Insider Preferences and the Problem of Self-Dealing Under the Bankruptcy Code

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Fordyce set up all night settling his books and affairs in contemplation of absconding . . . [H]e inclosed [the money] in a letter to Mr. Fishar as follows: . . . “Mr. Fordyce conceiving that the money [loaned] by Mr. Fishar . . . was a sum, about which perhaps even some pains have been taken to place it there, he has the honour to shew him that preference which he conceives is certainly his due.”

About six o'clock the same morning Fordyce absconded and went to France.

Harman v Fishar, 1 Cowp 117, 118 (KB 1774).

Fordyce's other creditors were able to recover the money he sent his friend Fishar just before absconding (thereby committing an “act of bankruptcy”¹) on the grounds that the transfer was a fraudulent preference. Although outside of bankruptcy Fordyce might be able to prefer one creditor who was a friend over another who was not, he was not free to do so when bankruptcy was imminent.

Today bankruptcy cases commence with the filing of a bankruptcy petition,² which marks the transition from the ordinary legal regime of individual creditors' rights and remedies to the bankruptcy regime of collective creditors' rights and remedies. The preference and fraudulent conveyance provisions of the Bankruptcy Code³ are the lineal descendants of such eighteenth-century

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¹ *Harman*, 1 Cowp at 118, 119.

² Under the Bankruptcy Code, 11 USC § 101 et seq (1988), corporations or individuals can file petitions under Chapter 7 (Liquidation) or Chapter 11 (Reorganization), and individuals can also file petitions under Chapter 13 (Adjustment). A petition may be filed by the debtor (voluntary) or by a creditor of the debtor (involuntary). A creditor's petition requires a showing of cause, i.e., either that the debtor has failed to pay debts as they came due or that, within 120 days prior to the filing, a custodian was appointed or took possession of substantially all of the debtor's property. 11 USC § 303(h).

³ Enacted in 1978, the Code replaced the Bankruptcy Act, first passed in 1898 and amended frequently in the intervening years. The text of the Act was previously codified as

cases as *Harman v Fishar*.⁴ This Comment investigates asset transfers involving an insider of the debtor that raise concerns of preferential or fraudulent conduct similar to those evoked by Fordyce's eve-of-bankruptcy transfer to Fishar. It argues that transfers made by or for the benefit of insiders should be subject to close scrutiny under the fraudulent conveyance provision as well as the preference provision of the Code. Just as common-law judges found transfers such as the one in *Harman* to violate the norms of fraudulent conveyance law, even in the absence of a specific rule governing preferences, so too modern judges should ask whether transfers that benefit insiders violate these norms even though they fall outside the ambit of preference law.

In *Harman*, Fishar was a creditor of Fordyce and Co., a partnership. Under the Code, Fordyce would be an "insider" of the partnership.⁵ The Code specifically addresses preferential and fraudulent conduct by insiders because of their ability to control the debtor's funds.⁶ Under § 547 of the Code (the "preference provision"), pre-bankruptcy transactions that prefer one creditor over others of the same class can be avoided by the bankruptcy trustee.⁷ Section 548 (the "fraudulent conveyance provision") proscribes any debtor's pre-filing transfers that harm the creditors as a group without a corresponding benefit to the debtor.⁸ The trustee's power

11 USC § 1 et seq.

⁴ See, for example, *Granfinanciera, S.A. v Nordberg*, 109 S Ct 2782, 2791 (1989) (citing *Harman*).

⁵ The Comment uses the term "insider" consistent with its statutory definition in the Code. In essence, § 101(30) defines an insider as a director, officer, partner, controlling person of the debtor, or a relative of such individuals. 11 USC § 101(30).

⁶ Both the fraudulent conveyance and the preference have a lengthy historical lineage dating back to early English bankruptcy laws. For an overview of the historical evolution of these laws, see *In re Hall*, 4 Am Bankr Reps 671, 679-92 (W D NY 1900); Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 Stan L Rev 3 (1986); and Garrard Glenn, *Fraudulent Conveyances and Preferences* (Baker & Voorhis 2d ed, 1940 & Supp 1950).

⁷ The requirements of § 547 are set forth in text at notes 15-16.

⁸ The essential provisions of 548, discussed in greater detail in Section III of this Comment, are set forth in the text at note 66.

The classic fraudulent conveyance is a gift to relatives before filing for bankruptcy. Such conduct has been a common ruse of debtors since at least the Middle Ages. See I. Treiman, *Escaping the Creditor in the Middle Ages*, 43 Law Quarterly Rev 230, 232-36 (1927). Fraudulent conveyances also violate non-bankruptcy provisions common in many state corporate law statutes. See, for example, Uniform Fraudulent Transfer Act §§ 4, 5 (1984). The bankruptcy trustee can invoke the applicable state fraudulent conveyance law. 11 USC § 544(b).

to recover such transfers derives from § 550 (the "liability provision").⁹

Absent the causes of action created by §§ 547 and 548 and the recovery power granted in § 550, creditors might prematurely dismantle business entities whose precarious financial condition is only temporary. Alternatively, debtors, anticipating imminent bankruptcy, might defraud creditors by transferring company assets, thus exacerbating the creditors' race for the debtor's assets.¹⁰ The Code seeks to create the proper incentives for parties to join, rather than evade, the collective proceeding. It attempts to maximize the pool of available assets through incentives and clear rules of conduct.¹¹

Critical to the effectiveness of the Code is attention to the substance rather than form of transactions.¹² If creditors can use alternative financial arrangements to evade the formal provisions of the Code, the legal rules are reduced to a roadmap for escaping bankruptcy proceedings and causing the harms noted above.

This Comment investigates the courts' failure to characterize transfers involving insiders according to their substantive impact. It illustrates how, by drawing upon analogous areas of corporate law to help characterize these transactions, courts can deter conduct that violates the principles of the Code. Section I discusses the courts' current treatment of a common three party financial

⁹ Section 550 provides, in relevant part, that "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." 11 USC § 550(a)(1). Section 550 establishes liability for various avoided transfers, including preferences and fraudulent conveyances. Section 550(c) limits the trustee to a single satisfaction of any avoided transfer.

¹⁰ The debtor would be harmed in other ways as well. If the trustee were forced to challenge numerous transactions, litigation costs would multiply. See Douglas G. Baird and Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand L Rev 829, 849 (1985) (discussing wastefulness and expense of individual creditor remedies). More importantly, the long-term damage to a firm from a temporary transfer of property could significantly affect the debtor's financial viability.

¹¹ These principles are widely recognized by courts, although their application has led to inconsistent results. Compare *Levit v Ingersoll Rand Financial Corp.*, 874 F2d 1186, 1194-95 (7th Cir 1989) ("*Deprizio*"), and *Matter of Midwestern Companies, Inc.*, 96 Bankr 224, 225 (Bankr W D Mo 1988), aff'd, 102 Bankr 169 (W D Mo 1989). See generally, Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* 124-26 (Harvard, 1986).

¹² At least in their rhetoric, courts have long recognized the Code's concern for the substance of transactions. See, for example, *National Bank of Newport v National Herkimer County Bank*, 225 US 178, 184 (1912) (applying prior Act); *Aulick v Largent*, 295 F2d 41, 49-51 (4th Cir 1961) (same); *Matter of Compton*, 831 F2d 586, 591-92 (5th Cir 1987), remanded after reh'g, 835 F2d 584 (5th Cir 1988) (citing *Newport* and applying Code); and *In re C-L Cartage*, 70 Bankr 928, 932-34 (Bankr E D Tenn 1987), rev'd, 1990 WL 35494 (6th Cir 1990).

arrangement, in which a debtor's insider guarantees a creditor's loan to the debtor. This discussion illustrates the courts' often faulty reasoning in such cases and proposes a more coherent characterization, one that focuses on the insider's peculiar ability to control the transaction. Section II explores shortcomings in the ability of the proposed approach and existing preference law generally to avoid transactions whose substance violates the primary objectives of the Code; the section concludes that, where transfers involving benefits to insiders are at issue, a singular focus on the rule-like requirements of preference law will not always identify transfers whose substance is essentially fraudulent or preferential. Rather, as Section III recommends, existing preference law must be complemented by the more expansive provisions of fraudulent conveyance law. In sum, by characterizing these transactions in terms of fraudulent conveyance law, established doctrines of corporate law, and the historical concept of fraudulent preferences, courts can apply the Code more consistently to prevent the harm to creditors often inflicted by three party transaction involving insiders.

I. CHARACTERIZING THREE-PARTY TRANSACTIONS: THE DISPUTE OVER § 550

Suppose that Bank, concerned about the financial condition of Debtor or perhaps seeking to obtain greater influence over Debtor's use of its funds, requires Insider, a principal officer of Debtor, to guarantee Bank's loan to Debtor. Insider in turn has rights of reimbursement and subrogation against Debtor in the event that Insider is forced to pay Bank.¹³ As Debtor encounters financial difficulties, it falls behind in payments to Bank. Anticipating default by Debtor and consequent personal liability to Bank, Insider uses Debtor's funds to pay Bank on the ninety-first day prior to filing,¹⁴ thus reducing or extinguishing the outstanding balance of the loan.

¹³ See 11 USC § 509. Subrogation allows the insider to stand in the shoes of the creditor whose claim he pays; reimbursement provides that the insider can file a claim in his own right against the debtor for the amount paid to the creditor under the guarantee.

¹⁴ The ninety-first day is used here to illustrate one problematic aspect of preference law under the Code. Section 547 contains various "hard edge" requirements, including fixed reachback periods for insiders (one year) and non-insiders (ninety days). To qualify as a preference, a transfer must satisfy all the criteria of § 547. If this hypothetical transfer occurred on the ninetieth day prior to the filing, it would be an avoidable preference as to Bank.

This transfer has the form of a preference under § 547, which permits the trustee to avoid a transfer when, among other things, the transfer is “to or for” the benefit of a creditor, is on account of an antecedent debt owed by the debtor, and occurs while the debtor is insolvent.¹⁵ The transfer must also occur outside the ordinary course of business and on or within ninety days of the bankruptcy filing or, if the creditor is an insider of the debtor, on or within a year of the filing.¹⁶

Insider is a creditor of Debtor because his rights of reimbursement constitute a contingent claim against Debtor.¹⁷ But this alone does not make the transfer of Debtor’s funds by Insider a voidable preference, because “transfer” is a defined term in the Code, whose existence turns on what Debtor pays rather than that which Bank or Insider receives; and while Bank has received a transfer of Debtor’s property, Insider has not.¹⁸

This distinction, however, is not fatal to the establishment of a preference because § 547 avoids transfers “to or for the benefit of a creditor.” The transfer to Bank certainly benefits Insider: every dollar paid by Debtor to Bank reduces Insider’s contingent liability by an equal amount. The other requirements of § 547 being met by assumption, this transfer is a preference to Insider and the payments made to Bank during the extended twelve-month reachback period can be recovered under § 547(b)(4)(B).¹⁹

¹⁵ Section 547(f) presumes insolvency of the debtor for the ninety days prior to the filing of the petition. This discussion assumes the debtor’s insolvency at the time of the transfer, which does occur during the extended twelve month reachback period for insiders provided in § 547(b)(4)(B).

¹⁶ An additional requirement is that the transfer enabled the creditor to receive more than he would have received under a Chapter 7 liquidation of the debtor’s assets. 11 USC § 547(b). Under § 547(c), transfers for contemporaneous new value or in the ordinary course of business are not avoidable.

¹⁷ The Code defines “creditor” broadly to include any entity with a claim against the debtor. 11 USC § 101(9). See also Bankruptcy Law Revision, HR Rep No 95-595, 95th Cong, 1st Sess 310 (1977) (“A guarantor of or surety for a claim against a 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.”).

“Claim” is also defined broadly to include any right to payment, whether “reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” 11 USC § 101(4). The legislative history supports this broad reading. See Bankruptcy Reform Act of 1978, S Rep No 95-989, 95th Cong, 2nd Sess 22 (1978) (definition contemplates that all legal obligations of debtor can be dealt with in bankruptcy proceeding); see also HR Rep No 95-595 at 309.

¹⁸ “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.” 11 USC § 101(50) (emphasis added). See also *Deprizio*, 874 F2d at 1195-96.

¹⁹ See, for example, *Deprizio*, 874 F2d at 1189 n 2 and cases cited therein. See also *Matter of Installation Services, Inc.*, 101 Bankr 282 (Bankr N D Ala 1989) (allowing recovery against both guarantor and creditor).

The presence of an action against Insider is clear in this case, because Insider is a creditor of Debtor. (This factor will be varied in the hypothetical in Section II, making avoidance under the preference provision more difficult.) But while recognizing the action against Insider, many courts on these facts would deny a recovery against Bank, ignoring the fundamentally self-dealing²⁰ nature of Insider's conduct.²¹ Resolution of Bank's liability as the initial transferee of the transfer requires consideration of § 550, the liability provision.

A. The Legislative Background

The Code has separate provisions for identifying an avoidable preference or fraudulent conveyance and for determining who shall be liable for the preference or fraudulent conveyance once found. Thus, if a preference is deemed voidable under § 547, it remains under § 550 to determine from whom the transfer can be recovered.

The legislative history of § 550 reveals that the original proposal for the liability section permitted recovery only from initial transferees (Bank, in the hypothetical case). The Commission on the Bankruptcy Laws (the "Commission") proposed that subsequent transferees of an avoided transfer also be liable for the transfer, but it did not include the "for whose benefit" language of § 550 that, in addition to the analysis set forth in the preceding section, is necessary to capture Insider.²² The early versions of what was to become § 550 mirrored the Commission's draft,²³ and the language permitting recovery from the "entity for whose benefit such transfer was made" appeared only in later drafts. Scholars

²⁰ As used in this Comment, "self-dealing" refers to a transaction that harms the corporation or its creditors because the transaction would not have been agreed to by a rational, well-informed decisionmaker loyal to the corporate and creditor interests. See Robert C. Clark, *Corporate Law* § 4.1 at 147-48 (Little, Brown, 1986).

²¹ A number of recent cases have permitted recovery of the avoided transfer in this hypothetical only from Insider. A few cases have allowed recovery from both Insider and Bank. See cases cited in notes 28, 29, 32, 34, 41, and 42.

²² Report of the Commission on the Bankruptcy Laws of the United States, HR Doc No 93-137, 93rd Cong, 1st Sess 178-79 (Part II) (1973) ("Commission Report"). The Commission was established to study the deficiencies in the prior Act and to propose new legislation. The current Code includes many of the Commission's recommendations. See note 9 for current text of § 550.

²³ See HR Rep No 95-595 at 375-76 (cited in note 17).

disagree about the relevance of this legislative history to the question of whether § 550 allows recovery from Bank.²⁴

Although the history is murky, it may be that Congress included the "for whose benefit" clause in order to give the trustee greater flexibility in recovering the transfer.²⁵ This flexibility does seem desirable to maintaining the integrity of the collective proceeding: in order for the Code to serve its purpose of averting the creditors' race for the debtor's assets, creditors must be confident that trustees actually will be able to recover fraudulent or preferential transfers. In cases like our hypothetical, however, Insider may be insolvent²⁶ or unreachable by the court. In particular, if Debtor is closely held, the assets of Debtor may represent most, if not all, of Insider's assets. Limiting recovery under § 550 in such cases to parties as to whom the transfer does not meet all the requirements for a preference would necessarily cause a loss to Debtor's other creditors. If the trustee can reach parties other than Insider, the likelihood of recovery is increased.

Even if the terms of the statute are unclear, the structure of § 550 suggests a bias towards holding liable initial transferees as to whom a transfer is not preferential (Bank, in this case, because the transfer occurs outside the ninety-day period applicable to outsiders). The Code provides that the trustee may recover "the property

²⁴ The legislative history of § 550 probably does not dispose of the question whether Bank should be liable as initial transferee in the hypothetical case. See, for example, Thomas E. Pitts, Jr., *Insider Guaranties And The Law Of Preferences*, 55 Am Bankr L J 343, 347 (1981).

At least one commentator has used this history to conclude that recovery from Bank and Insider should be allowed only when both Bank and Insider supply the factual predicate for the avoided transfer (i.e., a transfer within ninety days that benefits both parties and under which both parties fulfill all the requirements of the preference section). See Note, *The Interplay Between Sections 547(b) and 550 of the Bankruptcy Code*, 89 Colum L Rev 530, 543-44 (1989). Of all potential results, this one seems the least logical. If the language of § 550 is intended only to apply to parties as to whom a transaction is preferential, then the distinction between initial transferee and ultimate beneficiary in the Code has no relevance, because both Bank and Insider would be beneficiaries of a transfer that is avoided as to each of them. It is difficult to understand why legislative history that added the ultimate beneficiary language only late in the drafting process should be used to resolve this easy case. Rather, House and Senate reports indicate a focus on transfers in general, not just those that occur within ninety days of the filing. Furthermore, where statutory language is clear, the use of legislative history to support a more equivocal result violates standard canons of statutory construction.

²⁵ See Lawrence P. King, ed, 4 *Collier on Bankruptcy* ¶ 550.02 at 550-7, 550-8 (Bender, 15th ed 1989) ("*Collier*").

²⁶ If Insider is insolvent, he may have no incentive to avoid personal liability on the guarantee, but even then Insider is probably not indifferent to the amount of his liability. An increase in the outstanding claims against Insider should increase the difficulty of his personal bankruptcy case.

transferred, or, *if the court so orders*, the value of such property” from the initial transferee or the transfer’s beneficiary.²⁷ Because Bank is the initial transferee and alone possesses the actual property transferred in this hypothetical, recovery of the value of the property from Insider can only be granted to the trustee in the court’s discretion. A few bankruptcy and district courts, as well as the Sixth and Seventh Circuits, have allowed recovery from both Bank and Insider.²⁸ But as the following sections show, most courts have denied recovery from Bank and required the trustee to pursue Insider, an outcome that inverts both the Code’s legislative history and the structure of § 550.

B. The Judicial Approaches

1. Typical reasoning that denies recovery against a bank.

The courts that deny recovery from Bank cite any number of three grounds. First, many courts reason that Debtor’s payments to Bank constitute two transfers, one of dollars to Bank and another of an equivalent reduction of Insider’s contingent liability.²⁹ These courts conclude that only the transfer to Insider is avoidable and that consequently recovery must be solely from Insider, the de facto initial transferee and beneficiary of the transaction.

This “two transfer approach” mistakenly analyzes “transfer” in terms of benefits received rather than payments made. Focusing on benefits received does comport with treatment of such transfers under the old Act,³⁰ but such an approach is misplaced under the new Code; as noted above, the term “transfer” in the Code looks to “payments made.” More to the point, by bifurcating the transaction the two transfer approach misses a crucial aspect of the hypothetical transaction: the transfer to Bank is motivated in part by the benefit that accrues to Insider. The two transfer analysis relies

²⁷ 11 USC § 550(a)(1) (emphasis added).

²⁸ See, for example, *In re C-L Cartage, Co., Inc.*, 1990 WL 35494 (6th Cir 1990); *Deprizio*, 874 F2d 1186; *In re Coastal Petroleum Corp.*, 91 Bankr 35 (Bankr N D Ohio 1988); and *In re W.E. Tucker Oil, Inc.*, 42 Bankr 897 (Bankr W D Ark 1984). The Tenth Circuit appears to concur in this view. See *In re Robinson Bros. Drilling, Inc.*, 97 Bankr 77 (W D Okla 1988), *aff’d* without opinion, 892 F2d 850 (10th Cir 1989).

²⁹ See, for example, *Midwestern Companies*, 96 Bankr at 227-28 (alternative holding); *In re Marketing Resources Int’l. Corp.*, 41 Bankr 575 (Bankr E D Pa 1984); and *In re Mercon Industries, Inc.*, 37 Bankr 549, 551-52 (Bankr E D Pa 1984).

³⁰ See *Deprizio*, 874 F2d at 1196 n 6 (multiple transfers were used to explain recovery from indirect beneficiaries under the 1898 Act, which on the surface did not allow such recoveries). See also Pitts, 55 Am Bankr L J at 350-51 (cited in note 2).

on an intuitive sense of the transaction rather than substantive analysis of the transfer and of Insider's mixed motives.³¹

Rather than the two transfer approach, some courts rest denial of recovery from Bank on statutory grounds; the precise statutory grounds given vary, but all are problematic. For instance, one court has looked at § 550's provision that the "trustee may recover [from] . . . the initial transferee . . . or the entity for whose benefit such transfer was made," and concluded that the use of "or" permits the court to choose between the initial transferee and the third-party beneficiary; the language of § 550 and its legislative history clearly indicate, however, that the trustee, not the court, decides from whom to seek recovery.³² Other courts, purporting to apply fundamental canons of substantive and procedural law, have surmised that recovery from Bank is not consistent with the purposes of the Code and have limited recovery to Insider.³³ Still another court read § 550 literally for one aspect of the case but then admitted eschewing a literal reading of the same provision to deny recovery from the initial transferee.³⁴

A third characterization, rooted in equity, provides the most troubling reason for denying recovery from Bank. Operating on the notion that Bank is the "innocent" beneficiary of Insider's self-dealing, the courts in these cases invoke "equity" to protect Bank at the expense of Debtor's other creditors. As discussed in the following section, this characterization misperceives Bank's likely role

³¹ The term "mixed motives" refers to the situation in which a director, principal, or other insider of a corporation can influence corporate conduct and also produce a personal gain. See Clark, *Corporate Law* § 4.1 at 149 (cited in note 20).

³² For a case reading "or" as granting discretion to the court, see *In re Ducilli Formal Wear, Inc.*, 8 Bankr Ct Dec (CRR) 1180, 1183 (Bankr S D Ohio 1982). For a case in which the court concludes that the trustee must elect to sue either the initial transferee or the beneficiary, but not both parties as jointly liable, see *In re Acadiana Electrical Service, Inc.*, 66 Bankr 164, 166 (Bankr W D La 1986).

The trustee, not the court, is the subject of the clause in which "or" is used with regard to recovery. 11 USC § 550(a) ("the trustee may recover. . . the property transferred, or, if the court so orders, the value of such property . . ."). The legislative commentary on the meaning of "or" in the Code states that the conjunction denotes joint, rather than mutually exclusive, options. 11 USC § 102(5). See HR Rep No 95-595 at 315 (cited in note 17) ("'or' is not exclusive"). *Collier* also supports this reading. 4 *Collier* ¶ 550.02 at 550-7, n 8 (cited in note 25).

³³ See, for example, *Midwestern Companies*, 96 Bankr at 225.

³⁴ See *In re C-L Cartage Co., Inc.*, 70 Bankr 928, 934 (Bankr E D Tenn 1987), rev'd, 1990 WL 35494 (6th Cir 1990) (court "rejects a literal reading of § 550(a)(1) on this point [whether the bank is liable for a transfer to it that is preferential as to Insider] but adopts a literal reading on the issue of whether the bank is liable as an initial transferee despite not being a creditor. Logical consistency does not always make sense in applying statutes meant to cover a broad spectrum of factual situations.").

in the transaction; it also misperceives equity's role in bankruptcy law.

Frequent resort to equity more accurately reflects the role of bankruptcy courts under the old Act than under the modern Code, in which Congress sought to codify bankruptcy law in significant detail.³⁵ Yet courts have used their discretionary powers under § 105 to reach results directly contradictory to the substantive provisions of the Code, despite conventional notions of the limited applicability of equity in a statutory scheme.³⁶ Moreover, equitable approaches to bankruptcy are not only largely supplanted by the Code's statutory network but, where appropriate, constrained by the Code's particular provisions; to the extent it does contemplate resort to equity, the Code envisions that it will be used to protect creditors as a group rather than one creditor at the expense of other creditors in its class.³⁷ As far back as the eighteenth century, preference law recognized this collective focus.³⁸ The use of equity to concentrate on the relative culpability of transferees results in an unpredictable, ad hoc approach to preference law that frustrates the congressional desire for a uniform bankruptcy law. Finally, reference to Bank's supposed innocence directly contravenes § 547, which contains no transferee scienter requirement.³⁹

³⁵ See HR Rep No 95-595 at 174 (cited in note 17); Pitts, 55 Am Bankr L J at 343 (cited in note 24) (noting "maddeningly precise" draftsmanship of Code's preference and liability sections).

³⁶ Section 105 grants courts the powers necessary "to carry out the provisions of this title." 11 USC § 105(a).

A frequently criticized Supreme Court opinion under the prior Act, *Bank of Marin v England*, 385 US 99, 103 (1966), noted that courts do not read "statutory words with the ease of a computer" and appeared to grant courts broad discretion in applying equitable principles. Justice Harlan rejected the majority's use of its equitable powers: "The Court's disposition of this case may be taken to suggest that whenever equity is thought strongly to demand relief from the strictures of the Act, further exceptions may be appropriately created to the statutory scheme." 385 US at 110 (Harlan dissenting).

Marin does not appear to apply to the modern Code. *Norwest Bank Worthington v Ahlers*, 485 US 197, 108 S Ct 963, 968-69 (1988) ("[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised in the confines of the Bankruptcy Code").

³⁷ Indeed, this policy arises from the very nature of the collective proceeding. See, for example, HR Rep No 95-595 at 177-78 (cited in note 17); House Judiciary Committee, Analysis of HR 12889, 74th Cong, 2nd Sess 187 (1936) (discussing equality of distribution as prime motive of Chandler Amendments to 1898 Act). See also *In re Anders*, 20 Bankr 468, 469 (Bankr N D Fla 1982) (preference recovery intended to aid those who did not receive payment within the preference period, not the preferred creditor).

³⁸ See, for example, *Harman*, 1 Cowp at 119 (although the transfer might be fair as between the parties, a trader cannot, in contemplation of bankruptcy, give a preference because "it is a fraud upon the rest of the creditors, and against the general spirit" of the law).

³⁹ The Code removed the "reasonable cause to believe" requirement that, under the

The impetus for courts' use of their equitable powers in such situations seems to stem from an unsupported sentence in a bankruptcy treatise. Discussing Bank's liability in the hypothetical, *Collier* concludes:

[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. . . . [I]f a transfer is made to a creditor who is not an insider more than 90 days but within one year before bankruptcy and the effect is to prefer an insider-guarantor, recovery should be restricted to the guarantor and the creditor should be protected. Otherwise, a creditor who does not demand a guarantor can be better off than one who does.⁴⁰

Although this analysis is offered without reference to either the policies or provisions of the Code, its impact on the case law has been enormous. *Collier* provides the sole authority for many early decisions under the Code addressing the recovery issue in an insider guarantee context.⁴¹ These early opinions have in turn been cited as dispositive authority for subsequent decisions, thus creating a line of cases whose true precedent is one commentator's view of the use of equity in recovering transfers.⁴²

2. The creditor's bargain and the *Deprizio* analysis.

When courts use equity to protect banks from preference attacks on transfers occurring between ninety days and twelve months of the bankruptcy filing, they place great emphasis on the banks' "prudence" in obtaining a guarantee. It would seem unjust,

prior Act, prevented recovery from a creditor who did not know or have cause to believe that the debtor was insolvent. Because the creditor's knowledge of the debtor's financial state "has nothing whatsoever to do with the policy of equality of distribution," Congress eliminated these provisions. HR No 95-595 at 178 (cited in note 17).

⁴⁰ 4 *Collier* ¶ 550.02 at 550-8 (emphasis added) (cited in note 25).

⁴¹ See, for example, *In re Cove Patio Corp.*, 19 Bankr 843 (Bankr S D Fla 1982); and *In re Church Buildings and Interiors, Inc.*, 14 Bankr 128, 131 (Bankr W D Okla 1981). In a striking example of the weight accorded the *Collier* excerpt, the *Cove Patio* opinion rules in one short paragraph against recovery from Bank, citing *Collier* and admitted dicta in *Church Buildings* as its only precedents. 19 Bankr at 844.

⁴² Further cases relying on *Collier* and its progeny include: *In re T.B. Westex Foods, Inc.*, 96 Bankr 77, 79-80 (Bankr W D Tex 1989); *In re V.N. Deprizio Construction Co.*, 58 Bankr 478, 480-81 (Bankr N D Ill 1986), rev'd, 86 Bankr 545 (N D Ill), aff'd 874 F2d 1186 (7th Cir 1989); *In re Aerco Metals, Inc.*, 60 Bankr 77, 81-82 (Bankr N D Tex 1985); and *Matter of R.A. Beck Builder, Inc.*, 34 Bankr 888, 893-94 (Bankr W D Pa 1983).

in their view, to place in jeopardy the funds of a bank that took the precaution of contracting for a guarantee, when, because the transfer occurred outside the ninety-day period applicable to non-insiders, banks *not* bargaining for a guarantee are not subject to recovery. But for reasons discussed below, the Seventh Circuit was correct when it noted in *Levit v Ingersoll Rand Financial Corp.* (“*Deprizio*”) that if equitable concerns are relevant at all to liability under § 550 in cases of an insider guarantee, they dictate holding the Bank liable for the consequences of its contractual bargain.⁴³

To understand the error of equitable protection of Bank, it is important, first, to recognize Bank’s possible motives for securing a guarantee. Bank probably did not obtain Insider’s guarantee for its value as an alternative source of payment. That value seems minimal, particularly in the case of a closely held corporation whose Insider has most of his assets tied to the company; if Debtor is insolvent, Insider likely is too. The more probable explanation for the guarantee is that Bank sought the guarantee precisely for the added control over payments that Bank received in the hypothetical case.⁴⁴ If so, the likelihood of self-dealing increases because Bank’s motive adds a collusive element to Insider’s conduct. In short, Bank’s “prudence” in obtaining the guarantee will often be a thinly cloaked pursuit of a preference, and giving absolute protection to Bank merely encourages self-interested conduct by Insider.⁴⁵

Other, more rudimentary legal principles also counsel against invoking equity to exculpate Bank. It is unclear why, for instance, even if Bank is “innocent,” it would be inequitable to apply legal rules to a voluntary transaction between sophisticated parties.⁴⁶ If Bank is paid before other creditors of its class simply because of

⁴³ See *Deprizio*, 874 F2d at 1198. See also Pitts, 55 Am Bankr L J at 354-56 (cited in note 24).

⁴⁴ See, for example, Isaac Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1) and 546 (a)(1)*, 41 Bus Law 175, 196 (1985) (many, if not most, guarantees are sought for the indirect control of the debtor, not for the economic value, they provide). See also Pitts, 55 Amer Bankr L J at 354 (cited in note 24) (personal guarantee of an insider may be better security for repayment than legal interests in a debtor’s property).

⁴⁵ The potential for abuse by Insider is even more apparent. See, for example, *T.B. Westex*, 96 Bankr at 81 (debtor is forced to pay judgment awarded to Bank against Insider because debtor never appears at hearing; court holds that it would be inequitable to require Bank to return funds to debtor). One suspects that the insider in this case had a significant influence on the debtor’s failure to appear at the hearing.

⁴⁶ See *Deprizio*, 874 F2d at 1198; and *In re Coastal Petroleum Corp.*, 91 Bankr 35, 37 (Bankr N D Ohio 1988).

the contingent liability of Insider, that result conflicts with the intent of preference law.

Moreover, even if Bank is held liable for the preferential transfer, it is still better off than other creditors of its class who did not bargain for Insider's guarantee. After disgorging the transfer, Bank still has a claim against Insider on the guarantee for the balance of the loan remaining after its pro rata share in the collective proceeding. Other creditors will receive only their proportionate share. This secondary claim against Insider reflects the bargain between Bank, Debtor, and Insider. If Insider is financially unable to pay Bank, surely Bank, not Debtor's other creditors, should bear any loss resulting from Insider's inability to perform on the guarantee.⁴⁷

C. The Characterization Problem

These judicial analyses of three party transfers demonstrate the importance to the Code of how courts characterize the nature of the contested financial transaction. To an extent, courts already observe this responsibility. When, as illustrated above, courts identify a preference to Insider in the transfer to Bank, they do not limit themselves to a narrow view of the transfer as a mere cash disbursement to Bank by Debtor; rather, on such facts courts disregard the mere form of the transfer and recognize that it creates a benefit to the third party—the reduction in Insider's contingent liability. This benefit to Insider is not immediately suspect under the Code, since what Insider receives is a decrease in his liability—the right to keep his funds—rather than an absolute increase in his assets.⁴⁸

In its most general form, this characterization inquiry asks who pays for the transfer and who benefits from it.⁴⁹ The language of the Code's preference and liability provisions encourages courts to look beyond the initial transferee and the formal steps of a transaction to determine the allocation of costs and benefits. A court that does not pursue this inquiry fails to protect the creditors who cooperate in the collective bankruptcy proceeding.

⁴⁷ See, for example, *Coastal Petroleum*, 91 Bankr at 37 (implying that only when Insider is not creditworthy will Bank be worse off, and Bank is best positioned to determine Insider's creditworthiness).

⁴⁸ This observation, already accepted by most courts, will be important to the characterization of the hypothetical discussed in Section II.

⁴⁹ For a discussion of this principle as the basis for characterization of transactions in the context of fraudulent conveyance law, see Comment, *Guaranties and Section 548(a)(2) of the Bankruptcy Code*, 52 U Chi L Rev 194, 205-07 (1985).

Although principles of corporate law, such as self-dealing, will help courts recharacterize transfers like the one in this hypothetical, the analysis need not ignore the language of the Code, for recovery from Bank is technically consistent with the relevant provisions. In this hypothetical, the trustee clearly has a cause of action under the preference provision. The trustee will face the problem of recovery only in the second phase, when equity and bifurcation of the transfer's benefits are used to avoid the literal meaning of § 550, the liability provision. But, as Section II will illustrate, the characterization problem remains at its core identifying the cause of action itself.

II. THE LIMITS OF PREFERENCE LAW IN AVOIDING INSIDER TRANSFERS

Although §§ 547 and 550, properly applied, capture the substance of the first hypothetical, a slight variation in the facts indicates that the reading of § 550 developed above does not resolve all the characterization problems that inhere in these three party transactions.⁵⁰ The broad reading of § 550 merely provides an alternative source of recovery for what is already determined an avoidable preference under § 547. A sophisticated insider can escape preference liability altogether by failing to satisfy the requirements of § 547; yet the transaction in substance may be identical to the model case in Section I.

Suppose that in addition to guaranteeing the loan by Bank to Debtor, Insider explicitly waives his rights of reimbursement and equitable subrogation against Debtor.⁵¹ The urgency of avoiding a transfer in this case is arguably greater, because Insider has no claim against Debtor in the event of Debtor's failure to pay Bank;⁵² now, because he remains ultimately liable, Insider has an increased economic incentive to assure payment by Debtor to Bank. Indeed, because of this increased pressure on Insider, Bank will prefer this

⁵⁰ The transaction discussed in this section is alluded to in *Deprizio*, 874 F2d at 1190 n 4, 1192-93, but the court did not resolve the issue.

⁵¹ Such a waiver could be explicit in the loan agreement or might inhere in the label applied to Insider's role in this transaction. For example, if Insider were a co-maker of the note, he might have no right of reimbursement from Debtor. Insider might also waive these rights after the original agreement but before payments to Bank.

⁵² See Douglas G. Baird and Thomas H. Jackson, *Cases, Problems, and Materials on Bankruptcy* 448-49 (Little, Brown, 1990); and David I. Katzen, *Deprizio and Bankruptcy Code Section 550: Extended Preference Exposure Via Insider Guarantees, and Other Perils of Initial Transferee Liability*, 45 Bus Law 511, 531 (1990) (waiver strengthens lender's vicarious control over debtor).

arrangement if, as hypothesized above, it seeks Insider's guarantee to gain increased control of Debtor's funds. At the very least, even if operating with pure motives Bank would be indifferent between the two hypothetical schemes, because Insider's ability to recover from Debtor has no impact on whether Bank is paid. In short, this is a transfer the Code should reach, as surely as it reaches the transfer in the hypothetical in Section I. Whether it does, the following section shows, is unclear.

A. The Hard Edges of Preference Law

Assume that under these slightly modified facts, Insider once again instructs Debtor to pay on the ninety-first day prior to filing. Seeking to recover this transfer, the trustee turns, as under the first hypothetical, to § 547. But this time the trustee most likely has no recourse under the provision, for one of the crucial elements to recovery under the preference provision—Insider's creditor status—is gone. Now that Insider has waived his rights, traditional interpretation holds that he no longer is a creditor of Debtor.⁵³ Thus, the insider in the second hypothetical seems to have defeated the Code by adopting a form whose substance is identical to the invalid transaction in Section I, but which falls outside the parameters of preference law.

If this conclusion is correct, Debtor's other creditors will bear the cost of the benefit to Insider, who has undermined the collective process through a minor variation on an illegitimate transaction. Indeed, if this second hypothetical transfer cannot be avoided, the trustee's ability to reach Insider in the first hypothetical becomes moot, for informed insiders would eschew creditor status to escape the substantive preference provisions. The waiver effectively immunizes Insider, despite the extended reachback period.

Two hard-edged elements of § 547 combine to produce the problematic result discussed in this section. First, the ninety-day limit on the reachback period for non-insiders makes the transfer non-preferential as to Bank. Thus, the trustee's sole hope of identifying an avoidable preference is to pursue the benefit received by Insider. But Insider falls outside the second requirement of the preference provision—that the transfer sought to be avoided involve a creditor of the debtor—since he technically is not a credi-

⁵³ "Creditor" as defined in the Code includes all parties with any claim against the debtor. See note 17.

tor of Debtor. If the transfer does not benefit a creditor, preference law is inapplicable.

Preference law therefore provides an insufficient remedy for self-dealing by Insider on the eve of bankruptcy.⁵⁴ The hard edges of the provision do not always capture transfers that are in essence preferential; they allow an escape for transfers whose substance is identical to the first hypothetical.

The apparent inadequacy of preference law in this regard is troubling. One possible recourse for the trustee is to seek to establish Insider as a de facto creditor of Debtor, arguing as follows: Insider's liability is contingent on Debtor's conduct; because Insider *may* have a disputed (i.e., colorable) claim against Debtor—who, after all, received the benefit of his guarantee—he ought to be regarded as a creditor of Debtor for purposes of the preference provision.⁵⁵ This argument in effect forces a claim on Insider against Debtor, thus meeting the requirements of the preference provision and creating a cause of action. Although the result is satisfying, courts are likely to reject the convoluted characterization it entails. For one seeking a principled analysis of transactions, this approach is no more acceptable than those offered by *Collier* and the ensuing line of cases discussed in Section I. What is needed is a new analytic framework, one that takes in a course of conduct slightly more clever but no less undesirable than the pattern represented by the first hypothetical.

B. An Historical View of the Problem: *Dean v Davis*

The characterization problem in the preceding example is reflected in *Dean v Davis*, a prominent Supreme Court opinion under the prior Act.⁵⁶ Jones, a farmer, used forged notes to borrow money from a bank. When it discovered the fraud and realized Jones's inability to repay the loan, the bank threatened to have Jones arrested unless he immediately repaid the loan in full.

⁵⁴ See Thomas H. Jackson and Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditor's Bargain*, 75 Va L Rev 155, 170 (1989).

⁵⁵ This analysis essentially recognizes a right to indemnity on behalf of Insider against Bank. Courts have considered such an approach in the context of other financial obligations, such as a manager's personal liability for a corporation's payment of employee withholding taxes. See *Reid v United States*, 558 F Supp 686, 688 (N D Miss 1983) ("A right to indemnity arises when one party is exposed to liability by the action of another who, in equity or in law, should make good on the other's loss.").

⁵⁶ 242 US 438 (1917). For a general overview of the importance of *Dean* in modern bankruptcy law, see Thomas H. Jackson, *The Continuing Life of Dean v. Davis*, 1988 Ann Surv Bankr L 63.

Pledging all his assets, which amounted to five times the loan value, Jones borrowed money from his brother-in-law, Dean, and used the loan proceeds to repay the bank. Jones then defaulted on the loan from Dean, who kept the collateral.⁵⁷ Davis, Jones's trustee, sought to recover the collateral.

The Court held that only the bank had received a preference, because no antecedent debt existed between Dean and Jones.⁵⁸ That is, Davis was unable to reach Dean under the 1898 Act on the preference claim because of the same technical aspect of preference law that our hypothetical trustee confronts under the Code: the requirement of an antecedent debt (creditor status) between Jones and Dean. Davis could, of course, have avoided the transaction between Jones and the bank, but this was only a partial remedy because Jones's other creditors still lost the collateral—all of Jones's property—that Jones mortgaged to Dean.

Confronting this dilemma, the same as posed by the second hypothetical above, the Court permitted recovery from Dean on other grounds: it held that Dean had received a fraudulent preference, and ruled in favor of the trustee. The Court's conclusion that an advance by Dean enabling Jones to make a preference "presents an element upon which fraud may be predicated"⁵⁹ represents an important melding of preference and fraudulent conveyance law for the characterization of three party transactions. The *Dean* approach captures both Jones's motive and the transfer's substance.

It should be noted that a less wooden characterization of the transaction in *Dean* would permit resolution of the case under the preference provision of the Code, though not under the earlier Act. The *Dean* Court chose to view each transfer of Jones's property (the collateral to Dean and the cash to the bank) as a separate transaction. Under the approach developed in Section III of this Comment, however, these transactions might be collapsed and then characterized as a transfer of Jones's property to Dean, an insider of debtor Jones, for the benefit of the bank. Under the Code both Dean (as the initial transferee) and the bank (as the ultimate beneficiary) would be liable for a transfer of the debtor's assets constituting a preference to the bank. Thus, the Court's

⁵⁷ In the actual case, the mortgages of Jones's property to Dean were dated to establish a default shortly after Dean loaned Jones the money. This element of fraud makes the trustee's case against Dean for receipt of a fraudulent conveyance more persuasive, but is not important for this analysis. See *Dean v Davis*, 242 US at 442.

⁵⁸ In its often-quoted holding, the Court stated, "The bank, not Dean, was preferred." Id at 443.

⁵⁹ Id at 444.

holding that the bank rather than Dean was preferred would not necessarily prevent the trustee from avoiding the transfer of assets to Dean.⁶⁰

Although the excessive value of the collateral for the loan in *Dean* made the parties' fraudulent intent unmistakable, all transactions involving insiders should likewise be subject to close judicial scrutiny and the general principles of fraudulent conveyance law. Even where the incongruity of value that existed in *Dean* is not present to raise the court's suspicions, judicial attention should be attracted by another aspect present in *Dean* and other cases of its kind: the self-dealing nature of the transfer.

Under pressure from the bank, Jones initiated the transfer to stay out of jail, undoubtedly to his significant personal benefit but of limited benefit to Jones's other creditors, who lost the entire estate in the transfer. From the perspective of the creditors as a group, Jones conveyed all his assets to Dean and received in return only a fraction of their value, which was paid to the bank, an unsecured creditor. Similarly, in the hypothetical case, Debtor's payments on the loan benefit Insider more than they do Debtor, at least to the extent they exceed Bank's pro rata share.⁶¹ Debtor's other creditors capture only some of the benefit of the payments,

⁶⁰ Importantly, the above characterization would be the *only* way of avoiding the transfer of collateral to Dean had Jones mortgaged his property to Dean, and then directed Dean to pay the bank. In that case, Dean's payment to the bank would not have involved any of Jones's property and therefore could not itself be deemed a preference. In addition, a fraudulent conveyance under the Act required proof of intent, not merely failure of equivalent value. Because Dean might have extinguished Jones's antecedent debt in good faith, the trustee might not have succeeded in recovering the property unless the court collapsed these two transfers into a single transaction—the satisfaction of the debt owed by Jones to the bank.

The issue also arises in a similar three party transaction, the letter of credit. In effect, these transfers convert an unsecured claim of a supplier into a secured claim of the bank, just as Dean received a secured debt in place of the bank's unsecured claim. Under the prevailing judicial view, if an antecedent debt is paid off by use of a letter of credit, the issuing bank will not be held liable if the transfer is avoided. See, for example, *In re Air Conditioning Inc. of Stuart*, 845 F2d 293 (11th Cir 1988); and *Matter of Compton Corp.*, 831 F2d 586 (5th Cir 1987). See also Katzen, 45 Bus Law at 526-27, 535-36 (cited in note 52).

This result seems to directly contradict the substance-over-form analysis and also to ignore the allocation of risks in a letter of credit. Despite the *Compton* court's assertion that the transfer of the security interest to the bank is for the "sole benefit" of the bank, 831 F2d at 589, the very purpose of a letter of credit issued on an antecedent debt is to protect (benefit) a previously unsecured creditor. This suggests that the bank assumes not only the risk of the debtor's insolvency, 831 F2d at 590, but also the risk of any preference attack related to payment of the antecedent debt.

⁶¹ Given the time value of money, the actual size of the benefit to Debtor should be less than the amount of Bank's pro rata share.

yet only Debtor's funds are used to pay off the loan. Indeed, Debtor overpays just as Jones did. Were Bank required to seek satisfaction in the bankruptcy proceeding, it would, by hypothesis, receive less than one hundred cents on each dollar owed and would also lose the use of the funds for the intervening months or years before the Chapter 7 liquidation.⁶²

The overpayments in *Dean* and the hypothetical appear designed to benefit Jones (who stays out of jail) and Insider (who escapes personal liability), but not to give any real benefit to the debtor or the other creditors. Absent these benefits, it seems unlikely that a debtor would engage in either transfer.

III. THE APPLICATION OF FRAUDULENT CONVEYANCE LAW

The application of fraudulent conveyance law to three party transfers has more to recommend it than its functional value. The sense that such transfers ought to be avoided under preference law stems from the intuition that Insider's chief goal is to escape personal liability on his guarantee. In a non-bankruptcy setting, suspicion of such a motive would prompt a court to explore both the substantive and procedural aspects of the transaction to determine whether it resulted in an arms-length bargain.⁶³ Moreover, the Uniform Fraudulent Transfer Act ("UFTA"), the non-bankruptcy regime's analogue to the Code's fraudulent conveyance provision, emphasizes the insider's conduct and inquires into his intent in analyzing a suspect transfer.⁶⁴ By looking to fraudulent conveyance law when similar circumstances arise in the bankruptcy setting, courts would be promoting the orderly, consistent transition from the individualized creditor remedies of the non-bankruptcy regime to the collective rights of the bankruptcy case that the Bankruptcy Code itself is meant to provide.⁶⁵

⁶² Particularly if Debtor seeks to reorganize its business operations, the lost liquidity resulting from the early repayment to Bank is itself a significant cost to a cash-strapped organization with fragile lines of credit.

⁶³ For examples of corporate law statutes that regulate transfers involving conflicts of interest, see Del Gen Corp Law § 144 (8 Del Code Ann, 1983) (interested director transactions); Rev Model Bus Corp Act § 8.31 (1984) ("RMBCA"); ALI, Principles of Corporate Governance, Tent Draft No 5 § 5.02 (1986).

⁶⁴ Uniform Fraudulent Transfer Act § 5(b) (1984).

⁶⁵ On the fiduciary duties of directors and officers in a non-bankruptcy setting, see, for example, RMBCA § 8.42 (cited in note 63). One commentator has noted that fraudulent conveyance law implicates "a coherent set of conceptually distinct moral principles that should govern the conduct of debtors toward their creditors . . . Truth, Respect, and Evenhandedness." Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 Harv L Rev 505, 561 (1977). These duties seem quite similar to the ordinary fiduciary duties

The fraudulent conveyance provision, § 548, permits the trustee to avoid any transfer or obligation incurred within one year of the filing of the petition if (1) the transfer or obligation was incurred with "actual intent to hinder, delay, or defraud any entity" who is a creditor of the debtor, or (2) the debtor did not receive "reasonably equivalent value" for the transfer or obligation and was insolvent at the time, or as a result, of the transfer.⁶⁶ Under § 548(d), securing an antecedent debt can constitute reasonably equivalent value.

The evidentiary showing required by the provision's intent requirement is, as under the UFTA, a low one, more akin to the foreseeable consequences principle of the tort law than the criminal law's concept of *mens rea*,⁶⁷ it is a threshold that transfers affecting insiders may well meet. The references to fraud in *Harman* and *Dean* suggest that both Fordyce's and Jones's transfers would satisfy this requirement, and so should the conduct of Insider in the hypothetical. As a practical matter, a payment benefiting Insider made on the ninety-first day prior to filing should shift the burden of proof to Insider, who would then have to show that his conduct was not intended to hinder, delay, or defraud any of the other creditors.

The inquiry into Insider's conduct arises from the suspicion of self-dealing. A transfer whose substance betrays an intent to benefit a third party rather than Debtor may also be fraudulent because it fails the "reasonably equivalent value" test of § 548(a)(2).⁶⁸ Although payment of an antecedent debt constitutes value under § 548, an insolvent debtor's payments outside the ordinary course of business that extinguish the debtor's loan may fall short of reasonably equivalent value because the loan's present market value is likely to be discounted from its face value. Therefore, some of the value of the transfer redounds to Insider, not Debtor.⁶⁹ An inquiry into the allocation of benefits may thus reveal that the transfer violated the reasonably equivalent value test of § 548.

of loyalty and care imposed either by corporate statutes or common law upon directors and officers of a non-bankrupt entity.

⁶⁶ 11 USC § 548(a).

⁶⁷ This low standard of intent dates to much earlier case law treating fraudulent conveyance. See, for example, *Arnold v Maynard*, 1 F Cases 1181, 1183-84 (Cir Ct D Mass 1842).

⁶⁸ For a discussion of the potential limits of § 548(a)(2), see Baird and Jackson, 38 Vand L Rev 829 (cited in note 10).

⁶⁹ See *In re Vадnais Lumber Supply, Inc.*, 100 Bankr 127, 136 (Bankr D Mass 1989).

A. The Interplay Between Fraudulent Conveyance and Preference Law in the Characterization of an Insider Benefit

In seeking to establish the nexus, crucial to fraudulent conveyance law, between Insider's benefit and a detriment to Debtor and the remaining creditors, one might characterize this second hypothetical transaction in terms of its effect on the collective asset pool. Under this approach, one would contend that the asset pool should be regarded as consisting not only of Debtor's assets, but also of residual claims to be paid by guarantors.⁷⁰ The argument would run as follows: Insider's conduct allows Bank to recover fully from Debtor's assets instead of pursuing Insider for the outstanding balance less Bank's pro rata share. If instead Bank were to participate in the collective liquidation, it would receive only its pro rata share, and the remaining creditors would receive a larger aggregate distribution. But the recovery process for Bank would not end there—it still would have a claim against Insider as guarantor on the loan. If Insider is solvent and reachable by the court, he will be ordered to pay Bank the remaining amount, thus increasing the total funds disbursed to Debtor's creditors.⁷¹ In this sense, then, Insider's transfer of Debtor's funds to Bank depletes the total available funds, and through this characterization a fraudulent conveyance emerges: creditors as a group lose assets because of Debtor's payment to Bank.

The difficulty with this reasoning is its incorporation of Insider's assets into the pool of funds available in the bankruptcy case. The notion that the total available assets in the collective proceeding includes residual claims against guarantors of Debtor's liabilities may be problematic if, for example, Insider is insolvent or beyond the court's jurisdiction. Bank, from whom recovery might be sought, could argue that the asset pool had not been de-

(avoiding transfers in connection with a leveraged buyout, court states that reasonably equivalent value requirement under § 548 means that debtor, not some third party, must receive the required value).

⁷⁰ See Baird and Jackson, *Cases on Bankruptcy* at 449 (cited in note 52).

⁷¹ A numerical example illustrates the different effects of the two recovery scenarios on the creditors' asset pool. Suppose Debtor has \$200 in assets and \$400 in liabilities, including a \$100 obligation to Bank guaranteed by Insider. In the hypothetical, Bank receives \$100 and Insider evades liability because he is not a creditor of Debtor. Thus, the remaining creditors receive \$100, and the total size of the asset pool is \$200. But if Bank received only its pro rata share, \$50, then Bank would have received another \$50 from Insider, increasing the collective pool to \$250. Creditors of Debtor as a group are better off and Insider is worse off, a result consistent with the contractual obligations.

pleted, since Insider's funds were never part of the asset pool anyway.

The somewhat frustrating effort to reach Insider in the second hypothetical transaction illustrates the important interplay between the Code's preference and fraudulent conveyance provisions. The preference section has sharp, fixed requirements, such as payment of an antecedent debt and precise reachback periods. Fraudulent conveyance law, on the other hand, relies principally on either of two broad concepts: failure to receive reasonably equivalent value, or intent to hinder, delay, or defraud. All fraudulent conveyances, regardless of whether insiders are involved, are voidable if made within twelve months of the filing. Moreover, fraudulent conveyance law's intent requirement is not difficult to meet in the hypothetical case, because at least some courts presume intent from a foreseeable insider benefit. As the Seventh Circuit has noted, if the "primary and important benefits" accrued to the insider, a third party, the transfer fails the reasonably equivalent value test⁷² as well as the intent standard.

B. The Modern Relevance of the Fraudulent Preference

Lord Mansfield noted in *Harman* that Fordyce's preference of Fishar was "an act of fraud, contrary to the spirit of the bankrupt[cy] laws, and to the injury of his creditors."⁷³ Considering the policies supporting the preference and fraudulent conveyance provisions of the Code, the concept of a fraudulent preference⁷⁴ accurately captures the hybrid character of the financial arrangement between Bank, Debtor, and Insider in the model case. The trustee's ability to undo the debtor's preferences deters the debtor from paying a creditor more than his creditor's status entitles him in the collective proceeding. Section 547 also prevents any creditor from grabbing the debtor's assets or pressuring the debtor to pay off his debt. The transaction in the second hypothetical involves just these sorts of harms: Bank receives more than it would from Debtor in the collective proceeding, and indeed, if the transfer had

⁷² *Bullard v Aluminum Co. of America*, 468 F2d 11, 14 (7th Cir 1972). See *Palmer v Radio Corporation of America*, 453 F2d 1133, 1136 (5th Cir 1971). See also *In re Vadnais Lumber Supply, Inc.*, 100 Bankr 127.

⁷³ 1 Cowp at 123.

⁷⁴ Transfers that benefit insiders have often been regarded as occupying a middle ground between preferences and fraudulent conveyances, and are sometimes called fraudulent preferences. The overlap between fraudulent conveyance law and preference law is discussed in a number of judicial opinions under the prior Act. See, for example, *Van Iderstine v National Discount Co.*, 227 US 575, 582 (1913).

occurred one day later all the provisions of § 547 would be met and the transfer would be an avoidable preference as to Bank. Similarly, Insider receives the same type of benefit as in the first hypothetical; if he were a creditor of Debtor, transfers up to twelve months prior to the filing would also have been voidable. Both Insider and Fordyce “preferred” one creditor, and their actions violate the aim of preference law because they promote the asset grab by creditors.

The relationship between the rationale for avoiding these transfers and fraudulent conveyance law is more precarious. Fraudulent conveyance law aims to prevent decreases in the pool of funds available to creditors. In the model case, the fraud at issue concerns the benefit that Insider receives without contributing to the payment to Bank. In a sense, because the payments were to a creditor of Debtor, the transfer to Bank did not deplete the pool of available assets: rather, some of the assets were simply used to pay one creditor instead of another. Because the fraudulent conveyance provision allows satisfaction of an antecedent debt to constitute reasonably equivalent value for a transfer, this transfer may not violate the literal meaning of fraudulent conveyance law. Yet Insider’s potential self-dealing probably amounts to fraudulent intent under § 548, an alternative to the “reasonably equivalent value” test.⁷⁵ In addition, if one characterizes the payment as an indirect transfer to Insider, who is by assumption not a creditor of Debtor, the transfer also fails the reasonably equivalent value test. As discussed below, such a transfer represents a dividend to Insider, a fraudulent conveyance under the Code. Regardless of whether Bank will be held liable under § 550, the trustee has a claim against Insider.

Some might object that reinvigorating traditional fraudulent preference law will defeat the benefits noted earlier of a carefully detailed Code with clear legal rules.⁷⁶ Yet where fraudulent conduct is at issue, this objection seems weak. The fraudulent conveyance provision of the Code requires courts to consider the insider’s intent in a transfer. Courts already engage in a similar review when

⁷⁵ Both the UFTA and the *Bullard* approach, 468 F2d at 14, discussed in text at notes 80-83, recognize fraudulent intent in a transfer whose significant benefits accrue to an insider.

⁷⁶ See *Matter of Xonics Imaging, Inc.*, 837 F2d 763 (7th Cir 1988) (protections for creditors benefit creditors and debtors as a group).

considering claims for equitable subordination under the Code, which requires an inquiry into the debtor's conduct.⁷⁷

Section I developed an approach that permitted a coherent characterization of three party transfers for purposes of the liability provision, § 550. But broadening liability without recognizing the insider's possible conflict of interest merely alters the form of conduct engaged in by the parties, not its substance;⁷⁸ the analysis developed in Section I pushes the characterization problem toward its proper conclusion, but by itself is not a quick fix for the avoidance of preferential or fraudulent transfers involving an insider. Unless courts recharacterize transactions in light of Insider's potential self-dealing, the benefit of a broad recovery provision will be lost, for courts will fail to reach alternative forms of substantively similar arrangements. Courts must incorporate the notion of a fraudulent preference when characterizing these transactions, or differing forms of a transfer will continue to produce inconsistent judicial outcomes, and many arrangements will continue to escape through the cracks in the Code.

C. The Corporate Law Analogies: A Reevaluation of *Dean* and the Insider's Guarantee

The conduct at issue in *Dean* continues to pose analytical difficulties under the Code. The *Dean* Court viewed Jones's financial dealings as two separate transactions: borrowing money from Dean and paying off the bank. Principles of corporate law, however—including self-dealing, improper distributions, and heightened scrutiny of insiders' dealings with the firm—can help courts identify fraudulent or preferential motives in a transaction such as this, and to collapse the transfer into a single analysis of payor and beneficiary. In the hypothetical case, Debtor transfers a sum of money but only receives some of the benefits of the transfer. Insider, on the other hand, pays nothing and benefits to an arguably

⁷⁷ 11 USC § 510(c)(1) (authorizing equitable subordination by bankruptcy court). See, for example, *Matter of Clark Pipe & Supply Co., Inc.*, 893 F2d 693, 699 (5th Cir 1990) (requirement of inequitable conduct satisfied by fraud, illegality, breach of fiduciary duties, undercapitalization, or claimant's use of debtor as alter ego); and *In re Bellanca Aircraft Corp.*, 850 F2d 1275, 1282 n 13 (8th Cir 1988) (where subordination of insider's claims is sought, trustee need only prove that insider breached a fiduciary duty or engaged in "unfair" conduct). See also Clark, *Corporate Law* § 2.3 at 53-54 (cited in note 20).

⁷⁸ The second hypothetical illustrates such a case. The problematic characterization of letters of credit (see note 60) similarly encourages banks to insist on use of this instrument, which protects the issuing bank, rather than use of alternative forms for the same substantive transaction.

greater extent than Debtor, because without the transfer Debtor could default on the loan, file for bankruptcy, and force Insider to pay Bank for any remaining balance on the note. In these and other instances, courts must be prepared to employ principles of corporate law to collapse the phases of the transfer and focus on the benefits to the parties involved.⁷⁹

At least one appellate court has followed this treatment of transactions among a debtor, a creditor, and an insider.⁸⁰ The Seventh Circuit in *Bullard v Aluminum Company of America* analyzed a factual scenario⁸¹ similar to the hypothetical by collapsing the transfers among the three parties to determine who received benefits from the transaction and who paid for them. Not surprisingly, the court found that payments by the debtor on amounts guaranteed by debtor's insider benefited the insider as well as the debtor. The holding relies largely upon the suspect nature of the transaction, which gave a gain to the insider, whose liability on the debt had been reduced to a judgment against him, and whose benefit was financed by the debtor.⁸² The court did not consider whether the transfer was preferential,⁸³ but did find the payments

⁷⁹ It may be, as one commentator has argued, that the drafters of the Code failed to consider three party arrangements, Comment, 52 U Chi L Rev at 204 (cited in note 49), and no principled response to them exists under the present regime. But this sort of oversight by the drafters seems unlikely, as three party transfers and the problems they pose were hardly novel when the Code was drafted in 1978. The language of § 550, moreover, which speaks of initial transferees and ultimate beneficiaries, and of § 547, which identifies transfers "to or for the benefit of another," suggests that the Code seeks to capture the substance of complex financial arrangements.

⁸⁰ *Bullard*, 468 F2d 11. *Bullard* was decided under the prior Act, but for purposes of this analysis the differences between the Act and the Code are not material. The *Bullard* opinion does not use the language of self-dealing.

⁸¹ The actual agreement in *Bullard* involved a number of closely held organizations, a trade creditor, and an insider of these organizations; for purposes of the discussion, a simplified form is presented. 468 F2d at 12-13.

Although the court does not discuss the issue, the insider in *Bullard* may have had a right of reimbursement from the insolvent debtor. It is precisely the irrelevance of the right's existence (and hence creditor status) that makes the case informative for this discussion.

⁸² 468 F2d at 14 ("We find most significant the relationship of the parties to the settlement agreement and the respective allocation of its benefits."). Similar concerns have caused courts to collapse transactions when analyzing leveraged buyouts in a bankruptcy proceeding. See, for example, *United States v Gleneagles Investment Co. Inc.*, 565 F Supp 556, 573-77 (M D Pa 1983), *aff'd sub nom US v Tabor Realty Corp.*, modified, 803 F2d 1288 (3d Cir 1986).

⁸³ 468 F2d at 14. One suspects that the trustee did not seek recovery on preference grounds because the transfer occurred eleven months prior to the filing of the petition. *Id* at 12-13. The preference provisions of the prior Act did not provide an extended reachback period for transfers involving insiders.

to the trade creditor to be a fraudulent conveyance as to the insider.

Where an insider receives a benefit from a transfer to a non-insider during the extended reachback period of § 547(b)(4)(B), the court should inquire into the possibility of self-dealing. If, for instance, the transfer to Bank provides other benefits to Debtor besides extinguishing the debt, then self-dealing seems less likely. Thus, if Bank were an important trade creditor whose goods were essential to Debtor's operations, the transfer might not constitute self-dealing. Similarly, some who qualify as insiders under the Code may receive a benefit but not exert any control over Debtor's decision to make the transfer. Here, too, inquiry into the parties' conduct reduces or eliminates the fear of self-dealing and suggests that recovery would be unnecessary.⁸⁴

The benefit to Insider in the model case can be characterized as a dividend that violates both the Code's fraudulent conveyance law and corporate law regarding shareholder dividends. So characterized, the fraudulent nature of the underlying transfer becomes more apparent.⁸⁵ Even without a bankruptcy filing, disbursements to shareholders of insolvent corporations violate corporate law.⁸⁶ The Code prioritizes claims to effectively bar any dividend payments by Debtor. Thus, quite apart from whether recovery is allowed against Bank in such a case, the trustee should be able to reach Insider.

But if the fraudulent conduct of this transfer is apparent, it is the peculiar nature of the dividend which makes characterization difficult. Insider receives no property from Debtor, who transfers property to Bank. The benefit to Insider consists of his release from a contingent obligation, essentially the right to keep his funds. This benefit precisely mirrors that identified as a preference

⁸⁴ Lord Mansfield himself noted the need for such an inquiry: "[I]f a preference were only consequential, the case might be different: as if a payment were made . . . in pursuance of a prior agreement." *Harman*, 1 Cowp at 125.

⁸⁵ At least one court has identified the payment of a dividend to benefit an insider entity as a fraudulent conveyance. *Wells Fargo Bank v Desert View Building Supplies, Inc.*, 475 F Supp 693, 695-97 (D Nev 1978), aff'd without opinion, 633 F2d 225 (9th Cir 1980) (analyzing a complicated series of transactions involving Desert View (the bankrupt), its parent company, and Wells Fargo Bank, the court characterized the transfer as a dividend from Desert View to the parent company through the bank).

⁸⁶ Distributions are generally limited either by a capital test, which prohibits disbursements to shareholders that diminish capital to an amount less than current liabilities, or by a source-of-funds test, which prohibits disbursements unless they are paid out of net profits. See, for example, Del Gen Corp Law § 170(a) (8 Del Ann Code, 1983). The RMBCA also bars distributions if, as a result of the dividend, the corporation is unable to pay its debts in the usual course of business. RMBCA § 6.40(c)(1).

in Section I.⁸⁷ Indeed, the analysis in Section I recognizes that Insider's benefit need not result from the direct transfer of Debtor's property to Insider. Furthermore, the preference and recovery sections both reflect an intent to capture indirect benefits in their "for whose benefit" clauses. In the second model case, then, a requirement that the benefit to Insider relate tangibly to Debtor's property seems excessively formalistic.⁸⁸ The proposed characterization treats the transfer of Debtor's property as producing two benefits, just as the *Deprizio* analysis of Section I did in finding Bank liable.

The Code itself mandates heightened scrutiny of conduct by an insider. The inquiry must focus on the insider's possible mixed motives and the allocation of benefits flowing from the transaction. In this analysis, analogies to corporate law can help courts characterize the transfer. Just as conflict of interest transactions do not always prompt courts to void transactions in the non-bankruptcy setting, all transactions involving benefits to insiders during the relevant period preceding the filing will not mandate avoidance. The duties of impartiality and evenhandedness that a debtor in bankruptcy owes to creditors parallel the corporate law fiduciary duties of directors and officers of a financially healthy corporation.⁸⁹ A claim seeking to pierce the corporate veil or to nullify a self-dealing transaction requires inquiry into the insider's course of conduct and the challenged transaction's allocation of costs and benefits. Similarly, transfers involving insiders during the pre-filing period should lead the court to examine both the procedural (course of conduct) and the substantive (who paid and who benefited) aspects of the transaction.

IV. CONCLUSION

In *Harman v Fishar*, Fordyce's letter identified his "mere and sole motive" for paying Fishar as a desire to prefer one creditor over others.⁹⁰ Nearly 150 years later, in *Dean v Davis*, a self-dealing motive by an insider was similarly apparent. Such conduct still

⁸⁷ See text at note 48.

⁸⁸ The proposed characterization of the benefit reflects the nature of any business transaction involving more than two parties. A guarantee by one party of a transaction between two others contains in its very structure a web of interdependent relationships. Such tripartite arrangements are intended to create interlocking obligations and benefits among the parties.

⁸⁹ In the non-bankruptcy setting, conduct must be in the best interest of the corporation and its shareholders. The analogous "best interest" duty in the bankruptcy setting is owed to the corporation and its creditors.

⁹⁰ 1 Cowp at 124.

occurs under the Code. Courts must scrutinize transfers that benefit an insider to determine whether self-dealing is evident, an inquiry entailing not only bankruptcy rules for preferences and fraudulent conveyances but also corporate law principles and the historical concept of fraudulent preference.

This discussion has demonstrated the elusive nature of characterization under the Code in certain three party transactions producing a benefit to an insider of the debtor. While one recent case, *Deprizio*, begins to implement a principled approach to the Code's liability provision in the context of a transaction involving an insider guarantor, the characterization problem exceeded the scope of the issue under review in that case. There, the concern about reaching beyond the form of the transfer to uncover its motive and substance only arose in resolving the liability issue. But at its core, a court's characterization of a transfer determines whether a cause of action even exists.

To protect the collective nature of the bankruptcy case, to prevent the creditors' race for a debtor's assets, and to preserve the Code's stated goals of equality of distribution and maximization of the pool of funds available to creditors as a group, courts must analyze transactions with less concern for supposed equity issues and greater attention to the true substance of the transaction—who pays and who benefits. Such an approach collapses transactions in which the three parties are clearly interrelated into a single transaction involving assets of the debtor.

The prevention of insiders' self-dealing is crucial to the integrity of the bankruptcy process. If indirect arrangements, like the insider guarantee with a waiver of claims, lead courts to bifurcate a series of transactions whose substance in fact reflects a single beneficiary and initial transferee, creditors and insiders will merely seek these arrangements instead of accepting the risks associated with the collective proceeding. This outcome promotes rather than deters insider self-dealing, the race for the debtor's assets, and the consequent premature demise of insolvent organizations.

The accrual of benefits to an insider of a debtor from a transfer should signal a heightened substantive and procedural analysis of such transactions, regardless of whether the insider is also a creditor of the debtor. But the inquiry must not focus singularly on traditional preference law. By itself, preference law cannot capture all transfers with benefits to Insiders which indicate a breach of the principles of the collective bankruptcy case. Fraudulent conveyance law, whose expansive provisions should be informed by established principles of corporate law for remedying self-dealing,

will help courts identify and deal with inherently fraudulent or preferential conduct under the Code. Such an inquiry, when combined with fraudulent preference law's traditional focus on the conduct and intent of the insider, can promote the integrity of the collective bankruptcy proceeding by protecting the interests of the debtor's other creditors.