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Loan payments made within a year of a bankruptcy filing could be considered avoidable preferences if the loan were guaranteed by a corporate insider. In this article, Prof. Boshkoff argues that bankers should value insider guaranties only as a second source of payment, not for any subtle pressure they may exert on the borrower.

The Risks of Insider Guaranties

DOUGLASS G. BOSHKOFF

A BANK LOANS money on an unsecured basis to Ajax Corporation. The loan is guaranteed by Samuel Surety, Ajax's president. Ajax repays the loan. Six months later, the corporation files for protection under Chapter 11. Is the bank subject to a preference challenge?

After the beginning of the bankruptcy case, the bank receives a demand for return of the repayment. Ajax's trustee asserts that the payment amounted to an avoidable preference. Such transactions are normally vulnerable only if bankruptcy occurs within 90 days, but if an insider is involved the transaction remains at risk for a full year. The trustee seeks to take advantage of this longer period of vulnerability. The bank, vaguely aware of the insider preference rules, demurs. It understands that the longer time period applies only to payments received by an insider, and it clearly does not fall within this category. The trustee's response is troubling. She argues that the bank has received an avoidable transfer since the repayment indirectly benefited an insider, Ajax's president. If her contention is correct, the bank may regret its decision to obtain a guaranty from a corporate official. To understand why this is so, we must review some basic principles of preference law.

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An Avoidable Preference Defined

A preference has six elements, found in Section 547(b) of the Bankruptcy Code.[1] It is a transfer (1) of the debtor's property, (2) on account of an antecedent debt, (3) made while the debtor is insolvent, and (4) that enables the creditor to obtain more money than would have been obtained by waiting for the bankruptcy distribution. The trustee should have little difficulty in establishing these first four elements.[2] The remaining two elements deserve closer attention. It is worthwhile to quote the exact statutory language: The challenged transfer (5) must be "to or for the benefit of a creditor" and (6) must occur "(a) on or within 90 days before the date of filing of the petition; or (b) between 90 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 . . . ."

Now we can understand the trustee's argument. Our hypothetical transaction fits neatly within the statutory language. Both the bank and Surety are creditors of Ajax, the bank as the initial lender and Surety as a guarantor who is entitled to reimbursement if called upon to honor his guaranty.[3] The repayment by Ajax directly benefits the bank and indirectly benefits Surety since it satisfies his potential reimbursement claim. Since Surety is an insider of Ajax at the time of the repayment, the one-year period of vulnerability—not the shorter 90 days—is applicable to this transaction.

A second section of the bankruptcy statute confirms the soundness of the trustee's position. Section 550 of the Bankruptcy Code outlines the remedial rights of the trustee, once all the elements of an avoidable preference have been established. The trustee is entitled to recover avoidable prebankruptcy payments from "the initial transferee of such transfer [the bank] or the entity for whose benefit such transfer was made [Surety]," although the trustee "is entitled to only a single satisfaction."[4]

Thus, these sections of the Bankruptcy Code combine to give the trustee two rights it would not have had in the absence of an insider guaranty:

- The period of preference vulnerability is extended from 90 days to one year.

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[1]11 U.S.C. §547 (b) (1983).

[2]Only that third element (insolvency) presents a substantial evidentiary hurdle. The trustee will have to show that six months before bankruptcy, Ajax's liabilities exceeded its assets. This is the definition of insolvency found in 11 U.S.C. §101 (29) (1983). The presumption of insolvency created by 11 U.S.C. §547 (f) (1983) applies only to transactions occurring within 90 days of bankruptcy.

[3]A creditor is an entity with a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent [or] unmatured..." 11 U.S.C. §101(4), (9) (1983).

[4]11 U.S.C. §550 (a) (c) (1983).

- The trustee enjoys the option of proceeding against either Surety or the bank. This option will be significant, and detrimental to the bank, if Surety's financial condition always was weak or has deteriorated to the point where his guaranty is now worthless. Should this occur, the bank will regret its decision to require a guaranty of an insider because it is now the obvious target for the trustee's avoidance action.

Equitable Versus Literal Interpretations of Law

Bankruptcy is not a happy occasion. There are many losers and few, if any, winners. Bankruptcy judges face hard choices and may be tempted to eschew a literal application of the statute if it will produce what seems to be an inequitable result. Preference law often appears quite arbitrary. Not surprisingly, judges have been torn between two conflicting theories of statutory interpretation. They have vacillated between strict adherence to statutory language and a looser, more equitable interpretation. Collier, the leading commentator on bankruptcy law, has advocated the latter approach to our fact situation:

> In some circumstances, a literal application of section 550(a) would permit the trustee to recover from a party who is innocent of wrongdoing and deserves protection. . . . [I]f a transfer is made to a creditor who is not an insider more than 90 days but within one year before bankruptcy and the effect is to prefer an insider-guarantor, recovery should be restricted to the guarantor and the creditor should be protected. Otherwise, a creditor who does not demand a guarantor can be better off than one who does.[5]

Is Collier's analysis sound? I think not. It misstates the consequence of permitting a recovery against the bank and, more important, demonstrates a fundamental misunderstanding of the special insider preference rules that are a part of the bankruptcy statute enacted in 1978.

When financial distress occurs, persons in control of debtors often seek to advance their own interests. Occasionally, litigation illuminates this dark side of business life. My favorite example is *Katz v. First National Bank of Glen Head*,[6] a case that arose under the Bankruptcy Act of 1898. The bank in *Katz* had made an unsecured loan of $125,000 to Oakland. This loan was guaranteed by Oakland's president. The debtor maintained an account at the lender bank, but the balance and activity in this account was negligible until late April 1971. Before that time Oakland's regular banking business was conducted elsewhere. Between April 20 and June 30, 1971, there were several deposits, but no withdrawals, which brought the balance in the account from a meager $865.09 to $108,783.91. No explanation

[5] 4 Collier on Bankruptcy ¶550.02 (15 ed.1987).

[6] 568 F.2d 964 (2d Cir.1977), *cert. den.*, 434 U.S. 1069 (1978).

was offered for the dramatic change in banking practice. The lender then set off this sum against the outstanding guaranteed loan. Since Oakland was in serious financial difficulty (it had virtually ceased doing business in March 1971), the account build-up was very suspicious. It takes little imagination to conclude that Oakland's president, anxious about the guaranty, hoped to arrange for payment of the loan by providing the lender with the opportunity for setoff. A direct repayment by the debtor would have been both obvious and avoidable. Indirect payment by deposit and setoff looked like a more subtle and less clearly vulnerable procedure. The court in *Katz*, however, had no difficulty in fashioning a theory to vitiate the setoff, even without any proof of the bank's complicity in the build-up.[7]

Congress had such insider influence very much in mind when it enacted the new preference statute almost 10 years ago. For the first time, in Section 547, it provided a separate and more rigorous rule for transactions directly or indirectly advantageous to persons in a position to control the debtor's activity before bankruptcy. The extended period of vulnerability makes it almost impossible to escape the preference sanctions by stalling the bankruptcy case until the period of vulnerability has passed. One year is a very long time for a business in distress. Furthermore, the insider preference rules apply to all transactions involving insiders, not just insiders shown to have acted improperly.[8] Since there is no need to prove actual misconduct, this preference rule resembles the six-month insider-profit recapture rule in the Securities Exchange Act of 1934,[9] a highly pragmatic rule that recognizes the practical difficulty an outsider faces in proving insider misbehavior. Permitting recovery from the bank furthers the objective of the insider-preference rule—to deny persons of influence any opportunity of using assets of a financially distressed debtor in ways that benefit themselves and disadvantage unsecured creditors.

Collier may be correct in characterizing that bank as "a party who is innocent of wrongdoing," but this is beside the point. Since the insider rule operates without proof of actual misconduct by either Surety or the bank, Collier's argument against literal application of the statute loses its appeal.

Furthermore, the clear error in the last sentence of the quotation becomes apparent. A bank with an insider-guaranteed loan improves its chances for repayment. It must pay a price for this advantage. Insider guaranties carry increased risks. The bank's absolute liability

[7]The court, as a condition to validating the setoff required a showing that the deposits were made in the ordinary course of the debtor's business. A similar rule is now found in the Bankruptcy Code. See the discussion below.

[8]The definition of insider is found in 11 U.S.C. §101(28) (1983). It lists persons such as corporate presidents who are presumed to control the debtor and also persons who actually do control the debtor. There is no requirement of proof that the insider acted with regard to the challenged transaction.

[9]Securities Exchange Act of 1934 §16(b), 15 U.S.C. §78p(b) (1983).

is completely consistent with the new rule policing the activity of those who have the power to influence the debtor's conduct.

Was the Transfer in the Ordinary Course of Business?

Preference law is designed to prevent an unequal (and presumably unfair) distribution of the debtor's free assets among unsecured creditors on the eve of bankruptcy. There are occasions, however, when a literal application of the statutory language appears to produce results at variance with this policy. Collier's reluctance to follow the language of the statute is nothing new. There are many well-known examples of judicial refusal to apply preference rules because of a perception that the result is not consistent with preference policy. Courts often have disregarded the statutory language in favor of what is seen as an equitable solution.

Such an approach creates problems. It results in conflicting and confusing precedents and hastens the day that a statutory overhaul will be necessary. Congress was well aware of judges' attitudes when it enacted the current bankruptcy statute, and it attempted to deal with equitable issues in a more systematic fashion.[10] The statute now contains an entirely new subsection that prevents the avoidance of transfers containing all the statutory elements of a preference (the six elements discussed above) if the transferee (the bank in our example) sustains the burden[11] of proving that the transaction fits within one of seven carefully crafted exceptions. The exception relevant to this discussion is contained in 11 U.S.C. 547(c)(2):

> The trustee may not avoid . . . a transfer . . . to the extent that such transfer was—
> (A) In payment of a debt incurred by a debtor in the ordinary course of business or financial affairs of the debtor and transferee;
> (B) Made in the ordinary course of business or financial affairs of the debtor and the transferee; and
> (C) Made according to ordinary business terms.

Note the significant elements in this protective provision. The bank must establish the normality of the repayment both subjectively and objectively. The transfer must be regular from the perspective of the parties to the loan transaction and from the perspective of the larger commercial community. It will be very hard, but not impossible, for

[10]The inability of both courts and Congress to adopt a consistent approach to preference law is meticulously examined in Weisberg, *Commercial Morality, The Merchant Character, and the History of the Voidable Preference*, 39 Stan. L. Rev. 3 (1986).

[11]11 U.S.C. §547(g) (1983) provides: "For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subdivision (b) of this section, and the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subdivision (c) of this section."

the bank to sustain this burden. Certainly, it will not be sufficient to claim that there was no proof of improper motive on the part of the bank or Surety.[12] Since it will already have been demonstrated that Ajax Corporation was insolvent when the loan was repaid six months ago, the court will want a very full explanation of how and why it was decided that the bank should be repaid at a time when there was not enough money available to satisfy all creditors. Collier's plea for an equitable reading of Sections 547(b) and 550 of the statute ignores the fact that Congress has provided very effective protection for the bank but only if it can pass the test outlined in Section 547(c)(2). Instead of ignoring the substantive definition of a preference, one must accept that definition and then go to subdivision c to see whether the trustee will be prevented from avoiding the transaction.[13]

So Far, Court Cases Favor Lenders

The analysis above reflects my personal view. To what extent is it shared by judges and commentators? Most commentators agree with me.[14] Judges, with one exception, have reached results favorable to the lender and have limited the trustee to action against the insider-guarantor.[15] The notable exception is *In Re Big Three Transp., Inc.*,[16] an adversary proceeding brought by a trustee to recover payments on an unsecured loan guaranteed by a corporate insider. The challenged payments had been made more than 90 days before the involuntary case began. The court, nevertheless, ordered entry of judgment against both the insider-guarantor and the noninsider-creditor.

Judge Baker's opinion in *Big Three* stands in notable opposition to five other reported decisions that have refused to permit recovery from the noninsider-creditor when the preferential payment has occurred more than 90 days before bankruptcy. All these opinions were written

[12]In re AOV Industries, Inc., 62 Bankr. 968 (Bankr. D.D.C. 1986).

[13]I have assumed in this discussion that Surety in our example was guaranteeing a long-term loan and that Section 547(c)(2) protects repayments of both short- and long-term obligations. It is not yet clear, however, that this provision is applicable to single advance, long-term obligations. See, for example, In re Energy Corporation, Inc., 832 F.2d 997 (7th Cir. 1987). See also Broome, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments*, 1987 Duke L.J. 78.

[14]Markel, *Payments on Insider-Guaranteed Debts; A Bankruptcy Preference?*, 15 Colo. Lawyer 1390 (1986); Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547 (c) (2) 550 (a) (1), and 546 (a) (1)*, 41 Bus. Lawyer 175, 186-194 (1985); Pitts, *Insider Guarantees and the Law of Preferences*, 55 Am. Bankr. L.J. 343 (1981).

[15]In re C.L. Cartage Co., Inc., 70 Bankr. 928 (Bankr. E.D. Tenn. 1987); In re Aerco Metals, Inc., 60 Bankr. 77 (Bankr. N.D. Tex. 1986); In re V.N. Deprizio Constr. Co., 58 Bankr. 478 (Bankr. N.D. Ill. 1986); Matter of R.A. Beck Builder, Inc., 34 Bankr. 888 (Bankr. W.D. Pa. 1983); In re Church Bldgs. and Interiors, Inc., 14 Bankr. 128 (Bankr. W.D. Okla. 1981).

[16]41 Bankr. 16 (Bankr. W.D. Ark. 1983). *See also* In re W.E. Tucker Oil, Inc., 42 Bankr. 897, 901 (Bankr. W.D. Ark. 1984) (citing *Big Three* with approval).

by trial court judges. We have yet to hear from a court of appeals. Those that refuse to hold the bank liable sometimes rely on the quotation from Collier discussed above.[17] Not one of these opinions, not even *Big Three*, discusses the policy issue of whether the bank should be protected even though it is in a position to benefit from the exercise of insider influence.

With the exception of Collier, all the commentators clearly see the possibility for exercise of insider influence and argue that the lender should be liable. As one author notes:

> In many, if not most instances in which a creditor seeks guaranties by insiders, the guarantor's assets are insignificant in relation to the size of the credit advance or loan, and the guaranties are sought, not for their economic value, but for the indirect control of the debtor that they provide. There is the unspoken understanding that the creditor will ruin the guarantors if their activities in running the debtor corporation are not to the creditor's liking. In the case of unusual payments made to a creditor with an insider's guaranty, one is hard put to deny that the existence of the guaranty creates added incentive to make the transfer. . . [The] indirect control of the debtor corporation certainly detracts from a notion that [the lender's] plight merits special consideration so that the written words of Congress should not, in equity, be applied to them.[18]

Lenders undoubtedly would prefer to believe that Collier and the majority of judicial decisions will remain the prevailing view. This is a risky course of action. Sooner or later, some appellate court is going to take a close look at the insider guaranty transaction, read all the commentators, and see the weakness in Collier's position. Once there is one full discussion in a well-reasoned case imposing liability on the lender, the prevailing majority view will crumble. Indeed, the Seventh Circuit, in dictum, recently expressed doubts about the equitable protection currently provided to lenders who benefit from the presence of insider quarantors.[19] Perhaps the editors of *Collier* will soon decide to align the treatise with the weight of scholarly opinion.

[17]*Aerco Metals*, 60 Bankr. at 81; *Deprizio Constr.*, 58 Bankr. at 481; *R.A. Beck Builder*, 34 Bankr. at 893; *Church Bldgs.*, 14 Bankr. at 131.

[18]Nutovic, *supra* note 15, at 196.

[19]After describing a situation in which Lender has received payment outside the 90-day period from Firm when Guarantor is an insider, the Seventh Circuit offered this observation: "Most bankruptcy courts that have addressed this question conclude that 'equity' will relieve Lender from a literal construction of §550. Commentators, whose articles collect and discuss the cases, are divided We have serious doubts both about the amount of equity in Lender's position (for Firm may have paid Lender preferentially only to assist Guarantor, the insider) and about the propriety of judges declining to enforce statutes that produce inequitable results . . . " *Bonded Financial Services v. European-American Bank*, 838 F.2nd 890 (1988).

What Should Lenders Do?

Lenders worried about insider guaranties should consider placing greater reliance on fully collateralized loans and on loan guaranties provided by persons who are not insiders. While this article has stressed the risk that insider guarantors may expose the lender to an extended period of preference vulnerability, the presence of an insider guarantor could be detrimental even when the loan is repaid in the 90 days before bankruptcy. The lender is clearly a vulnerable transferee when payments are received during this 90-day period. The only option may be to seek protection under the ordinary course payment exception found in Section 547(c)(2).The presence of an insider guarantor may arouse the court's suspicion and make it much more difficult to advance a convincing argument that the payment was a normal business transaction.[20]

Lenders who want to continue demanding insider guaranties should do so only when the guarantor has assets that are adequate to discharge the guaranteed obligation. If this is the case, it is worthwhile to have a guaranty because the lender forced to return payments to the bankruptcy trustee may still proceed against the guarantor. If the guarantor's assets are insufficient, however, a court is likely to infer that the desire to benefit from insider influence and not the desire for additional financial security was the lender's primary objective in asking for the guaranty. Such a conclusion is not helpful to a lender seeking to establish its good faith and benefit from Collier's position.

Assume that an insider guarantor had adequate assets at the time the guaranty was obtained but is in poor financial condition when the loan is due to be repaid. The lender should consider releasing the guarantor before receiving payment. The insider-preference rules apply only when an insider is involved at the moment of payment.[21] Furthermore, since the released insider no longer has an incentive to induce debtor conduct favorable to the lender, it becomes easier to argue that the payment meets the regularity requirements of Section 547(c)(2). The lender should ensure that there is no linkage between release and payment ("We will release you if the loan is repaid"). The best course of action is to leave a substantial period of time between the two events, so that the lack of linkage will be obvious to all observers.[22]

It is most appropriate to release the insider when there is no significant likelihood of any recovery on the guaranty. The decision is more difficult when the insider has some assets, although not enough to discharge the entire corporate obligation. Here, the lender must bal-

[20]The presence of an insider guarantor, although not dispositive, was noted in In re Craig Oil Co., 31 Bankr. 402 (Bankr. M.D. Ga. 1983).

[21]11 U.S.C. §547 (b) (4) (B) (1983).

[22]It is absolutely crucial that the guarantor *not* be an insider at the time the corporate decision to repay the loan is made. See In re Trans Air, Inc., 79 Bankr. 947 (Bankr. S.D. Fla. 1987); In re F & S Central Manufacturing Corp., 53 Bankr. 842 (Bankr. E.D.N.Y. 1985).

ance the cost of release against the possibility of improving its strategic position.

Any reluctance to release Surety simply because it will lessen the possibility of extracting payment from Ajax supports the main point of this article. Notwithstanding Collier's position, insider guaranties are different from all other guaranties. They bring with them the possibility of asserting influence over the debtor's affairs and producing payments that would not otherwise be made. Sooner or later, more judges will recognize this and act to neutralize the especially beneficial effect of insider guaranties.