *see also* 11 U.S.C. § 547(b)(1) (1988). Because no relationship existed between the transfer and the benefit or the affiliate's creditor status, the decision reaches far beyond *Levit* and seems obviously wrong.

Although only a proxy for the policy balance, the creditor requirement is not adventitious. In the insider-guarantee case, the benefit to the insider is directly linked, dollar for dollar, with the payment to the creditor.[88] In the marginal Hackman example, the benefit remains unquantified and relates only indirectly to the payment.[89] The creditor requirement reflects the direct and quantified connection between the company's transfer and the insider's benefit in the insider-guarantee case. The absence of creditor status for the insider in the Hackman example reflects an indirect and unquantified relationship between payment and benefit. The presence or absence of creditor status for the insider stands proxy for the strength and clarity of the relationship between transfer and benefit.

If we were to decide that this rough proxy approach was too imprecise and chancy, we could eliminate the creditor requirement in insider-preference cases by amending section 547(b)(1) to read "to or for the benefit of a creditor or an insider."[90] Following such an amendment, the payment to the bank in our example would qualify as a preference, given the assumptions previously stated. The change in qualification would impose additional costs. One cost would involve quantifying the benefit the insider receives to determine the amount of the voidable preference, because only the amount of the benefit should be avoidable.[91] In our example, the qualification of

88. *See, e.g.*, *Levit*, 874 F.2d at 1190. The insider guarantor derives benefit from the decrease of exposure to liability. This decrease directly correlates to the payment to the creditor.

89. *See, e.g.*, *In re* Kroh Bros. Dev. Co., 115 B.R. 1011, 1017-18 (Bankr. W.D. Mo. 1990) (alleged benefit to insiders through tax benefits of indirect capital contributions).

90. Section 547(b)(1) currently allows the avoidance of a transfer of the debtor "to or for the benefit of a creditor," 11 U.S.C. § 547(b)(1) (1988), but does not include the proposed addition of "or an insider."

91. Many aspects of preference theory remain murky. For example, courts and commentators have not developed a theory for unraveling the transactions that are connected with a transfer later recovered as a preference. *See* Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 272 n.200 (1989). By the same token, the proper analytical treatment of a partial preference also has not been resolved. In the case of a partially secured creditor, for example, do we theoretically recover the entire payment and then allow the creditor to recoup from the collateral? Or do we only recover the preferential portion? *See* Countryman, *supra* note 20, at 744 n.171. In the case of an insider payment, I conclude that a preference includes only the portion of the transfer that benefits the insider, and, therefore, the trustee should recover only that portion. Thus, given a $100,000 unsecured debt to an unaffiliated lender, an insider guarantee limited to $50,000, full payment of the debt six months before bankruptcy, and insolvency on the transfer

the payment as a preference would necessitate valuing the benefit of the shopping-center financing to Hackman, which is not an easy task. One can think of other examples that would present even more difficult valuation problems.

An even larger cost of the amended statute would involve the uncertainty created in many types of corporate transactions. Insiders benefit in a host of indirect ways from the activities of their corporations, especially the process of restructuring debt. These transactions often entail complicated elements, including guarantees, cross-defaults, the giving of security interests, and the provision of letters of credit. Substantial transaction costs and inefficiencies would arise if lenders and their counsel had to scrutinize all these transactions for possible connections between insider benefits, however indirect and unquantified, and payments or other transfers to lenders.

I doubt that the benefits of extending the insider-preference rules would justify these costs. Indeed, I think these costs would force the courts to adopt a balancing rule along the lines discussed previously, so that the insider-preference rules would apply only to fairly direct and quantifiable benefits to the insider. At worst, the courts, in search of a practical rule, might develop some notion of a "proximate cause" relationship between transfer and benefit, lurching between foreseeability and factual cause. Under such an approach, the insider-preference rule would lose most of the advantages of a more formulaic rule, leaving an unappealing combination of arbitrariness and uncertainty.

It must be admitted that there are costs associated with the constraints imposed by the creditor requirement. The difficulties of proof in the use of the more case-specific doctrines in marginal cases will permit some insider abuses to escape the trustee's net. Those difficulties also will increase the delay and cost of litigation and result in lower settlements for the estate. Greater cost and fact-specific rulings ultimately will result in less deterrence of certain insider abuses that offend preference policy. In cases like our H Corporation example, corporate officers like Hackman often will escape the consequences of their

---

date, the trustee would avoid only $50,000 of the $100,000 payment. Any other result would ignore the central role of the "benefit" to the insider and would create a pointless distinction between making one or two payments. Acceptance of this analysis would eliminate some of the concerns about the *Levit* line of cases. *See supra* note 28.

abuse of position, as will lenders who induce that abuse for their own purposes. These are substantial costs.

Furthermore, emerging litigation may reveal that the creditor requirement is too rough and uncertain a substitute for the proper limits of preference enforcement against insider abuses. As new problems emerge, we may decide upon a constraint more directly related to the competing concerns involved.

My purpose is not to elaborate all the pros and cons concerning the right place to draw the line on insider-preference law. My aim has been merely to explore the apparent gap between the creditor requirement as applied in *Levit* and the preference policy served by the *Levit* rule. I began my thinking about the problem of the creditor requirement with a concern that the lack of connection between that requirement and the policies served by preference law would lead to nonenforcement of the *Levit* rule, through waiver or otherwise.[92] I am now satisfied that it need not have that effect if the courts are sensitive to the somewhat clumsy and indirect role it has to play. The analysis is entirely consistent with the idea of voiding lender attempts to obtain immunity from *Levit* through waivers.[93] Because the creditor requirement acts as a rough and indirect proxy for the policies constraining application of the preference rules, it is not surprising that a formal manipulation could threaten its proper operation. A recognition of its proxy role should comfort the courts that voiding such waivers will not implicate some substantive economic right.

III. CONCLUSION

The modest goal of this commentary has been to look a bit more deeply at the role of preference law in regulating insider abuses. I hope that the distinction between true and pure-leverage guarantees will help clarify what is actually at stake in insider-preference cases. The discussion of the role of the creditor requirement may mitigate the widespread feeling that the result in *Levit* was somehow arbitrary or merely technical and may assist analysis as the problem develops in the courts. Appreciation of the usefulness of the distinction between more formulaic and more case-specific rules may be of some value in other bankruptcy contexts as well.

Many people in the bankruptcy field believe that *Levit* rep-

92. *See supra* text accompanying notes 58-64.
93. *See supra* text accompanying note 60.

resents a disturbing extension of preference law to the outer limits.[94] I am sure it does not. Continuing encounters among traditional bankruptcy doctrines, evolving commercial practices, and exotic financial products will provide a steady stream of new and surprising results. *Durrett*[95] was astounding and outré in 1980; today it represents one more routine item on a workout checklist. Leveraged buyouts constituted the high-tech financial breakthrough of the 1980s; in the 1990s, they are the classroom examples of fraudulent conveyances.[96] *Levit* merely provides the logical extension of classic preference doctrine and policy in the context of modern financial practices. Preference law as applied to insider abuses will no doubt continue to develop in unanticipated ways. My intention has been to provide some clarifying background for that evolution.

94. *See supra* note 2 (citing articles that conclude that *Levit* represents an inappropriate extension of preference law).

95. Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980).

96. *See, e.g.,* Sharrer v. Sandlas, 477 N.Y.S.2d 897, 899 (1984); *In re* Revco D.S., Inc., 118 B.R. 468 app. at 512 (Bankr. N.D. Ohio 1990) (Barry L. Zaretsky, *Preliminary Report of Examiner*); *see also* ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS: TEXT, CASES, AND PROBLEMS 146-53 (2d ed. 1991). *But see* Kupetz v. Wolf, 845 F.2d 842, 847 (9th Cir. 1988) (LBOs not fraudulent conveyances absent actual intent to defraud).