

1993

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Recommended Citation

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Rethinking Professor Westbrook's *Two Thoughts About Insider Preferences*

Peter A. Alces*

Even the most powerful, most secure creditor interests fear the operation of the fraudulent disposition provisions of the Bankruptcy Code.¹ Large institutional creditors have reason to be anxious when the trustee in bankruptcy may interpose a sixteenth-century theory² to frustrate their best laid plans.

* Professor of Law, Marshall-Wythe School of Law, The College of William and Mary. I am indebted to my colleagues Jayne Barnard, Charles Koch, and Harold See for their thoughtful comments on a draft of this manuscript. I also acknowledge the thorough and careful work of my research assistant, Karen J. Smith, J.D. 1993, The College of William and Mary. Deficiencies of the finished product, however, remain the fault of the author.

1. See 11 U.S.C. §§ 547, 548 (1988) ("Preferences" & "Fraudulent transfers and obligations"). Section 544(b) of the Bankruptcy Code also provides the trustee in bankruptcy the right to utilize state law in order to recover property for the bankruptcy estate. *Id.* § 544(b). The trustee could use state uniform fraudulent disposition law, the Uniform Fraudulent Conveyance Act, 7A U.L.A. 427 (1985) [hereinafter U.F.C.A.], or Uniform Fraudulent Transfer Act, 7A U.L.A. 639 (1985) [hereinafter U.F.T.A.], when to do so would permit the trustee to reach transfers not within the scope of the Bankruptcy Code fraudulent transfer or preference provisions.

To the extent that the states retain bulk sales law under Article Six of the Uniform Commercial Code, the trustee may also prosecute a bulk sales action on behalf of the estate. For a discussion of the affinity between the fraudulent transfer and bulk sales law, see Peter A. Alces, *Fraud Bases of Bulk Transferee Liability*, 63 TEMP. L. REV. 679 (1990).

2. Scholars generally trace fraudulent disposition law in the United States to the English Statute of 13 Elizabeth, 13 Eliz., ch. 5 (1571). The Elizabethan legislation was essentially criminal in nature, proscribing transfers effected with "intent to delay, hinder or defraud creditors and others of their just and lawful actions, suits, debts, accounts, damages, penalties, forfeitures, heriots, mortuaries, and reliefs." *Id.* § 1. That "actual intent" proscription is continued in the U.F.C.A. (§ 7), U.F.T.A. (§ 4(a)(1)), and the Bankruptcy Code (11 U.S.C. § 548 (a)(1)(1988)).

The decision of Star Chamber in *Twyne's Case*, 3 Co. Rep. 80b, 76 Eng. Rep. 809 (1601), established the so-called "badges of fraud," which essentially converted actual intent to defraud under the Statute of 13 Elizabeth into what has become contemporary constructive fraudulent disposition law. Though scholars generally recognize *Twyne's Case* as a fraudulent conveyance decision, in fact it was a preference decision. See Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 513 (1977) ("[O]ne of

One of the latest causes of secured lenders' disquiet is Judge Frank Easterbrook's opinion for the Seventh Circuit Court of Appeals in *Levit v. Ingersoll Rand Financial Corp.*³ Though the individuals involved and the facts are, to say the least, intemperate,⁴ it is the stark holding of the case that lenders and their counsel find most chilling. *Levit* construed Bankruptcy Code section 550(a)(1) to provide the trustee⁵ with the right to recover payments made to a lender within one year of the debtor's bankruptcy⁶ when those payments effectively reduce the exposure of an insider-guarantor. For reasons that make sense in terms of statutory semantics, but do not make good commercial sense, the recovery theory is available only if the insider is a creditor of the debtor with regard to the guaranty.⁷ Creditor status is generally established by suretyship law, which provides that a secondary obligor (i.e., the guarantor) may recover from the principal obligor (debtor) when the secondary obligor satisfies the debt of the principal to the obligee, the lender.⁸

Most of the commentary responding to *Levit* has not been

the great ironies of legal history is that *Twyne's Case*, which is widely regarded as the fountainhead of the modern Anglo-American law of fraudulent conveyances, does not, as presented in the reports, clearly involve anything more than a preference.").

Commentators have questioned the continued vitality of these sixteenth-century commercial principles. See Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 852 (1985) ("A firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance.").

3. (*In re V.N. Deprizio Constr. Corp.*) 874 F.2d 1186 (7th Cir. 1989).

4. "As the investigation continued and Deprizio's [the insider-guarantor's] indictment was imminent, word circulated that he might 'sing.' So in January 1986 Deprizio was lured to a vacant parking lot, where an assassin's gun and the obligations of a lifetime were discharged together. Corporations are not so easily liquidated." *Id.* at 1187.

5. Cf. 11 U.S.C. § 1101(1) (1988) (providing that the "debtor in possession" may act in lieu of a § 322 (*Id.* § 322) trustee). Reference to the trustee in this article includes as well the qualified debtor in possession.

6. The trustee may avoid transfers that prefer an insider for the full year before the bankruptcy. *Id.* § 101(31) (Supp. III 1991) (defining insider). See *id.* § 547(b)(4)(B).

7. See *id.* § 547(b)(1) (providing that the "trustee may avoid any transfer to or for the benefit of a creditor"). See also *infra* notes 66-73 and accompanying text (explaining the creditor requirement in greater detail).

8. See RESTATEMENT (THIRD) OF SURETYSHIP § 14 (Tent. Draft No. 1, 1992):

supportive of either the opinion's policy analysis⁹ or conclusion.¹⁰ Recently, in the pages of the *Minnesota Law Review*, Professor Jay Westbrook wrote a qualified defense of *Levit*.¹¹ He recognizes the concerns of Judge Easterbrook's critics but argues nonetheless that with certain limitations the logic of the decision can be made to work. Westbrook endeavors to distinguish among insider guaranties, to urge the commercial efficacy of one type but not the other, and then to explain how *Levit*, apparently fortuitously, accommodates this discrimination.¹² He also engages the curious requirement that the insider be a creditor of the debtor and discovers serendipity in that accident

(2) The right to require the principal obligor to perform the underlying obligation or bear the cost of performance may be effectuated by:

(a) enforcement of the principal obligor's duty of performance . . . ; or

. . . .

(c) subrogation of the secondary obligor to the rights of the obligee.

See also RESTATEMENT OF SECURITY § 104 (1941):

(1) Where the surety makes a payment or otherwise performs on default by the principal, or where the surety's property is used to satisfy the principal's duty, it is the duty of the principal to reimburse the surety to the extent of his reasonable outlay if

- (a) the surety's obligation has been incurred, or his property has been subjected to a charge, with the consent of the principal, or
- (b) the principal has assumed an obligation which was once the primary obligation of the surety.

(2) Where a surety who has undertaken his obligation without the consent of the principal makes a payment or otherwise performs on account of the principal, it is the duty of the principal to reimburse the surety to the extent that the principal has been unjustly enriched.

Subsection 104(2) could operate to compromise a waiver of the right to reimbursement contained in the terms of the guaranty agreement, so far as the *Levit* creditor requirement is concerned. See *infra* note 63 and accompanying text.

Commentators have treated the rights to reimbursement, subrogation, and contribution at some length. See, e.g., JOHN HANNA, CASES AND MATERIALS ON SECURITY 378-82 (2d ed. 1940); LAURENCE P. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP, 165-264 (1950); ARTHUR A. STEARNS, THE LAW OF SURETYSHIP 439-528 (5th ed. 1951).

9. For a catalogue of the commentary hostile to *Levit*, see Jay L. Westbrook, *Two Thoughts About Insider Preferences*, 76 MINN. L. REV. 73, 73 n.2 (1991).

10. 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).

11. Westbrook, *supra* note 9. Though the tone of this response at times may be somewhat aggressively argumentative, this article should not be read as demonstrating a lack of respect for either Professor Westbrook or his work. His article and its argument are provocative and provoke this response.

12. *Id.* at 80-86.

as well.¹³ For Westbrook, *Levit* makes sense despite itself, or at least despite Judge Easterbrook's rationale.

Westbrook is a good deal more considerate of the anti-*Levit* commentators and courts than I am. He does not offer the best defense for *Levit* and it is crucial that the case for the decision be made as convincingly as possible. Congress in the last year considered carefully and at great length amendments to the Bankruptcy Code that would have overruled *Levit*.¹⁴ The 1992 initiative failed¹⁵ but there is reason to believe that Congress will try again, and *Levit* is in jeopardy. Congress would eviscerate the rationale of the decision were it to save only so much of *Levit* as Westbrook suggests. Indeed, the forces arrayed against *Levit* might find much in the Westbrook argument to arm their attack.

The limits Westbrook would graft onto the *Levit* doctrine are inappropriate and rely on insupportable distinctions. It is error to suggest that somehow an invisible, or at least unwitting, hand of bankruptcy jurisprudence has trickled sufficient commercial reason down through the preference provisions to impose just the right limits on the logic of *Levit*. Essentially, the problem is that Westbrook posits what he deems the proper, defensible scope of *Levit*, and thereby delimits an improper scope as well, excepting from the grasp of the *Levit* sanction a substantial number of instances that should be within the decision's proscription.

Part I of this Article describes Westbrook's distinction between "true" guaranties and "pure-leverage" guaranties and refutes his argument that *Levit* provides a reliable means to distinguish the uncommercial consequences of the bad (pure-leverage) guaranty from the commercial benefits of the good (true) guaranty. The distinction is ultimately ephemeral and has no meaning in insider preference law. Part II turns to Westbrook's defense of the accidental requirement that, in determining the availability of *Levit*, it matters whether the insider-guarantor is a "creditor" of the debtor by virtue of his retention of a right to reimbursement from the debtor upon satisfaction of the secondary obligation. I am certain that creditor status is irrelevant to the calculus.

13. *Id.* at 86-98.

14. See *infra* notes 93-97 and accompanying text.

15. For the "scuttlebutt" about what may have "scuttled" the 1992 reform legislation, see *Legislative Update: Why The Bankruptcy Bill Failed*, BANKR. CT. DECISION WKLY. NEWS & COMMENT, Oct. 22, 1992, at A4.

It is first worthwhile to describe the frame of reference from which this response proceeds. A necessary predicate to an examination of any difficult fraudulent disposition law problem is an appreciation of the constructive fraud foundation of the fraudulent disposition provisions of the Bankruptcy Code. Commentators, including Westbrook, have identified the two purposes of preference law: equality of distribution and reduction of the incentives for premature dismemberment of the impecunious debtor.¹⁶ To effect these purposes, the preference provisions of the Bankruptcy Code resonate with the principles of constructive fraud law.¹⁷

The basis of constructive fraud liability is prejudice to the plaintiff (i.e., general unsecured creditors in bankruptcy) without regard to the intent of the defendant (i.e., preferential transferee).¹⁸ Intent is irrelevant to the calcu-

16. See Westbrook, *supra* note 9, at 76 nn.20-22; see also *Report of the Comm. on the Bankruptcy Laws of the United States*, H. DOC. NO. 137, 93d Cong., 1st Sess., pt. 1 at 213-13 (1973) (citation omitted) (describing three purposes of preference law: "First, it lessens the possibility of a scramble among creditors for advantage; second, it promotes equality [among creditor classes]; and third, it eliminates the incentive to make unwise loans in order to obtain a preferential payment or security.").

17. In light of two recent bankruptcy decisions, there may be reason to believe that the constructive fraud nature of fraudulent dispositions law extends to equitable subordination under 11 U.S.C. § 510 (1988). The Massachusetts bankruptcy court in *In re O'Day*, 126 B.R. 370 (Bankr. D. Mass. 1991), avoided a leveraged business acquisition on constructive fraudulent disposition and equitable subordination bases without discerning an actual intent to defraud. *Id.* at 411-12. Thus, apparently, equity may intervene without a showing of the defendant-transferee's mala fides. Also, in *In re Virtual Network Serv. Corp.*, 902 F.2d 1246 (7th Cir. 1990), the Seventh Circuit recognized what commentators have dubbed "no-fault" equitable subordination. *Id.* at 1248-49; see also David G. Heiman et al., *Case in Controversy: "No-Fault" Equitable Subordination After Virtual Network — Lenders Take Cover or a False Alarm?*, 1 J. BANKR. L. & PRAC. 208 (1992); cf. *William Iselin & Co. v. Boardwalk Regency Corp.*, 703 F. Supp. 1084, 1088 (S.D.N.Y. 1989) (reading the actual intent to defraud section of New York's version of the U.F.C.A. to presume intent to defraud from a conveyance made when grantor receives no consideration in return).

For commentaries identifying the constructive fraud bases of fraudulent disposition law, see generally PETER A. ALCES, *THE LAW OF FRAUDULENT TRANSACTIONS* ¶ 5.03[3] (1989 & Supp. 1992); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725 (1984).

18. The focus of constructive fraud principles in generic misrepresentation or fraud law is the detriment the victim of a misrepresentation suffers rather than the benefit the fraud-feasor realizes. Some states have statutorily recognized causes of action for innocent misrepresentation. See, e.g., ALA. CODE § 6-5-101 (1977); CAL. CIV. CODE § 1573 (West 1982). Courts have also recognized causes of action for breach of fiduciary duty, essentially imposing liability on a party in a position of trust upon whom the victim was entitled to

lus.¹⁹ Constructive fraud law proceeds from a decidedly normative foundation: as between two (or perhaps more) parties to a transaction, the victim of the constructive fraud should recover, but only to the extent that the victim is made whole.²⁰ The recovery does no more than restore the victim to its pre-tort condition.²¹

Westbrook recognizes the constructive fraud nature of preference liability by concluding that preference law is "formulaic";²² he does not, however, appreciate the consequences of this characterization. He argues that preference law is becoming more and more formulaic²³ notwithstanding the "normative

rely. See, e.g., *Crawford Painting & Drywall Co. v. J.W. Bateson Co.*, 857 F.2d 981, 985 (5th Cir.), cert. denied, 488 U.S. 1035 (1988); *Hofstetter v. Fletcher*, 905 F.2d 897, 907 (6th Cir.); *Roberts v. Sears Roebuck & Co.*, 573 F.2d 976, 983 & n.6 (7th Cir.), cert. denied, 439 U.S. 860 (1978). See generally *Alces*, supra note 17, ¶ 2.02[4].

19. See Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 747-48 (1985):

[W]e have finally come, in part by accident, to a voidable preference concept that abandons the English requirement of the debtor's culpability and our own former requirement of the creditor-defendant's culpability. . . .

. . . .

. . . . The function of the preference concept is to avoid prebankruptcy transfers that distort the bankruptcy policy of distribution. Transfers that do distort this policy do so without regard to the state of mind of either the debtor or the preferred creditor.

At this same juncture, Professor Countryman questions whether preference law has any deterrent effect or in any real way assures equality of distribution. *Id.* at 748-49 & nn.188-92.

20. See RESTATEMENT (SECOND) OF TORTS § 552B (1977):

(1) The damages recoverable for a negligent misrepresentation are those necessary to compensate the plaintiff for the pecuniary loss to him of which the misrepresentation is the legal cause

(2) [T]he damages recoverable for a negligent misrepresentation do not include the benefit of the plaintiff's contract with the defendant.

Courts finding negligent misrepresentation often award only "out-of-pocket" tort damages. See, e.g., *Rosales v. A.T. & T. Information Sys., Inc.* 702 F. Supp. 1489, 1501 (D. Colo. 1988); *Law Offices of L.J. Stockler, P.C. v. Rose*, 436 N.W.2d 70, 86 (Mich. Ct. App. 1989); *First Interstate Bank v. Foutz*, 764 P.2d 1307, 1309-10 (N.M. 1988). A few decisions, however, have sanctioned benefit of the bargain recovery in non-intentional fraud cases. See, e.g., *Orsini v. Bratten*, 713 P.2d 791, 794 (Alaska 1986); *Rose v. City of Covington*, 634 S.W.2d 268, 270 (Tenn. 1982).

21. Because preference law only allows the trustee to recover the amount of the preferential transfer without imposing penalty on the transferee, even if the transferee intentionally exacted the preference, the preference provisions have little deterrent effect. See Westbrook, supra note 9, at 85 n.49.

22. "The term 'formulaic' refers to legal standards that are at once more definite and more arbitrary, more predictable and more inflexible." *Id.* at 90.

23. See *id.* at 91 n.75. Professor Westbrook responds to the thesis devel-

pull" of some of the exception provisions.²⁴ The value of perceiving preference law as increasingly formulaic, so far as Westbrook is concerned, stems from the cost savings accomplished by avoiding the litigation necessary to vindicate conceptions of justice.²⁵

The value of constructive fraud law, however, is not in the reduction of litigation for the sake of reducing litigation. Certainly constructive fraud produces cost savings, and such savings matter in bankruptcy law at least as much as and perhaps more than they matter in the law generally.²⁶ The benefit of constructive fraud law is better results, or more justice more often than not.²⁷ This may, in turn, pay dividends in reduced

oped by Professor Robert Weisberg in his article, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 116-29 (1986). Westbrook understands the Weisberg article to suggest that

"scientific" [rules] and "moral" [standards] conceptions of preference will always remain in tension and that the latter repeatedly reemerge despite legislative efforts to apply mechanical rules. [Weisberg's] 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.

Westbrook, *supra* note 9, at 91 n.75 (citation omitted).

Westbrook is certainly right: the spiral describes the evolution of preference law more accurately than Weisberg's circle. But both commentators disregard the fact that preference law is one part of the general fraudulent disposition law mosaic. It matters little to the trustee or lender what theory results in a transfer's avoidance. The most accurate graphic depiction of this area of the law might well require a set of interconnected spirals representing, alternatively, fraudulent transfer (state and federal), equitable subordination and preference law. Dean Clark's important article supports this understanding of fraudulent disposition circularity. *See generally* Clark, *supra* note 2.

24. As an example of adjustments that reflect the persistent "normative pull," Westbrook cites the "cases under the ordinary course defense of § 547(c)(2) where pressure from the creditor has been viewed as tending to defeat the defense." Westbrook, *supra* note 9, at 91 n.75. This could indicate the courts' eagerness to reach the right result on the facts before them rather than any statutory attraction to the normative.

25. *See id.* at 96 n.90.

26. The bankruptcy estate bears the litigation costs involving the estate's property. The trustee and the creditors therefore have an even greater interest in avoiding protracted and costly litigation in bankruptcy. Litigation costs deplete the estate and may thereby reduce the recovery of the debtor's creditors. Westbrook also recognizes this point. *See id.* at 83-84.

27. Sales law governing express warranties provides a useful analogy. Under U.C.C. § 2-313 (1987), the buyer may prevail in a breach of express warranty action by establishing that the seller's representation formed a "part of the basis of the bargain." U.C.C. § 2-313 (1987). It is not necessary for the buyer to establish that she in fact *relied* on the seller's representation. In trying to distinguish "basis of the bargain" from "reliance," (then Professor, now University President) John Murray observed that:

litigation as well. It is this type of litigation cost reduction that should be the object of constructive fraud law: the savings realized because the rule formulates the most just result, the result otherwise obtained only through protracted litigation.²⁸

The *Levit* decision is fundamentally a case about the constructive fraud nature of preference law, fraudulent dispositions law, and bankruptcy law generally.²⁹ Therefore, perhaps

[i]f business agreements could be invalidated by asserting a lack of reliance, a 'business man knowing, or sensing that [this] stood in the way of judicial relief would hesitate to rely on a promise in [a] case where the legal sanction was of significance to him.' Requiring proof of reliance, in effect, decreases reliance.

John Murray, "Basis of the Bargain": *Transcending Classical Concepts*, 66 MINN. L. REV. 283, 319 (1982) (footnotes omitted) (citing L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52, 62 (1936)).

28. Bankruptcy courts have discerned the constructive fraud nature of preference law. For example, in *Graban v. McDowell Nat'l Bank (In re Engel)*, 96 B.R. 602 (Bankr. W.D. Pa. 1989), the trustee attempted to recover as preferential the value of certain accounts receivable that "fed the lien" of the secured creditor within ninety days of bankruptcy. *Id.* at 603. In defense, the secured creditor objected that it had no idea that it was undersecured at the time the accounts became part of its collateral base. *Id.* The court dismissed that objection summarily: "The state of mind of a secured party is not relevant. It is 'value' which is important." *Id.*

That conclusion is further supported by the legislative history of the so-called "no improvement of position test":

The [test] sacrifices a great deal to simplicity of administration. It seeks to avoid complicated and expensive litigation by focusing the judicial inquiry on the situation as it existed on the two dates chosen as measuring points. . . . There has to be a straight policy choice between the rough and ready provisions of the [Code] (which, it is thought, will work reasonably well in all but the unusual case) and the desire to do justice case by case (which may require tedious, asset-exhausting litigation in all cases).

H.R. REP. NO. 595, 95th Cong., 1st Sess. 216 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6176. This observation confirms that preference law is animated by constructive fraud principles, in part because it is too expensive to more finely tune the equitable balance.

Professor Countryman, after surveying the development of preferential transfer legislation in England and the United States, and considering especially the nature of insider preference liability, concluded that there is no good reason to condition the operation of the insider preference avoidance provision on the insider-transferee's state of mind: "A transfer to an insider-creditor by an insolvent debtor, like the debtor's transfer to any other creditor, is not any more or less a distortion of the bankruptcy distribution policy depending on the transferee's state of mind." Countryman, *supra* note 19, at 749.

29. Similar "semaphore" cases in fraudulent dispositions law include *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied* 483 U.S. 1005 (1987) (avoidance of leveraged business acquisition on constructive and actual fraud bases); *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981) (valuation of direct and indirect benefits in cross-steam and upstream guaranties attacked as fraudulent conveyances);

even more than because of its impact on commercial lending, there is much at stake in the way we read *Levit*. In a world impatient for identification of and salvation by fundamental bankruptcy principles,³⁰ *Levit* seems to chart a course. The two parts of this Article proceed from a constructive fraud perspec-

Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980) (avoidance of real property foreclosure as constructively fraudulent conveyance).

Bankruptcy scholars seem to have little trouble identifying the particular issue in which they are interested in a particular article as a kind of *roman a clef* of bankruptcy jurisprudence generally. See, e.g., Weisberg, *supra* note 23, at 11-12 ("Indeed, the legislative and judicial history of preference law becomes a medium for political debate over such [fundamental] questions. . . . [P]reference laws have inadvertently become symptoms of the instability of our commercial norms."); Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. L. REV. 919, 938 n.59 (1991) ("[L]egitimate questions remain about the limits of the bankruptcy process. . . . [M]uch about the scope of bankruptcy policy can be learned by observing the courts' use of the good faith device in the decided case law.")

30. A veritable cottage industry has sprung up offering alternative metatheories of bankruptcy. Two views have attained particular prominence. Ponoroff & Knippenberg, *supra* note 29, at 948-66, describe the "Traditional" and "Collectivist" views of bankruptcy. They trace the Collectivist view to the work of Professor Baird and Provost Jackson:

"Collectivism," as we [Ponoroff and Knippenberg] use that term, should be taken to mean the set of shared fundamental assumptions and postulates of a group of scholars writing mainly from an economics-based perspective of the law. . . . For the Collectivists . . . bankruptcy serves a single purpose: it is a federal debt collection system. Accordingly, bankruptcy is properly invoked only in response to a common pool problem, a term Jackson uses to describe the situation created when a debtor's assets are insufficient to satisfy the demands of a common pool of claimants. The purpose of bankruptcy—or, to use Jackson's term, the 'first principle' of bankruptcy—is to serve as a debt collection device targeted to the common pool problem.

Id. at 949-50 (footnotes omitted).

They attribute the Traditional view to Professor Elizabeth Warren, particularly her article *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 776 (1987). They describe her Traditionalism as recognizing

that the financial collapse of a firm presents questions of loss allocation and community interest simply not implicated in individual debtor-creditor disputes. For this reason, the Traditionalist believes that the bankruptcy system is and should be designed to address a broad range of interests affected by the collapse of a debtor enterprise. This broad range should include, but not consist exclusively of, the interests of creditors with unpaid state law claims. Brought within the bankruptcy process, diverse interests can be taken into account and, perhaps, protected and accommodated collectively under the auspice of the proceeding itself.

Ponoroff & Knippenberg, *supra* note 29, at 960-61 (footnotes omitted).

It would probably be worthwhile to test preference law against both of those views, as well as in terms of fraudulent disposition law generally. I reserve that endeavor, however, for another day.

tive to demonstrate the incongruity of both the true guaranty versus pure-leverage guaranty distinction and the use of the "creditor" requirement to distinguish among those guaranties within and those without the scope of *Levit*.

I. DISTINGUISHING LEVERAGE FROM LEVERAGE: GOOD, BAD, AND UGLY GUARANTIES

Westbrook describes two points at the ends of a guaranty spectrum, what I term a guaranty "ugliness continuum": the true (or good) guaranty and the pure-leverage (or bad) guaranty. The goodness or badness of a guaranty for Westbrook is a function of the lender's purposes in taking the guaranty: a product, then, of the lender's intent. The "more" the lender obtains the guaranty to gain access to the guarantor's assets, the better the lender's purpose and the less desirable it is, according to Westbrook, to punish the lender for taking it. If the lender's motive in taking the guaranty is to obtain leverage to cause the guarantor to prefer the lender over the general creditors, then the purpose is bad and preference law should deter such behavior.³¹

Westbrook concludes that *Levit, deus ex machina*, will disappoint the lender who takes the bad guaranty but will not similarly discomfit the lender who takes the good guaranty:

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 non-payment is more likely than an action by the bankruptcy trustee for an indirect preference. . . . 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.³²

Westbrook distinguishes the good guaranty from the bad guaranty by distinguishing the good lender from the bad lender:

31. See Westbrook, *supra* note 9, at 82-83.

32. *Id.* at 83-84 (footnotes omitted).

the lender who takes the guaranty from a judgment-proof insider does so to realize an improper, *in terrorem* effect. The lender who takes the guaranty from a judgment-worthy insider takes it for proper reasons, and should not be exposed to the *Levit* sanction. To draw that distinction, along lines of motive, contravenes the sense of constructive fraud law. The distinction is untenable because preference law is constructive fraud law. Westbrook cannot both acknowledge the formulaic nature of preference law and then so profoundly undermine his characterization.³³

The next two sections respond to Westbrook's distinction between good and bad guaranties by arguing that there is no reason to believe that the party liable on a good guaranty will be any less likely to cause the principal obligor to prefer the lender-obligee than would the party liable on a bad guaranty. In fact, just the opposite is true. Further, there are neither good nor bad guaranties; all guaranties are ugly.

33. Westbrook does not draw his distinction along formulaic or constructive fraud lines; it is instead an incarnation of the contract bargain model, a kinder and gentler incarnation perhaps, but based on the contract paradigm nonetheless. For the genesis of that model in the fraudulent disposition context, see Baird & Jackson, *supra* note 2. For criticisms of the model, see generally David G. Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73 (1985); Kathryn V. Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 IND. L. J. 781 (1988); Kevin J. Liss, Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491 (1987).

Westbrook's argument echoes the contract bargain model: "The true-guarant[y] commitment will maximize the chances of the business' success, to the benefit of all concerned." Westbrook, *supra* note 9, at 84. While that is certainly a laudable goal, and one not exclusively the province of contract principles, it implies the business would not realize a similar benefit if courts apply *Levit* more broadly than Westbrook suggests. At a time when Congress is looking for ways to respond to powerful lenders' interests, see *infra* notes 93-97 and accompanying text, it is dangerous, and in fact inconsistent with fundamental fraudulent disposition principles, to argue that a limited operation of *Levit* will give effect to the "bargain" that the victims of an insider preference, unsecured trade creditors, would have made with the debtor and its lender had they merely been invited to the table.

Compare Carlson, *supra*, at 103 n.95 (commenting on the contract bargain model):

This is all very irrelevant. Such a hypothetical agreement costs neither the debtor nor the creditor anything to make. The person who pays the bill under fraudulent conveyance law is the third party who may not retain a gift or dividend. Why should that party participate in a hypothetical creditor's bargain? An *ex ante* reconstruction of what parties really want is rather worthless when it excludes the very parties who must bear the cost of the agreement.

A. PRESSURING THE JUDGMENT-PROOF

In all the world there is nothing more timorous than a million dollars, except ten million. In revolutionary times the rich are always the people who are most afraid.³⁴

For Westbrook, a good guaranty vindicates two legitimate lender interests: first, greater protection for the lender, in the form of more assets (those of the insider-guarantor) supporting the loan to the debtor; and second, the insider's enhanced commitment to her business, more "hard work and sacrifice"³⁵ than the guarantor would have otherwise devoted to the success of the business. Yet

[a] "pure-leverage" guarant[y] is a guarant[y] given by an insider who is not likely to be able to offset any shortfall in the debtor's performance. . . . The value of such a guarant[y] is primarily a matter of control over the debtor company through leverage on the insider. The insider will be anxious to see the guaranteed debt paid and will be vulnerable to pressure to see that it is.³⁶

When the guaranty operates *in terrorem*, it is illegitimate. Such a guaranty is not due the indulgence of preference law. A pure-leverage guaranty is bad because it does not serve a legitimate commercial purpose.³⁷

Westbrook argues that as a matter of fact the lender who has taken a good guaranty will not be required to disgorge payments on the guaranteed debt. The party liable on the good guaranty will resist the lender's pressure, reinvigorate the debtor-business, and, in so doing, avoid bankruptcy altogether.³⁸ Such a guarantor, solvent and afraid of losing it all, or most of it, has all the right incentives. Were he to cause the debtor to prefer the lender, those payments would be recovered from

34. JOHN BARTLETT, FAMILIAR QUOTATIONS 1017 (Emily M. Beck ed., 14th ed. 1968) (citing Gerald White Johnson, *American Freedom and the Press*, 1958).

35. Westbrook, *supra* note 9, at 79.

36. *Id.* at 80 (footnote omitted).

37. 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 guarant[y]. 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. Both aspects of the pure-leverage guarant[y] are *in terrorem* pressures that are generally regarded as quasi-legitimate at best. It is not clear that commitment obtained on such a basis has much claim to policy consideration. It certainly should not be considered of sufficient value to counterbalance the anti-dismemberment policy.

Id. at 82-83 (footnotes omitted).

38. See *supra* text accompanying note 32.

him as the party who benefitted from the preferential transfer.³⁹

Westbrook's argument depends upon the assumption that a judgment-proof guarantor, the party who, by definition, makes a bad or pure-leverage guaranty, will have more incentive to raid the business-debtor's coffers to prefer the lender than would the good, "judgment-worthy" guarantor,⁴⁰ the party who has assets exposed to the risk of either the lender's enforcement of the guaranty or the trustee's recovery of the preference in the debtor's bankruptcy. This may be a specious distinction. The guarantor's *incentive* could just as likely be a function of how much the guarantor has to lose, or how much the guarantor believes she has to lose, as it is a function of the guarantor's apprehension about personal bankruptcy.⁴¹

Consider the nature of the threats that each guarantor confronts. The lender threatens the guarantor, good or bad, with enforcement of the guaranty if the corporate debtor does not make certain preferential payments to the lender. The good guarantor may either succumb to the pressure and cause the preferential payments or resist the pressure and force the lender's hand. If the guarantor succumbs, the trustee will be able to recover the amount of the preferential payments from the guarantor. (If the trustee recovers instead from the lender, the lender may proceed against the guarantor on the guaranty.)

If the good guarantor believes the probability the business will fail within one year is less than 1.0,⁴² and that, therefore, there is less than a one hundred percent chance the trustee will prevail in the insider preference action,⁴³ then the guarantor

39. Recall that *Levit* nowhere *requires* that the trustee proceed against the initial transferee (the lender); the Bankruptcy Code allows the trustee to recover from either the "initial transferee" or the creditor who benefitted from the transfer (the insider). 11 U.S.C. § 550(a)(1) (1988). Westbrook does, however, assert, without citing supporting authority, that "the bankruptcy trustee likely will seek recovery from the [judgment-worthy] insider in the first place." Westbrook, *supra* note 9, at 81.

40. Westbrook, *supra* note 9, at 80.

41. The Bankruptcy Code and state exemption laws provide some protection against the type of extortion that Westbrook fears. *See, e.g.*, 11 U.S.C. § 522(d)(3) & (4) (1988); TEX. PROP. CODE ANN. § 42.002 (West Supp. 1992); VA. CODE ANN. § 34-26 (Michie Supp. 1992).

42. And Westbrook must allow that this would be the norm.

43. The trustee will not prevail if the lender-transferee can identify an apose exception to preference liability. The exceptions are collected in 11 U.S.C. § 547(c) (1988). Moreover, in *Union Bank v. Wolas*, 112 S. Ct. 527 (1991), the United States Supreme Court held that courts may consider installment payments made on long-term debt in the ordinary course of business and

may cause the debtor to make the preferential payment. In fact, the judgment-worthy guarantor, the guarantor who makes good guaranties, is always better off causing the corporate debtor to make the preferential payment because the probability of the guarantor's ultimate preference liability for the amount of the payment is always less than 1.0.

The judgment-worthy guarantor, however, may be able to resist either forcing the preferential payment or paying on the guaranty. This is the scenario Westbrook foresees. He believes that the good guarantor will respond to the lender's threat by putting her shoulder to the grindstone. The good guarantor may, or she may not. If the guarantor does not so choose, the lender may decide not to enforce the guaranty either because of fluctuations in the economy generally, or simply because the lender is not interested in foreclosing on the guarantor's home after all.

If the lender proceeds against the guarantor (or the guarantor believes the lender will proceed), then the *potential* creditor, the trustee recovering an insider preference, is replaced by the very real creditor, the lender-beneficiary of the guaranty. The good guarantor may have more reason to fear this actual creditor than the specter of a trustee in bankruptcy. If we assume you pay the creditor you fear the most, your mortgagee before the newspaper delivery service, the good guarantor will prefer the threat of a trustee in bankruptcy to the (at least perceived) 1.0 probability, the reality of one hundred cents on the dollar satisfaction of the guaranty.

Contrast the incentives that operate on the judgment-proof or bad guarantor on the pure-leverage guaranty. This guarantor also confronts two creditors: the potential trustee in bank-

therefore insulate them from preference avoidance. Explaining the *Levit* sanction's limited utility, Judge Easterbrook anticipated the *Wolas* decision: "To the extent that debtor paid on time, the creditor is protected by the current version of § 547(c)(2), the 'ordinary course' rule." *Levit*, 874 F.2d at 1200.

Wolas, then, should shelter all payments made on a debt guaranteed by an insider so long as the payments were otherwise in the ordinary course of business. See Barkley Clark, *Scheduled Debt Payments as Preferences: Paradigm of the Plain Meaning Rule*, 1 J. BANKR. L. & PRAC. 7 (1991).

Consider the limited circumstances in which a lender would fear *Levit* sanctions: only if the lender has taken an insider guaranty and receives more than the scheduled loan payments. If in fact the lender receives payments in an amount that takes them outside the scope of the ordinary course, is that not the best evidence that the debtor preferred the lender at a time when the debtor's financial condition was compromised? For a survey and discussion of the ordinary course of business exception cases, see *ALCES*, *supra* note 17, ¶ 6.03[2].

ruptcy and the very real lender exerting preference pressure. In a world without *Levit*, the lender could exert that pressure with impunity, unconcerned with recovery beyond the ninety-day preference period. The bad guarantor may be only too happy to oblige because the trustee would not be able to get blood from a stone; the bad guarantor, recall, is defined by his judgment-proof financial status.

Post-*Levit*, however, the lender will know better than to try to pressure the bad guarantor because the trustee in bankruptcy will recover the transfer from the lender. It matters little if the lender does not know better. The trustee will reach the preferential payments in the hands of the lender anyway. This result, Westbrook argues, is appropriate because the bad guarantor, judgment-proof but curiously in fear of bankruptcy,⁴⁴ is more likely to cause the corporate debtor she controls to make the preferential transfers than would the good guarantor who fears what may happen to his assets in the bankruptcy of the corporate-debtor.

I agree with Westbrook that *Levit* provides the pure-leverage guarantor a means to respond to the lender's *in terrorem* pressure: "Threaten me or my company and I will take my company into bankruptcy so that the trustee can recover the payments you've been receiving for the last year." In addition, the bad guarantor will say something else to the lender: "I'll go into bankruptcy myself too, and discharge any liability I might have on that bad guaranty you made me sign." Indeed, personal bankruptcy may be the best friend of the pure-leverage guarantor. The availability of personal bankruptcy may give the bad guarantor the resolve to stand up to the lender who takes a bad guaranty and then tries to pressure the insider. To conclude otherwise we would have to know more about the "bankruptcy-averseness" of the particular judgment-proof guarantor. What Westbrook misses by focusing on the judgment-proof guarantor's fear of personal bankruptcy is the way that impecunious status *empowers* rather than compromises both the guarantor and the debtor-corporation the guarantor "controls."⁴⁵

44. Indeed, bankruptcy may be the one place where the judgment-proof insider's meager assets will be relatively safe. See 11 U.S.C. § 522 (1988 & Supp. III 1991) (providing the exemptions available to an individual debtor).

45. The essence of the Bankruptcy Code's definition of an insider is "control." See 11 U.S.C. § 101(31) (Supp. III 1991), particularly subsections (A)(iv), (B)(iii) & (vi), and (C)(ii) & (v). For a survey of the insider "control" cases, see generally ALCES, *supra* note 17, ¶ 6.02[5][c]; 2 WILLIAM M. COLLIER, COL-

According to Westbrook, the judgment-worthy guarantor will be less subject to lender pressure because such a guarantor knows that the trustee can recover any preference from the party benefitted, the true guarantor. He asserts, without elaboration and without support, that "the bankruptcy trustee likely will seek recovery from the insider in the first place."⁴⁶ When the lender exerts pressure, the solvent insider must decide whether to cause the debtor to pay the lender, and hope to avoid *Levit* liability, or resist the lender's entreaties and rehabilitate the debtor's business.

Westbrook concludes that such a guarantor will stand tall, call the lender's bluff and resist pressure to cause the debtor to make preferential payments. I would suggest that, if there is greater or lesser pressure in either the good or bad guaranty settings, the lender may well be in the position to impose greater pressure on the good guarantor. The impecunious guarantor is not necessarily more subject to the lender's pressure than would be the judgment-worthy guarantor, who could have much more to lose. Westbrook has not given reason to conclude otherwise; he offers no empirical support for his conclusion.

Therefore, because *Levit* actually may afford Westbrook's so-called bad guarantor more power to resist the lender than it does the good guarantor, the commentator's distinction would be untenable, if it were viable. Further, were his distinction the best, or even a plausible, argument in favor of the operation of the rule, the rule would be assailable. Congress might be able to find good reason in the Westbrook dichotomy to overrule *Levit* statutorily. The next section explains why West-

LIER ON BANKRUPTCY ¶ 101.31 (Lawrence P. King, ed., 15th ed. 1991 & Supp. 1992). The Ninth Circuit bankruptcy appellate panel explained the nature of the insider inquiry under the Bankruptcy Code in *Friedman v. Sheila Plotsky Brokers, Inc.* (*In re Friedman*), 126 B.R. 63, 69-70 (Bankr. 9th Cir. 1991) (footnote omitted):

First, the Code assigns insider status to entities or relatives of the debtor, or of persons in control of a related entity, whose affinity or consanguinity gives rise to a conclusive presumption that the individual or entity commands preferential treatment by the debtor. Second, insider status may be based on a professional or business relationship with the debtor, in addition to the Code's *per se* classifications, where such relationship compels the conclusion that the individual or entity has a relationship with the debtor, close enough to gain an advantage attributable simply to affinity rather than to the course of business dealings between the parties.

46. Westbrook, *supra* note 9, at 81.

brook's distinction between good guaranties and bad guaranties is untenable.

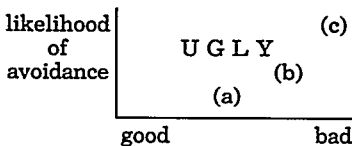
B. ALL GUARANTIES ARE UGLY

According to Westbrook, a good guaranty is less likely, and the bad guaranty more likely, to be subject to *Levit* avoidance. In a footnote, Westbrook acknowledges that a guaranty's goodness and badness is a matter of degree: "Most guarant[ies] 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 guarant[y] is a true or a pure-leverage guarant[y]."⁴⁷ All guaranties are "ugly" in terms of the true/good versus pure-leverage/bad dichotomy Westbrook formulates, if we understand "ugly" to mean no more than some combination of the good and bad.⁴⁸ When a loan is closed and the guaranty executed, the guaranty may be good, the guarantor judgment-worthy. There would be no reason to question the bona fides of the parties. The same could be true of a bad guaranty. At the time the loan is closed everyone in the room knows that the guarantor is judgment-proof. Indeed, the lender and its counsel may even have some question about the prospects of keeping the corporate debtor out of bankruptcy for a year.

During the course of the credit relationship, however, things change. The guaranty that started out quite good goes through degrees of ugly until finally it becomes bad. The guarantor went from judgment-worthy to judgment-proof, maybe in the course of little more than a year. Contrast the perhaps less typical but certainly plausible converse, the guaranty that starts out very bad, improves to merely ugly, and finally achieves "good." During this metamorphosis the fiscal well-being of the

47. *Id.* at 81 n.39 (emphasis added). Westbrook develops the same idea at 82 n.41.

48. The continuum, then, must be redrawn along axes.



Westbrook argues essentially that the more "bad" a guaranty is, the greater the likelihood that the trustee will recover a preferential transfer to the lender on account of the guaranty. The trustee will be more likely to "avoid" (recover from the lender) a guaranty as bad as (c) than she would guaranty (a) or (b).

corporate debtor may improve as well. Or the debtor's financial condition may deteriorate, perhaps in part because the guarantor is taking too much home and not reinvesting more in the business.⁴⁹

There are obvious questions: when do we measure the goodness, badness, or ugliness? How do we measure? What do we do with the ugly guaranty, neither purely good nor purely bad, certainly the most typical form? The next three sections consider the questions seriatim.

1. When to Measure

Westbrook identified two legitimate reasons for taking the insider's guaranty: greater protection for the lender through increased assets supporting the loan, and enhancement of the insider's commitment through "nights and weekends" at the office.⁵⁰ Because *Levit* avoidability occurs at the time of the corporate debtor's bankruptcy, the lender may avoid insider preference exposure despite the good commercial reasons of the lender when it first took the guaranty. If the object is to appraise the purity of the lender's intentions when it takes the guaranty, then applying *Levit* in the bankruptcy proceeding, perhaps long after the fact, may not be the way to do it.

The lender who took a good guaranty "viewed prospectively" may not deserve the *Levit* sanction if the guarantor's personal financial fortunes deteriorate between the execution of the guaranty and the bankruptcy of the corporate debtor. It is the financial condition of the guarantor at the time of the bankruptcy proceeding, however, that determines the insider preference exposure of the lender. At that time the trustee decides whether to pursue the lender or the insider under section 550(a)(1).

2. How to Measure

Westbrook uses the financial condition of the guarantor as a measure of the guaranty's, and lender's, goodness (the extent to which the lender took the guaranty for the right reasons: assets and commitment). Assuming that it would be feasible to

49. The guarantor's actions need not be so extreme that corporate laws would intervene to provide the bases to pierce the corporate veil. See generally STEPHEN B. PRESSER, *PIERCING THE CORPORATE VEIL* (1992).

50. The phrase "nights-and-weekends commitment" is Westbrook's description of the type of commitment that legitimizes the true guaranty. See Westbrook, *supra* note 9, at 84.

determine the relative ugliness of a guaranty by reference to the judgment-worthiness of the guarantor, it is not enough to appraise that status in the abstract. "[I]t is a true guarant[y] if the guarantor is judgment-worthy for the full amount of the debtor's obligation."⁵¹ Thus, if the net worth of the guarantor is less than the debt the corporate debtor owes the lender, the guaranty is at least ugly, if not all bad.

Any deficiency may be enough to make the guaranty all bad if what makes the guaranty bad is the lender's threat to put the guarantor into personal bankruptcy. The guarantor who is bankruptcy-averse is not more or less so because he is only a little bit insolvent. A debtor is not thrown "deeper" into bankruptcy because she is "very" insolvent.⁵² The stigma, to the extent that it provides leverage, is much the same no matter how impecunious the guarantor.

What of the not atypical case in which a guarantor's net worth is less than the amount of the guaranteed loan? The lender may take a guaranty in order to dedicate additional assets to the loan, even if those assets are not sufficient to cover the full amount of the outstanding indebtedness, and to assure the guarantor's commitment to the corporate debtor. Do that lender's bona fides differ substantially from the bona fides of the lender willing to make a loan to a corporate debtor whose principal has personal assets in an amount equal to or exceeding the line of credit? It is possible to conclude that the lender making a loan to a less-than-judgment-worthy guarantor's business has more faith in the transaction *ab initio*; the lender is willing to take some risk because the lender believes in the business and the guarantor. Why favor the lender who took a guaranty for the wrong reasons but turned out to have a judgment-worthy guarantor after all over the lender who took a guaranty from a principal without the means to answer for the "full amount of the debtor's obligation"?

The problem, ultimately, is that the guarantor's judgment-worthiness at the time of the corporate debtor's bankruptcy is not a good proxy for the asset enhancement/commitment legitimacy. But there are additional problems.

51. *Id.* at 80.

52. It is, of course, not necessary that an individual or a business be insolvent in order to become a "debtor" under the Bankruptcy Code. *See* 11 U.S.C. §§ 301, 303 (1988).

3. What To Do With the Ugly

A persistent challenge in all law is how to treat a case that is not at the polar extremes of a continuum. In preference law, the answer is to impose the sanction "to the extent" of the preference.⁵³ A preferential transfer is avoidable *to the extent* that the transfer enabled the transferee to receive more than it would have in a liquidation of the debtor.⁵⁴

Westbrook acknowledges that most guaranties are ugly, "partake to some extent of both [true and pure-leverage characteristics],"⁵⁵ but then he asserts that *Levit* will work to the extent that the guaranty is good or bad. The operation of the *Levit* rule, then, will be a function of the guaranty's ugliness, the extent to which the guarantor is judgment-proof or judgment-worthy. We can construct the calculus.

If a lender makes a \$1 million loan to a corporate debtor and takes a guaranty from an insider with a net worth of \$500,000, that guaranty is both good and bad, or truly ugly. When the corporate debtor goes into bankruptcy and the trustee attempts to recover the \$100,000 in loan payments made during the year before the bankruptcy, the trustee, according to Westbrook,⁵⁶ will proceed against the insider and the lender will avoid the *Levit* effect. The lender, however, does not deserve to avoid *Levit* completely. The lender only deserves to avoid *Levit to the extent* that the guaranty was good rather than bad. So to effect the result for which Westbrook argues, the trustee should recover only \$50,000 from the insider and \$50,000 from the lender.

The net worth of the guarantor compared to the amount of the debtor's obligation, the full loan, does not matter. The trustee will recover from the insider whatever the trustee can recover from the insider. The trustee will not stop at an amount equal to the ratio that the preferential payments bear to the relation between the net worth of the insider and the amount of the loan the lender made to the corporate debtor.⁵⁷

Westbrook has to use a comparison of the net worth of the

53. *Id.* § 547(b)(5); see also *id.* § 547(c)(5).

54. *Id.* § 547(b)(5)(A).

55. Westbrook, *supra* note 9, at 81 n.39.

56. See *supra* note 39.

57. The relationships described in the text may be illustrated with contrasting formulae. Let "P" represent the amount of the voidable preference, "T" the payments made to the lender within one year of bankruptcy, "A" the assets of the guarantor, and "L" the amount of the guaranteed indebtedness, the outstanding loan. Were Westbrook's understanding to be accurate, P =

guarantor with the amount of the loan in order to raise the specter of the guarantor's personal bankruptcy. It is that specter, the guarantor's exposure to and risk of personal bankruptcy, that distinguishes the good from bad, the true from the pure-leverage guaranty. The comparison is convenient, but does not have the meaning on bankruptcy day that Westbrook urges.

II. DISTINGUISHING CREDITORS FROM CREDITORS: THE IRRELEVANCE OF BENEFIT

Because the drafters of the Bankruptcy Code did not have *Levit* in mind when they formulated section 550(1)(a), it is not surprising that a glitch appears when courts apply the provision to preferences benefitting insider-guarantors. Westbrook correctly reads Judge Easterbrook's opinion as imposing two requirements: first, that the insider be a creditor of the debtor ("creditor requirement"), and, second, that the insider be a creditor *on account of* the guaranteed indebtedness ("nexus requirement").⁵⁸ The creditor requirement comes from the language of section 547(b)(1): "[T]he trustee may avoid any transfer of an interest of the debtor in property — (1) to or for the benefit of a creditor."⁵⁹ Judge Easterbrook imposed the nexus requirement, the requirement that the creditor status relate to the guaranteed indebtedness, with regard to *Levit* avoidance of the Internal Revenue Service's tax claim. The requirement has no foundation whatsoever in the Bankruptcy Code.⁶⁰ The nexus requirement means no more than what Judge Easterbrook said it means.

A/L x T. In fact, however, the trustee's recovery will be $P = \min [T, A]$; that is, $P =$ the lesser of T or A.

58. In *Levit*, the trustee attempted to recover tax payments made to the Internal Revenue Service within one year of the debtor's bankruptcy by arguing that had the debtor not made the payments, the individual principals of the debtor would have been personally liable. *Levit*, 874 F.2d at 1191-92. Judge Easterbrook concluded that while the benefit to the insiders from the debtor's payments to the I.R.S. was "obvious . . . their status as 'creditors' is not." *Id.* at 1192. The insiders were not creditors with regard to the tax claim because the statutory provision fixing their personal liability did not provide the insiders a corresponding right to obtain reimbursement from the debtor on account of those payments. Judge Easterbrook reasoned that although tax law imposed a penalty on the insiders that would amount to personal liability, it did not constitute the imposition of liability for payment of the tax, with a corresponding right to reimbursement from the debtor. *Id.*

59. 11 U.S.C. § 547(b)(1) (1988) (emphasis added).

60. The terms of the nexus requirement cannot be found in § 547, § 550, or the Bankruptcy Code definition of "insider" in § 101(31).

Suretyship law provides a guarantor who discharges the principal obligation a right to reimbursement from the debtor, and subrogates the guarantor to the rights of the creditor against the debtor.⁶¹ Commentators critical of the *Levit* result⁶² and counsel for lenders who take insider-guaranties have discovered in those suretyship rights and in the curious *Levit* creditor requirement a means to circumvent *Levit's* sting. If the lender is liable only for the benefit to the insider-guarantor when the guarantor is a creditor of the debtor on account of the guaranteed indebtedness, the lender can avoid the *Levit* risk by destroying the guarantor's creditor status with regard to that guaranteed indebtedness. In that event, section 547(b)(1) will not be satisfied; the preferential payments did not benefit a "creditor" of the debtor, and section 550(a)(1) is only apposite after the elements of section 547(b) are established.

In order to destroy the guarantor's creditor status, the guaranty agreements may be drafted to include express waivers of the guarantor's right to reimbursement or subrogation.⁶³ Insofar as the existence of that waiver may actually increase rather than moderate the guarantor's exposure, such a guaranty certainly increases the risk *Levit* polices: the guarantor has a greater interest in causing the debtor to prefer the lender. The guarantor's only hope to remain whole is to cause the debtor to satisfy the guaranteed indebtedness.⁶⁴

A Tennessee bankruptcy court reviewed such a waiver. The boilerplate in *In re Fastrans, Inc.*⁶⁵ was sweeping: the guarantor waived any and all common law, statutory, legal, and equitable rights arising in relation to the guaranteed indebtedness.⁶⁶ The court reasoned that for the trustee to utilize *Levit*, "he must establish that the insider-guarantor . . . has a 'claim' against the debtor arising from his obligations under the Guar-

61. See RESTATEMENT (THIRD) OF SURETYSHIP, *supra* note 8, at § 14. The apposite Reporter's Note cites LA. CIV. CODE ANN. ART. 3047 (West 1982) and *Poling v. Morgan*, 829 F.2d 882 (9th Cir. 1987).

62. See *supra* notes 9 & 10.

63. See, e.g., 2 PETER A. ALCES ET AL., UNIFORM COMMERCIAL CODE TRANSACTION GUIDE § 16.18 (1988) ("Guarantor waives . . . any right to subrogation against [Debtor] or contribution against any party liable with regard to the Liabilities.").

64. See Peter L. Borowitz, *Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio*, 45 BUS. LAW. 2151, 2156 (1990). It is unlikely, however, that a lender would enforce such a waiver provision after the debtor has paid the lender in full.

65. 142 B.R. 241 (Bankr. E.D. Tenn. 1992).

66. *Id.* at 243.

anty and is not just as [sic] a creditor of the debtor generally."⁶⁷ The trustee could not make that showing in light of the terms of the waiver.

The *Fastrans* decision confirms that if form is not to prevail over substance, if the policy *Levit* vindicates is substantial, the "creditor" requirement must be abrogated. Otherwise, it is unlikely the lender with the bargaining power to obtain the guaranty in the first place would be constrained to agree to the guarantor's terms.⁶⁸

Westbrook sets up a straw man model revision of section 547(b)(1) to circumvent *Levit's* formal but insubstantial creditor requirement: amend the subsection "to read 'to or for the benefit of a creditor or an insider.'"⁶⁹ He then knocks it down by confusing the judicially-imposed nexus requirement with the statutorily-imposed creditor status requirement. Westbrook's argument proceeds from a hypothetical that reveals his confusion.

Westbrook proposes a scenario in which the lender who has taken an insider-guaranty does not use its insider-leverage to cause payment of the guaranteed indebtedness; instead, the lender conditions provision of additional financing for a separate, new project of the insider upon preferential payment of the guaranteed indebtedness.⁷⁰ In the debtor's bankruptcy, the trustee cannot invoke *Levit* to recover from the lender⁷¹ because the guarantor "possesses no rights against the corporation regarding the debt (*au contraire*) and therefore lacks creditor status for the purpose of section 547."⁷² Westbrook concludes that "[t]his 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."⁷³

Westbrook errs both in his application of the *Levit* creditor status and nexus rules to his own hypothetical and, more fundamentally, in his analysis of the apposite commercial and preference policies.

67. *Id.* at 245.

68. Such waivers appeared in form guaranty agreements long before *Levit*. See 2 ALCES, *supra* note 63, § 16.18.

69. Westbrook, *supra* note 9, at 96.

70. *Id.* at 93.

71. Westbrook does acknowledge that other avoidance theories might be available to the trustee "[o]n other facts." *Id.* at 94.

72. *Id.*

73. *Id.*

A. PRESSURE AT THE NEXUS

According to Judge Easterbrook's *Levit* tax holding, if a debtor has two creditors, A and B, the insider's guarantying repayment of the debt owed creditor A (and concomitant suretyship rights against the debtor if the insider discharges A's claim) does not satisfy the nexus requirement with regard to preferential payment of B's claim. Only if the insider had rights against the debtor in the event the insider paid B would the nexus requirement be satisfied with regard to the preferential payment to B.

Westbrook's hypothetical, however, involves one lender and two loans. The lender applies pressure to the insider in the form of withholding financing of the second business unless the insider effects preferential payment of the first debt. In this case, Westbrook finds the nexus requirement not met and, in turn, the *Levit* creditor test not satisfied. Judge Easterbrook, however, nowhere described the nexus requirement in those terms. The *Fastrans* court formulated the nexus requirement nicely:

[I]t is not enough that an insider be a creditor of the debtor in a general sense; the insider must have a 'claim' against the debtor attributable to the specific debt he or she guaranteed in order to render transfers made by the debtor on account of that debt to the non-insider transferee avoidable under § 547(b).⁷⁴

In Westbrook's hypothetical, the insider does have a claim against the debtor attributable to the specific debt she guaranteed (the valuable suretyship rights). All that differs from the *Levit* non-tax facts⁷⁵ is the *form or nature of the pressure the lender* (the non-insider transferee) *imposes*. Rather than threatening to enforce the guaranty, the lender in Westbrook's hypothetical "threatens" to withhold the financing of a separate project. The nexus requirement does not relate to the *form* of the pressure, only its location. If the pressure is brought to bear by a lender holding the insider's guaranty, the nexus requirement is satisfied; *Levit* avoidance is possible. As far as the nexus requirement is concerned, there is no difference between a lender imposing a detriment (enforcing the guaranty) and withholding a benefit (additional financing for a new project). From the insider's perspective, a penny earned is a penny saved.

The payment on the preferred debt to the lender in West-

74. *Fastrans*, 142 B.R. at 245.

75. That is, the voidable preferential transfer in *Levit*.

brook's hypothetical would be avoidable as an insider preference because the nexus requirement is met; the insider is a creditor *with regard to* the preferred debt payment and that is enough to satisfy the *Levit* tax holding. Further, not only *would* the resolution of Westbrook's hypothetical be the opposite of what he concludes, it *should* be because the policy bases of the creditor requirement (if the requirement is read as strictly as Westbrook reads it) are nonexistent.

B. "CORE" PREFERENCE CASES AND THE QUANTUM OF BENEFIT

Westbrook finds that the creditor requirement operates to keep non-core preferential transfer cases outside the scope of *Levit* avoidance: "As the example [in the hypothetical] demonstrates, the creditor requirement prevents the application of insider-preference law to some circumstances where preference policy is very much involved. . . . [W]ithin the universe of cases involving insider-preference policies, the creditor requirement makes preference law applicable to core cases and inapplicable to marginal ones."⁷⁶ The preceding section of this article revealed that the creditor requirement would not, in fact, operate in the way Westbrook suggests on the facts of his own hypothetical. Assume he was right about the creditor requirement's application to the case in which the lender imposes pressure on an insider by hesitating to make a new loan to the insider unless the insider-guarantor⁷⁷ causes the debtor to prefer the lender. Is Westbrook then correct that there is good reason to exclude the facts of the hypothetical from the scope of *Levit*? No.⁷⁸

Recall that the creditor requirement, as currently construed in cases such as *Fastrans*, is wholly insubstantial. It provides a trap only for the unwary lender who does not know

76. Westbrook, *supra* note 9, at 95.

77. Judge Easterbrook also made the point that an insider preference may be recoverable from the lender even if the insider is not a "guarantor" of the lender's loan to the debtor: "We hold . . . that the preference-recovery period for outside creditors is one year when the payment produces a benefit for an inside creditor, *including a guarantor.*" *Levit v. Ingersoll Fin. Corp. (In re V.N. Deprizio Constr. Corp.)*, 874 F.2d 1186, 1200-01 (7th Cir. 1989) (emphasis added). The Westbrook "marginal" hypothetical would seem to fall squarely within the scope of that statement of the *Levit* holding.

78. Furthermore, would it be worth saving the creditor requirement even as construed by Westbrook if the cost were decisions such as *Fastrans*, which protect the extortionist lender merely because the lender had the foresight to obtain a blanket waiver?

enough to get a formal, boilerplate waiver of the guarantor's rights against the debtor. Also, the breadth of the Bankruptcy Code's "creditor" definition⁷⁹ suggests that it might not be all that difficult for a court to find that the waiver is personal to the lender. The next bankruptcy court could conclude that the waiver does not have the effect the lender intended. Although it might constitute a default of the guaranty agreement for the guarantor to prosecute suretyship rights against the debtor, the guarantor's covenant not to do so would not extinguish the guarantor's creditor status vis-a-vis the debtor.⁸⁰ Even a *disputed* "claim" is sufficient to support creditor status.⁸¹

It could be that the existence of a debtor-creditor relationship with regard to the guaranty should be deemed a matter for the insider and the debtor to resolve irrespective of the lender's intercession. What then, would prevent the debtor, on the eve of its bankruptcy, after the lender has been receiving preferential payments for a year or more, from entering into a new and separate contract with the insider? The contract could provide that, in exchange for a peppercorn or two, the debtor agrees to indemnify the guarantor for any funds paid to the lender on the debtor's behalf as a result of the lender's enforcement of the guaranty. The insider would have little to lose and a lot of leverage to gain. Even the guaranty agreement's description of such a contract as an event of default may not be enough to sway the guarantor who, given the curious creditor requirement, would be in a position to expose the lender to preference liability literally with the stroke of a pen.

Westbrook also suggests that the creditor requirement is valuable because it provides the bankruptcy court with the means to avoid the necessary indirect benefit valuations, were the Westbrook hypothetical not without the scope of *Levit* avoidance. He explains:

Although only a proxy for the policy balance, the creditor requirement is not adventitious. In the insider-guarant[y] case, the benefit to the insider is directly linked, dollar for dollar, with the payment to the creditor. In the marginal [hypothetical], the benefit remains unquantified and relates only indirectly to the payment. The creditor requirement reflects the direct and quantified connection between the company's transfer and the insider's benefit in the insider-

79. 11 U.S.C. § 101(10) (1988).

80. This is similar to but distinguishable from the argument, rejected in *Fastrans*, that the trustee was a third party beneficiary of the guaranty. *In re Fastrans*, 142 B.R. 241, 246 (Bankr. E.D. Tenn. 1992). See also RESTATEMENT OF SECURITY, *supra* note 8, at § 104(1)(b).

81. See 11 U.S.C. § 101(5) (Supp. III 1991).

guarant[y] case. The absence of creditor status for the insider in the [hypothetical] reflects an indirect and unquantified relationship between payment and benefit.⁸²

Because the creditor requirement would insulate some insider benefit cases from *Levit* avoidance,⁸³ Westbrook contends “[t]he presence or absence of creditor status for the insider stands proxy for the strength and clarity of the relationship between transfer and benefit.”⁸⁴ The requirement results in the exclusion of marginal insider cases from the *Levit* rule, and thereby avoids the additional uncertainty costs generated were the rule to apply irrespective of the insider’s creditor status. “One cost would involve quantifying the benefit the insider receives to determine the amount of the avoidable preference, *because only the amount of the benefit should be avoidable.*”⁸⁵ This, however, misses the central point of preference law: the amount of the *transfer* to the lender would be the amount of the preference, not the value of the *benefit* the insider realizes as a result of the preference.

Though Westbrook may believe that only the amount of the benefit should be avoidable, there is nothing in the language of section 547 to support that conclusion. The only reference to “benefit” is in section 550(a)(1), but the provision does not define a preference; it only describes the parties from whom a preferential transfer may be recovered. Section 550 nowhere provides that only the benefit may be recovered.

Westbrook explains his curious textual use of “benefit” in a footnote, that reads, in pertinent part:

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 guarant[y] limited to \$50,000, full payment of the debt six months before bankruptcy, and insolvency on the transfer 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.⁸⁶

Notwithstanding Westbrook’s failure to support his reading of

82. Westbrook, *supra* note 9, at 96 (footnotes omitted).

83. Of course, insofar as Westbrook errs with regard to the operation of the creditor requirement on the facts of his own hypothetical, his argument that the requirement’s operation on his hypothetical facts reveals its inherent good sense is certainly suspect.

84. Westbrook, *supra* note 9, at 96.

85. *Id.* (emphasis added).

86. *Id.* at 96-97 n.91, which also contains a cross-reference to n.28. Neither footnote cites any authority for that curious reading of the statute.

the section 550 benefit language as the measure of the section 547 avoiding power with any case law, statutory law, or commentary, there is a more fundamental deficiency. Preference law focuses on the value transferred from the debtor to the preferred creditor rather than on the benefit the insider-beneficiary realizes because the value transferred is the precise amount of the detriment the other creditors of the debtor-transferor suffer.

Further, the difficulties of insider benefit valuation, which Westbrook cites to justify his exclusion of marginal from core insider preference cases, are nonexistent when the focus is on the amount of the transfer to the lender. Even though that correction responds to Westbrook's discovery of a valuation problem in order to support his means to circumvent it, the correction obscures a fact of preference law life: valuation issues are built into the preference law.

The valuation uncertainties are incorporated largely into the subsection 547(c) exceptions.⁸⁷ The incorporation is appropriate because after the trustee has established the elements of a preference, the burden shifts to the creditor to establish an applicable exception.⁸⁸ Westbrook's misreading of the statute denies the role of valuation in preference law and concludes that valuation of an insider benefit should be precluded because it is difficult. In so concluding, Westbrook confuses the relative burdens of proof imposed on the trustee and transferee: "In our example, the qualification of the payment as a preference would necessitate valuing the benefit of the shopping-center financing to [the insider-guarantor], which is not an easy task."⁸⁹

Westbrook essentially reverses the preference analysis by replacing valuation of the transfer with valuation of the benefit and then contending that because valuation of the benefit is inherently problematic, there must be something wrong with a principle that would require valuation of the benefit. He is right, to an extent. There is something wrong with a principle requiring valuation of the benefit to an insider-guarantor, but it is Westbrook's principle that is wrong, not the Bankruptcy Code's. Succinctly, Westbrook greases the slope and then complains that it is slippery.

It may be that Westbrook fully understood that his focus

87. 11 U.S.C. § 547(c) (1988). This is particularly true of subsections (c)(4) ("new value" exception) and (c)(5) ("no-improvement-of-position" exception).

88. *Id.* § 547(g).

89. Westbrook, *supra* note 9, at 96-97.

on benefit was innovative, and would represent a sea change, disconnected from the current formulation of sections 547 and 550. If this were his understanding, then his article could have offered a comprehensive argument for the thesis. It is curious, however, that Westbrook would bury a proposal to redraft the two crucial insider preference provisions within two interconnected footnotes, and do so summarily.⁹⁰

CONCLUSION

The preference wars continue unabated, and those with an affection for logic in the law, or at least some sense of normative symmetry, take sides in the battle between standards and rules.⁹¹ It may be that Heisenberg has more to say on the matter than either Westbrook or Alces.⁹² Meanwhile, Congress waits for no law professor, not even so far as *Levit* is concerned. Throughout 1992, the House and Senate Judiciary Committees worked on bankruptcy reform legislation, although nothing as radical as the 1978 Act, just a snip here, a patch there. Ultimately and fortunately, Congress failed to pass the legislation that came out of committee, legislation that would have overruled *Levit*.

The first version of Senate Bill 1985 would have abrogated *Levit* by amending section 547 to add a new paragraph:

(8) if the transfer sought to be recovered to an insider is on account of goods or services sold and delivered to the debtor in the ordinary course of business and the transferee is deemed to be an insider under section 101(31) solely because the transferee holds a guaranty of payment or performance from another insider of the debtor.⁹³

90. Westbrook's cryptic footnotes 28 and 91 leave open more questions than they answer. For example: how do we measure benefit in those cases certainly within the scope of 547(b)? If we do not value benefit in all of those cases, how do we distinguish those preference actions in which we focus on insider-benefit from those in which we focus on the value of the transfer? Would the benefit test work in all preference settings, or just in insider-guaranties? What result when the insider's real benefit is nil but the lender-transferee's is great, as might be the case when a judgment-proof insider causes the debtor to effect a preference? In such a case, the insider receives no or virtually no benefit, so a valuation of benefit analysis suggests there would be no preference. According to the first part of his article, this is the setting in which Westbrook would most urge *Levit* avoidance. Westbrook, *supra* note 9, at 78-86.

91. See Pierre Schlag, *Rules and Standards*, 33 U.C.L.A. L. REV. 379 (1985); see also Westbrook, *supra* note 9, at 90 n.69 and Weisberg, *supra* note 23.

92. For an accessible discussion of the Heisenberg uncertainty principle, see generally STEPHEN W. HAWKING, *A BRIEF HISTORY OF TIME* 53-61 (1988).

93. S. 1985, 102d Cong., 1st Sess. § 204 (1991).

Justice Holmes recognized that "[i]gnorance is the best of law reformers."⁹⁴ That might explain why the first version of Senate Bill 1985 is unresponsive to the formal *Levit* problem, yet scores a direct hit at the foundation of *Levit*. The insider-guarantor problem is a problem of control, in the subsection 101(31) sense: the capacity to "control" is the bottom line of the Code's definition of an insider.⁹⁵ Judge Easterbrook's opinion in *Levit* understands that the creditor who controls the insider of the debtor controls the debtor.⁹⁶ So it is not surprising that when Senator Howell Heflin's staff first tried to undo *Levit*, the product focused on the crucial issue: control. Who could blame the staff, or Senator Heflin, for not knowing any better?⁹⁷

This response to Professor Westbrook has not been directed to a defense of *Levit*. Though I believe the *Levit* doctrine is defensible, the focus here has been more on revealing the incongruities of limiting the breadth of *Levit*. Perhaps this

94. OLIVER W. HOLMES, *THE COMMON LAW* 64 (Mark DeWolfe Howe ed., Belknap Press 1963) (1881).

95. See generally Peter A. Alces & Luther M. Dorr, Jr., *A Critical Analysis of the New Uniform Fraudulent Transfer Act*, 1985 U. ILL. L. REV. 527, 551-57.

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

97. The second reform bill approach to *Levit* proceeded from a different perspective. The proposed amendment of section 550(b) provided:

The trustee may recover under subsection (a) a transfer avoided under section 547(b) from a first transferee or an immediate or mediate transferee of a first transferee only to the extent that —

- (1) all the elements of section 547(b) are satisfied as to the first transferee; and
- (2) the exceptions in section 547(c) do not protect the first transferee.

S. 1985, 102d Cong., 2d Sess. § 204 (1992).

That version effectively avoided the impact of section 550(a)(1) in the insider-guaranty context by using a two-transfer buffer (see *Levit*, 874 F.2d at 1195-96) to distinguish the transfer to the lender from the benefit that necessarily inures to the insider-guarantor. Though no more defensible in terms of preference policy, this version did respond directly to the *Levit* holding.

The final version also amended section 550 rather than section 547, this time by adding a new subsection (c):

(c) If a transfer made between ninety days and one year before the filing of the petition —

- (1) is avoided under section 547(b) of this title; and
- (2) was made for the benefit of a creditor that at the time of such transfer was an insider;

the trustee may not recover under subsection (a) from a transferee that is not an insider.

S. 1985, 102d Cong., 2d Sess. § 301 (1992).

will reveal the immanent good sense of Judge Easterbrook's opinion.

Westbrook's article was both a defense and a refutation of *Levit*. Westbrook's analysis of *Levit* fails because he misconstrues the operation of preference policy in the commercial guaranty dynamic. The fact that Westbrook must contort *Levit* to make it work in his model suggests that either his model is bad or *Levit* is bad. By demonstrating the incongruities of his model, I hope to have established that the case against *Levit* has yet to be made, even by those who would damn it with faint praise.

