Insider Preference Recovery against Non-Insider Creditors

Thomas E. Johnston
West Virginia University College of Law

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I. INTRODUCTION

As the Bush administration passes the half-way point of its first term, analysts would agree that one of the most pressing domestic problems on the national agenda is the savings and loan debacle. Perhaps never again will the thrift industry, or for that matter the banking industry generally, enjoy the public confidence that it did prior to the crisis.

In this troubled time for lending institutions, additional unanticipated liability is almost certainly unwelcome. It is just such surprise liability with which this article deals. This unexpected liability arises in the arena of Title 11 Bankruptcy.

If a lender finds itself in the following fact pattern, then a trap is set and waiting to spring in the event of bankruptcy on the part
of the borrower. It is a common scenario. A borrower approaches a lender about a loan. For whatever reason, a loan is arranged so that the borrower is required to have a guarantor but is otherwise unsecured. So the borrower gets as its guarantor an owner, officer or family member of the borrower, depending on the type of entity the borrower is. If a lender executes a loan under these circumstances, and the borrower enters bankruptcy, the lender could, because of the guarantee arrangement, find itself subject to an unexpected recovery by the trustee in bankruptcy for certain payments made to the lender by the borrower. This fact pattern and the difficulties it has produced will be referred to through the remainder of this article as insider preference recovery against non-insider creditors.

It is a complicated construction of the Bankruptcy Code which has brought about this complex problem. For the purposes of this introduction, however, lenders in the above guarantee loan situation should pay close attention to this possible recovery. Since many lawyers, even those well versed in these specific topics, never expected the Bankruptcy Code to be interpreted in this way, the lending institutions have been by and large equally unaware of this potential recovery. Therein lies the surprise. Simply knowing of the problem, its genesis, and the rationale behind decisions creating it, can provide lenders the opportunity to avail themselves of means by which the problem may be avoided. This Note is meant to be an overview of this troubling puzzle.

1. For the purposes of this Note, the term borrower will be used interchangeably with debtor, guarantor with insider, and lender with creditor. Each pair of terms represents the same party in the transactions which will be discussed. Of course, in everyday business transactions, these terms are not necessarily synonymous.

2. See generally 11 U.S.C. § 550 (1988). Recovery of avoided preferences is one function of the trustee in the bankruptcy proceeding. For the uninitiated, a brief explanation of the bankruptcy process is warranted at this time. Once the debtor files for bankruptcy, a trustee is selected to administer the estate of the debtor. If no trustee is appointed, the debtor may become a debtor in possession and act as trustee. Once gathered, this estate is distributed to creditors according to the provisions of the Bankruptcy Code. The avoided transfers which will be mentioned throughout this Note are recovered and returned to the estate of the debtor.

II. **INSIDER PREFERENCE RECOVERY AGAINST NON-INSIDER CREDITORS**

A. **Relevant Bankruptcy Code Provisions**

Bankruptcy and other courts have woven together several Bankruptcy Code provisions to arrive at insider preference recovery against non-insider creditors. To understand the problem, it is necessary to set forth the relevant Bankruptcy Code provisions.

The Bankruptcy Code defines a creditor as "an entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor...".

When an insolvent debtor makes a payment to a creditor to the detriment or exclusion of other creditors, the payment is known as a preference.

One of the powers of the trustee in bankruptcy is that of avoidance. Avoidance, in the context of this Note, means that the trustee may make void a transfer made from the debtor to a creditor which is a preference. Section 547 of the Code outlines the power of the trustee to avoid preference.

Under section 547(b), the trustee in bankruptcy may avoid transfers of property made by the insolvent debtor to or for the

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4. See *infra* note 114.

Section 547. Preferences

(b) the trustee may avoid any transfer of property of the debtor—

(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 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; and
benefit of a creditor for an antecedent debt. This avoidance includes transfers made for a certain period of time prior to the filing of the bankruptcy petition. The length of that period of time is prescribed in section 547(b)(4). For all creditors, transfers made to them, or for their benefit, are avoidable up to ninety days prior to the filing of the bankruptcy petition. Thus, any transfer made within this period to any creditor is avoided as a preference. However, in the case of a transfer made to, or for the benefit of, an insider creditor, the preference period is one year. Therefore, all transfers made to or for the benefit of insider creditors are avoided for one year prior to the filing of the bankruptcy petition.

Combining the Code's definition above of a creditor and its characterization in section 101(30) of an insider produces a meaning for the term "insider creditor." Under section 101(30), an insider is essentially someone who is intimately involved in the affairs of the debtor. For example, if the debtor is an individual, section 101(30)(A) says that an insider can be a relative, partner or partnership in which the debtor is a member, or a corporation of which the debtor is an officer, director or otherwise in control. Similar provision is made for a partnership debtor under section 101(30)(C).

(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 [the Bankruptcy Code];
(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.

While not directly relevant to this Note, one should be aware that the Code provides for certain "defenses" to the finding of a preference. 11 U.S.C. § 547(c) (1987); see also infra note 76.

9. This clause was modified in 1984. The following language was removed: "was an insider; and . . . had reasonable cause to believe the debtor was insolvent at the time of such transfer . . . ." Compare 11 U.S.C. § 547(b)(4)(B) (1982) with 11 U.S.C. § 547(b)(4)(B) (Supp. 1984).


The Code at § 101(30) defines an "insider" as:

(A) if the debtor is an individual -
   (i) relative of the debtor or of a general partner of the debtor;
   (ii) partnership in which the debtor is a general partner;
   (iv) corporation of which the debtor is a director, officer, or person in control;

(B) if the debtor is a corporation -
   (i) director of the debtor;
   (ii) officer of the debtor;
It says that an insider to a partnership can be a partner, relative of a partner, or a person in control of the debtor.

Most important to the topic in this Note is the definition of an insider to a corporation given in section 101(30)(B). Under this section, an insider to a corporate debtor is a director, officer, person in control or partner or relative of a director, officer or person in control of the corporate entity.

Having now defined creditor, insider creditor, preference, and avoidance of a preference, it is necessary to look to section 550 of the Code (entitled “Liability of transferee of avoided transfer”) to determine from whom a preference is recovered. One must keep in mind that section 547 simply characterizes a transfer as preferential and thus void, and it is section 550 which allows for the recovery of the avoided transfer.

Under section 550(a), the trustee may recover an avoided property transfer, or its value, from either the initial transferee or the entity for whose benefit the transfer was made. If necessary, the trustee may also recover avoided transfers from the immediate or

(iii) person in control of the debtor;
(iv) partnership in which the debtor is a general partner;
(v) general partner of the debtor; or
(vi) relative of a general partner, director, officer, or person in control of the debtor;
(C) if the debtor is a partnership -
(i) general partner of the debtor;
(ii) relative of a general partner in, general partner of, or person in control of the debtor;
(iii) partnership in which the debtor is a general partner;
(iv) general partner of the debtor; or
(v) person in control of the debtor;


Section 550. Liability of transferee of avoided transfer.
(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, or 724(a) of this title, 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.

* * *
(c) The trustee is entitled to only a single satisfaction under subsection (a) of this section.
mediate transferee of the initial transferee. It should also be noted that section 550(c) allows only one recovery from among these parties.

It is the interaction of sections 101(30), 547, and 550 of the Code which has been used to grant insider preference recovery against non-insider creditors. If the problem still seems unclear, that is not surprising. The express language of the Code does not directly state the principle in question. Insider preference recovery against non-insider creditors came about as a result of judicial construction of the above Code provisions.

B. Example: The Deprizio Case

An illustrative case can be used to explicate the problem at issue in this Note. The case which has been selected for this purpose is often cited as the principle case on point, Levit v. Ingersoll Rand Financial Corp.\(^\text{12}\) (In re V.N. Deprizio Construction Co.; this case is known popularly as “Deprizio”).

The Deprizio case involved an individual named Richard Deprizio.\(^\text{13}\) He had various business arrangements which required the making of loans, in which his company borrowed from various sources and Mr. Deprizio and his two brothers guaranteed the otherwise unsecured loans.\(^\text{14}\) Nothing beyond these facts was known about these loan arrangements.\(^\text{15}\)

The Deprizio Company had borrowed money on numerous occasions from several lenders, including Ingersoll Rand Financial Corp.\(^\text{16}\) In each case, Richard Deprizio and/or his brothers guar-

\(^{12}\) Levit v. Ingersoll Rand Financial Corp., 874 F.2d 1186 (7th Cir. 1989).
\(^{13}\) Id. at 1187.
\(^{14}\) Id.
\(^{15}\) Id. As an aside, Mr. Deprizio had some questionable connections with the administration of Mayor Jane Byrne in-Chicago. In the 1983 mayoral race, Mr. Deprizio and his company were apparently approached by the Byrne administration about some construction, the purpose of which was to bolster the mayor’s re-election chances. The result of this proposal was a series of loans to Deprizio Co. all of which found Mr. Deprizio guaranteeing them and a donation of $3,000 from Deprizio Co. to the mayor's campaign. Subsequently, the United States Attorney opened an investigation of Mr. Deprizio and his business. Apparently someone was apprehensive about some information Mr. Deprizio held. Mr. Deprizio was assassinated in January 1986.
\(^{16}\) Id.
antedeed the loans.\textsuperscript{17} Although not stated in the opinion, it is apparent that Deprizio Company had been making payments on these loans right up to the point at which the bankruptcy petition was filed, \textit{i.e.} to well within ninety days of the filing.\textsuperscript{18}

Upon these facts, the court accepted the trustee’s argument that payments in satisfaction of Deprizio Co.’s obligation to the lender made up to one year prior to the filing of the petition for bankruptcy were avoidable and could be recovered from the lender by the trustee.\textsuperscript{19} The manner in which the Code sections are woven together to achieve this result is best presented in the court’s summary of the Trustee’s argument:

Suppose Firm borrows money from Lender, with payment guaranteed by Firm’s officer (Guarantor). Section 101(30)(B)(ii) renders Guarantor an “insider.” Guarantor is not Firm’s creditor in the colloquial sense but under § 101 of the Code any person with a “claim” against Firm is a “creditor,” and anyone with a contingent right to payment holds a “claim” under § 101(4)(A). A guarantor has a contingent right to payment from the debtor: if Lender collects from Guarantor, Guarantor succeeds to Lender’s entitlements and can collect from Firm. So Guarantor is a “creditor” in Firm’s bankruptcy. A payment (“transfer”) by Firm to Lender is “for the benefit of” Guarantor under § 547(b)(1) because every reduction in the debt to Lender reduces Guarantor’s exposure. Because the payment to Lender assists Guarantor, it is avoidable under § 547(b)(4)(B) unless one of the exemptions in § 547(c) applies. Once the transfer is avoided under 547, the Trustee turns to § 550 for authority to recover.\textsuperscript{20}

The court then goes on to point out that under section 550(a) the trustee has the option of recovering from either the lender or the guarantor, subject only to the proviso in section 550(c) that there shall be only one recovery.\textsuperscript{21}

Of course, if it is not already clear, the nonstatutory aspect of this problem is the contingent claim the Guarantor has against the Firm by way of subrogation.\textsuperscript{22}

\textsuperscript{17} Id.
\textsuperscript{18} See id.
\textsuperscript{19} Id. at 1200-01.
\textsuperscript{20} Id. at 1190.
\textsuperscript{21} Id.
This discussion of the *Deprizio* case is meant to describe how the court arrived at this recovery. The rationale for this holding, along with other decisions supporting it, will be discussed at length next in Section III.

III. ARGUMENTS IN FAVOR OF THE *DEPRIZIO* INTERPRETATION

A. Policy

Several courts have justified the *Deprizio* interpretation on grounds of policy. In fact, the *Deprizio* case engages in an extensive discussion of policy reasons for recovery against lenders for preferences to insider guarantors.24

The *Deprizio* court noted that the purpose of the preference rules was to prevent the occurrence of asset-grabbing.25 When it becomes apparent prior to bankruptcy that an entity simply does not have adequate assets to satisfy all its obligations, there is an incentive to favor those creditors whom, for whatever reason, the entity most wishes to satisfy.26 Those preferred creditors are thus unfairly advantaged in the satisfaction of debts owed to them by the debtor over those creditors to whom the entity did not choose to make a preferential payment.27 The assumption behind this is that the whole is greater than the sum of the parts; an intact debtor being liquidated as a whole is likely to be more valuable than the liquidation of its individual parts.28 In addition, all creditors are treated alike, and thus, presumably, fairly, by joining in the collective proceeding29 rather than picking away at the entity individually like vultures in the wild.

The extended preference period for insiders is commensurate to the knowledge they can be assumed to possess.30 They are more

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23. See also infra notes 84-90, 96-102 and accompanying text.
24. E.g., Levit v. Ingersoll Rand Financial Corp., 874 F.2d 1186, 1198 (7th Cir. 1989).
25. Id. at 1194.
26. Id. at 1195.
27. Id.
28. Id. at 1194.
29. Id.
30. Id. at 1195.
likely to know farther in advance than other creditors that the entity is likely to enter bankruptcy proceedings.\textsuperscript{31} Thus, payments made to or for the benefit of insiders are avoidable for up to one year rather than for only ninety days.\textsuperscript{32} In a situation where an insider is the guarantor of a debt held by the entity, it is not surprising to expect the occurrence of a preference. The insider/guarantor is going to be personally liable if the debtor defaults.\textsuperscript{33} Information to which such an individual is likely to be privy would certainly make him or her sufficiently nervous to influence the debtor to discharge the debt in the face of impending bankruptcy.\textsuperscript{34} Thus, an extended recovery period provides a disincentive against the preference.\textsuperscript{35} If the payment is made, then the trustee may recover it either from the creditor or the guarantor. The \textit{Deprizio} court noted that this result is consistent with the structure and purposes of the Code.\textsuperscript{36}

The defendants in \textit{Deprizio} argued that the court's holding would put creditors on guard and give them incentive to precipitate bankruptcy proceedings at the least sign of trouble.\textsuperscript{37} This in turn would lessen the potential for a "workout," \textit{e.g.}, a negotiated restructuring of debt.\textsuperscript{38} The court's response to this argument was that it doubted that workouts were economically superior to bankruptcy proceedings and thus not desirable enough to discard the holding.\textsuperscript{39}

Also looking to the policies behind the \textit{Deprizio} principle, the Bankruptcy Court in \textit{In re Coastal Petroleum Corp.} addressed concerns about the vulnerability of creditors with the statement that, "[a]ny failure of the creditor to adequately investigate the credit worthiness of the debtor or its insider guarantors should not be viewed as a statutory deficiency but, rather, as an inherent business
Risk.” The court went on to point out the very salient point that the creditor had an action against the guarantor for the obligation of the debtor as well as the avoided payments. The court did not, however, consider the possibility of a judgment-proof guarantor.

B. Statutory Language

The Deprizio case itself and most cases in accord with it make use of the language of the Bankruptcy Code itself to justify the result. The Deprizio case states that the language of the Code requires that the transfers to non-insider creditors be avoided as preferences. However, courts which rely heavily or solely on the language of the Code tend to gloss over the findings of a preference and treat it as a given. They instead address themselves to the recovery aspect of the proceeding. Indeed, it is acknowledged that there is a distinction made in the Code between a finding that a transfer is preferential, and thus avoided, and the recovery of that transfer by the trustee. There are, in effect, two separate activities as well as two separate statutes involved in the recovery of a preference. First, there is a finding that a transfer is indeed avoided as a preference under section 547. Then, a recovery is made by the trustee on the basis of section 550. As stated above, the courts which have concentrated on the language of the Code have done so in reference to the recovery phase.

The key language in that phase of the proceeding is the provision in section 550(a) that recovery may be had from “the initial transferee of such transfer or the entity for whose benefit such transfer was made.” Courts have found this language by itself to be quite compelling. In In re Big Three Transportation Inc.,

41. Id.
42. E.g., 874 F.2d at 1190.
43. Id.
44. See, e.g., In re C-L Cartage Co., 899 F.2d 1490, 1494 (6th Cir. 1990).
47. 11 U.S.C. § 550(a).
the Bankruptcy Court, in allowing insider preference recovery against non-insider creditors, stated, "[t]his Court . . . refuses to overlook the unambiguous language of 11 U.S.C. section 550(a)(2) . . . . The language is susceptible of no other interpretation than the result reached herein."\(^{49}\) Similar language is found in the case of *In re Coastal Petroleum Corp.*\(^ {50}\) In holding that recovery could be had from the non-insider creditor for transfers made more than ninety days prior to filing, the court cited section 550(a) and said that its language was "clear to state that recovery may be had from the initial transferee . . . . That language is not only unambiguous but is also unconditional."\(^ {51}\)

Although this section deals with statutory arguments in favor of the *Deprizio* interpretation, one case has relied on statutory provisions to reach a result contrary to *Deprizio*. In *In the Matter of the Midwestern Companies*,\(^ {52}\) the bankruptcy court heard the trustee argue that recovery should be had against the non-insider and based his argument on *Deprizio*, *Big Three*, and *Coastal Petroleum*.\(^ {53}\) The court stated that regardless of the clarity of the Code language, standard canons of statutory construction prevented such a recovery.\(^ {54}\) The Court elaborated:

One statute, if possible, should not be construed to rescind all or part of another and, in statutory as well as other construction, the specific controls over the general. Accordingly, the specific provisions in § 547 against recovery from a non-insider recipient of a transfer more than 90 days before bankruptcy cannot be overruled by the general provisions of § 550(a)(1). Rather, under these standard canons of construction, the "initial transferee" provision of the latter section must be read to include only "initial transferees" who have received transfers which are prohibited preferences as to them.\(^ {55}\)

Thus, the language of the Code has been used on both sides of the issue. But it has been used more often to extend the period

\(^{49}\) *Id.* at 20-21.
\(^{50}\) *In re Coastal Petroleum Corp.*, 91 Bankr. 35 (Bankr. N.D. Ohio 1988).
\(^{51}\) *Id.* at 38.
\(^{53}\) *Id.* at 225.
\(^{54}\) *Id.*
\(^{55}\) *Id.*
for recovery of preferences from non-insiders rather than to protect them.⁵⁶

C. Congressional Intent

When approving arguments in favor of the Deprizio interpretation of the Bankruptcy Code, several courts have relied on the intent of Congress, or what they estimate to be the intent of Congress. Indeed, courts have recognized the dearth of legislative history behind the Code provisions relevant to the Deprizio interpretation.⁵⁷

One case in this area which relied heavily on the scant legislative history of the these Code provisions is In re Robinson Brothers Drilling, Inc.⁵⁸ This case involved the classic scenario, with the insider guarantying a loan and the debtor making payments within one year prior to the filing of the petition.⁵⁹ In its thorough discussion of the entire topic, the United States District Court first examined the issue of whether the insider guarantor was a creditor by making use of an excerpt from the history of 11 U.S.C. § 101(9)(A) which defined "creditor."⁶⁰ The court noted that Congress had stated, "[a] guarantor of or surety for a claim against the debtor will also be a creditor, because he will hold a contingent claim against the debtor that will become fixed when he pays the creditor whose claim he has guaranteed or insured."⁶¹ This court and others have found this passage persuasive evidence of Congress's intent that a guarantor should be a creditor.⁶² The remainder of the references to legislative intent in the Robinson

⁵⁶. Midwestern is perhaps the only case in which statutory construction has been used to protect creditors.


⁵⁹. Id. at 78.

⁶⁰. Id. at 80.


The court discussed arguments made by the parties that this section was not intended to allow recovery of voided transfers to non-insiders, but found them unpersuasive. The court stated that it favored a literal interpretation of the Bankruptcy Code as enacted which reflects the clear intent of Congress. In its conclusion, the court in Robinson Brothers stated, "With plain language, Congress developed this hard and fast rule to help prevent litigation over the issue of bad faith preferential payments by debtors." Other courts have followed this approach.

The Arkansas Bankruptcy Court in In re Big Three Transportation agreed, noting that if initial transferees were not intended to be subject to preference recovery, that language could easily have been omitted by Congress. Similarly, the Bankruptcy Court in In re Coastal Petroleum Corp. came to the conclusion that if there was no significant legislative history on section 550(a)(1), and subsequent changes in the Code had left that provision unchanged, then Congress must have meant for its literal meaning to be the correct one.

This lack of substantive legislative history on section 550(a)(1) led at least one court in an opposite direction. In In re Cove Patio Corp., the court, without citing authority, held that section 550(a)(1) was not meant to be interpreted literally so as to expand to non-insiders the insider preference recovery powers of the trustee. It was instead meant merely to facilitate the existing recovery

64. Id. at 82-3.
65. Id. at 82.
66. Id. at 83.
68. Id. at 21.
70. Id. at 38.
72. Id. at 844.
powers of the trustee.\textsuperscript{73} As noted in the introduction to this Note, this was, at least at one time, the prevailing attitude among the bankruptcy community.

One final case of note on the subject of legislative intent is \textit{In the Matter of R. A. Beck Builder}\textsuperscript{74} The defendant lenders in that case argued the defenses to preference avoidance\textsuperscript{75} in section 547(c)(2), which provides:

\begin{quote}
(2) to the extent that such transfer was-
(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
(B) made not later than 45 days after such debt was incurred;
(C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
(D) made according to ordinary business terms; . . . \textsuperscript{76}
\end{quote}

If these conditions are met, then the trustee may not avoid the transfer.\textsuperscript{77} The defendants in \textit{R. A. Beck} argued that a new debt was formed each time a payment on a loan was due and so long as the payment was made within forty-five days of the point at which the payment came due and otherwise complied with section 547(c)(2), then these monthly payments on loans were excepted from avoidance.\textsuperscript{78} The court rejected this argument stating that Congress did not intend such an interpretation of the Code and that the debt is incurred upon execution of the note, not when each payment comes due.\textsuperscript{79}

While arguments in favor of insider preference recovery against non-insider creditors are persuasive, the arguments against this interpretation are also weighty.

\textsuperscript{73} Id.
\textsuperscript{75} Id. at 892.
\textsuperscript{76} 11 U.S.C. § 547(c)(2) (1987). It should be noted that this section has been amended since \textit{Beck}. The "forty-five-day rule" no longer applies.
\textsuperscript{77} Id.
\textsuperscript{78} 34 Bankr. at 892.
\textsuperscript{79} Id. at 893.
IV. Arguments Against the Deprizio Interpretation\textsuperscript{80}

A. Appeals to Equity

The majority of courts addressing the topic of insider preference recovery against non-insider creditors have discussed appeals to equity. This is not surprising. Certainly, the least culpable party in the scenario is being penalized the most. The debtor is, for whatever reason, insolvent and unable to meet its responsibilities. The guarantor is presumed to be the culprit in a transaction designed to cheat other creditors. The bank merely receives payment in satisfaction of a debt owed to it. The situation, at least on the surface, has an unfair flavor to it.

\textit{Collier On Bankruptcy} is in accord with this notion. Its passage on the subject provides in pertinent part:

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. In such circumstances the bankruptcy court should use its equitable powers to prevent an inequitable result.\textsuperscript{81}

The majority of bankruptcy courts addressing the issue have agreed either explicitly or implicitly with \textit{Collier}.\textsuperscript{82} This attitude was best summed up in the language of \textit{In the Matter of the Midwestern Companies Inc.}:

Further, the abhorrence of avoiding a transfer with respect to a non-insider as to whom it is not preferential is so great that, apart from principles of statutory construction, it has long been recognized that a preference action is a creature of equity and that the bankruptcy courts, in employing the doctrine, are to apply equitable principles. The case decisions which have held that re-

\textsuperscript{80} See also supra notes 52-56, 71-73 and accompanying text.
\textsuperscript{81} 4 Collier on Bankruptcy, § 550.02, at 550-58 (15th ed. 1985).

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covery cannot be had against a bank in circumstances such as those at bar have simply seized upon the obvious unfairness and inequity of permitting the trustee to recover under such circumstances.83

In general, then, bankruptcy courts view such a recovery as inequitable.

There have, however, been formidable challenges to this use of a bankruptcy court's equitable powers. The Deprizio case addressed this issue and found, as have other courts deciding the equity issue in the same manner,84 that when dealing with explicit statutory language, bankruptcy courts may not invoke equity powers.85 Other courts fail to see the equity in the situation because the lender has an action against the guarantor for any loss incurred on the obligation.86

The Deprizio court took the argument against the use of equity one step further and mixed it with economic reasoning.87 The court noted that if the extended preference period facilitated bankruptcy as a debt-adjustment process, then credit, in the aggregate would become available on slightly better terms.88 If the extended period had the opposite effect, credit would be slightly more expensive and monitoring of creditors more stringent.89 The court acknowledged that either result was possible, but concluded that even if the interest rate were raised slightly by the rule, "inefficiency is not inequitable."90 This argument, however, seems to commit the "strawman fallacy" in that those who argue equity in opposition to recovery from non-insider creditors do not find market reactions

83. 96 Bankr. at 225.
85. Levit v. Ingersoll Rand Financial Corp., 874 F.2d 1186, 1197 (7th Cir. 1989).
87. 874 F.2d at 1198.
88. Id. Further explanation of the court's reasoning may be in order. Debt-adjustment represents a certain cost to the lending industry. Costs to the industry show up in the price of its money, the interest rate. Thus, if the debt-adjustment process is changed such that it is somewhat less costly, this will translate into a slight decrease in interest rates.
89. Id.
90. Id.
inequitable but instead the unfairness of recovering from the least culpable party in the transaction. Other arguments besides equity have also been advanced to attack insider preference recovery against non-insider creditors.

B. "Two-Transfer" Theory

One fairly creative attempt to circumvent insider preference recovery against non-insider creditors is what has become known as the "two transfer" theory. The two transfer theory focuses on the payment itself and splits it into two transfers.\textsuperscript{91} The first is a transfer to the creditor, which, of course, is in the form of cash value.\textsuperscript{92} The second transfer is the benefit received by the insider guarantor when its obligation is lessened by the amount of the payment.\textsuperscript{93} The second transfer, being to an insider, is avoidable up to one year prior to filing.\textsuperscript{94} The first transfer, as one to a non-insider, is only avoidable if it is within ninety days of filing.\textsuperscript{95}

The "two-transfer" theory has, however, met strong opposition. The court in \textit{Deprizio} dismissed the theory as an incorrect interpretation of the definition of "transfer" according to the Code.\textsuperscript{96} Noting that the theory equates "transfer" with benefits received, the court concluded that a transfer was actually a payment made.\textsuperscript{97} Thus, the court concluded that "[a] single payment . . . is one ‘transfer,’ no matter how many persons gain thereby."\textsuperscript{98}

The Sixth Circuit in \textit{C-L Cartage}\textsuperscript{99} concurred with the \textit{Deprizio} approach to the two-transfer theory.\textsuperscript{100} They also saw the payment

\textsuperscript{92} \textit{Id.}
\textsuperscript{93} \textit{Id.}
\textsuperscript{94} \textit{Id.}
\textsuperscript{95} \textit{Id.}
\textsuperscript{96} \textit{Levit v. Ingersoll Rand Financial Corp.}, 874 F.2d 1186, 1195-96 (7th Cir. 1989).
\textsuperscript{97} \textit{Id.}
\textsuperscript{98} \textit{Id. at 1196.}
\textsuperscript{99} \textit{In re C-L Cartage Co.}, 899 F.2d 1490 (6th Cir. 1990).
\textsuperscript{100} \textit{Id. at 1495.}
as one transfer, but in addition criticized the two-transfer theory as a "tortured construction of the statute."  

Similarly, the United States District Court in Robinson Brothers rejected the two-transfer theory as "result-oriented." Beyond the two-transfer theory argument against insider preference recovery from non-insider creditors lie policy considerations.

C. Policy

The principle policy argument against the Deprizio principle is best stated by Collier on Bankruptcy:  

if 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.

Indeed, it is not difficult to understand why a creditor might be hesitant to enter into such a loan arrangement when it may subject to this extended window of recovery. The incentives created by the Deprizio interpretation could potentially make credit somewhat more difficult to obtain. Courts which have rejected this argument have tended to ignore it on its own merits and reject it as part of an overall rejection of an equity argument.

V. Methods of Avoiding the Deprizio Problem

While the principle set forth in the Deprizio case, and others like it, is by no means set in the concrete of case law, it is none-

101. Id.


104. (Emphasis added); see, e.g., Levit v. Ingersoll Rand Financial Corp., 874 F.2d 1186,
theless a problem that the banking industry must address or face more unexpected recoveries by bankruptcy trustees. This section proposes a few possible means by which avoidance of transfers in these situations could be limited or eliminated.

A. Waiving Subrogation Rights of the Guarantor\textsuperscript{105}

Generally speaking, if a debtor defaults on a loan and the guarantor is forced to fulfill the debtor's obligations, then the guarantor will have an action against the debtor by way of subrogation.\textsuperscript{106} This is the so-called "claim" against the debtor that purportedly makes the guarantor a creditor of the debtor.

If the guarantor were to waive this right of subrogation against the debtor, then the claim would no longer exist and the guarantor would no longer be a creditor. Thus, if a transfer were made from the debtor to the creditor less than one year but more than ninety days prior to bankruptcy, there would be no insider creditor to be preferred by the payment.

Of course, the problem created is that the guarantor will no longer have a remedy in the event that the debtor defaults and the guarantor is forced to make good its pledge. While this exposure is troublesome, it is not significant. After all, if the debtor had such limited remaining resources that it was forced to default on the loan, what are the chances the debtor will be able to satisfy a judgment against it for the same amount? It seems as though the guarantor gives up little by waiving subrogation rights.

B. Guarantor Endorsements

The case of Ray v. City Bank and Trust Co. (In re C-L Cartage)\textsuperscript{107} suggested yet another solution to the Deprizio problem

\textsuperscript{105} There is now doubt in the bankruptcy community about the effectiveness of the waiver of subrogation rights. It has been noted that such an arrangement only increases the incentive for the insider guarantor to act in such a way as to subvert the bankruptcy process. Borowitz, Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio, 45 Bus. Law. 2151 (1990).

\textsuperscript{106} See supra note 22.

\textsuperscript{107} 899 F.2d 1490 (6th Cir. 1990).
for bankers. In that case, some of the payments in the insider preference period of one year were not paid directly to the creditor.\textsuperscript{108} Instead, the payments were made from the debtor to the guarantor and the checks then endorsed to the creditor by the guarantor.\textsuperscript{109} In remanding the case to district court, the court stated, “As a mediate transferee within section 550(a)(2), the bank may be able to claim the benefit of section 550(b)(1) defenses.”\textsuperscript{110} Section 550(b)(1) provides, “The trustee may not recover under section (a)(2) of this section from (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; . . . .”\textsuperscript{111}

By the language of the statute, then, two elements are required to claim section 550(b)(1) defenses, good faith lack of knowledge that the transfer is avoidable.\textsuperscript{112} In the Deprizio scenario, it seems unlikely that a creditor, by definition a non-insider, will know prior to ninety days before bankruptcy that a transfer will be avoided as a preference. Non-insider creditors in general are not imputed by the Code to have such knowledge until ninety or fewer days prior to bankruptcy.\textsuperscript{113} Thus, the knowledge requirement seems easily fulfilled.

“Good faith” is a much more troubling term. It is not defined by the Code. Thus, it is an amorphous example of weasel words which lay the entire matter in the hands of the court. Perhaps the answer to this problem is standardization of a provision in loans which requires the guarantor endorsement for all payments made by all otherwise unsecured debtors. Such a “boilerplate” provision would remove as much as possible the appearance of attempting to avoid preference liability. Whether this would be interpreted by a court as “good faith” is, however, beyond accurate prediction.

\textsuperscript{108} Id. at 1495.  
\textsuperscript{109} Id.  
\textsuperscript{110} Id.  
\textsuperscript{111} 11 U.S.C. § 550(b)(1).  
\textsuperscript{112} See id.  
\textsuperscript{113} 11 U.S.C. § 547(b)(4)(A).
The key advantage to the guarantor endorsement scheme is that no new exposure is placed on anyone. All the parties' rights remain intact. There is, of course, no advantage to the guarantor since it will still be liable as an insider for preference recovery just as it was in the *Deprizio* case. And there are generally higher transaction costs because of the trouble which must be taken to have the guarantor endorse each payment. But the non-insider creditor would be insulated from insider preference liability.

C. *A Legislative Proposal*

The most frequent first reaction which this Note's author has encountered to the *Deprizio* interpretation is "isn't the guarantor's claim only contingent?" Indeed, it seems to be a bit of a legal stretch to take this contingent claim and make the guarantor a creditor as a result thereof. However, it cannot be disputed that the Code definition of a claim includes those which are contingent.\(^\text{114}\)

The *Deprizio* problem could thus be solved by an amendment to the Bankruptcy Code which removes the word "contingent" from the definition of a claim. The guarantor's contingent claim against the debtor would thus no longer be a claim under the Code and the insider guarantor would no longer be a creditor.

There are two costs involved with this solution. First, there would be the cost of pushing legislation through Congress. Of course, it comes as no surprise in 1991 that the banking industry is, at least for the time being, financially able to effectively influence Congress. Second, there would inevitably be, in the infinite transactions which occur in the business world, situations in which contingent claims should, by the spirit and policies of the Code, be included as claims under the Code. Obviously there will be occasions when a transfer could be recovered otherwise but for the removal of the word "contingent" from the Code. Whether

\(^{114}\) 11 U.S.C. § 101(4)(A) states that a claim means, "... a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, disputed, undisputed, legal, equitable, secured or unsecured ..." (Emphasis added). See also 11 U.S.C. § 101(4)(B).
this hindrance of the bankruptcy process is insignificant enough to justify this amendment is a question left for another time.

VI. CONCLUSION

This Note is meant, first, as an overview of the *Deprizio* case and its ramifications, and, second, as a search for an effective means by which a lending institution may avoid liability under this case. If a lender sets up a loan in which the debtor is unsecured and a guarantor co-signs who is an insider to the debtor, the lender may be subject to an extended preference period for transfers made to the lender in satisfaction of the debt even though the lender is not an insider.

There has been considerable debate over this principle. Bankruptcy courts have been less willing to accept this idea and reject it frequently on equitable grounds. On the other hand, the Federal Circuit Courts of Appeal which have addressed the issue have favored the extended recovery. Only the Fourth Circuit has hinted otherwise. Thus, any lender stands such a significantly high chance of being subject to a *Deprizio* recovery in a bankruptcy proceeding that precautions are wise.

The bottom line message to lenders sent by the *Deprizio* court, and others which have ruled likewise, is beware the unsecured loan guaranteed by an insider. There is thus an incentive to look very carefully at the guarantor and its financial health, because the lender has recourse to no other party in the event of such a preference recovery.

*Thomas Johnston*

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115. *In re Harbour*, 845 F.2d 1254, 1256-58 (4th Cir. 1988); see also supra note 82.