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COMMENTS

BANKRUPTCY PREFERENCES AND INSIDER GUARANTEES

Introduction

One goal of bankruptcy law is equal distribution of the insolvent debtor's assets among the members of each class of his creditors.¹ The insolvent debtor's assets, however, can be depleted by transfers made on the eve of bankruptcy, paying favored or preferred creditors to the detriment of those remaining unpaid. Such transfers of a debtor's assets for which the debtor does not receive a contemporaneous equivalent exchange in value are commonly referred to as preferential transfers or preferences.

Congress was concerned that these so-called preferential transfers would frustrate the equality of distribution goal² of bankruptcy. It desired to remove incentives for creditors to race for the debtor's assets and thereby dismantle the debtor shortly before it filed for bankruptcy.³ Accordingly, it enacted Code⁴ sections 547⁵ and 550⁶ which grant the trustee the remedial power to restore the debtor's estate to the position it was in prior to any preferential transfers.

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1. J. Moore and L. King, *Collier on Bankruptcy*, ¶ 60.01 at 743 (14th ed. 1977); Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess., pt. 1 at 19 (1973). Congress has not been consistent in seeking equality, however. See Bowers, *Groping and Coping in the Shadow of Murphey's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 Mich. L. Rev. 2097, 2101-03 (1990). The idea of "equality" as a legal norm has been attacked as being incoherent because "equality" may be defined from numerous perspectives. See, e.g., Weston, *The Empty Idea of Equality*, 95 Harv. L. Rev. 537 (1982). Congress has not given any guidance as to why one perspective should be used over another. This article does not attempt to question the soundness of our current system as a whole, but rather focuses on functional problems which exist within that system taking the expressed goal at face value.

2. Hereinafter referred to occasionally as "equality goal."

3. Bankruptcy Law Revision, H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78 (1977).

4. Throughout this article the Bankruptcy Code of 1978 (Title 11 of the United States Code), along with its current revisions unless otherwise indicated, will be referred to as the "Code." The Bankruptcy Act of 1898 will be referred to as the "Act." Other bankruptcy acts will be specifically referred to by their year of enactment.

5. 11 U.S.C. § 547 (1988) (hereinafter referred to as section 547).

6. 11 U.S.C. § 550 (1988) (hereinafter referred to as section 550).

Specifically, section 547(b)⁷ allows the trustee to "avoid"⁸ any transfers made within ninety days of the debtor's filing for bankruptcy if the trustee can establish the five elements of a preferential transfer.⁹ Once the transfer has been "avoided," the trustee can resort to section 550¹⁰ of the Code to recover the transferred assets;¹¹ that is, to restore the item transferred (or its value) back to the debtor's estate.

Congress also recognized that "insiders"¹² posed an increased threat to the equality goal. The bankruptcy code defines an insider by illus-

7. 11 U.S.C. § 547(b) (1988).

8. Avoiding a transfer is, in effect, having the transfer declared a nullity and allowing the trustee to recover the item transferred or its value.

9. Subsection 547(b) provides:

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made:

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if:

(A) the case were a case under Chapter 7 of this title [11 U.S.C.S. Section 701 et seq.];

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title [11 U.S.C.S. Section 101 et seq.].

11 U.S.C. § 547(b) (1988).

Subsection 547(c) provides several exceptions to the trustee's avoidance powers primarily focusing on transfers in the ordinary scope of the debtor's business or transfers for which the debtor received a contemporaneous exchange in value. For purposes of this article, it will be assumed that the transfers do not fall within the subsection 547(c) exceptions to the trustee's avoidance powers. 11 U.S.C. § 547(c) (1988).

10. 11 U.S.C. § 550 (1988).

11. Section 550 provides in part:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title [11 U.S.C.S. Sections 544, 545, 547, 548, 549, 553(b), or 724(a)], the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from:

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550 (1988).

12. Section 101(30) of the Code identifies insiders in the context of debtor-firms as

tration rather than by definition. In general, an insider is a person who has such a close relationship with the management of a debtor that he is perceived as having some degree of control over it. Insider-creditors could be aware of the debtor's troubled financial condition prior to the ordinary ninety-day preference avoidance period. Their insider influence could cause the debtor to prefer the insiders at this earlier time. Such early preferential transfers would not be recoverable under the ninety-day rule.¹³ Alternatively, the insider might use his position to influence the debtor to delay filing the petition for bankruptcy until ninety days after all the insiders had been paid off. Either way, Congress perceived the insider as potentially able to abuse his inside knowledge and position to circumvent the effects of the normal preference avoidance/recovery provisions.¹⁴ Accordingly, a special provision was included in Code section 547,¹⁵ granting the trustee of an insolvent debtor the power to avoid transfers made within *one year* before the bankruptcy which were "to or for the benefit of a creditor"¹⁶ when the creditor "was an insider"¹⁷ of the debtor.

The development of this "extended reach-back period" for insiders, along with several other revisions to the Code, has created a perplexing problem when insiders guaranteed loans to the bankrupt debtor. This problem has been addressed in several recent decisions, the most notable being *Levit v. Ingersoll Rand Financial Corp.*¹⁸

The difficulty arises in the guarantee context because the party being paid is not always the one being preferred.¹⁹ When an insider has given

follows:

(30) "insider" includes -

...

(B)(i) director of the debtor;

(B)(ii) officer of the debtor;

(B)(iii) person in control of the debtor;

...

(C)(i) general partner of the debtor;

(C)(ii) relative of a general partner, director, officer or person in control of the debtor; . . .

11 U.S.C. 101(30) (1988).

13. See, D. Baird and T. Jackson, *Cases, Problems, and Material on Bankruptcy* 432 (2d ed. 1990).

14. This increased threat is accented by the House Report's definition of an insider: "An insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor." *Bankruptcy Law Revision*, H.R. Rep. No. 595, 95th Cong., 1st Sess. 180 (1977).

15. 11 U.S.C. § 547 (1988).

16. 11 U.S.C. § 547(b)(1) (1988). See *supra* note 9.

17. 11 U.S.C. § 547(b)(4)(B) (1988). See *supra* note 9.

18. 874 F.2d 1186 (7th Cir. 1989).

19. In many situations the party paid (i.e., who received the transfer) will in fact

a personal guarantee to a creditor as security for a loan to the debtor, the insider-guarantor will benefit from a payment on the loan²⁰ even though the payment will actually be made to the non-insider creditor.

In these situations courts and commentators disagree whether the trustee may recover from the non-insider creditor any payments made during the full year before the debtor filed for bankruptcy because the payment benefited an insider-guarantor.²¹ The issue is whether the trustee should be allowed to use the extended reach-back period to avoid a transfer which was (arguably) preferential to an insider and then seek recovery of the transfer, not from the insider who was preferred (i.e. who provided the factual predicate for use of the extended period), but rather from an outside creditor who may have been wholly unaware of any preference at all.

Should these provisions be interpreted to reflect Congressional hostility toward lenders who take personal guarantees from insiders? If personal guarantees are superficially undesirable because they frustrate the equality goal of bankruptcy law, that hostility is well placed. Under this assessment, a literal application of these provisions should be enforced to further the equality goal by protecting unsecured creditors from the depletion of their debtor's assets by insiders. However, a deeper

also be the party preferred. This would be the case if an insider made a loan to the debtor and then shortly before the debtor filed for bankruptcy the insider compelled it to repay the loan in full. On the other hand, payment on a guaranteed loan more than ninety days before bankruptcy will not "prefer" the lender (party paid). It will, however, prefer the insider-guarantor (party preferred).

20. The benefit which the insider-guarantor receives is a reduction in its contingent liability as a guarantor on the loan.

21. Compare *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186 (7th Cir. 1989) (concluding "yes" by applying the clear and unambiguous words of the statute) with *In re T. B. Westex Foods, Inc.*, 96 Bankr. 77 (W.D. Tex. 1989) and *In re Mercon Industries, Inc.*, 37 Bankr. 549 (E.D. Penn. 1984) (both concluding "no"). See also the cases cited *infra* note 97.

Compare also Katzen, DePrizio and Bankruptcy Code Section 550: Extended Preference Exposure Via Insider Guarantees, and Other Perils of Initial Transferee Liability, 45 Bus. Law. 511, 514-16 (1990); L. King, 4 Collier on Bankruptcy, ¶ 550.02, at 550-58 (15th ed. 1987); Countryman, The Trustee's Recovery in Preference Actions, 3 Bankr. Dev. J. 449, 464 (1986), all arguing recovery from the non-insider creditor should not be allowed on grounds of equity with Nutovic, The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1), 41 Bus. Law. 175, 186-99 (1985) and Pitts, Insider Guaranties and the Law of Preferences, 55 Am. Bankr. L.J. 343 (1981), both arguing recovery should be allowed. See also P. Blumberg, The Law of Corporate Groups: Bankruptcy Law Section 9.03 (1985 and supp. 1988) contending that the answer should depend on whether the insider is insolvent, and Note, The Interplay Between Sections 547(b) and 550 of the Bankruptcy Code, 89 Colum. L.Rev. 530 (1989) taking an altogether different approach based on the structure of the code. These commentaries have grouped the holdings of the courts as to whether or not the trustee could recover from the outside creditor into three approaches: the literal reading approach, the two transfer approach, and the equitable approach.

analysis of why lenders obtain personal guarantees from insiders reveals that a literal application of these provisions may actually work against the interests of unsecured creditors.

This article traces the development of the preference laws from their inception in the Bankruptcy Act of 1841²² to the present to determine how they have evolved and how they were intended to promote the general goals of bankruptcy law. It then assesses the creditor's objectives in obtaining personal guarantees from insiders and the effects of these guarantees on the debtor's vitality. Finally, it considers whether a hostile reading of the insider preference provisions actually achieves results consistent with the goals of the preference provisions in general.

Before proceeding with the history of these provisions, the presentation of a brief hypothetical illustration of these articles may be helpful. Suppose Lender lends money to Borrower Corporation, the loan being personally guaranteed by Surety, the President of Borrower. Surety is an "insider"²³ of Borrower. Because Surety will be liable to Lender if Borrower does not repay the loan, Surety is entitled to be subrogated to Lender's claim against Borrower for amounts he pays Lender on the guarantee. Surety thus holds a "claim"²⁴ against Borrower because of his contingent right to seek repayment from Borrower. Because he holds this contingent claim, Surety is termed a "creditor."²⁵ Payments made by Borrower to Lender on the loan are "transfers."²⁶ Because each payment to Lender within the year preceding bankruptcy reduced the contingent liability of Surety, the insider-guarantor, the payments are for the benefit of an insider (Surety).²⁷ Thus, provided the trustee can establish the other requisite elements of an avoidable preferential transfer under section 547(b),²⁸ and provided the transfer does not fall into one

22. Act of Aug. 19, 1841, ch. IX, 5 Stat. 440, repealed by Act of Mar. 3, 1943, ch. LXXXII, 5 Stat. 614.

23. 11 U.S.C. § 101(30)(B)(ii) (1988). See *supra* note 12.

24. 11 U.S.C. § 101(4)(A) (1988) in part defines a claim as follows:

(4) "claim" means -

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, *contingent*, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; . . . (emphasis added).

25. 11 U.S.C. § 101(9)(A) (1988) in part defines a creditor as follows:

(9) "creditor" means -

(A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor; . . .

26. 11 U.S.C. § 101(50) (1988) in part defines a transfer as:

(50) "transfer" means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption.

27. I.e., they "prefer" the insider.

28. 11 U.S.C. § 547(b) (1988). See *supra* note 9. For purposes of this analysis it

of the exceptions to the trustee's avoidance powers under 547(c),²⁹ the trustee will be able to "avoid" all of the payments made to Lender for the full one year period prior to Borrower's filing for bankruptcy. Had Lender not taken an insider guarantee, on the other hand, only payments made within the last ninety days preceding bankruptcy would have been avoidable.

As noted previously, however, section 547³⁰ only provides the grounds for the trustee to "avoid" the preferential transfer. To *recover* the "avoided" transfer, the trustee must resort to section 550³¹ of the Code. While section 547(b)(4)³² distinguishes between ordinary preferences (transfers preferential to an outsider which are avoidable if made within ninety days before filing) and insider preferences (transfers preferential to an insider which are avoidable for one year before filing), section 550³³ does not draw any such distinction between those from whom recovery may be had once the transfer has been avoided. Thus, a literal application of section 547³⁴ allows the trustee, because of the insider guarantee, to "avoid" payments made during the full year prior to filing for bankruptcy. Once "avoided," under section 550,³⁵ the full amount of the payment may then be recovered by the trustee from *either* the party who was paid, the "initial transferee" (Lender), or the party who was preferred ("the entity for whose benefit such transfer was made")³⁶ the insider-guarantor, or Surety in the hypothetical, regardless of which preferential period the trustee relied upon to avoid

will be assumed that Borrower was insolvent for the entire year prior to its filing for bankruptcy, thus meeting the requirement of section 547(b)(3). It will further be assumed that, if the payment had not been made, Surety would have received less than 100 cents on the dollar in a liquidation of the company under chapter 7 of the Code, thus fulfilling the requirement of section 547(b)(5). This latter assumption is a typical result in situations involving insider guarantees, as the insider himself will not normally obtain a security interest to protect his liability on the guarantee. As such, upon the debtor's filing for bankruptcy, the insider-guarantor's claim will be grouped into a class with other unsecured creditors. This class of creditors, however, is typically paid less than the full amount of their claim. See, e.g., Bowers, *supra* note 1 at 2098 n.2; *In re Granada, Inc.*, 115 Bankr. 702 (Utah 1990).

29. 11 U.S.C. § 547(c) (1988).

30. 11 U.S.C. § 547 (1988).

31. 11 U.S.C. § 550 (1988). The functional reasoning for the bifurcated process of avoidance under section 547 of the Code and recovery under section 550 is that section 550 is also the operative provision for recovery of avoidable transfers under several other sections of the Code such as section 548 (11 U.S.C. § 548 (1988)) dealing with fraudulent conveyances. For a more complete discussion of this bifurcated process see *infra* text accompanying notes 68-78.

32. 11 U.S.C. § 547(b)(4) (1988).

33. 11 U.S.C. § 550 (1988).

34. 11 U.S.C. § 547 (1988).

35. 11 U.S.C. § 550 (1988).

36. 11 U.S.C. § 550(a)(1) (1988).

the transfer. This result is not always conducive to the purposes of the legislation. An examination of the development of the preference laws and the legislative history of the current Congressional enactments when compared with the reasons why lenders obtain personal guarantees from insiders will bear this out.

The Development of the Preference Laws

The Early History of the Preference Provisions

Congress first provided for avoidance and recovery of preferential transfers in the second bankruptcy act of the United States (the Act of 1841³⁷). Since that time, all of the successor bankruptcy acts have also contained provisions for the avoidance and recovery of preferential transfers.

Under the Act of 1841, both fraudulent conveyances and preferential transfers were "avoidable." Any such transfer could be "avoided" if made within two months of filing for bankruptcy. Transfers made more than two months prior to bankruptcy were "avoidable" if the transferee had notice of the debtor's commission of an "act of bankruptcy"³⁸ or of his "intention to . . . take the benefit of this act."³⁹ Thus the original American preference doctrine looked to the knowledge or intent of the creditor in determining whether a transfer was avoidable.⁴⁰ This require-

37. *Id.* The United States first bankruptcy act contained provisions for avoidance and recovery of fraudulent conveyances, but contained no provisions for avoidance and recovery of preferential transfers. See Act of Apr. 4, 1800, ch. XIX, 2 Stat. 19-21, repealed by Act of Dec. 19, 1803, ch. VI, 2 Stat. 248.

38. Act of Aug. 19, 1841, ch. IX, 5 Stat. 440, § 2 (repealed 1843). An act of bankruptcy is exemplified when a creditor

shall depart from the State, District, or Territory, of which he is an inhabitant, with intent to defraud his creditors; or shall conceal himself to avoid being arrested; or shall willingly or fraudulently procure himself to be arrested, or his goods and chattels, lands, or tenements, to be attached, distrained, sequestered, or taken in execution; or shall remove his goods, chattels, and effects, or conceal them to prevent their being levied upon, or taken in execution, or by other process; or make any fraudulent conveyance, assignment, sale, gift or other transfer of his lands, tenements, goods or chattels, credits, or evidence of debt

.....

Id. at § 1.

39. *Id.* at § 2.

40. Interestingly, in England, the model source of our bankruptcy laws, the focus is entirely upon the intent of the debtor. Thus if the debtor intended to give a preference to a particular creditor it was recoverable regardless of whether or not the creditor was even aware of the preference. See Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, 714-18 (1985). In enacting the Bankruptcy Act of 1841, Congress expressly rejected this notion by including these provisions which looked instead, only to the knowledge of the creditor.

ment was retained in all subsequent bankruptcy acts in the United States until the current Bankruptcy Code was enacted in 1978.⁴¹

The Act of 1841 was short-lived and, in 1867, Congress enacted the United States' third bankruptcy act (the Bankruptcy Act of 1867⁴²). Preferences remained avoidable under this act; however, there was an additional requirement that the debtor must have made the transfer "with a view to[ward] giv[ing] a preference to any creditor."⁴³ Further, there was a modification to the requirement that the transferee have received notice of the debtor's commission of an act of bankruptcy or of his intent to become a bankrupt. Under the revised act, the creditor must simply have had "reasonable cause to believe [the debtor] insolvent" and the transfer to be in fraud "of the provisions of this act."⁴⁴ This latter change began a trend toward relaxing the trustee's burden for avoiding a transfer. The objective "reasonable cause to believe" requirement was far easier to establish than the 1841 requirement that the trustee show "the transferee had [received] notice of the debtor's commission of an act of bankruptcy" or of his "intention to . . . take the benefit of the act."⁴⁵ This trend, as will be seen, was followed in each subsequent bankruptcy act as Congress allowed trustees to more easily avoid preferential transfers. This growing avoidance power fostered the bankruptcy goal of equality of distribution by enabling the trustee to preserve more of the assets in the debtor's estate to be equitably distributed in one collective proceeding. In particular, this increased avoidance power provided the unsecured creditors of the debtor with greater protection from preferential transfers.

In 1898, Congress enacted the United States' fourth bankruptcy act (the Bankruptcy Act of 1898⁴⁶). This act, the longest lived of any of the bankruptcy acts to date, remained in effect until 1978 when our present Bankruptcy Code was enacted.

Section 60 of the Act of 1898 dealt with preferential transfers. Section 60a defined a preferential transfer as follows:

[A debtor] shall be deemed to have given a preference if, being insolvent, he has procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer [would] be to enable any one of his cred-

41. Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549.

42. Act of Mar. 2, 1867, ch. CLXXVI, 14 Stat. 517, repealed by Act of June 7, 1878, ch. 160, 20 Stat. 99.

43. Act of Mar. 2, 1867, ch. CLXXVI, § 3, 14 Stat. 517, 534 (repealed 1878).

44. *Id.*

45. Act of Aug. 19, 1841, ch. IX, § 2, 5 Stat. 440 (repealed 1843).

46. Act of July 1, 1898, ch. 541, 30 Stat. 544 (repealed 1978).

itors to obtain a greater percentage of his debt than any other such creditor of the same class.⁴⁷

Upon determination that a transfer was preferential under section 60a, section 60b provided the means for avoiding and possibly recovering the avoided transfer. Section 60b provided in part:

b. If a bankrupt shall have given a preference . . . and the person receiving it, or to be benefited thereby, or his agent acting therein, shall have had reasonable cause to believe that it was intended thereby to give a preference, it shall be voidable by the trustee, and he may recover the property or its value from such person.⁴⁸

According to this statute, if a preferential transfer was made to a creditor who "had reasonable cause to believe that it was intended thereby to give a preference,"⁴⁹ it was voidable by the trustee, and the trustee could recover the property or its value only "*from such person.*"⁵⁰ Hence, under the Act as originally enacted in 1898, there was no possibility of the trustee seeking recovery of the avoided transfer from any creditor other than one who knew or should have known that he was a party to a preferential transfer.

In 1938, however, section 60b of the 1898 act was revised so that the literal language no longer seemed to limit the trustee's recovery power strictly to creditors who were aware of the preferential nature of the transfer. After these revisions, section 60b provided in part:

b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from *any* person who has received or converted such property . . . ⁵¹

While this language seemed to allow recovery from either the party paid or the party preferred (in cases where they were different people) regardless of the knowledge of that party, there were no cases under the 1898 act where a trustee even attempted recovery from a creditor as to whom the transfer was not preferential.⁵² Perhaps this was due

47. Act of July 1, 1898, ch. 541, § 60(a), 30 Stat. 544, 562 (repealed 1978).

48. Act of July 1, 1898, ch. 541, § 60(b), 30 Stat. 544, 566 (repealed 1978).

49. *Id.*

50. *Id.*

51. Act of June 22, 1938, ch. 575, § 60(b), 52 Stat. 840, 870 (repealed 1978) (emphasis added).

52. Pitts, *Insider Guarantees and the Law of Preferences*, 55 *Am. Bankr. L.J.* 343, 350 (1981).

to the absence of any indication in the legislative history that this revision was anything other than "merely an unfortunate by-product of Congressional preoccupation with more important, substantial concerns."⁵³

The Bankruptcy Code of 1978

Realizing that the bankruptcy laws were plagued with deficiencies in various areas, Congress created a commission in 1970⁵⁴ to study the problems with the then current bankruptcy laws and to develop proposals for new laws to govern bankruptcy. In 1973, the Commission completed its study and presented its findings to Congress along with a proposal for a new bankruptcy code.⁵⁵ In 1978, after years of debate and numerous revisions to the Commission's proposals, Congress repealed the Act of 1898⁵⁶ and enacted the present Bankruptcy Code.⁵⁷ The new Code made several major changes to the existing bankruptcy laws, including modifications to the preferential transfer avoidance/recovery provisions.

One of the major changes was the creation of separate provisions for avoidance and recovery of *insider* preferential transfers. As noted earlier,⁵⁸ Congress feared insiders would be aware of the debtor's troubled financial position prior to the ordinary ninety-day preference avoidance period and hence might prefer themselves at an earlier time.⁵⁹ Accordingly, the allowable avoidance period was extended from ninety days (the time allowed for all other preferential transfers) to one year for transfers preferring insiders. This change represented the first express recognition by Congress of the additional threat to the goals of the bankruptcy laws posed by insiders of the debtor.

Another major change was the elimination of the requirement that the creditor have "reasonable cause to believe the debtor was insolvent"⁶⁰ at the time of the transfer, a requirement which had been in all bank-

53. *Id.* at 350-51.

54. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468 [hereinafter "Commission"].

55. Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess. (1973).

56. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682.

57. Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549.

58. See *supra* text accompanying notes 12-17.

59. See D. Baird and T. Jackson, *supra* note 13, at 432. Notably, prior to the enactment of the present bankruptcy code in 1978 the avoidable period for ordinary preferences was four months. When Congress created the extended one-year reach back period for insider preferences it reduced the ordinary preference avoidance period from four months to ninety days as a rough trade-off for the greater avoidance period for insider preferences. See Countryman, *supra* note 40, at 726. Although this change might seem to indicate a restriction of the trustee's avoidance powers, the net change as a result of all revisions was again a relaxation of the trustee's burden for establishing an avoidable transfer.

60. Act of June 22, 1938, ch. 575, 52 Stat. 840.

ruptcy acts since 1841. The rationale for the creditor knowledge requirement was to discourage the "race of diligence," that is, the race among creditors of the debtor to seize the debtor's assets before the debtor filed for bankruptcy and before another creditor seized them first.⁶¹ The "reasonable cause to believe" requirement drew a distinction between "good" creditors (those who were unaware of the preferential nature of the transfer and therefore from whom recovery was not allowed), and "bad" creditors (those who were aware of the preferential nature and from whom recovery was allowed). In general, however, this requirement did nothing to further the fundamental goal of the bankruptcy law, which was (and is) to promote equality of distribution.⁶² Furthermore, the burden of proof it imposed upon the trustee was so difficult to meet that Congress feared the element was actually defeating avoidance of many otherwise deleterious transfers. Indeed, the House Report on the change noted that this burden of proving creditor knowledge was "nearly insurmountable, and defeated many preference actions."⁶³ Hence, in practice, because of this insurmountable burden, the element did not discourage the race of diligence nor did it foster the equality of distribution goal.

Accordingly, the creditor knowledge element was eliminated, again expanding the trustee's avoidance power to better protect the unsecured creditors of the debtor. Nevertheless, while Congress clearly recognized the burden which this requirement placed on the trustee, Congress notably *included* this requirement in the newly created *insider* preference avoidance section.⁶⁴ This inclusion was seemingly done in an effort to balance the interest of all of the parties involved. Congress apparently rationalized that because the period during which avoidance could be

61. This was done by the creditors in an attempt to collect payment of their debt in full without having to be a party to the bankruptcy proceedings. A result of this "race," however, was the dismantling of the troubled debtor causing its premature death.

62. Bankruptcy Law Revision, H.R. Rep. No. 595, 95th Cong., 1st Sess. 178 (1977).

63. *Id.*

64. As enacted in 1978, subsection 547(b)(4) allowed avoidance of a preferential transfer meeting the other requisite elements of section 547(b) listed *supra* note 9 if the transfer was:

(4) made—

(A) on or within ninety days before the date of filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer—

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and . . .

This element for avoidance of an insider preferential transfer was eventually eliminated in what has been viewed by many as a mere Congressional oversight. For a complete discussion of this revision and its impact on the avoidance and recovery of insider preferential transfers see *infra* text accompanying notes 80-82.

sought was increased, the trustee's burden for establishing his case during this extended period should likewise be increased.⁶⁵ Thus, Congress intentionally made it more difficult to establish a case for use of the extended reach-back period.

A third major change made during the 1978 revisions was the creation of a bifurcated process for avoidance and recovery of preferential transfers. Under all of the previous acts, these two powers had been treated in the same statutory article. In the new Code, however, avoidance is governed by section 547,⁶⁶ while recovery is separately dealt with in section 550.⁶⁷ Under this new scheme, the trustee could avoid the transfer under section 547⁶⁸ and then recover the avoided transfer from either the "initial transferee" or from "the entity for whose benefit such transfer was made" under section 550.⁶⁹

Interestingly, neither the initial proposal by the Commission nor the revisions to the proposed section 550⁷⁰ as developed by the House or the Senate included provisions for recovery from the nonrecipient beneficiaries of the transfers ("the entity for whose benefit such transfer was made"). Despite this initial omission, however, the provision as later enacted had been changed to allow recovery from *either* the recipient or the beneficiary. The statements made by the Code's House and Senate floor managers⁷¹ indicate that the change was designed "to permit recovery from an entity for whose benefit an avoided transfer is made *in addition to* recovery from the initial transferee."⁷² Thus it is clear that the lawmakers did envision situations where recovery from the

65. Curiously, Congress' action in selecting one year for avoidance of insider preferential transfers and ninety days for ordinary preferences seems to be an arbitrary selection of time periods (as evidenced by the numerous changes made to the ordinary preference avoidance period since the provision first appeared in the Act of 1841, Act of Aug. 19, 1841, ch. IX, 5 Stat. 440, repealed by Act of March 3, 1843, ch. LXXXII, 5 Stat. 614). The absence of any sound policy dictating the duration of the term of avoidability should simply be noted. Achieving true equality might perhaps require a period much longer than either ninety days or one year. This article does not question the arbitrariness of these time periods.

66. 11 U.S.C. § 547 (1988).

67. 11 U.S.C. § 550 (1988).

68. 11 U.S.C. § 547 (1988).

69. 11 U.S.C. § 550(a) (1988).

70. 11 U.S.C. § 550 (1988).

71. Congressman Edwards and Senator DeConcini, respectively.

72. 124 Cong. Rec. H. 11,097 (daily ed. Sept. 28, 1978) (emphasis added); 124 Cong. Rec. S 17,414 (daily ed. Oct. 6, 1978) (emphasis added). Perhaps Congress, in enacting this avoidance/recovery scheme, was only reinforcing the changes made in 1938 to section 60b of the Act of 1898 which would literally allow recovery from either the recipient or the beneficiary. The legislative history on the change, however, does not contain enough information from which to draw such a conclusion.

beneficiary of an avoided transfer would be appropriate.⁷³ The main question which remains, however, is to what extent and under what circumstances Congress perceived that the trustee would be allowed to use the extended insider reach-back provision to recover transfers from a creditor whose status or conduct did not provide the factual grounds for use of this extended period.⁷⁴ As will be shown in the next section, the question became even more difficult to answer after the 1984 revisions to the Code. However, before proceeding to a discussion of the 1984 changes, one other significant change which was made in 1978 should be pointed out. Under the Bankruptcy Act of 1898, the trustee, in order to avoid a preferential transfer, was required to prove that the debtor was insolvent at the time the transfer was made. In its study of that Act, however, the Commission⁷⁵ found that trustee ability to prove the dates of insolvency hampered his power to avoid transfers. In its report

73. The intent of Congress to allow recovery from the initial transferee of avoided *preferential* transfers remains questionable, however, primarily as a result of the creation of this bifurcated avoidance/recovery process. As noted previously, see *supra* note 31, section 550 serves as the operative provision for recovery of *all* avoided transfers, not just preferential transfers. Although the legislative history on section 550 is sparse, it seems possible, if not likely, that Congress was focusing on recovery of fraudulent conveyances (11 USC § 548) when it defined section 550 to allow recovery from the initial transferee as well as the beneficiary of the transfer.

In a situation involving a fraudulent conveyance, recovery from the initial transferee is typically desirable, for the initial transferee will normally be the person holding the debtor's asset. Furthermore, because of the very nature of a fraudulent conveyance, the initial transferee's conduct in obtaining the transfer is most certainly culpable. See, e.g., *Rutter v. General Motors Acceptance Corp.*, 70 F.2d 479, 481-82 (10th Cir. 1934) ("There is a clear and broad distinction between a preferential transfer and a fraudulent transfer. The latter involves moral turpitude. The former does not."). Thus, under section 548 recovery from the initial transferee is not harsh or unusual. In comparison with an avoided preference, however, the initial transferee may have been wholly unaware of any preference, and moreover he may have intentionally refrained from obtaining an insider guarantee (the nexus which renders him potentially liable for the avoided transfer).

Further evidence that allowing recovery from *either* the beneficiary or the recipient alike of avoided *preferential* transfers was not intended is found in that there are different types of preferential transfers (i.e., ordinary or insider), each type consists of different elements, and the time for avoidance varies under each. To give the different types of preferences this distinct an identity for avoidance and then allow recovery from a party who did not provide grounds for insider avoidance seems to ignore parts of the legislation. This article will not attempt to criticize a literal application of the provisions on this ground, however, as even accepting a literal application as the correct interpretation of Congressional intent in this regard despite this anomaly, there is still evidence indicating this was not the *result* intended by Congress based on the purpose of the preference provisions and the objective sought by lenders obtaining insider guarantees.

74. See *supra* text accompanying notes 19-20.

75. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

to Congress,⁷⁶ the Commission⁷⁷ noted that proof of insolvency was a worthy requirement, but concluded it would almost always be the case that the debtor was insolvent during the preference period. Because of the state of distressed debtors' books, however, the trustee was often faced with a virtually impossible task of proving it. The House Report concluded that "[b]ecause of the difficulty of proof, creditors are not deterred from the race of diligence, and the policy of equality is defeated."⁷⁸ Accordingly, a presumption of insolvency for the ninety days prior to the debtor's filing for bankruptcy was added to section 547⁷⁹ of the Code. Again, however, this change, which made it easier for the trustee to avoid an ordinary preferential transfer, was *not* adopted for the new insider preference avoidance section. Thus, this change reflects the same considerations seen in the elimination of the "reasonable cause to believe" element—a desire by Congress to expand the trustee's avoidance powers in general and thereby better serve the policy of equality of distribution; yet, Congress again cautiously limited this power with regard to the extended reach-back period.

The 1984 Revisions

In 1984, Congress made further changes to the Code.⁸⁰ Among them were several modifications to the preference section, particularly section 547(b).⁸¹ In the 1978 reform, Congress relieved trustees of the duty to show that the creditor had a "reasonable cause to believe" the debtor was insolvent before avoiding a transfer for all *except* insider preferences. Prior to the amendments of 1984, there was a move in the Senate to reimpose the creditor knowledge requirement as an element for all avoidable preferential transfers. The Senate version of the 1984 bill, accordingly, deleted that requirement from the subsection dealing with insider preferences as unnecessary in view of the proposal to establish it as an element for the entire section (i.e., for all preferences).

When the proposed revisions were in conference, the amendment which would have added the "reasonable cause to believe" requirement for all preferences was removed from the proposed amended article. Unfortunately, the related deletion of the creditor knowledge requirement

76. Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess. (1973).

77. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

78. Bankruptcy Law Revision, H.R. Rep. No. 595, 95th Cong., 1st Sess. 178 (1977).

79. 11 U.S.C. § 547(f) (1988). This provision provides in part:

For purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

80. Act of July 10, 1984, Pub. L. No. 98-353, 98 Stat. 333.

81. 11 U.S.C. § 547(b) (1988).

for insider preferences (which would not have been required had the article been amended to require the "reasonable cause to believe" for all preferences) was not added back to that article. Thus, through an apparent Congressional oversight, the "reasonable cause to believe" requirement was eliminated for all preferences.⁸²

As noted previously, Congress in 1978 expressly meant to retain this requirement with regard to insider preferences. Congress had expressly recognized the difficulty which this requirement created for the trustee in avoiding transfers when it relieved the trustee of the burden of proving it for a transfer during the ordinary preference period. At the same time, Congress had consciously imposed this burden on trustees seeking to avoid transfers made during the extended period. When the burden for proving creditor knowledge for insider preferences was removed from the trustee's case, trustees began scrutinizing payments made by debtors more than ninety days before bankruptcy more often. Thus arose several preference cases which breathed life into the potential problem which had been present in the code since its enactment in 1978, but which had never surfaced because trustees could not prove creditor knowledge: The problem of the trustee avoiding a transfer preferential to an insider during the extended reach-back period and then seeking recovery of the avoided transfer from a non-insider creditor who did not provide the factual grounds for use of the extended period.

Evaluation of the Preference Provisions

This brief overview of the development of preference law indicates that their general purpose is to give the trustee of an insolvent debtor the power to maintain or restore the assets of the debtor's estate so that they may be equitably distributed in one collective proceeding. Throughout the evolution of these provisions, Congress has gradually increased the trustee's avoidance power by relaxing his burden for avoiding a transfer. This trend by Congress depicts an effort to better protect unsecured creditors and thereby further the equality of distribution goal of bankruptcy law. The trustee's avoidance power has also been expanded through the creation of the extended reach-back period for transfers preferential to insiders. However, Congress has been very cautious in this area, imposing limitations on the trustee which are not present under the ordinary preference provisions.

The Objectives of an Insider Guarantee

Many courts and commentators agree that insider-guarantees are not sought by lenders as a source for payment of a loan defaulted on by

82. For a complete discussion of the events which led to the error, see Countryman, *supra* note 40, at 732 n.115.

their debtor.⁸³ This is all the more so in the case of a closely held corporation where all of the insider's assets will frequently be tied up in the corporation. Thus it is generally agreed that "sugar daddy" guarantors, that is guarantors capable of repaying the loan, are rarely encountered. Why then, do lenders seek such guarantees?

Many commentators opine that lenders obtain personal guarantees from insiders of the debtor in order to establish a certain degree of control over the debtor. These authors assert that this control is then used to manage the debtor to the lender's liking.⁸⁴ Furthermore, should the debtor become financially unstable, these authors believe the lender will use his control over the debtor to compel it to repay the loan secured by the insider guarantee prior to any anticipated bankruptcy proceedings.⁸⁵ Based on this logic, these authors argue persuasively that the lender should be liable under section 550 of the code⁸⁶ for recovery of any preferential transfers.⁸⁷ This conclusion rests on the assumption that the lender sought the insider guarantee in order to assure itself preferential treatment, actually received preferential treatment, and now

83. Indeed, as one commentator noted, "[i]n many, if not most, instances in which a creditor seeks guarantees by insiders, the guarantors' assets are insignificant in relation to the size of the credit advance or loan . . ." Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1)*, 41 *Bus. Law.* 175, 196 (1985).

84. "[T]he guarantees 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." *Id.*

85. This view is shared by many courts as well. See, e.g., *In re Mercon Industries, Inc.* 37 *Bankr.* 549, 553 (E.D. Pa. 1984):

Insiders . . . typically have a significant amount of control over the operations of the debtor. . . . When the debtor's demise is imminent, the insiders who guaranteed the debtor's loan frequently hold enough sway with the debtor to cause it to pay off these guaranteed loans prior to the payment of other obligations. Consequently, the insiders have diverted the debtor resources to protect themselves.

86. 11 U.S.C. § 550 (1988).

87. This argument does not address the situation wherein the lender from whom recovery is sought was not the party who procured the insider guarantee. See, e.g., *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186 (7th Cir. 1989), where the creditor from whom recovery was sought had no insider guarantee at all, but rather was fully secured with a senior security interest in some of the debtor's assets in which another creditor who did have an insider guarantee also held a junior security interest. In this scenario the insider benefited from payments to the fully secured creditor because the release of a portion of its security interest inured to the benefit of the junior lienholder and thereby reduced the insider's contingent liability, which also made the transfer avoidable. However, even in this situation there must be an insider guarantee for the issue to ever arise. As to the creditor with the insider guarantee the following analysis should apply.

should be held liable for those preferences which it has received.⁸⁸ If this assessment of the lender's reasons for obtaining the insider guarantee is accurate and complete, then the *Levit* result (recovery from the lender) should prevail.

The lender, however, may have actually had other motives for procuring the insider guarantee. These other motives may, in fact, be conducive to the goals of bankruptcy law and their impairment may adversely affect other unsecured creditors of the debtor.

Consider shareholders who invest their personal wealth into corporations which pool resources of several shareholders in order to establish an entity which can most efficiently develop business opportunities. In exchange for their contributions, the shareholders are entitled to share in the proceeds from the exploitation of corporate opportunities (through dividends, increased market value of their stock, and so forth).

The officers and directors of the corporation (i.e., "insiders" in a bankruptcy context), however, have a natural but perverse incentive to seize the corporation's opportunities for themselves where the opportunity can be exploited without the need to share the gains with the investors. Such actions by the officers or directors would not only deprive the shareholders of the benefits for which they bargained by pooling their assets but would also tend to divert the exploitation of opportunities from the organization designed to efficiently do so to less well suited exploiting organizations.

Corporation law has developed statutory remedies to discourage this perverse incentive of "insiders" to siphon-off corporate opportunities for their personal gain to the detriment of the corporation and its shareholders. Under the "corporate opportunities" doctrine, as it is sometimes called, shareholders of a corporation can bring a derivative or secondary action on behalf of the corporation against the opportunistic insider to force him to make restitution to the corporation for the lost opportunities.⁸⁹ Thus, the corporate opportunities doctrine protects the shareholder's interest in the corporation by removing the officers' and directors' incentive to divert opportunities away from it and by providing a means for the shareholders to compel recovery for the corporation if an officer or director does pilfer a corporation's opportunity.

Creditors contribute to the corporation in hopes that the corporation will successfully develop opportunities and share the gain by repaying

88. Cf. *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d at 1198 ("In what sense is it 'inequitable' to require the outside lenders to pursue the inside guarantors for any shortfall, when they bargained for exactly that recourse?"). See also *In re Coastal Petroleum Corp.*, 91 Bankr. 35, 37 (N.D. Ohio 1988) ("[N]othing in section 550 prohibits the creditor from seeking recovery from its guarantor.").

89. See generally 3 W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 8.61 (rev. perm. ed. 1986 and Supp. 1990).

the loan plus any charges for use of the funds. Creditors, unlike shareholders, however, have no statutory rights outside of bankruptcy to protect themselves from this perverse incentive of insiders to pilfer the corporation's opportunities and thus increase the risk that the debtor-corporation will become insolvent and unable to repay its loans.⁹⁰

To remedy this shortcoming in the statutory law of debtor-creditor relations, the creditor may obtain an insider-guarantee from an officer or director of the corporate debtor. The guarantee provides the creditor with protection similar to the shareholders' against the insider's incentives to siphon opportunities by binding the insider to share in the proceeds of the exploited opportunity regardless of whether it is developed by the firm or by the insider.⁹¹

Extending the hypothetical mentioned earlier, if Borrower Corporation loses some of its opportunities and subsequently becomes insolvent (i.e., unable to repay its debt to Lender), Lender will then look to Surety (the insider-guarantor) for payment. Surety will be able to pay a portion of his liability on the guarantee by developing the opportunity, but because Surety's development will be inefficient, the opportunity is less valuable in his hands than in the corporations'. As a result, guaranteeing-Surety is much worse off having appropriated the opportunity for his own use than he would have been had he allowed the corporation to develop it to begin with. Thus, this contractual relationship reduces Surety's incentive to pilfer the corporation's opportunities. Furthermore, Surety's personal guarantee also encourages him to scrutinize the activity of other insiders of Borrower to make sure they are not usurping the corporation's opportunities either because he will be liable under the guarantee if Borrower becomes insolvent for any reason.⁹²

90. Only shareholders can bring a derivative or secondary action to recover the lost opportunities. See, e.g., La. Code Civ. P. art. 596 providing in part:

The petition in a class action brought by a shareholder or member of a corporation or unincorporated association because it refuses to enforce a right which it may enforce shall:

(1) Allege that the plaintiff was a shareholder or member at the time of the occurrence or transaction of which he complains, or that his share or membership thereafter devolved on him by operation of law; . . .

91. As pointed out earlier, "sugar daddy" guarantees are quite rare. In the case of an insider absconding with a corporation's opportunity, however, the insider may generate the personal funds with which to satisfy at least a portion of his liability on the guarantee. Still, because the firm has been designed to develop the opportunity most efficiently, the opportunity would generate greater revenues if developed by it.

92. Extending this reasoning, one concludes that insider guarantees should be favored and that if more of the corporation's insiders have executed personal guarantees on loans to the corporation, the security of any additional loans made to the corporation would be increased. This conclusion ignores other possible motives for lenders seeking personal guarantees from insiders. See *supra* text accompanying notes 84-88. The purpose of this

Analysis

Viewed in this light, the lender's procurement of an insider guarantee as security for its loan serves at least two distinct functions. The guarantee produces a deterrent effect, discouraging insiders of the debtor from stealing its opportunities and thereby increasing the potential vitality of the debtor-corporation and providing the lender with a greater assurance that the loan will be repaid. More importantly for this article, (and as a direct corollary to the deterrent effect which protects the guaranteed lenders), the *wholly unsecured* creditors receive the same benefit—the protection against the debtor's insiders siphoning off corporate opportunities resulting in an insolvent debtor. Thus, while insider guarantees may serve as a means for a creditor to establish control over the debtor and assure itself of preferential treatment in the event the debtor faces imminent bankruptcy,⁹³ the insider guarantee also serves a much deeper purpose; it seeks to establish safeguards against bankruptcy occurring at all.

As discussed earlier, the ostensible purpose of the preference provisions is to benefit unsecured creditors (by granting the trustee the power to maintain the debtor's estate in order to equitably distribute it at one collective proceeding). This benefit to the unsecured creditors, to some extent, comes at the expense of those creditors who obtained personal guarantees of insiders of the debtors (which creditors may, under the application of the provisions noted earlier in the hypothetical, be held liable for return of any transfers occurring within one year prior to bankruptcy). This potential liability of guaranteed creditors under section 550⁹⁴ of the Code resulting from their insider guarantees will undoubtedly induce some of them to seek alternative methods of protecting their interests. Perhaps these alternative methods will include establishing a security interest in some of the debtor's fixed assets and/or increasing interest and related finance charges. These alternative means, however, will do nothing to protect the wholly unsecured creditor. Thus, making insider guarantees more costly or less viable to lenders through use of the preference avoidance/recovery provisions will ultimately discourage their use and induce lenders to seek secured-creditor status or to find alternative less efficient means to adequately secure their loans. This shift away from insider guarantees, however, will likely have more severe effects on the wholly unsecured creditors than those who tradi-

article is not to suggest that insider guarantees are not sought for these "illicit" reasons, but rather to suggest that there may be other additional reasons for the guarantees which are conducive to the goals of bankruptcy law which create a need to resolve the desirability of these guarantees before enforcing a rigid rule which discourages their use.

93. See *supra* text accompanying notes 84-88.

94. 11 U.S.C. § 550 (1988).

tionally relied on insider guarantees. Those lenders previously relying on insider guarantees will still be repaid via alternative security measures which do not expose them to liability under section 550.⁹⁵ The unsecured creditors, however, will no longer have the benefit of insiders guarding against dissipation of corporate opportunities by opportunistic insiders of the debtor potentially casting the debtor into bankruptcy where the unsecured creditor will be forced to settle for less than the full amount of his claim.⁹⁶ This result is particularly ironic in light of the underlying purpose of the preference provisions which is to protect the unsecured creditors.

Thus, it becomes apparent that a strict literal application of the preference provisions as they currently exist may ultimately undermine the welfare of the very unsecured creditors whose interest they are supposed to protect. As noted previously, this is not to suggest that insider guarantees should be wholly favored either, however, as they do also enable the secured lender to abuse his relationship with the debtor (via the insider-guarantor) to afford himself preferential treatment. This conclusion should, however, warrant reconsideration of these provisions before rigidly applying them to the extent of conclusively discouraging insider guarantees among lenders.⁹⁷ Such reconsideration should entail a balancing of all of the functions which insider guarantees serve for both the guaranteed as well as other unsecured creditors against the potential they pose for frustrating the goals of bankruptcy law.

95. 11 U.S.C. § 550 (1988).

96. Cf. Jackson and Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155, 158 (1989) ("Because lower classes (equity interests and often general creditors) fare so poorly in any liquidation that follows insolvency, they are likely to want the debtor to continue in business.").

97. Several courts have recognized (basically on grounds of the inequitable results to the guaranteed creditor), that the provisions should not be applied literally to allow recovery from this guaranteed creditor. See, e.g., *In re Midwestern Companies, Inc.*, 102 Bankr. 169 (W.D. Mo. 1989); *In re T.B. Westex Foods, Inc.*, 96 Bankr. 77 (W.D. Tex. 1989); *In re Midwestern Companies, Inc.*, 96 Bankr. 224 (W.D. Mo. 1988); *In re C-L Cartage Co.*, 70 Bankr. 928 (E.D. Tenn. 1987); *In re Aerco Metals, Inc.*, 60 Bankr. 77 (N.D. Tex. 1985); *In re R.A. Beck Builder, Inc.*, 34 Bankr. 888 (W.D. Pa. 1983); *In re Duccilli Formal Wear, Inc.*, 8 Bankr Ct. Dec. (CRR) 1180 (S.D. Ohio 1982); *In re Cove Patio Corp.*, 19 Bankr. 843 (S.D. Fla. 1982); *In re Church Buildings and Interiors, Inc.*, 14 Bankr. 128 (W.D. Okla. 1981). Other courts have refused to allow recovery from the non-insider by applying an analysis to the definition of the term transfer which concludes transfers such as that discussed in the hypothetical are actually two transfers: one to the insider which is avoidable and which may be recovered from that insider and another to the creditor which is not avoidable. See, e.g., *In re V.N. DePrizio Construction Co.*, 58 Bankr. 478 (N.D. Ill. 1986); *In re Mercon Industries, Inc.*, 37 Bankr. 549 (E.D. Pa. 1984). However they are reasoned, the outcomes of these cases are probably the best to promote the purpose of the preference provisions.

Conclusion

The preference provisions in bankruptcy law are designed to further the bankruptcy goal of equality of distribution of the insolvent debtor's assets among the various classes of his creditors. This function is served by the provisions enabling the trustee of an insolvent debtor to recover assets transferred shortly before the debtor filed for bankruptcy and for which the debtor did not receive a contemporaneous exchange in value. The development of these provisions since they first appeared in the Bankruptcy Act of 1841⁹⁸ has reflected a concern by Congress for unsecured creditors in a bankruptcy proceeding. This concern is manifested in a broadening of the trustee's avoidance and recovery powers with regard to preferential transfers which better enabled the trustee to maintain the debtor's estate. One area which has been broadened is that of insider preferences where the period during which the trustee can seek avoidance of a preferential transfer has been expanded to one full year prior to the debtor's filing for bankruptcy.

As a result of the creation of this extended reach-back period as well as several other revisions to the bankruptcy code, the trustee of an insolvent debtor may now seek recovery from a non-insider creditor of a transfer which was avoided during the extended insider preference avoidance period. This result, while beneficial to the unsecured creditors of the debtor in that it precludes creditors with insider guarantees from receiving the benefit of preferential treatment as a corollary to the guarantee, may also have adverse effects on the unsecured creditors. The guaranteed creditor may have procured and may be utilizing the guarantee to discourage insiders of the debtor from pilfering corporate opportunities from the debtor, a protection which benefits both guaranteed and wholly unsecured creditors alike. Thus, making insider guarantees less viable or more costly, while resolving some of the problems associated with the guaranteed creditor assuring itself of preferential treatment, may also increase the unsecured creditors' risk of having the debt settled in a bankruptcy setting.

With these two conflicting effects of insider guarantees on unsecured creditors of the debtor, a strict use of the preference provisions to discourage all insider guarantees may not serve the ostensible purpose of these provisions, which is to greater protect the unsecured creditors. Perhaps a revision to these provisions incorporating a balance of all the interests of the parties would provide a rule which would better serve this purpose.

Scott C. Barney

98. Act of Aug. 19, 1841, ch. IX, 5 Stat. 440, repealed by Act of March 3, 1843, ch. LXXXII, 5 Stat. 614.

