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Casenotes: Federal Bankruptcy Law — a Personal Guarantee from a Corporate Insider May Mean That Payments Received by the Lender within One Year Prior to the Debtor's Filing for Insolvency Are Subject to an Extended Preference Period and Recovery from the Lender. Levit v. Ingersoll Rand Financial Corp., 874 F.2d 1186 (7th Cir. 1989)

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CASENOTES

FEDERAL BANKRUPTCY LAW—A PERSONAL GUARANTEE FROM A CORPORATE INSIDER MAY MEAN THAT PAYMENTS RECEIVED BY THE LENDER WITHIN ONE YEAR PRIOR TO THE DEBTOR'S FILING FOR INSOLVENCY ARE SUBJECT TO AN EXTENDED PREFERENCE PERIOD AND RECOVERY FROM THE LENDER. *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186 (7th Cir. 1989).

A recent Seventh Circuit opinion may mean lenders everywhere should more carefully consider accepting personal guarantees as a form of credit support. Lenders often are exposed to uncertainty concerning possible avoidance by trustees of payments made by debtors within ninety days of the debtors' entry into bankruptcy. A federal appeals court, applying a literal interpretation of the Bankruptcy Code, has extended that period of uncertainty to one year for lenders holding personal guarantees from business "insiders."[1] This Note discusses the legal basis of the Seventh Circuit's decision in *Levit v. Ingersoll Rand Financial Corp.*[2] and its potential implications for lenders.

Insiders guaranteed the debts of a corporation awarded a contract to construct an extension of Chicago's subway system to O'Hare Airport.[3] Experiencing serious financial and legal difficulties, the corporation failed to complete the subway line, despite substantial loans from a number of sources.[4] In 1983 the company filed a petition under the Bankruptcy Code of 1978. The bankruptcy trustee sought to avoid and recover from lenders with insider guarantees all payments made between ninety days and one year prior to the filing. The bankruptcy court dismissed the action based upon the trustee's failure to state a claim upon which relief could be granted.[5] On an interlocutory appeal, the decision was reversed and remanded by a federal district court.[6] The Seventh Circuit Court of

1. The term "insider" includes officers of the debtor corporation and the relatives of an officer. 11 U.S.C. § 101(30)(B)(ii)(vi) (1988).
2. 874 F.2d 1186 (7th Cir. 1989).
3. *Id.* at 1187. The insiders consisted of the firm's president, Richard N. Deprizio, and his brothers. *Id.*
4. *Id.* The legal difficulties involved an investigation by the United States Attorney into allegations of affiliations with organized crime. The legal difficulties were partially resolved in January 1986, when Richard Deprizio was assassinated in a vacant parking lot. *Id.*
5. *In re* V.N. Deprizio Constr. Co., 58 Bankr. 478 (Bankr. N.D. Ill. 1986). The decision by the bankruptcy court was grounded on the so called "two-transfer" theory. Under this theory, payments made to lenders holding insider guarantees constitute two transfers: the first transfer is to the lender in satisfaction of the debt, subject only to a ninety day avoidance period; the second transfer, constituting the benefit to the inside creditor, is the only transfer potentially avoidable during the expanded preference period. The two-transfer theory is discussed *infra* in notes 19-36 and accompanying text. As an alternative holding, the bankruptcy court invoked considerations of equity as a basis for dismissing the complaint. *Id.* at 480-81. The equitable theory is discussed *infra* in notes 41-46 and accompanying text.
6. *In re* V.N. Deprizio Constr. Co., 86 Bankr. 545 (N.D. Ill. 1988).

Appeals granted leave to appeal. The court affirmed with respect to ordinary lender/creditors and reversed with respect to payments made to satisfy certain pension and tax obligations.[7] The decision marks the first time that a federal appeals court has applied a literal reading of the Bankruptcy Code to hold that payments made to creditors who have dealt at arms length with a debtor are subject to an extended preference period and recovery from the creditors, when insiders have guaranteed the debts.

The straight-forward analysis that led the Seventh Circuit to this extraordinary result begins with section 547(b) of the Bankruptcy Code.[8] This section of the Code allows a trustee to avoid any transfers, made within ninety days preceding the filing of the petition, that preferentially benefit a creditor.[9] When the creditor is also an insider, the period of avoidability extends to include the entire year preceding the filing of the petition.[10]

Upon confirming that the transfers made to lenders with insider guarantees might be avoidable,[11] the Seventh Circuit next addressed on

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7. Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989).
8. The pertinent text of § 547 provides that:
   (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer. . .
      (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;
         (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. § 547(b) (1988). The Bankruptcy Code was amended in 1984. The prior version of § 547(b) required the insider have reasonable cause to believe the debtor was insolvent at the time of the transfer. 11 U.S.C. § 547(b) (1982). The prior version of § 547(b) applied in *Levit* because the case was filed in 1983. Neither party, however, appears to have raised the issue of whether the insiders had reasonable cause to believe the debtor was insolvent.
9. 11 U.S.C. § 547(b) (1988). A "creditor" is any entity that has a claim against the debtor. 11 U.S.C. § 101(9)(A) (1988). Any right to payment, whether or not the right is contingent, is a "claim." *Id.* § 101(4)(A).
10. 11 U.S.C. § 547(b)(4)(B) (1988). If the guarantor is forced to pay because the debtor has defaulted, the guarantor may attempt to recover from the debtor the amount paid. Thus, the insider guarantor is a creditor of the debtor. *See In re* V.N. Deprizio Constr. Co., 86 Bankr. 545, 548 n.2 (N.D. Ill. 1988).
11. Ultimately, the avoidability of any transfer depends upon whether the circumstances of the transfer are within any of the exceptions in § 547 of the Code. 11 U.S.C. § 547(c) (1988); *see also infra* notes 93-97 and accompanying text.

whom the burden of avoidance should fall. The heart of the court's opinion was its subsequent analysis of section 550 of the Bankruptcy Code, which governs transferee liability. Section 550 provides that the trustee may recover the property transferred or its value 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.[12]

Literal application of section 550 results in equal liability of the lender and the insider guarantor.[13] At first impression, it appears incongruous that a disinterested financial institution, dealing in good faith and at arms length, could be liable for payments made throughout an extended preference period solely because the lender obtained a personal guarantee—one of the most common forms of credit support. The Seventh Circuit harmonized the apparent incongruity by an examination of the manifest intent of the Code and the realities that lay behind the lender's bargain with the debtor.

Initially, the court reviewed the two-fold purpose of the trustee's avoiding powers: first, to provide a disincentive for creditors' rushing to attach assets within the ninety days preceding the debtor's filing; second, to reassure creditors acting with restraint that they will not suffer from their inaction, or as the Seventh Circuit phrased it, that "the pickings of anyone less civil will be fetched back into the pot."[14] The court observed that the purpose of the extended preference period for insiders is to neutralize self-serving behavior by insiders, made possible by the insiders' greater knowledge of the debtor's financial situation and their greater control over the conduct of the debtor's business.[15] The Seventh Circuit concluded that a literal reading of section 550—giving the trustee the option of collecting from either a creditor/lender or the insider guarantor—advances the purposes of both the avoidance powers and the extended insider preference period.[16] The court recognized that allowing a trustee to recover only from the insider could further some of the underlying purposes of sections 547 and 550. The court observed, however, that the effectiveness of allowing recovery only from insiders is limited by the difficulties of valuing a released guarantee[17] and a tendency for the insiders to prefer risking actions by the trustee than by the "hounds of the outside creditors."[18] Thus, the court began its application of section 550 with a policy examination that left the court completely poised to

12. 11 U.S.C. § 550(a) (1988).
13. The lender is liable in its capacity as the initial transferee of the avoided payments; the insider guarantor is liable as the party benefited by the payment.
14. Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1194 (7th Cir. 1989).
15. *Id.*
16. *Id.*
17. One reason a released guarantee may be difficult to value is because at least part of the debt would have been paid during the regular course of business or in a liquidation proceeding notwithstanding the preferential payoff.
18. *Levit*, 874 F.2d at 1194.

endorse the literal application of the Code. The creditors in *Levit* advanced a "two-transfer" theory[19] and policy considerations as justifications for avoiding the literal interpretation of section 550.[20] The Seventh Circuit, however, rejected both arguments.

According to the two-transfer theory, the payment by debtor to lender in satisfaction of the primary indebtedness is the first of two simultaneous transfers. The second transfer—the only one that creates an avoidable preference—is from the debtor to the insider guarantor in satisfaction of the guarantor's contingent liability.[21] According to this theory, therefore, recovery is appropriate only from the insider guarantor since it is the only transfer that can be avoided on the basis of a benefit received by the insider.[22]

The two-transfer theory hinges on equating "benefit received" with "transfer."[23] The Seventh Circuit noted that the difficulty with this theory is that the Code already has defined a transfer, from the perspective of the debtor, as the "disposing of or parting with property or with an interest in property."[24] In comparison, according to the two-transfer theory, there is a disparity between the property parted with and the property received by the lender in the first transfer. The difference between the property disposed of and that which is received is reflected in a separate transfer to the guarantor. This second transfer, the reduction in contingent liability (arguably an "interest in property") received by the guarantor, is a by-product of the first transfer.[25] Thus, under the two-transfer theory, the payment to the lender consists of one property transfer and two transfers of an interest in the property.[26] Conceptualizing the interest received in the property as split between the lender and the insider guarantor requires that "transfer" be defined from the creditor's point of view.[27] The district court in *Deprizio* pointed out that if Con-

19. The two-transfer theory has been accepted by a number of courts. *See In re* V.N. Deprizio Constr. Co., 58 Bankr. 478 (Bankr. N.D. Ill. 1986), *rev'd*, 86 Bankr. 545 (N.D. Ill. 1988), *aff'd in part, rev'd in part*, 874 F.2d 1186 (7th Cir. 1989); *In re* Midwestern Cos., Inc., 96 Bankr. 224 (Bankr. W.D. Mo. 1988) (alternative holding), *aff'd*, 102 Bankr. 169, *appeal docketed*, No. 89-1877 (8th Cir. June 6, 1989); *In re* Mercon Industries, Inc., 37 Bankr. 549 (Bankr. E.D. Pa. 1984); *see also In re* Compton Corp., 831 F.2d 586, 591-96 (5th Cir. 1987) (approving two-transfer theory to protect initial transferee when third party benefits).
20. *Levit*, 874 F.2d at 1195, 1198.
21. It is the satisfaction of the guarantor's contingent liability that is the "benefit" transferred to the insider guarantor.
22. *Levit*, 874 F.2d at 1195.
23. *Id.*
24. *Id.* (paraphrasing 11 U.S.C. § 101(50) (1988)).
25. *Id.* at 1195-96; *see also* Note, *The Interplay Between Sections 547(b) and 550 of the Bankruptcy Code*, 89 COL. L. REV. 530, 534-36 (1989)[hereinafter Note, *The Interplay Between Sections 547(b) and 550*].
26. This is in contrast to the mere conduit exception, which involves two transfers of property and only one transfer of an interest in property. For further discussion of the "mere conduit" theory, *see infra* notes 76-81 and accompanying text.
27. *Levit*, 874 F.2d at 1195; *see also* Note, *The Interplay Between Sections 547(b) and 550, supra* note 25, at 534-36.

gress had intended to define transfer from the recipient's perspective, it could have defined transfer as "receiving or acquiring property or an interest in property."[28]

Another difficulty with the two-transfer theory noted by the district court lies in the express recognition in section 550 that one transfer may benefit an outside creditor and an insider guarantor.[29] Because section 550 recognizes that a single transfer can consist of more than one benefit,[30] it would be inconsistent for Congress to have intended under section 547 that one payment consist of two transfers, just because the single payment confers two benefits.[31]

The creditors attempted to justify reading two transfers into section 547 on the basis of legislative history.[32] The 1978 Code separated for the first time the identification of avoidable transfers from the identification of those who must pay for avoided transfers.[33] The creditors argued that an absence of legislative history indicated that the previous practice of allowing recovery of avoided transfers only from those who received a preference should continue.[34] In rejecting this approach, the Seventh Circuit stated that silence in the legislative history neither required nor authorized a court to depart from the text or structure of the Code.[35] Additionally, the court reiterated its position that reading the Code according to its ordinary meaning was completely consistent with the Code's policy of maximized equitable distribution among creditors of the same class.[36]

The creditors argued against literal interpretation as being a poor business policy that would lead to precipitous bankruptcy filings resulting from nervous creditors hastening to shore up their positions.[37] The Seventh Circuit, apparently relying in great measure on its prior review of the purposes underlying the preference avoidance and recovery sections of the Code, discounted the creditors' predictions.[38] Pointing to the

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28. *In re* V.N. Deprizio Constr. Co., 86 Bankr. 545, 551 (N.D. Ill. 1988).
29. *Id.*
30. This conclusion follows from the dichotomized recovery, under § 550, from either the initial transferee or the party benefitted. *Id.* The initial transferee would not be a "transferee" but for being the recipient of an "interest in property." This interest in property must confer some benefit or the reach of § 550 extends to the absurd. *See* Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890, 893-94 (7th Cir. 1988) (Hypothesizing potential liability of armored car companies or even banking intermediaries when "transferee" is treated as "anyone who touches the money."); *see also* discussion of the mere conduit exception, *infra* notes 76-81 and accompanying text.
31. *See In re* V. N. Deprizio Constr. Co., 86 Bankr. 545, 551 (N.D. Ill. 1988).
32. *Levit*, 874 F.2d at 1196-97.
33. *Id.*
34. *Id.*
35. *Id.* at 1197.
36. *Id.*
37. *Id.* at 1198.
38. *Id.*

mitigating effects of the numerous exclusions and exceptions,[39] the court directed further complaints to Congress.[40]

Though the argument was not before the court, the Seventh Circuit also discussed and rejected equitable considerations as a possible grounds for avoiding the literal language of the Code.[41] Noting that a number of decisions,[42] and several commentators,[43] have rejected literal application on the basis of equity, the Seventh Circuit nonetheless refused to tamper with the unambiguous language of the Code.[44] The Seventh Circuit observed that whatever equitable powers a bankruptcy court may wield, they must be limited to the "confines of the Bankruptcy Code."[45] Prior courts have extended their powers of equity to avoid punishing a lender for exercising prudence in obtaining a guarantee.[46] The Seventh Circuit, by contrast, articulated a cogent explanation for Congress' desire to have the statute implemented as written.[47] The Seventh Circuit considered the literal application of section 550 in the context of the financial realities that underlie the extension of a personal guarantee.

The presence of a guarantee creates an identity of interests between the lender and the insider guarantor.[48] It is precisely this identity of interests that gives a personal guarantee by an insider its value as credit support, for a guarantee from an otherwise impoverished insider is of little use. The "innocent" lender, therefore, is attempting to capitalize on the insider guarantor's natural inclination to minimize personal exposure, to the detriment of other creditors.[49] Viewed from this perspective, the apparently "inequitable result" of literal application of the Code ap-

39. For further discussion of the "ordinary course," and other exclusions, see *infra* notes 82-86 and accompanying text.
40. *Levit*, 874 F.2d at 1200.
41. *Id.* at 1197-98.
42. Cases in which courts invoked their equitable powers to avoid literal application of the Code include: *In re* T.B. Westex Foods, Inc., 96 Bankr. 77 (Bankr. W.D. Tex. 1989) (alternative holding); *In re* Midwestern Cos., Inc., 96 Bankr. 224 (Bankr. W.D. Mo. 1988), *aff'd*, 102 Bankr. 169, *appeal docketed*, No. 89-1877 (8th Cir. June 6, 1989); *In re* C-L Cartage Co., 70 Bankr. 928 (Bankr. E.D. Tenn. 1987); *In re* Aerco Metals, Inc. 60 Bankr. 77 (Bankr. N.D. Tex. 1985); *In re* R.A. Beck Builder, Inc., 34 Bankr. 888 (Bankr. W.D. Pa. 1983); *In re* Duccilli Formal Wear, Inc., 8 Bankr. Ct. Dec. (CRR) 1180 (Bankr. S.D. Ohio 1982); *In re* Cove Patio Corp., 19 Bankr. 843 (Bankr. S.D. Fla. 1982).
43. *See* 4 COLLIER ON BANKRUPTCY ¶ 550.02, at 550-58 (L. King 15th ed. 1989); *see also* Countryman, *The Trustee's Recovery in Preference Actions*, 3 BANKR. DEVELOP. J. 449, 464 (1986).
44. Levit v. Ingersoll Rand Fin. Corp., 874 F.2d at 1197-98.
45. *Id.* (quoting Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963, 969 (1988)).
46. *In re* Aerco Metals, Inc., 60 Bankr. 77, 82 (Bankr. N.D. Tex. 1985).
47. Only two commentators previously had expressed the same view. *See* Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(l), and 546(a)(l)*, 41 BUS. LAW. 175, 186-99 (1985); *see also* Pitts, *Insider Guaranties and the Law of Preferences*, 55 AM. BANKR. L.J. 343 (1981) [hereinafter Pitts, *Insider Guaranties*].
48. Both the lender and the inside guarantor share an interest in the debtor repaying the loan. *See* Pitts, *Insider Guaranties*, *supra* note 47, at 354.
49. *Id.*

pears, instead, to be the fair result of a lender's choice to align itself with the baser instincts of those in control of the debtor corporation.[50] As the Seventh Circuit stated, "rules of law affecting parties to voluntary arrangements do not operate 'inequitably' in the business world—at least not once the rule is understood."[51]

Another creditor that relies on an insider's instinct of self-preservation to ensure prompt payment on its claims is the United States Government. Taxes paid by the corporation were held not subject to an extended preference period in *Levit* because the control person, though potentially liable for unpaid taxes, would have no subsequent claim against the corporation and thus would not be a "creditor."[52] The trustee in *Deprizio* had argued that the United States, as tax collector, received preferential payments because insiders were personally liable under section 6672(a) of the Internal Revenue Code in the event that the debtor corporation did not pay over taxes.[53] The trustee argued that, because of the potential personal liability, the insider would have a contingent claim against the corporation and, consequently, would be a creditor of the corporation.[54] The Seventh Circuit refused to allow recovery, maintaining that no claim was created by this liability because the liability was cast by the statute as a separate penalty to the responsible person, without creating a private right by the person against the corporation.[55]

As an alternative theory, the trustee argued that the responsible person would have a claim against the corporation based upon a common law right of indemnity.[56] This argument was dismissed by the Seventh Circuit on the ground that any insider subjected to the penalty would have a degree of involvement and willfulness that would preclude indemnity at common law.[57] The summary dismissal of the trustee's arguments by the Seventh Circuit appears to be based on a modest distinction between contingent claims that are certain and those that are barely colorable.[58]

A further distinction between certain and colorable contingent claims was decisive in the trustee's attempt to recover payments made in

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50. *Id.* at 353-55.
51. Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1198 (7th Cir. 1989).
52. *Id.* at 1191-92.
53. *Id.*
54. *Id.* The trustee relied on 26 U.S.C. § 6672(a), which provides that:

> Any person required to collect . . . and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax . . . shall . . . be liable to a penalty equal to the total amount of the tax evaded. . . .

26 U.S.C. § 6672(a) (1982).
55. *Levit*, 874 F.2d at 1991-92.
56. *Id.*
57. *Id.*
58. In this context, a barely colorable contingent claim could be defined as a claim for which, in the abstract, a theoretical argument can be made, although its successful application in the face of most facts would raise the most cynical brow.

the preceding year to pension and welfare funds.[59] The trustee argued that insiders in the firm were secondarily liable on these payments as well.[60] The Seventh Circuit held that payments made to funds holding notes co-signed by Deprizio were potentially avoidable and recoverable as if the funds were commercial creditors.[61] The court disallowed recovery from funds not holding insider guarantees, however, because the liability of the insiders and any right to reimbursement by the pension fund was speculative.[62] The border between certain and barely colorable claims likely will become a major battleground if literal application develops a significant following among other circuits.

The Seventh Circuit foresaw little difficulty associated with requiring the lender to shoulder the enhanced risk of an extended preference-recovery period. The court reasoned that creditors could simply charge higher rates and monitor debtors more closely to compensate for the increased risk.[63] Similarly, the court discerned no inequity in requiring a creditor to pursue the insider guarantor for recovered payments since that was part of the creditor's original bargain.[64] Prospectively, lenders may be able to accommodate the expanded at-risk period in accordance with the "financial realities" and commercial perceptions articulated by the *Levit* court. Difficulties arise, however, when there is uncertainty about whether the new interpretation of the rule will be applied consistently in other jurisdictions.

The Seventh Circuit first raised the specter of literal application of sections 547 and 550 as dictum in *Bonded Financial Services, Inc. v. European American Bank.*[65] Thereafter, at least one federal district court found the approach taken by the *Bonded Financial* court persuasive and expressly followed "the Seventh Circuit's sound guidance for heeding the clear intent of Congress. . . ."[66] The district court decision in *Deprizio*

59. *Levit*, 874 F.2d at 1192.
60. *Id.*
61. *Id.*
62. *Id.* An insider could be a creditor only if the insider had secondary liability for pension fund payments and then an implied right of reimbursement. The Seventh Circuit was unpersuaded that the insiders had any liability. Insider liability for pension fund payments would arise, in theory, if the insider is an "employer" required to pay into the pension plans under the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1145 (1982). *Id.* The court left the question to be explored in detail at remand, but observed that not all employers are required to make contributions to the funds and that several courts as well as the general counsel of the pension fund insurer had concluded that there was no secondary liability. *Id.*
63. *Id.* at 1198-99.
64. *Id.*
65. 838 F.2d 890, 894-95 (7th Cir. 1988) (dictum). The Seventh Circuit in *Bonded Financial* was concerned with recovery under section 550 of transfers avoided under section 548. In discussing the relative equities involved, the court hypothesized the insider guarantor problem as an illustration of a situation where equity would have little impact on statutory interpretation. *Id.*
66. *In re* Robinson Bros. Drilling v. First National Bank of Bethany, 97 Bankr. 77, 81 (W.D. Okl. 1988), *aff'd*, 892 F.2d 850 (10th Cir. 1989). The district court decision in *Deprizio* similarly has been cited with approval. *See In re* Coastal Petroleum

likewise was modeled after the Seventh Circuit's decision in *Bonded Services*.[67] Still another federal district court has cited with approval the Seventh Circuit's rejection of the two-transfer theory.[68] The temporal proximity of these decisions may be an indication that literal application of the Code is gaining attraction. An appeal from a decision rejecting literal interpretation, however, presently is pending before the Eighth Circuit Court of Appeals.[69]

The Fourth Circuit never has focused on the interplay between sections 547(b) and 550. The court, however, has addressed some peripheral issues in two cases involving preferential transfers.[70] In *Aulick v. Largent*,[71] the Fourth Circuit considered whether a transfer of property to one creditor in exchange for that creditor's endorsement of a note to a second creditor was an avoidable preference to the second creditor. The court concluded that it was, and allowed recovery from the second creditor.[72] The court indicated in dicta that the transfer to the first creditor was not avoidable because it was part of a contemporaneous exchange.[73]

The ultimate result in *Aulick* was, in a sense, an avoidance of the transfer to the endorser (the first creditor). The second creditor was forced to return the endorser's money to the debtor's estate and the debtor's estate returned it to the endorser contemporaneously with a return of the security from the endorser to the debtor's estate.[74] The Fourth Circuit intimated, however, that the contractual obligation between the first and second creditor remained, though the court refrained from deciding the issue of ultimate liability.[75] The undecided issue of ultimate liability renders the dicta indicating that the transfer to the endorser was not avoidable more confusing than helpful in predicting a Fourth Circuit response to presentation of the *Levit* issue.

The peculiar circumstances within the Fourth Circuit's consideration in the second case similarly hamper its predictive utility. The case, *In re Harbour*,[76] involved a debtor who made a series of large preferential transfers to his friend, using his friend's mother as a conduit. The friend's mother never inquired as to the reasons for her participation, derived no benefit from the transfers, and passed them immediately to

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Corp. 91 Bankr. 35 (Bankr. N.D. Ohio 1988); *see also In re* Installation Services, Inc., 101 Bankr. 282 (Bankr. N.D. Ala. 1989) (citing and approving the district court's *Deprizio* decision).

67. *In re* V.N. Deprizio Constr. Co., 86 B.R. 545 (N.D. Ill. 1988).
68. *In re* H & S Transp. Co., 110 Bankr. 827 (M.D. Tenn. 1990).
69. *In re* Midwestern Cos., 102 Bankr. 169 (W.D. Mo. 1989), *appeal docketed*, No. 89-1877 (8th Cir. June 6, 1989).
70. *See* Aulick v. Largent, 295 F.2d 41 (4th Cir. 1961); *In re* Harbour, 845 F.2d 1254 (4th Cir. 1988).
71. 295 F.2d 41 (4th Cir. 1961)
72. *Id.*
73. *Id.*
74. *Id.* at 52-53.
75. *Id.* at 52.
76. *In re* Harbour, 845 F.2d 1254 (4th Cir. 1988).

her son.[77] The Fourth Circuit expressed broad approval for "cases which recognize that the initial recipient of a payment may not always be an 'initial transferee' for purposes of section 550(a)(1)."[78] The equitable exception expressly recognized in the case, however, was the narrower circumstance of when the initial transferee functions as a "mere conduit," deriving no independent benefit from the transaction. The court refused to apply even the mere conduit exception in *Harbour* because of "aggressive ignorance" on the mother's part, which it likened to inequitable conduct.[79]

Unlike the two-transfer theory, in a mere conduit exception, there are, in fact, two transfers of the property, but only one transfer of an interest in the property. The current version of section 547(b) indicates that the only transfer that is avoidable is "an interest in property" falling within the proscribed circumstances.[80] A conduit may handle the property but the interest in the property moves from the debtor to the preferred creditor.[81]

The equitable "exception" condoned by the Fourth Circuit does not appear to be an exception at all. Rather, it is an outcome consistent with the plain language of the Bankruptcy Code. Consequently, the acceptance by the Fourth Circuit of a mere conduit exception may provide only marginal insight into whether it would as eagerly embrace the two-transfer fiction. Moreover, the ease with which the court rejected equitable consideration for the mother because of her inaction indicates a willingness to hold the initial transferee to a strict standard in order to warrant equitable intervention. This standard is not likely to be met by a lender who benefits from a debtor's self-preferring behavior when the lender has provided the motivation for such behavior.

If the Seventh Circuit decision in *Levit* evidences a new trend in the application of bankruptcy law, "financial realities" may need to be reshaped to better conform with judicial perceptions. Even if literal application does not become widely accepted, a reevaluation of the utility of insider personal guarantees is in order. Any potential for a lender's exposure to the one year look back period introduces a risk that increases the cost of the transaction. The measure of that risk must be ascertained in

77. *Id.*
78. *Id.* at 1257.
79. *Id.*
80. 11 U.S.C. § 547(b) (1988).
81. Conceivably, simple custody of money in transit could be an avoidable interest in property. *See* S. REP. NO. 989, 95th Cong., 2d Sess. 27, *reprinted in* U.S. CODE CONG. & ADMIN. NEWS 5787, 5813 (definition of transfer includes a transfer of custody because custody is an interest in property). This construction, however, would lead to absurd results for two reasons. First, there would be the problem of widespread liability. Banks, hotel safe keepers, postal service employees and others all could innocently serve as intermediaries to avoidable transfers. Second, the only interest, as to the intermediary, that would be avoidable would be custody. It makes little sense to attempt to avoid a transaction that, once custody is relinquished, is as if it never transpired.

order to accurately gauge the utility of a personal guarantee from an insider. Although lenders may not be able to anticipate the frequency with which the rule may be applied, they should be able to predict the effect of its application. Lenders can minimize the effect of literal application by maintaining a prudent awareness of the limitations of preference avoidance and recovery in addition to reviewing their policies regarding acceptance of personal guarantees from insiders.

The Bankruptcy Code places limitations on the trustee's avoidance power that will act to minimize most lenders' exposure as a matter of course.[82] Transfers made in exchange for new value, for instance, are not avoidable.[83] Likewise, a transfer that does not improve the creditor's position over what it would be if the debtor had already filed for bankruptcy is not avoidable.[84] Hence, if the lender is otherwise fully collateralized, the payments would not be avoidable because the insider guarantors would not benefit by receiving more than they would under a Chapter 7 liquidation.

The most important limitation that will operate to minimize risk in many cases is the trustee's inability to avoid transfers made in the debtor's and creditor's usual course of business.[85] Thus, to the extent that payments were made on time, ordinary loan payments on an obligation secured by an insider's guarantee are secure from recapture.[86]

Although lenders may be exposed to an extended voidable preference period if they obtain guarantees from insiders, lenders can still bring an action against a credit-worthy guarantor to reclaim any recovered payments. Some caution in this area, however, is appropriate. Lenders should consider whether a guarantee from an insider who does not, and is not expected to, have any significant credit-worthiness is necessary. Boilerplate guarantees should be carefully reviewed and modified to ensure that the guarantor remains obligated for payments made by the debtor, but recovered after insolvency. One commentator suggests that lenders use a guarantee provision requiring the guarantor to waive any right of subrogation or other reimbursement against the debtor's estate arising out of the guarantor's satisfaction of the debtor's obligation.[87] By this mechanism the insider no longer would be a contingent creditor and only the ninety day recovery period would apply.[88] Lenders should be especially aware of the heightened risk they are taking if the only value of a guarantee is that it will serve as an incentive to a related borrower to

82. 11 U.S.C. § 547(c) (1988).

83. *Id.*

84. *Id.*

85. *Id.*

86. The Seventh Circuit Court of Appeals indicated approval for such an outcome in dicta. *Levit*, 874 F.2d at 1199-1200.

87. Gross, *New Law Threatens Creditors Who Sign With Insider Securers,* Daily Record, Oct. 11, 1989, at cols. 3-4.

88. *Id.*

make its payments.[89] Lenders may want to consider obtaining a guarantee from a non-insider, or other credit support such as a letter of credit or a pledge of collateral.[90]

The implications of the *Levit* decision reach equipment lessors, landlords, pension funds and private parties as well as commercial lenders. Any party contemplating an advance of credit based, in whole or in part, on the strength of a personal guarantee from an insider, and the party's counsel, should carefully monitor future developments in the case law in this area.

The *Levit* decision's endorsement of literal application of section 550 unquestionably affects the value of insider guarantees. The impact of this decision could be significantly lessened, however, if literal interpretation is uniformly applied. Because of the destabilizing effect of disaccord among the federal circuits, this issue should be addressed by the Supreme Court. In the interim, however, the *Levit* decision stands—as either a harbinger or an aberration.

Chellis E. Neal

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89. *Id.*
90. *Id.*