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# Bankruptcy - The Creditor's Dilemma of Insider Guarantees - Levit v. Ingersoll Rand Financial Corp.

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**BANKRUPTCY—The Creditor's Dilemma of Insider Guarantees. *Levit v. Ingersoll Rand Financial Corp.*, 874 F.2d 1186 (7th Cir. 1989).**

V. N. Deprizio Construction Co., an Illinois corporation, operated a construction business in the Chicago area.[1] Over the course of several years prior to its bankruptcy, the company borrowed money from various lenders including Ingersoll Rand Financial Corporation, CIT Corporation, and All Motive Equipment Company.[2] The debt to these three creditors had been personally guaranteed by Richard, Robert, and Edward Deprizio, all insiders of the firm.[3] On April 13, 1983, the construction company filed a petition for reorganization under Chapter 11 of the Bankruptcy Code (Code).[4] The case was later converted to a liquidation proceeding under Chapter 7 of the Code.[5]

On August 22, 1985, Louis W. Levit, the bankruptcy trustee, filed a motion for declaratory judgment in the bankruptcy court for the Northern District of Illinois seeking to avoid certain transfers.[6] In this motion the trustee alleged that payments to Ingersoll Rand Financial Corporation, CIT Corporation, and All Motive Equipment Company made more than ninety days, but less than one year prior to the filing of the bankruptcy, were voidable transfers under section 547(b) of the Code.[7] He argued that even though the payments were received by the

1. Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1187 (7th Cir. 1989).
2. *Id.*
3. *Id.* A "creditor" is defined as the "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(9)(A) (1988).

A "guaranty" is defined as the promise to answer for the payment of debt, in the case where the person who is primarily liable for the debt fails to make such payment. 4 T. Eisenberg, Debtor-Creditor Law ¶ 17.03, at 17-5 (1986 & Cum. Supp. 1987).

An "insider" of a debtor corporation is defined as any of the following:
(i) director of the debtor;
(ii) officer of the debtor;
(iii) person in control of the debtor;
(iv) partnership in which the debtor is a general partner;
(v) general partner of the debtor; or
(vi) relative of a general partner, director, officer, or person in control of the debtor; 11 U.S.C. § 101(28)(B) (1988).

The debt owed to CIT Corporation was allegedly not guaranteed by an insider. The court indicated that the record was void of detail concerning these guarantees, and held that the matter should be resolved in the bankruptcy court. *Levit*, 874 F.2d at 1191.

4. Levit v. Ingersoll Rand Financial Corp. (*In re* V.N. Deprizio Const. Co.), 86 Bankr. 545, 556 (N.D. Ill. 1988), *aff'd in part, rev'd in part*, 874 F.2d 1186 (7th Cir. 1989) (citing 11 U.S.C. §§ 1101-1174 (1988)).
5. *In re* V.N. Deprizio Const. Co., 86 Bankr. at 556.
6. Complaint To Avoid Transfers, Levit v. Melrose Park National Bank (*In re* V.N. Deprizio Const. Co.), 58 Bankr. 478, 479 (Bankr. N.D. Ill. 1986) (No. 83-B-04804).

A "transfer" is defined as "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 U.S.C. § 101(48) (1988).

7. Levit v. Melrose Park National Bank (*In re* V.N. Deprizio Const. Co.), 58 Bankr. 478, 479 (Bankr. N.D. Ill. 1986), *rev'd*, 86 Bankr. 545 (N.D. Ill. 1988), *aff'd in*

creditors they also benefited the insider guarantors.[8] The trustee further alleged that these transfers were recoverable from the three creditors pursuant to section 550(a) of the Code.[9]

The bankruptcy court denied the trustee's motion for declaratory judgment.[10] The court stated that a payment made on the debt created two separate transfers: one being received by the insider and the other by the outside creditor.[11] The court denied the trustee recovery of the payments made more than ninety days prior to the bankruptcy from the three creditors, because the transfers received did not meet the avoiding requirement of section 547(b) as to the creditors.[12] It

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*part, rev'd in part*, 874 F.2d. 1186 (7th Cir. 1989).

Total payments consisted of:
Ingersoll Rand Financial Corp: $98,292;
CIT Corporation: $38,259;
All Motive Equipment Company: $ 6,062.

Complaint to Avoid Transfers, Levit v. Melrose Park National Bank (*In re* V.N. Deprizio Const. Co.), 58 Bankr. 478 (Bankr. N.D. Ill. 1986) (No. 83-B-04804).

The trustee sought avoidance of these transfers under 11 U.S.C. § 547(b) which states:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property-
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made-
> (A) on or within 90 days before the date of the filing of the petition; or
> (B) between ninety days and one year before the date of 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).

This is section 547(b) as amended in 1984 and 1986. The version in force in 1983, when this case began, applied the expanded avoidance period in section 547(b)(4)(B)(ii) to insiders only if the insider "had reasonable cause to believe the debtor was insolvent at the time of the transfer." The court in *Levit* found this qualification unimportant to the case. *Levit*, 874 F.2d at 1189.

8. *In re* V.N. Deprizio Const. Co., 58 Bankr. at 479.

9. *Id.* Section 550(a) states:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section . . . 547, the trustee may recover, for the benefit of the estate, the property transferred, or if the court so orders, the value of such property, from-
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a) (1988).

10. *In re* V.N. Deprizio Const. Co., 58 Bankr. at 481.

11. *Id.* at 480.

12. *Id.*

held that the result sought by the trustee would be inequitable.[13]

On appeal, the United States District Court for the Northern District of Illinois reversed the bankruptcy court's decision.[14] The district court based its decision on a literal reading of the Code and held that the transfers were voidable.[15] It further held that, based on a direct application of section 550(a), the trustee could recover from the three creditors not only the payments received within ninety days, but also those received between ninety days and one year prior to the filing for bankruptcy.[16] The court stated that, when Congress drafts an unambiguous and comprehensive statutory scheme, courts should be extremely hesitant in tampering with it by using "vague equitable powers."[17] This decision was appealed to the United States Seventh Circuit Court of Appeals.[18]

The Seventh Circuit Court of Appeals, the first circuit court to rule on this issue, affirmed the district court's literal application of the Code.[19] It held that the trustee acting under section 547(b) could avoid transfers made within one year prior to the filing of the bankruptcy petition to outside creditors when the payment produced a benefit for an insider, including a guarantor.[20] The court further held that the trustee could recover these payments not only from the insider, but also from the outside creditor.[21]

This casenote will address the issue faced by the Seventh Circuit Court of Appeals in *Levit v. Ingersoll Rand Financial Corp.*. The issue is whether transfers made more than ninety days, but less than one year, prior to the filing for bankruptcy to outside creditors on debt guaranteed by an insider can be avoided and from whom such transfers can be recovered.

## BACKGROUND

The adoption of the Bankruptcy Reform Act of 1978[22] and the subsequent repeal of the 1898 Bankruptcy Act[23] materially changed bankruptcy law.[24] The preference laws were also modified.[25] Changes

13. *Id.* at 481.
14. *In re* V.N. Deprizio Const. Co., 86 Bankr. at 556.
15. *Id.* at 550.
16. *Id.* at 553.
17. *Id.* at 552.
18. *Levit,* 874 F.2d at 1188.
19. *Id.* at 1201.
20. *Id.*
21. *Id.*
22. The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amend. at 11 U.S.C. §§ 100-1331 (1988)).
23. The Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898) (repealed 1978).
24. Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1),* 41 BUS. LAW., Nov. 1985, at 175.
25. "A preference is a transfer that enables a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the

included the expansion of the preference period and the distinction between insider and outside creditors.[26] The trustee's power to avoid transfers is no longer limited to four months for all creditors. The Code allows for the avoidance of payments to outside creditors made within ninety days prior to the filing for bankruptcy.[27] It also provides that payments to insiders made one year prior to bankruptcy can be avoided.[28]

One of the most powerful arrows in the trustee's quiver is the ability to avoid preferential transfers. The avoiding power is expressly given to stop creditors from collecting from the financially distressed debtor on the eve of bankruptcy.[29] Avoiding preferential transfers promotes the equality of distribution among creditors and encourages reorganization.[30]

The Code divides the avoidance and recovery of a transfer into two distinct legal actions. This bifurcation determines if avoidance of a transfer is appropriate, and, if so, from whom recovery is allowed. Section 547(b) specifies that the trustee must first establish five requirements to avoid a transfer.[31] Once a trustee succeeds in avoiding a transfer under section 547(b), he/she must then turn to section 550 to determine from whom recovery is possible. Under section 550(a)(1), the trustee can recover from the initial transferee or the entity for whose benefit the transfer was made.[32]

The following hypothetical will illustrate the difficulties the judiciary has faced in addressing this issue.[33] Two years prior to filing for bankruptcy a debtor corporation obtains an unsecured term loan from a creditor requiring monthly payments.[34] An insider of the debtor per-

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transfer had not been made and he had participated in the distribution of the assets of the bankrupt estate." H.R. Rep. No. 595, 95th Cong., 2nd Sess. 1, 4 (1978) *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6138.

26. 11 U.S.C. § 547(b) (1988).

27. *Id.*

28. *Id.*

29. Katzen, *Deprizio and Bankruptcy Code Section 550: Extended Preference Exposure Via Insider Guarantees, and Other Perils of Initial Transferee Liability*, 45 BUS. LAW., Feb. 1990, at 512.

A "debtor" is defined as the "person or municipality concerning which a case under this title has . . . commenced." 11 U.S.C. § 101(12) (1988).

30. H.R. Rep. No. 595, 95th Cong., 2nd Sess. 1, 4 (1978) *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6138.

31. *See supra* note 7.

32. 11 U.S.C. § 550(a)(1) (1988). It should be noted that the trustee is entitled to only a single recovery from either party under section 550(a). *Id.* at § 550(c).

33. This hypothetical is based on the example set forth by Pitts, *Insider Guaranties and the Law of Preferences*, 55 AM. BANKR. L.J. 343, 344 (1981).

34. The term of the loan in the hypothetical is set at two years for a specific reason. In *Levit*, the court stated that the ordinary course of business exception in section 547(c)(2) would provide protection from an otherwise preferential debt. *Levit*, 874 F.2d at 1200. Arguably, the hypothetical loan and the subsequent payments would be excluded from preference action by the ordinary course of business exception in section 547(c)(2). However, assuming that a loan with a two year term is "long term", it might be suggested that payments on long term debt would not fall under the excep-

sonally guarantees the loan. Although insolvent during the entire year preceding bankruptcy, debtor's payments on the antecedent debt are kept current up to the filing.[35] After the filing, the bankruptcy court concludes that the creditor received more than it would have under Chapter 7 of the Code, absent the payments. The court also finds that the creditor was not at any time prior to the filing an insider or acting in concert with the insider.

The application of sections 547 and 550 to the hypothetical seems straight forward. The final three monthly payments are clearly voidable preferences under section 547(b). These payments were made within ninety days of the filing for bankruptcy ("the ordinary preference period"). However, an unsettled issue exists regarding the payments made to an outside creditor more than ninety days, but less than one year, prior to the filing for bankruptcy ("the insider preference period").

The problem arises because payments made during the insider preference period went to the outside creditor, but also *benefited the insider guarantor as a creditor*.[36] There is little disagreement among commentators or courts that the trustee can recover transfers made within the insider preference period from the insider.[37] However, there is a split of authority on whether transfers within this time period, avoided as to the insider, can be recovered from the outside creditor.[38] Put more simply, can the trustee under section 550(a) recover from the outside creditor payments made during the insider preference period even though the preference is voidable only because the required elements of section 547(b) are met by the insider?

*Statutory Background*

The statutory background of this issue evolves from section 60 of the 1898 Bankruptcy Act and its use in creating sections 547 and 550.

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tion of section 547(c)(2). Broome, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments*, DUKE L.J. 78, 82 (1987).

There is significant controversy on this subject, but it is beyond the scope of this casenote. The hypothetical will assume that payments on the debt will not be excluded from avoidance by the exception in section 547(c)(2).

35. "Insolvent" with reference to an entity other than a partnership and a municipality, is defined as when the sum of the entity's debt exceeds the sum of the fair valuation of its property. 11 U.S.C. § 101(29) (1988).

36. A guarantor for the debtor will be a creditor under the Code because the guarantor holds a contingent claim against the debtor that becomes fixed when the guarantor pays the creditor whose claim was guaranteed. 4 COLLIER ON BANKRUPTCY ¶ 547[1], at 547-33 (L. King 15th ed. 1990) [hereinafter COLLIER]. It is also well established law that payment on a guaranteed obligation benefits the guarantor. Nutovic, *supra* note 24 at 187. *See also* Seeley v. Church Bldgs. & Interiors, Inc. (*In re* Church Bldgs. & Interiors), 14 Bankr. 128, 129 (Bankr. W.D. Okla. 1981).

37. Note, *The Interplay Between Sections 547(b) and 550 of the Bankruptcy Code*, 89 COLUM. L. REV. 530, 531 (1989). *See, e.g., In re* Church Bldgs. & Interiors, 14 Bankr. at 129.

38. *See infra* notes 58, 63, & 70.

Section 60(a) closely parallels section 547(b) with the exception that it did not distinguish between insider and outside creditors.[39] Section 60(b) specified from whom a preference was recoverable. In its original form subsection 60(b) stated that if *the person receiving or being benefited by the preference had reasonable cause to believe* that it was intended to be given as a preference then recovery was possible from *such person.*[40] Therefore, recovery was only possible from "such person" whose "reasonable cause to believe" made the preference voidable.[41]

However, in 1938, Congress amended the original version. Section 60(b) in its amended form stated that a preference may be avoided *if the creditor receiving or benefiting from the preference had reasonable cause to believe* that the debtor was insolvent, and that recovery could come from *any person* who had received or converted such property.[42]

The 1938 amendment created uncertainty in the statute by the use of the words "any person." Based on the language of the 1938 version it would seem conceivable to allow recovery from any creditor even if they had not met the "reasonable cause to believe" requirement. That is, recovery could come from any creditor who had received a transfer so long as another person also receiving the transfer (e.g., an insider) had met the "reasonable cause to believe" standard.

The judiciary had no difficulty in allowing recovery from an insider satisfying the "reasonable cause to believe" standard.[43] However, courts consistently refused to allow the trustee to recover from a creditor when the transfer constituted a preference as to another creditor that had met the "reasonable cause to believe" requirement.[44] If a creditor lacked the "reasonable cause to believe," recovery was not possible from such creditor. One author suggests that courts were un-

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39. The 1938 version of subsection 60(a) in relevant part stated:

> (a) A preference is a transfer . . . of any property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing . . . of the petition in bankruptcy . . . .

The Bankruptcy Act of 1898, 52 Stat. 840, 869 (1938) (repealed 1978).

40. The Bankruptcy Act of 1898, 30 Stat. 544, 562 (1898) (repealed 1978).

41. Pitts, *supra* note 33, at 350.

42. The Bankruptcy Act of 1898, 52 Stat. 840, 870 (1938) (repealed 1978). "Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby . . . [had] reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property . . . from any person who has received or converted such property . . . ." *Id.*

43. *See, e.g.*, Cooper Petroleum Co. v. Hart, 379 F.2d 777, 780 (5th Cir. 1967); Fenold v. Green, 175 F.2d 247, 249 (2d Cir. 1949); 3 COLLIER ON BANKRUPTCY ¶ 60.17, at 835-40 (J. Moore 14th ed. 1977).

44. Pitts, *supra* note 33, at 350-51. This principle was recognized in the representative case of Dean v. Davis, 242 U.S. 438 (1917). However, Pitts suggests that the only authority supporting the rule, that the recipient who lacks "reasonable cause to believe" is precluded from recovery, is found in unsupported statements in secondary sources. Pitts *supra* note 33, at 35 at 351 n.38.

willing to allow recovery from the creditor that lacked the "reasonable cause to believe" in such a situation due to the pre-1938 language of section 60(b).[45]

The 1984 amendments to the Bankruptcy Reform Act of 1978 eliminated the "reasonable cause to believe" provision.[46] This provision was criticized for being difficult to prove and for causing inconsistent results among the courts.[47] Bills introduced in Congress in 1977 considered the "reasonable cause to believe" requirement to be "the most litigated question under the preference provision of the 1898 Act."[48]

In addition to eliminating the "reasonable cause to believe" prerequisite, the Bankruptcy Reform Act of 1978 also recognized the difference between insider and outside creditors.[49] Under the 1898 Bankruptcy Act and its amendments, the preference period was four months regardless of the relationship of the creditor to the debtor.[50] The Code, however, makes the distinction to protect the estate from improper insider activities prior to bankruptcy which might hinder reorganization. The Code places insiders in a special class and expands the preference period for this group to one year.[51]

The changes reflected in the Code improved and modernized bankruptcy law. One commentator has described the draftsmanship of the Code as "maddeningly precise" and a "commitment to clarity and precision."[52] Nonetheless, the elimination of the "reasonable cause to believe" provision and the expansion of the preference period for insiders created an uncertainty with respect to the treatment of payments on insider guaranteed debt to outside creditors within the insider preference period.

*Judicial Background*

Judicial authority is definitively split regarding the recoverability of a transfer made during the insider preference period from an outside creditor if it is voidable only because of the insider.[53] Three theories have evolved. Two of the theories would deny recovery from the outside creditor for transfers made within the insider preference period. These are referred to as the equitable approach and the two-

45. Pitts, *supra* note 33, at 349. Pitts performs a more complete and thorough analysis of the development of section 60 and sections 547 & 550.
46. Bankruptcy Amendments and Federal Judgeship Act of 1984, 98 Stat. 333 (1984).
47. Broome, *supra* note 34, at 94.
48. *Id.*
49. 11 U.S.C. § 547(b)(4) (1988).
50. The Bankruptcy Act of 1898 § 60(a), 52 Stat. 869 (1938) (repealed 1978).
51. 11 U.S.C. § 547(b)(4)(B) (1988).
52. Pitts, *supra* note 33, at 343, 353.
53. *See infra* notes 58, 63, & 70.

transfers approach.[54] The third theory, the literal reading approach, would allow recovery under section 550 from the outside creditor.[55]

The equitable approach has been adopted by the majority of courts.[56] The proponents of the equitable approach argue that allowing recovery from the outside creditor for a transfer in the insider preference period is inequitable. The contention is that by allowing such recovery the outside creditor is unfairly penalized simply because it has sought to acquire a guarantor.[57] Courts following this approach have exercised their equitable powers to prevent this result.[58]

The bankruptcy court in *In re Church Buildings and Interiors, Inc.* was the first to adopt the equitable approach.[59] This court based its holding on the treatment of section 550(a) in *Collier on Bankruptcy*.[60] *Collier on Bankruptcy* suggests that even though a literal application of section 550(a) would permit recovery of payments made within the insider preference period from a creditor holding an insider guaranty, the bankruptcy court should use its discretion to avoid such an inequitable result.[61] This passage from *Collier* is the cornerstone upon which the equitable theory lies and the basis of many courts' decisions.[62]

Courts have also applied the two-transfers approach in finding that the trustee cannot recover from the outside creditor for those payments made within the insider preference period. Two bankruptcy courts have held this novel theory to be persuasive.[63]

The two-transfers theory rests on the view that a single payment on debt guaranteed by an insider is effectively two transfers: the first transfer is payment from the debtor to the creditor for the primary indebtedness; and the second transfer is to the guarantors in satisfac-

54. Note, *supra* note 37, at 530.
55. *Id.*
56. Katzen, *supra* note 29, at 515.
57. Schmitt v. Equibank (*In re* R.A. Beck Builder, Inc.) 34 Bankr. 888, 894 (Bankr. W.D. Pa. 1983).
58. Block v. Texas Commerce Bank, N.A. (*In re* Midwestern Companies, Inc.), 96 Bankr. 224, 228 (Bankr. W.D. Mo. 1988), *aff'd*, 102 Bankr. 169, 173 (W.D. Mo. 1989); *In re* R.A. Beck Builder, Inc., 34 Bankr. at 894; Bakst v. Schilling (*In re* Cove Patio Corp.), 19 Bankr. 843, 844 (Bankr. S.D. Fla. 1982); *In re* Ducilli Formal Wear, 8 Bankr. Ct. Dec. (CRR) 1180 (Bankr. S.D. Ohio 1982).
59. *In re* Church Bldgs. & Interiors, Inc., 14 Bankr. at 131.
60. *Id.*
61. 4 COLLIER, *supra* note 36, ¶ 550.02, at 550-7. "The trustee can theoretically recover from both the initial transferee . . . as well as from any entity for whose benefit the transfer was made . . . . In some circumstances, a literal application of section 550(a) would permit the trustee to recover from a party who is innocent of wrongdoing and deserves protection. In such circumstances the bankruptcy court should exercise its discretion to use its equitable powers [under section 105(a) and 28 U.S.C. § 1481] to prevent an inequitable result." *Id.*
62. *See supra* note 58.
63. Goldberger v. Davis Jay Corregated Box Corp. (*In re* Mercon Industries, Inc.), 37 Bankr. 549, 552 (Bankr. E.D. Pa. 1984); *In re* V.N. Deprizio Const. Co., 58 Bankr. at 480.

tion of their contingent liability.[64] The court in *In re Mercon Industries, Inc.* stated that the two transfers were independent from each other and not derivative.[65]

The *In re Mercon Industries, Inc.* court held that section 550(a) did not act to expand the scope of section 547(b).[66] It noted that the language of the Code suggests that only preferences arising under section 547(b) could be applied to section 550(a).[67] The court concluded that because of the distinction between the two transfers, an outside creditor could not be liable for transfers made within the insider preference period.[68] The court supported this holding by stating that the trustee could not meet the requirements of section 547(b)(4)(B) as to the outside creditor.[69]

The third theory followed by courts, including the Tenth Circuit, is based on a literal reading of sections 547(b) and 550(a), and allows recovery from the outside creditor for payments made within the insider preference period.[70] The literal reading approach relies on the language of section 550(a)(1) which allows recovery either from "the initial transferee of such transfer or the entity for whose benefit such transfer was made."[71]

The *In re Big Three Transportation, Inc.* court was the first to apply the literal reading approach.[72] In *Big Three Transportation, Inc.* the court acknowledged the equitable approach, but refused to overlook the unambiguous language of section 550 and allowed recovery from the outside creditor.[73]

## THE PRINCIPAL CASE

The United States Seventh Circuit Court of Appeals upheld the decision of the district court.[74] The appellate court held that pay-

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64. *In re* Mercon Industries, Inc., 37 Bankr. at 552.
65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. Lowrey v. First Nat'l Bank of Bethany (*In re* Robinson Bros. Drilling, Inc.), 97 Bankr. 77, 80 (Bankr. W.D. Okla. 1988), *aff'd*, 892 F.2d 850 (10th Cir. 1990); Coastal Petroleum Corp. v. Union Bank & Trust Co. (*In re* Coastal Petroleum Corp.), 91 Bankr. 35, 38 (Bankr. N.D. Ohio 1988); *In re* V.N. Deprizio, 86 Bankr. at 552; Mixon v. Mid-Continent Sys., Inc. (*In re* Big Three Transp.), 41 Bankr. 16, 20 (Bankr. W.D. Ark. 1983).
71. 11 U.S.C. § 550(a)(1) (1988).
72. *In re* Big Three Transp., 41 Bankr. at 20.
73. *Id.*
74. *Levit*, 874 F.2d at 1201. The United States Circuit Court of Appeals affirmed in part and reversed in part the decision of the district court. The appellate court reversed the lower court ruling regarding certain payments which were made to pension and welfare funds. However, it affirmed the district court decision pertaining to the outside creditor holding debt guaranteed by the insiders which is the issue being considered in this casenote. *Id.*

ments from Deprizio Construction Co. to Ingersoll Rand Financial Corp. and CIT Corp. within the insider preference period on debt guaranteed by insiders were voidable.[75] It further held that the trustee could recover the transfers from these creditors.[76]

Levit, the trustee, requested that the extended one year recovery period be applied to the outside creditors, based upon the direct and unambiguous language of sections 547 and 550.[77] Levit contended that a payment made to a creditor within the insider preference period is "for the benefit of the guarantor" under section 547(b)(1), because each reduction in debt reduces the guarantor's exposure.[78]

The trustee also sought recovery from the outside creditors under section 550(a).[79] Levit stated that the statute was undeniably clear "as to the identity of those potentially liable."[80] He argued that recovery was possible from either "the initial transferee" or "the entity for whose benefit such transfer was made."[81]

The creditors argued that they should not be liable for recovery of the payments received within the insider preference period.[82] They contended that "[t]he . . . Code was enacted against a background of well-established . . . law holding that a creditor cannot be liable for a preference unless all the elements of a preference are established as to that creditor."[83] They maintained that the principles under the 1898 Bankruptcy Act should continue to apply under the Code unless there is clear evidence of congressional intent to change them.[84]

The creditors also argued for the two-transfers approach adopted by the bankruptcy court in the initial proceeding. They contended that the qualifying language in section 550(a) which states "to the extent that a transfer is avoided under section . . . 547" could not be ignored.[85] They asserted that this qualification would allow recovery only "to the extent that" the trustee first satisfies the requirements of section 547 as to that creditor.[86] From this notion the creditors then argued that a single payment constituted two distinct transfers.[87] The creditors stated that under the two-transfers theory the separate

75. *Id.* The payments made to All Motive Equipment Co. were not addressed by the court. This creditor's name does not appear in the briefs submitted for appeal or in any record of the appellate court.
76. *Id.* at 1200.
77. Appellee's Brief at 6, Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989) (Nos. 88-3091, 88-3092, 88-3093) [hereinafter Appellee's Brief].
78. *Levit*, 874 F.2d at 1190.
79. *Id.* at 1194.
80. Appellee's Brief, *supra* note 77, at 9.
81. *Id.*
82. Joint Brief of Appellants at 6, Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989) (Nos. 88-3091, 88-3092, 88-3093) [hereinafter Joint Brief].
83. *Id.* at 10.
84. *Id.* at 11.
85. *Id.* at 21 (citing 11 U.S.C. § 550(a) (1988)).
86. *Id.* at 21.
87. *Id.* at 24.

transfer to themselves failed to be avoided by section 547(b)(4) and was therefore not recoverable.[88]

The court unanimously rejected the arguments of the creditors and adopted the the literal reading approach.[89] The Seventh Circuit court agreed with the district court in finding that Congress had created an "unambiguous comprehensive statutory scheme" to allow recovery from the outside creditors for payments made within the insider preference period.[90]

The court's analysis began by pointing out that the avoiding power of the trustee is essential for a collective proceeding for the determination and payments of debts.[91] The opinion noted that an extension of the recovery period to outside creditors for payments made within the insider preference period would prevent last minute asset grabbing which would reduce the aggregate value of the estate.[92]

The court then noted the practical problems of insiders guaranteeing company debt and the unique position of an outside creditor with debt guaranteed by insiders.[93] It suggested that insiders, in serving personal interests, could reduce their own contingent liability by "inducing the firm to pay the guaranteed loans preferentially."[94]

After indicating the distinctive position of the creditor with the insider guaranty, the court held that transfers should be viewed from the payer's point of view and not from the recipient's.[95] Based on this perception the court rejected the two-transfers theory.[96] It followed the district court ruling that this theory equated transfer with benefit received, rather than with payments made. The court explained that avoidability should be viewed as "an attribute of the transfer rather than of the creditor."[97]

The court then addressed the creditors' argument that well-established pre-Code judicial principles could not be ignored. It stated that the Code represented a "wholesale change" to the text and structure of the bankruptcy laws.[98] The court rejected the creditors' argument by stating that a silent legislative history should not be construed to allow existing practices to continue unchanged.[99]

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88. *Id.* at 23.
89. *Levit,* 874 F.2d at 1196, 1200.
90. *Id.* at 1200. The "unambiguous comprehensive statutory scheme" language appears at: *In re* V.N. Deprizio Const. Co., 86 Bankr. at 552.
91. *Levit,* 874 F.2d at 1194.
92. *Id.* (citing Jackson, *Avoiding Powers in Bankruptcy,* 36 STAN. L. REV. 725, 727-31, 756-68 (1984)).
93. *Id.* at 1194.
94. *Id.* at 1195.
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.* at 1196.
99. *Id.* The court relied on the decision of Pittston Coal Group v. Sebben, 488 U.S. 105, 115 (1988). In *Pittston,* the United States Supreme Court held that "[i]t is

Although not specifically argued by the creditors, the court also rejected the equitable approach.[100] It held that the result of its decision would not be inequitable to lenders, but would simply result in an adjustment of credit terms in the market.[101] The court noted that its result would also cause creditors to more closely monitor debtors.[102] The decision stated that it would not be inequitable for a creditor to return payments made in the insider preference period if the creditor "may have been favored only because payment reduced insiders' exposure. . . ."[103]

## ANALYSIS

The court's decision to allow recovery from the outside creditors for payments made within the insider preference period is analytically flawed. The equitable theory, and not the literal reading theory adopted by the court, should be applied to this issue. The equitable theory's result is more satisfactory than the literal reading approach when three important arguments are considered. *First*, in light of the statutory construction of the Code, the equitable approach more correctly supports a fundamental goal of bankruptcy—equality of distribution among creditors. *Second*, the literal reading theory fails to consider the pre-Code treatment of the issue. *Third*, the equitable theory, unlike the literal reading approach, does not change preference policy in a manner which thereby negatively impacts the credit market. While this decision has certain positive ramifications on debtor-creditor relationships regarding guarantees, its overall impact on bankruptcy law is undesirable.

### *The Code and Equality of Distribution Among the Creditors*

The preference power of the trustee facilitates an established goal in bankruptcy. The goal is an equal distribution of payment to the creditors of the debtor.[104] Section 547(b) of the Code is the modern-

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not the law that a statute can have no effects which are not explicitly mentioned in its legislative history."

In order to support its argument that pre-Code practices were not helpful in this situation the court specifically distinguished its holding from Kelly v. Robinson, 479 U.S. 36, 44-47 (1986), and Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494, 501 (1986).

100. *Levit*, 874 F.2d at 1197. The court had previously rebuffed equity arguments in Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 894 (7th Cir. 1988).

101. *Levit*, 874 F.2d at 1198. The court hypothesized that the cost and availability of credit would change depending on how the extended preference period to outside creditors was viewed. It suggested that if the extended period was thought to facilitate the collective debt-adjustment of bankruptcy then credit would become available on better terms. Conversely, the court stated that if the longer period was considered to be undesirable then creditors would charge higher rates of interest. *Id.*

102. *Id.*

103. *Id.*

104. H.R. Rep. No. 595, 95th Cong., 2nd Sess. 1, 177 (1978) *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6138.

ized preference provision designed to achieve this objective.[105] By making a clear distinction between insider and outside creditors with respect to the avoidance of transfers, subsection 547(b)(4) acts to support the goal.[106] This subsection assists in maintaining a level playing field for creditors, and protects the estate from abusive insider transactions. The distinction had no predecessor in the Bankruptcy Act of 1898, and creates two separate classes of creditors which indicates that a insider's liability is exclusive from the outside creditor.[107]

Admittedly, the literal reading approach would be the ultimate promoter of equality. Under this theory, allowing recovery of payments made within the insider preference period from outside creditors would increase the value of the estate for greater distribution to other creditors. However, in attempting to achieve this goal, it circumvents the important distinction between insider and outside creditors. Allowing the trustee to pursue outside creditors for such payments tilts the playing field and pushes these creditors into a class established exclusively for insiders. No provision in the Code allows the outside creditor to be identified so fully with the insider.[108]

By seeking to achieve ultimate parity between creditors, the literal reading approach violates the standard rules of statutory construction by eliminating this distinction.[109] In interpreting statutes a court should avoid an interpretation which rescinds all or part of another statute.[110] By its decision the court places the outside creditor in the same class as the insider which acts to rescind section 547(b)(4).

Application of section 550(a) is also dependent upon the distinction between the insider and outside creditors. Recovery under section 550(a) is limited "to the extent the transfer is avoided under section . . . 547."[111] Subsections 547(b)(1) and (b)(4) state that the trustee may avoid a transfer to or for the benefit of a creditor made between ninety days and one year before the filing, if *such creditor* was an insider.[112] Therefore, recovery under section 550(a) should only be allowed from a creditor to the extent the transfer is avoided under section 547(b) as to such creditor.

In evaluating the preference action the court does not focus on the creditor, but instead on the transfer itself. The literal reading approach allows recovery regardless of as to which creditor the transfer was avoided under section 547(b)(4). This theory, by ignoring the distinction between the insider and outside creditor, imposes preference

105. 11 U.S.C. § 547(b) (1988).
106. *Id.* § 547(b)(4).
107. The Bankruptcy Act of 1898 § 60(a), 52 Stat. 869 (1938) (repealed 1978).
108. *In re* Midwestern Cos., 96 Bankr. at 228.
109. *See generally* 2A N. SINGER, SUTHERLAND STAT. CONST. §§ 51.01-51.03 (4th ed. 1984 & Cum. Supp. 1989).
110. *In re* Midwestern Cos., 96 Bankr. at 225.
111. 11 U.S.C. § 550(a) (1988).
112. *Id.* § 547(b)(1), (b)(4).

liability for payments received within the insider preference period on a non-preferred creditor for that time period.

The equitable approach has been criticized for ignoring the clear and unambiguous language of the Code. However, by maintaining the distinction in section 547(b)(4), and thereby assuring an acceptable application of section 550(a), this theory arguably interprets these sections with precision. Nonetheless, despite this distinction, and the long recognition by other courts that a preference action is a creature of equity, this court rejected the equitable theory.[113] Dismissing this approach, the court quoted a ruling from the United States Supreme Court which stated that "whatever equitable powers remain in the bankruptcy court must and can only be exercised within the confines of the statute."[114]

A court denying recovery of payments made during the insider preference period from the outside creditor is applying its equitable powers within the confines of the Code. By holding that recovery from such creditor is inequitable, a court is attempting to promote equality of distribution by maintaining the distinction between the insider and outside creditor clearly specified in the Code. Such an effort to enforce the provisions of the Code is an action within the statutory confines.

Both the literal reading and the equitable theories attempt to support the goal of equal distribution between creditors. However, this objective is more properly supported by the equitable theory, when the goal is considered in light of its application to sections 547 and 550.

*The Pre-Code Treatment of the Recovery of Transfers*

The pre-Code practice with respect to the recovery of payments received by a creditor was to limit recovery only from those to whom the transfer represented a preference.[115] The legislative history is silent with regards to congressional intent concerning this practice.[116] Because congressional intent is not evident in the legislative history, the pre-Code handling of this issue becomes an important principle in evaluating the applications of the equitable and literal reading theories.

Legislative silence supports the contention that the pre-Code treatment of this issue should continue through the application of the equitable approach. The literal reading approach results in an out-

113. *Levit*, 874 F.2d at 1197. The court in *In re* Midwestern Companies, noted that preference action has long been a creature of equity. *In re* Midwestern Cos., 96 Bankr. at 225.

114. *Levit*, 874 F.2d at 1197 (citing Norwest Bank v. Ahlers, 485 U.S. 197 (1988)).

115. *See supra* note 44.

116. *Levit*, 874 F.2d at 1196. The court noted that the legislative history of sections 547(b) and 550(a) is relatively silent and not helpful in drawing a conclusion of congressional intent. *Id.*

come which is contradictory to the judicial handling this matter received prior to the enactment of the Code. Arguably, if Congress had desired to amend this long standing pre-Code practice, its intent would be clearly evident in the legislative history.[117]

The court dismissed the pre-Code treatment of this issue and held, "[w]hen Congress makes wholesale changes in the text and structure of the law, it is fatuous to pretend that a silent legislative history means existing practices should continue unchanged."[118] This dismissal should be considered in light of the changes to the preference laws referred to by the court.

The "wholesale changes" perceived by the court related to the separate legal actions of avoidance of a transfer and its subsequent recovery.[119] The court, in dismissing the prior judicial treatment, stated that such a structural change had no antecedents in the Bankruptcy Act of 1898.[120]

Arguably, however, the bifurcation of avoidance and recovery existed in section 60(b) of the Bankruptcy Act of 1898. Section 60(b) stated in relevant part that "[w]here the preference is voidable, the trustee may recover the property . . . from any person who has received . . . such property."[121] Admittedly, in a manner less exacting than the Code, this phrase of section 60(b) provides for the segregation of avoidance and recovery. Therefore, with respect to this bifurcation, it can be argued that the Code does not represent such "wholesale changes."

Since the legislative intent is silent regarding the pre-Code treatment of this issue, and the changes to the Code are not entirely "wholesale," a court should rely on the historical antecedents. The equitable approach maintains a consistent application of the pre-Code treatment of this issue, and is supported by the Supreme Court's decision of *Kelly v. Robinson*.[122] In *Kelly* the court held, "[w]e decline to hold that the new Bankruptcy Code silently abrogated another exception created by courts construing the [Bankruptcy Act of 1898]."[123]

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117. When Congress resolves to amend or ratify existing practices such determination will be explicitly stated in the legislative history. Edmonds v. Compagnie Generale Transatlantique, 443 U.S. 256, 266 (1979).

The legislative history of the Code has numerous examples of express overulings or affirmations of judicial decisions. An example is the legislative history on 11 U.S.C. § 541 (1988). H.R. Rep. No. 595, 95th Cong., 2nd Sess. 1, 367 (1978) *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6323.

118. *Levit*, 874 F.2d at 1196.

119. *Id.*

120. *Id.*

121. The Bankruptcy Act of 1898 § 60(b), 52 Stat. 840, 869 (1938) (repealed 1978).

122. 479 U.S. 36 (1986).

123. *Id.* at 47.

*Preference Policy and the Effect on the Credit Market*

By adopting the literal reading approach, the court's holding impacts preference policy in a manner which could result in undesirable effects to the credit markets. The literal reading theory creates an uncertainty for creditors making lending decisions. This uncertainty could result in a decrease in the availability of credit to borrowers.

The court's holding has an adverse effect on preference policy by providing the trustee with an extension of power greater than what Congress intended. Congressional intent was to give the trustee the avoiding powers to assure a cooperative proceeding in the payments of debts.[124] The objective is to allow the trustee to prevent last minute dismemberment of the estate or insider activity which could prevent reorganization, but "leave undisturbed normal financial relations."[125]

Policy, therefore, requires some limitation to the trustee's avoidance powers to protect ordinary business transactions and prevent complete uncertainty to creditors. The focus should be on the nature of the relationship of the creditor to the insider. Undoubtedly, a creditor acting in concert with an insider or receiving payment only because it holds an insider guaranty is not acting within "normal financial relations." However, when an outside creditor with the insider guaranty is not receiving special treatment, forcing it to return such payments is not within the powers of the trustee. Theoretically, if the outside creditor is precluded from recovery, then the trustee can look to the insider for repayment of those transfers made within the insider preference period.[126]

The court's decision, by increasing the preference power of the trustee, could effect the availability of credit. There is no empirical evidence to support this contention, but this holding will arguably effect some credit markets in an adverse manner. The court recognizes the possible impact of its decision on the credit market, but views it primarily from the standpoint of the creditor.[127] The court did not fully consider the potential adverse effect its ruling would have on marginal borrowers seeking credit.

To cope with the risk of being forced to return payments received within the insider preference period, the creditors might seek other avenues of protection. The possible alternatives include a higher rate of interest or greater collateral requirements. These different forms of protection will effect the availability of credit to a borrower. The in-

124. H.R. Rep. No. 595, 95th Cong., 2nd Sess. 1, 177 (1978) *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6138.

125. *Id.* at 373, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6329.

126. Recovery under section 550(a) would be possible to the extent the transfer was avoided as to the insider. However, it is acknowledged that in a closely held corporation the insider may possibly be unavailable for recovery once the debtor files for bankruptcy.

127. *Levit*, 874 F.2d at 1195. *See supra* note 101.

creased rate of interest and additional collateral requirements could preclude some borrowers from credit. Arguably, such a restriction on credit was not within congressional intent in the passage of the Code.

The equitable approach would maintain the powers of the trustee at such a level to prevent dismemberment of the estate. Furthermore, this theory would not act to disrupt the use of guarantees in normal financial relations or adversely impact the availability of credit.

Despite the stated problems, the holding of the court does provide specific beneficial consequences to debtor-creditor relationships with respect to insider guarantees. The creditor holding an insider guaranty maintains a hybrid identity to other creditors.[128] In some instances the guarantors' assets are inadequate to provide meaningful security to the borrowing. The creditor, may as a matter of economic and psychological reality, take the guaranty not as additional security, but for greater indirect control over the debtor.[129] This type of action is not within "normal financial relations" and gives such a creditor a considerable advantage over other creditors.

The court's decision could act to prevent creditors from taking guarantees solely for the purpose of obtaining additional control over the debtor. This ruling will encourage the creditor to obtain a guaranty only for additional security when the guarantor is financially secure and provides an alternative source of repayment. However, the weight of these favorable aspects of the literal reading approach cannot justify the decision of the court. This ruling has significant adverse consequences on: the statutory construction of the Code in promoting a fundamental goal in bankruptcy; the pre-Code judicial treatment; and preference policy as it effects the credit markets.

## CONCLUSION

The court adopts a mechanical application of the Code which creates an undesirable result. This decision provides the bankruptcy trustee with previously unavailable powers. The literal reading approach condones this increase in power, but does so capriciously in light of the statutory construction of the Code, the pre-Code judicial practice, and the changes to preference policy which impact the credit markets.

The equitable approach provides a more compelling result. This theory supports the goal of equality of distribution among creditors without dismissing the distinction between the insider and outside creditors specified in the Code. Furthermore, this approach conforms with the pre-Code treatment of this issue which becomes relevant after considering the silent legislative history and "changes" in the

128. Pitts, *supra* note 33, at 354.
129. Nutovic, *supra* note 24, at 196.

Code. Finally, the equitable theory does not adversely effect preference policy in a manner which could preclude certain borrowers from the credit market.

The court's decision is based on what it interprets to be a clear and unambiguous statute. However, this analysis shows that the clarity of the statute diminishes with the application of the different theories. Therefore, it is important for Congress to amend this statute and specify its intent. Nonetheless, until such time or until the issue is resolved by the Supreme Court, bankruptcy trustees will be testing the limits of the expanded powers granted by this court. Unfortunately this testing will be performed to the detriment of the bankruptcy preference action.

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