INTRODUCTION

With the high rate of failed start-up ventures, lenders are often reluctant to lend to undercapitalized small businesses without some sort of personal guarantee from the officers. However, this guarantee from the officers can lead to conflicting loyalties. As a company is failing, a corporate insider will prefer to first pay off loans that he or she has personal exposure, leaving other debts to be discharged in bankruptcy, as the corporate entity dissolves. To curb this incentive, Congress has provided for a longer reach-back period on insider debts. Rather than the standard ninety days, a Bankruptcy trustee can reach back one year for transactions that were for the benefit of an insider.

The United States Court of Appeals for the Seventh Circuit sent shockwaves through the lending industry as a result of its holding in Levit v. Ingersoll Rand Financial Corp. As a result of Levit, secured creditors who took insider guarantees had to return payments made on those debts if made more than ninety days (but less than one year) from the time of the Bankruptcy filing if those payments benefited an insider to the debtor. Due to intense lobbying by the lending industry, Congress passed an amendment to the Bankruptcy Code. Secured creditors also had insider guarantors sign waiver agreements, where those guarantors contractually agreed with the creditor never to seek reimbursement from the debtor if the debtor defaulted. These creditor self-help guarantor waivers and Congress’s statutory override to the Deprizio case have created an unfair and inefficient preference avoiding scheme resulting in two problems – one which favors creditors with guarantees, one which disfavors creditors with guarantees: First, insider guarantors, with greater knowledge of a debtor’s impeding bankruptcy, can still potentially preferentially repay creditors that they have debt exposure on. Second, liens and other non-possessory security interests are treated differently than possessory security interests
or cash payments under the Congressional override. As a result, a new solution that balances the rights of all creditors, not just those with guarantees, is needed. A proposed Congressional amendment to the Bankruptcy Code coupled with heightened judicial scrutiny of guarantor waivers will provide the answer.

This note will examine the current status of insider guarantees and avoiding preferences after the Deprizio case and the subsequent amendments to the Bankruptcy Code. Part I provides a general background on a Bankruptcy Trustee’s power to avoiding preferences under the Bankruptcy Code, the necessity of insider guarantees, and the Deprizio case – the source of all the current problems with preferences in Bankruptcy. Part II then discusses the Congressional override to the Deprizio case, exploring the distinction it created between payments or possessory security interests and non-possessory liens. Part III focuses on the credit industry’s self-help remedy, guarantor waivers of their equitable rights as sureties. Finally, part IV examines several alternatives to fix the holes left in the wake of the Deprizio case and its subsequent amendment.

I. AVOIDING PREFERENCES BY THE BANKRUPTCY TRUSTEE

In order to understand the issue in Deprizio, it is necessary to first examine the concept of a preference. By examining the historical background of preferences, the reason lenders seek insider guarantees in the first place become clear. However, the 7th Circuit’s opinion in Levit v. Ingersoll Rand upset the balance that Congress had created between the rights of secured creditors to receive the value of their security and the rights of unsecured creditors to a fair division of the debtor’s estate.

A. Concept of Preferences

The Bankruptcy Code is the product of two competing goals: Bankruptcy should provide the debtor with a “fresh start,” while at the same time provide for an equitable division of the Bankruptcy estate among all similarly situated creditors. In order to effectuate the equitable division of a debtor’s assets, it is necessary to protect creditors from each other, stopping a race to raid the debtor’s assets, while at the same time protecting creditors from the debtor,
preventing any fraudulent transactions that diminish the creditors’ recovery.\textsuperscript{16} As a result, a Bankruptcy Trustee is given certain powers to achieve a fair division of a debtor’s estate.\textsuperscript{17} One of these powers is the power to avoid any preferences.\textsuperscript{18} A preference is simply a property transfer from an insolvent debtor to one of its creditors shortly before the debtor files for bankruptcy, allowing that creditor to receive more than it would have without that transfer.\textsuperscript{19} In isolation, basic notions of equality support the bankruptcy’s preference avoiding powers.

\textit{B. Purpose of Insider Guarantees}

When preferences are examined in the context of an insider guarantee, problems begin to emerge. Due to the intimate relationship that an insider has with a debtor, an insider has greater knowledge of a company’s impending bankruptcy. Further, as a debtor heads toward bankruptcy, the debtor is in a tempting position to use his remaining assets to repay certain creditors over others. For example, if a debtor anticipates doing further business with a creditor, or is a friend or relative of a creditor, a debtor approaching bankruptcy may try to pay that creditor first. This is the reason a trustee can recover preferential payments made to insiders for a period up to one year before the bankruptcy filing, rather than ninety days as with general creditors.\textsuperscript{20}

Despite the potential for abuse, creditors seek to take advantage of the relationship insiders have with the debtor by seeking insider guarantees. Insider guarantees serve a critical role in our economy. For entrepreneurs, they are essential for small business finance and real estate development.\textsuperscript{21} Insider guarantees have been traditionally thought to secure repayment to the creditor from the guarantor should the debtor default, thus reducing the risk and cost of financing. Further, modern commentators have found them to be an efficient lending device that aligns the interests of the insider with those of the creditor.\textsuperscript{22}

\textit{C. Deprizio}

The interplay between preferences and insider guarantees was explored in \textit{Levit v. Ingersoll Rand Financial Corp.}\textsuperscript{23} In \textit{Deprizio}, Richard Deprizio, an insider to the Deprizio...
Construction Company, made preferential payments on loans that he had personally guaranteed to several creditors within one year of the bankruptcy filing, but beyond ninety days of the filing. Because Deprizio was insolvent, the trustee sought to recover those payments made outside the ordinary course of business from the “innocent” creditors. Allowing the recovery, the Seventh Circuit Court of Appeals scared the lending industry. The Seventh Circuit reasoned that although the lenders were not themselves insiders, the preference avoidance period would be subject to a one-year reach-back because the payments were for the benefit of an insider creditor.

As the first circuit court to consider the issue, Deprizio had an enormous impact. It challenged the value of a guarantee for the first time. Before Deprizio, a cosigner on a loan was always desirable, providing for additional security in the event of a default. Further, it treated non-insider creditors as insiders if they took a guarantee. After Deprizio, lenders who had outstanding loans with insider guarantees were subjected to increased uncertainty, with loan payments potentially being subjected to recovery a full year after bankruptcy. However, despite its critics, it was followed by every circuit court that considered the issue.

II. CONGRESSIONAL RESPONSE TO THE DEPRIZIO CASE

After Deprizio and its resulting financial uncertainty, lenders cried foul. Losing in the courts, they began lobbying Congress for a legislative override to Deprizio. With § 202 of the Bankruptcy Reform Act of 1994, Congress attempted to temper the effects of Deprizio. This section explores § 550(c) of the Bankruptcy Code and the differing treatment of the recovery of payments or other possessory security interests from the recovery of non-possessory interests. Finally, problems with this disparate treatment are discussed.

A. Congressional Amendment

With § 550(c) of the Bankruptcy Code, Congress attempted to narrow the effects of the Deprizio case. Section 550(c) provides:

If a transfer made between 90 days and one year before the filing of the petition—

(1) is avoided under section 547(b) of this title; and
(2) was made for the benefit of a creditor that at the time of such transfer was an insider; the trustee may not recover under subsection (a) from a transferee that is not an insider.\footnote{32}

While many lenders and even some Congressmen\footnote{33} thought that § 550(c) provided a complete override to Deprizio case,\footnote{34} it fell short. Due to the distinction between avoidance of a preference under § 547 and recovery of a preference under § 550,\footnote{35} the amendment only addressed the recovery portion.\footnote{36} This distinction left a hole wherein payments or possessory security interests and non-possessory security interests would be treated differently. Several cases decided in light of the Congressional amendment illustrate this difference.

\textit{B. Treatment of Payments or Possessory Security Interests}

The case \textit{In re Carpenter}\footnote{37} illustrates the treatment of payments made to a non-insider creditor under Section 550(c). In a convoluted fact pattern, a debtor directed a cash payment be made to a bank on behalf of his grandson.\footnote{38} When the debtor later filed for bankruptcy, the trustee sought to recover the payment from the bank.\footnote{39} Although the payment had been made outside of the standard ninety-day reach-back period of § 547, the trustee tried to apply the extended one-year reach-back period because the payment was made for the benefit of an insider, the grandson.\footnote{40} The trustee failed to recover the payment because the court found that “[t]he language of § 550(c) unequivocally states that the Trustee may not recover a preferential transfer from the transferee that is not an insider, if the transfer occurred outside the general ninety day preference period.”\footnote{41}

This clear application of § 550(c) demonstrates that the Congressional amendment operates as a bar to recovery when dealing with cases where a preferential payment has been made to a non-insider creditor outside of the ninety-day reach-back period. The same analysis would hold true for possessory security interests, or those security interests where a creditor actually takes possession of the collateral.\footnote{42} Consider the following hypothetical: Suppose a debtor gives a bank, a non-insider creditor, some machinery as collateral for a prior debt nine months before filing for bankruptcy. A relative of the debtor had guaranteed that same debt.
Suppose further that understanding the implications of § 550(c), the bank takes actual possession of the machinery. Rather than recording a lien on the machinery, the bank has the debtor deliver the machinery to its parking lot.

In the above hypothetical, the transfer of collateral to the bank meets the statutory requirement of “to or for the benefit of an insider.” Although the bank is a non-insider creditor, because a relative of the debtor had been a guarantor on the loan, the transfer of collateral to the bank had been for the benefit of an insider. It reduced the relative’s contingent liability on the loan. As a result, the transfer was clearly a preference under § 547. However, because the transfer occurred outside the general ninety-day reach-back period of § 547, § 550(c) would operate to prevent recovery of the collateral from the bank. As the debtor’s estate is being liquidated, the bank would be entitled to use the proceeds from the sale of the collateral machinery towards satisfaction of its debt. The trustee would still be able to recover the value of the preference from the relative, however.

C. Treatment of Non-possessory Security Interests

While § 550(c) prevents recovery from non-insider creditors in the cases of payments or possessory security interests, liens and other non-possessory security interests are treated differently. As an example, consider Williams v. Associates Home Equity Services, Inc. In Williams, a husband and wife borrowed $59,671 from Associates Home Equity Services to purchase a mobile home and plot of land. Although the lender failed to timely perfect their security interest, they did perfect the security interest within two months of the closing. When the husband later filed for bankruptcy over five months later, the trustee avoided the security interest as a preferential transfer that was made for the benefit of an insider. The insider in this case was the wife, who would still otherwise be personally liable on the mortgage. Because the late perfection occurred outside the ninety-day reach-back period of § 547, the lender argued that Section 550(c) barred any recovery of the security
Distinguishing between avoiding a preference under § 547 and recovering that preference under § 550, the bankruptcy court found that no recovery was being made. The property had remained with the debtor at all times. As a result, the lender was treated just as any other unsecured creditor, and would likely recover only a fraction of the value of his original loan.

D. Problems With the Congressional Amendment

This disparate treatment of payments and other possessory security interests from liens or other non-possessory security interests poses several problems. First, as it was before the amendment, guarantees are subjected to increased uncertainty. Before Deprizio, guarantees were always a positive thing. Lenders obtained additional people to look to in the event of default, while borrowers received lower interest rates or additional financing at a reduced cost. Second, the Congressional Amendment treats cash payments or possessory security interests differently than non-security interests. For a cash-strapped debtor, it may be more advantageous to give a lien or non-possessory security interest rather than make a payment. In the hypothetical described above, a near-insolvent debtor will either be forced to part with desperately needed cash or equipment necessary to run his business. Finally, the Congressional Amendment may be contrary to legislative intent. In Williams, the lender referenced a statement by Senator Grassley from the Congressional record: “Our legislation overrules the Deprizio line of decisions and clarifies congressional intent that non-insider transferees should not be subject to the preference provisions of the Bankruptcy Code beyond the ninety-day statutory period. Our aim is to encourage commercial lenders and landlords to extend credit to smaller business entities.”

III. CREDITOR’S SELF-HELP REMEDIES: GUARANTOR WAIVERS

In addition to their lobbying efforts to Congress, the lending industry also pursued their own contractual remedies to the problems posed by Deprizio. Creditors resorted to waivers of all
of a guarantor’s equitable or legal rights to recover from the debtor in their guarantee agreements. The operation of such waivers is explored in detail below. These waivers are also being upheld as valid in the courts. Three cases highlight their success: *In re Fastrans, Inc.*, [54] *In re XTI Xonix Technologies Inc.*, [55] and *In re Northeastern Contracting Co.* [56] Also, despite the amendment to § 550(c), because of the disparate treatment of possessory security interests from non-possessory ones, several commentators are recommending the continued use of guarantor waivers. These waivers of subrogation are not without their own unique problems, however.

A. Operation of Waivers of Subrogation

Waivers of subrogation are a contract between the lender and the third-party guarantor. They are designed to combat the “to or for the benefit of a creditor” language in § 547. [57] By having the insider guarantor waive all of his equitable rights of indemnification, subrogation, contribution, and exoneration against the debtor in the loan documents, the insider guarantor loses his status as a creditor of the debtor. [58] This result may not seem obvious at first, but by examining the definitions of “creditor” and “claim” under the Bankruptcy Code, the result is apparent. [59]

With a waiver of subrogation, when a debtor makes payments to a lender on a loan guaranteed by an insider beyond ninety days from the bankruptcy, but within one year, those payments are no longer preferences under § 547 (b). [60] As a result, not only is the lender protected from the one-year reach-back period of § 547 (b), so is the guarantor. The trustee will not even be able to recover such payments from the guarantor. Through the waiver, the guarantor lacks any claim against the debtor’s estate – contingent or otherwise. [61] Even if a debtor subsequently defaults on the guaranteed loan and the guarantor is forced to repay the debt, the guarantor lacks any recourse against the debtor.

B. Judicial Treatment of Waivers of Subrogation

The following cases, [62] all decided prior to the Congressional Amendment bringing about § 550(c), illustrate positive judicial treatment of guarantor waivers. Provided a guarantor waives
all of his rights of indemnification, subrogation, contribution, and exoneration against the debtor in the loan documents, the courts have found that the insider guarantor loses his status as a creditor of the debtor. As a result, the one-year extended reach-back period for transfers to or for the benefit of an insider does not apply.

1. **In re Fastrans, Inc.**

In *In re Fastrans, Inc.*, Stephen Yuhas, an insider guarantor, guaranteed payment of all present and future liabilities of the debtor to Associates Commercial Corp. (“Associates”). The guaranty also contained a waiver of subrogation. After the debtor subsequently filed for bankruptcy, the trustee sought to recover those payments to Associates made beyond ninety days but within one year of the bankruptcy. The court granted Associates’ motion to dismiss the trustee’s adversary proceeding. The court found that “it is undisputed that the unambiguous meaning of the waiver is to prohibit the guarantor, Stephen W. Yuhas, from asserting any claim against the debtor if called upon by Associates to honor the Guaranty.” Finding that Yuhas lacked a claim against the debtor, the court reasoned that Yuhas was therefore not a creditor of the debtor. As a result, the transfer could not have been “to or for the benefit of a creditor” under § 547(b)(1) and (5).

The trustee challenged this ruling on several grounds. First, he argued that the waiver in the Guaranty was invalid due to a lack of consideration. In addressing this argument, the court stated “the trustee stands in the shoes of the debtor, who was not a party to the Guaranty.” As a result, the trustee lacked standing to even contest the terms of the Guaranty. The trustee next argued that public policy considerations mandate that waivers of subrogation be declared void. The trustee argued that in allowing the waiver provisions to stand, the court was disturbing “the policy of equality of distribution of the bankruptcy estate by encouraging a ‘race of diligence’ of creditors to dismember the debtor.” In dicta, the court commented that due to the competing policy arguments, the court would apply the letter of the statute to the facts before it. The trustee finally argued that because Yuhas was a creditor of the estate generally, the payments
still qualified as an avoidable preference. Rejecting this argument, the court drew from *Deprizio* and stated:

[I]t is not enough that an insider be a creditor of the debtor in a general sense; the insider must have a “claim” against the debtor attributable to the specific debt he or she guaranteed in order to render transfers made by the debtor on account of that debt to the non-insider transferee avoidable under § 547(b).\[76\]

2. *In re XTI Xonix Technologies, Inc.*

In *In re XTI Xonix Technologies, Inc.*\[77\] Thomas and Gloria Peterson executed continuing guarantees to the First Interstate Bank of Oregon (“FIOR”) for business loans incurred by the Petersons’s company, XTI.\[78\] After the *Deprizio* case, FIOR had the Petersons sign amended guarantees, waiving their equitable rights against the debtor under the guarantee.\[79\] XTI subsequently filed for bankruptcy.\[80\] As in *Fastrans*, the trustee tried to recover payments made to FIOR secured by the Peterson’s guarantees made beyond ninety days but within one year of the bankruptcy filing.\[81\] Further, similarly to *Fastrans*, the trustee attacked the validity of the waiver provision, and challenged it on public policy grounds.\[82\] Unlike *Fastrans*, however, the court found that the trustee had standing on the issue.\[83\] The court stated that:

[The trustee had] argued against the effectiveness of the waiver only in reply to the waiver raised as an affirmative defense by FIOR. To deny the trustee standing to do this would be tantamount to denying him the right to pursue the § 547 claim against FIOR, something all parties agree he may do.\[84\]

This proved to be a relatively short-lived victory for the trustee, however, as the court ultimately found the waiver provision in the guarantee waived all rights of indemnity, contribution, exoneration, and subrogation.\[85\] As a result, the Petersons lacked a claim against the debtor, were not creditors of the estate, and the payments were not considered “to or for the benefit of an insider.”\[86\] The trustee also made the same policy arguments made in *Fastrans*, but the court did not address those arguments and adopted the same position as in *Fastrans*.\[87\]

3. *In re Northeastern Contracting Co.*
In *In re Northeastern Contracting Co.*, Orix Credit Alliance, Inc. ("Orix") had guaranties from two insiders, Salvatore J. Marino, Sr. ("Marino, Sr.") and Salvatore J. Marino, Jr. ("Marino, Jr."). As with *Fastrans* and *XTI*, Orix had waiver provisions in their guaranties with Marino, Jr. and Marino, Sr. These waiver provisions were substantially the same, with the only difference being that the following clause was inserted in the guaranty agreement of Marino, Sr.: "[I]f the undersigned shall be deemed an “insider”, (as the term is used in the Bankruptcy Code) then all rights of subrogation are waived."

After the debtor filed for bankruptcy, the trustee brought an adversary proceeding to set aside two payments on the guarantied debt made to Orix. The payments had been made more than ninety days but less than one year before the bankruptcy filing, so the trustee was relying upon the *Deprizio* doctrine to recover from Orix. With the same approach as the courts in *Fastrans* and *XTI*, the court found that the waiver provision in Marion, Sr.’s guarantee prevented his classification as a creditor of the debtor’s estate, and ultimately prevented extending the reach-back period for those transfers on the basis of his guarantee. However, the waiver provision in Marino, Jr.’s guarantee was ineffective. It served merely to delay the insider’s right of subrogation, not waive it. As a result, Marino, Jr. remained a creditor of the estate, and the payments were potentially recoverable as preferences.

C. Why Waivers of Subrogation are Still Used

Despite the addition of § 550(c) to the Bankruptcy Code, several commentators are still advocating the use of waivers of subrogation in guaranties. Two main reasons exist for their continued inclusion: First, as discussed above, the recovery of liens and other non-possessory security interests are treated differently from payments after the Congressional amendment. By including waivers, lenders that obtain insider guarantees are securing themselves maximum flexibility in their later rights to obtain payment or collateral from a debtor. The waivers would prevent recovery of otherwise preferential payments from non-insider creditors. Second, the
waivers would serve to prevent recovery against insider guarantors, as well. Similar to other secured creditors, non-insider creditors with insider guarantees want to preserve the entire value of the guarantee for their own benefit. If the Bankruptcy Trustee is allowed to recover the preferential payments made to the creditor from the “benefited” insider, the insider will be much less likely to be able to make good on their guarantee to the creditor.

D. Problems with Waivers of Subrogation

Waivers of subrogation pose several problems. First, their existence is uncertain. As discussed above, depending on the drafting of the waiver, some equitable rights may remain in the guarantor. This drafting error would allow a trustee’s recovery against the insider guarantor for any preferences and against the non-insider creditor for any non-possessory liens during the extended reach-back period. Second, as advocated by the trustees in Fastrans and XTI, waivers offend the policy behind an extended reach-back period for insider guarantors. Limiting the recovery period to ninety days disturbs one of the central themes of bankruptcy, that of ensuring equality of distribution. This promotes a race among creditors to raid the debtor’s assets. Further, such waivers provide incentive to debtors to favor those debts with insider guarantees. Finally, these waivers unfairly shift the burden of default on the guarantor – often, with no alternate sources of financing available, the guarantor will forfeit substantive legal rights against the debtor all in contemplation of Bankruptcy. This forfeiture of rights is too broad, however. If an otherwise solvent debtor defaults on his payment to the creditor, the guarantor that is forced to pay under the guarantee is left without any legal rights against the debtor.

IV. CLOSING UP HOLES LEFT BY § 550(C) AND GUARANTOR WAIVERS

The problems created by waivers of guarantor rights and the distinction between payments and non-possessory liens require a multi-faceted solution. Congress, in a proposed amendment to the Bankruptcy Code, is seeking to address only one part of the problem by eliminating recovery from non-insider creditors during the extended reach-back period, treating payments and non-possessory liens the same. However, assuming that the amendment eventually
becomes law, the problem created by guarantor waivers, with a trustee unable to recover from a guarantor, must still be addressed. Due to the difficulty in passing new bankruptcy legislation, trustees should seek a judicial remedy to solve the dilemma posed by insiders who seek to preferentially repay loans that they have debt exposure on.

A. Current Proposed Amendments to the Bankruptcy Code

In the proposed Bankruptcy Reform Act of 1999, Congress sought to eliminate the distinction between payments and non-possessory security interests by attacking § 547. Specifically, the 1999 amendment would add the following subsection to § 547:

If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the date of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer may be avoided under this section only with respect to the creditor that is an insider.

This amendment would put an end to any extended recovery period against non-insider creditors, yet leave open recovery against insider guarantors, closing the hole identified in Williams. Applying the above amendment to the facts of Williams, the trustee would have been unable to avoid the lender’s security interest, while still allowing the lender to seek recourse against Mrs. Williams, the insider. However, the amendment completely ignores the issue of guarantor waivers.

B. Judicial Remedy Dealing with Guarantor Waivers

As described in Part III above, creditors will likely continue to use guarantor waivers to prevent bankruptcy trustees from recovering from the guarantor and ultimately harming the solvency of the guarantor. In the proposed bankruptcy reform legislation, Congress ignores this problem. As a result, the original policy arguments allowing an extended reach-back period against insider guarantors are potentially defeated. The insider, now potentially shielded from recovery, still has incentive to use his influence to have the debtor preferentially repay the guaranteed debt over other obligations. Trustees must turn to the judicial system to restore
the balance between secured creditor’s rights to realize the value of their guarantee and general unsecured creditors rights to a fair distribution of a debtor’s assets.

1. Dealing with Positive Judicial Treatment of Guarantor Waivers

As discussed above in In re Fastrans,\(^{[113]}\) and In re XTI Xonix Technologies,\(^{[114]}\) courts have upheld the validity of guarantor waivers. Finding that the waivers served to eliminate the guarantor’s status as creditors of the estate, arguments challenging the waivers due to a lack of consideration or a violation of public policy have both failed.\(^{[115]}\) Courts have found that the trustee lacks standing and as a result cannot challenge the validity of the guarantor waiver.\(^{[116]}\) Alternatively, courts have declined to even address public policy arguments – finding that countervailing policy existed to weigh against recovery.\(^{[117]}\) In order for a bankruptcy trustee to recover preferences from an insider guarantor, these obstacles must be overcome.

In order to challenge the validity of guarantor waivers, a bankruptcy trustee must first establish standing to sue. As discussed above in Part III, although the court in In re Fastrans found that the trustee lacked standing to even contest the terms of the guarantee,\(^{[118]}\) the In re XTI Xonix Technologies court disagreed with that analysis.\(^{[119]}\) In light of that reasoning, further courts have not even addressed the issue.\(^{[120]}\) In addition, the countervailing policy arguments that originally served to protect non-insider creditors do not exist when a trustee seeks to recover from the insider, rather than the non-insider creditor.

2. Recent Cases Disregarding Guarantor Waivers

Two recent cases may provide trustees with the path needed to recover from an insider guarantor shielded by a guarantor waiver. In In re Telesphere Communications,\(^{[121]}\) the bankruptcy trustee sought to recover a preference against an insider guarantor in a failed leveraged buy-out.\(^{[122]}\) The insider argued that his guarantor waiver eliminated his status as a creditor of the debtor.\(^{[123]}\) In a footnote, the court referred to its earlier determination that a guarantor waiver had no economic impact, and as a result, was a “sham provision, unenforceable as a matter of public policy.”\(^{[124]}\) The court stated that despite the waiver, the insider could still obtain a claim against the debtor simply by purchasing the lender’s note rather than paying on
the guarantor. Therefore, the guarantor waiver operated only as a contractual attempt to eliminate a provision of the Bankruptcy Code.

In a more thorough analysis, the court in In re Pro Page Partners dealt with a similar situation. A trustee sought to recover preferential payments from an insider guarantee on three different guarantees. With respect to one of the guarantees, the trustee even conceded that she would be unable to establish a claim against the insider if Fastrans was still good law and controlling in her case. Noting that while the holding in Fastrans was not appealed and had been followed by many other courts, the court stated that “Fastrans is not controlling in this case.”

Citing both In re Telesphere Communications and several commentator’s disapproval with the Fastrans approach, the court rejected the insider’s argument that the guarantor waivers operated to shield him from preference liability. The court stated: “the use of Bankruptcy Code terminology and definitions in a commercial, nonbankruptcy setting was designed to posture the players in this transaction in such a way to forestall any future preference exposure, whether on the part of [the lender] or the [insider].” Because the guarantor could easily override the waiver by purchasing the lender’s note rather than paying on it, concluding that the waiver eliminates the insider’s creditor status and resulting preference liability would improperly elevate form over substance.

CONCLUSION

Seeking to maintain insider guarantees as an efficient security device, Congress and the courts have sought to temper the incentive for insider guarantors to abuse their position. However, the current system that evolved after Deprizio is flawed, with guarantor waivers preventing recovery from insider guarantors and the operation of § 550(c) distinguishing between payments and non-possessory security interests. Although a proposed Congressional amendment will stop the distinction between payments and non-possessory security interests, a judicial solution is required to recover from insider guarantors with waivers. While such a
judicial solution will have to surmount contrary case law, the policy arguments underlying those cases do not apply. Indeed, two recent cases have refused to enforce waivers of subrogation.

* J.D. Candidate, May 2003, Chicago-Kent College of Law.


[3] Under the Bankruptcy Code, an insider is defined as: “(1) For individuals, includes relatives or general partners of the debtor; (2) For corporations, includes directors, officers, persons in control, partners, or relatives of a general partner, director, officer, or persons in control of the debtor.” 11 U.S.C. § 101 (31).


[5] 874 F.2d 1186 (7th Cir. 1989). The case is also referred to as In re Deprizio, named after Richard Deprizio, the debtor in bankruptcy.

[6] The definition of “benefit” is a very liberal one. Reducing his exposure on the guarantee could indirectly benefit an insider. Id. at 1194-95.

[7] The Bankruptcy Code takes an expansive view of who may be considered to be an insider. It provides:

“insider” includes—

(A) if the debtor is an individual—

(i) relative of the debtor or of a general partner of the debtor;

(ii) partnership in which the debtor is a general partner;

(iii) general partner of the debtor; or

(iv) corporation of which the debtor is a director, officer, or person in control;

(B) if the debtor is a corporation—

(i) director of the debtor;

(ii) officer of the debtor;

(iii) person in control of the debtor

(iv) partnership in which the debtor is a general partner;

(v) general partner of the debtor; or

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

(C) if the debtor is a partnership—

(i) general partner in the debtor;

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

(iii) partnership in which the debtor is a general partner;

(iv) general partner of the debtor; or

(v) person in control of the debtor;

(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;

(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and

(F) managing agent of the debtor.


[8] LeVít, 874 F.2d at 1200-01.
Preferences have also been defined as “eve-of-bankruptcy transfers to creditors that distort bankruptcy’s pro-rata sharing rule.” DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 155 (1992).


See id.

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

Id. at 1187.

The court used particularly colorful language to describe the fate of Richard N. Deprizio, the firm’s president with rumored ties to organized crime: “Deprizio was lured to a vacant parking lot, where an assassin’s gun and the obligations of a lifetime were discharged together. Corporations are not so easily liquidated.” Id.

The Seventh Circuit accomplished this logical leap through the Bankruptcy Code’s separation of the concepts of avoidability and recoverability. Preferences are avoided through § 547, while they are recovered through § 550. The Deprizio analysis works because any transfer to or for the benefit of an insider creditor (Deprizio) made within one year of bankruptcy is avoidable. Due to Deprizio’s rights of exoneration, reimbursement, and subrogation from his guaranty, he met the statutory definition of a creditor under the Bankruptcy Code. Because payment on Deprizio’s guaranteed loan reduced his contingent liability under the guaranty, it was for the benefit of an insider, even though paid to a third party. Id. at 1200-01. For a more thorough analysis of the Deprizio case, see 1 EPSTEIN, NICKLES & WHITE, BANKRUPTCY § 6-10 (1992).

Deprizio was criticized because it used a literal reading of complex statutes to reach a result contrary to Congressional intent. See Donald W. Baker, Repayments of Loan Guaranteed by Insiders as Avoidable Preferences in Bankruptcy: Deprizio and Its Aftermath, 23 U.C.C. L.J. 115 (1990). Another commentator claimed that it unduly


JORDAN ET AL., supra note 14 at 522.

Id.


[29] Id.


[30] Id.

[31] Id.


[33] Id.

[34] [33] The legislative history can be found in House Report No. 103-885, and 1994 U.S. Code Cong. and Adm. News P. 3340.

[35] Deprizio remains solid law for the proposition that preferences made within one year of the bankruptcy to non-insider creditors may still be recovered from the insider guarantor (as opposed to the “innocent” creditor). See Gordon v. Sturm (In Re: M2Direct, Inc.), 282 B.R. 60 (Bankr. N.D. Ga. 2002). In In re: M2 Direct, four insider guarantors unsuccessfully attempted to use § 550 (c) as a defense to preferences made resulting from payments made between ninety days and one year prior to the bankruptcy petition date. Id. at 62-64. Interestingly, the court commented on the guarantors’ failure to argue that they are not creditors of the debtor by waiving all rights of indemnification, subrogation, contribution, and exoneration against the debtor in the loan documents. Id. at 65, citing Jo Ann J. Brighton, Payments Benefitting Insider Guarantors Can be Protected from Recovery by Artful Loan Drafting, AM. BANKR. INST. INST. J.,2001 ABI JNL. LEXIS 181, *3-4 (Oct. 2000).


[39] Id. at 633.

[40] Id.

[41] Id.

[42] Under Article 9 of the U.C.C., a creditor can perfect a security interest by taking actual possession of the collateral. U.C.C. § 9-313 (2003).


[46] Id. at 802.

[47] Id.

[48] Id. Had the lenders perfected their security interest within 10 days of closing, the perfection would have been an uncontestable U.C.C. Article 9 perfection. Id.

[49] Id.

[50] Id. at 802-803.

[51] Id. at 803-804.

[52] More than thirty years ago, unsecured creditors in business bankruptcies received an average of 8% of their claims, while general creditors in personal bankruptcies received 7% of their claims. Petitioning Creditors of Melon Produce, Inc. v. Braunstein, 112 F.3d 1232, 1238-39 (1st Cir. 1997)


The Supreme Court has made it clear that, in questions of statutory interpretation, the plain meaning of the statute is to be given effect. When a statute is clear (i.e. non-ambiguous) recourse to the legislative history is not appropriate.

Here, it is noteworthy that Congress chose to amend § 550 of the Code, the “recovery” statute. Had Congress intended to completely override the Deprizio line of cases and to prevent any adversary proceeding, such as the case at bar, the most effective method would have been to add another defense or exception to avoidance in § 547(c).
Id. at 805 (citations omitted).


For purposes of § 547:

(9) “creditor means—

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

(B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(h) or 502(i) of this title;

11 U.S.C. § 101(9) (2002). The Seventh Circuit found that the insider guarantor’s contingent claim against the debtor for repayment in the event that the insider guarantor had to pay on the guarantee satisfied the Code’s definition of claim. Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989). Under the Code:

(4) “claim” means—

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


For additional cases that would uphold guarantor waivers, see Matter of Southmark Corp., 993 F.2d 117, 120-21 (5th Cir. 1993); Brandt v. American Nat’l Bank & Trust Co. of Chicago (In re Foos), 188 B.R. 239, 240-43 (Bankr. N.D. Ill. 1995).


Id. at 243.

Id. The waiver stated:

Each guarantor also hereby waives any claim, right or remedy which such guarantor may now have or hereafter acquire against the [debtor] … that arises hereunder and/or from the performance by any guarantor hereunder including, without limitation, any claim, remedy or right of subrogation, reimbursement, exoneration, contribution, indemnification, or participation in any claim, right or remedy of Associates against the [debtor] … or any security which Associates now has or hereafter acquires, whether or not such claim, right or remedy arises in equity, under contract, by statute, under common law or otherwise.

Id.

Id.

Id. at 246.

Id. at 243-44.

Id. at 244.

Id.

Id. at 245.

Id. The court found that under Tennessee law, the trustee/debtor was not an interested third party beneficiary of the Guaranty and had no standing to enforce, challenge, or otherwise interfere with the contract. Id. As a result, the court did not address the validity of the waiver provision in the Guaranty. Id.

Id.

Id.

Id. at 244. In a separate transaction, the debtor owed Yuhas $72,000 for unpaid rent. Id.

Id. at 824-25.

Id. at 825. In addition to subrogating the rights of the Petersons to the bank, the guarantee provided: “Guarantor irrevocably waives, disclaims, and relinquishes all claims against Debtor which Guarantor otherwise has or would have by virtue of having executed this Guaranty, specifically including but not limited to all rights of indemnity, contribution or exoneration.” Id.

Id.

Id. at 824.

Id.

Id. at 826.

Id.

Id. at 833-34. There was some question over whether the provision waived the Peterson’s equitable right of subrogation, however. Id. at 828-33. Ultimately, the court found that the unrefuted evidence of the parties’ intent waived the Petersons’ right of subrogation. Id. at 833.

Id. at 833.

Id. at 833-34.


Id. at 421.

Id. at 422.

Id. The waiver provision of Marino, Jr. provided:

We shall have no right of subrogation, reimbursement or indemnity whatsoever and no right of recourse to or with respect to any assets or property of Subject [the Debtor] or to any collateral for Security Obligations [the guaranteed indebtedness], unless and until all Security Obligations shall have been paid and performed in full.

Id.

Id.

Id.

Id. at 423.

Id.

Id.

Id. at 424.

See Jo Ann J. Brighton, Payments Benefitting Insider Guarantors Can be Protected from Recovery by Artful Loan Drafting, AM. BANKR. INST. J., 2001 ABI JNL. LEXIS 181, *3-4 (Oct. 20001). She advocates the use of waivers of the guarantor’s equitable rights not only to protect the creditor, but to protect the guarantor from becoming a creditor of the estate, and thus subject to recovery by the trustee and reducing the creditor’s ability to recover from the guarantor. Id. See also Warren Gorham Lamont, Bankruptcy: Avoidance of Insider Preferences, REAL ESTATE LAW REPORT (Sept. 1999); Richard C. Josephson, The Deprizio Override: Don’t Kiss Those Waivers Goodbye Yet, BUSINESS LAW TODAY May/June 1995. But see Peter L. Borowitz, Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio, 45 BUS. LAW. 2151, 2157-64 (Aug. 1990) (analyzing waivers of subrogation under Fraudulent Conveyance laws).

See Brighton, supra note 99 at *4 (stating that lenders found a way to contract around § 550(c) and prevent guarantors from becoming creditors of the estate with weakened financial positions).

See Id. at *4.

See In re Mercon Indus., Inc., 37 B.R. 549, 553 (Bankr. E.D. Pa. 1984). It stated:

[I]nsiders commonly benefit in the form of increased salaries, bonuses or stock dividends, from the debtor's receipt of the funds, when the monies serve to increase the debtor's revenue. When the debtor's demise is imminent, the insiders who guaranteed the debtor's loan frequently hold enough sway with the debtor to cause it to pay off these guaranteed loans prior to the payment of other obligations. Consequently, the insiders have diverted resources to protect themselves.
Id. But see In re Sufolla, Inc., 2 F.3d 977 (9th Cir. 1993) (finding that “[b]ecause an insider gives up something of little or no practical value when he executes a waiver, he is only very slightly, if at all, more likely to cause a preferential payment); Mark E. Toth, Comment, The Impossible State of Preference Law Under the Bankruptcy Code: Levit v. Ingersoll Rand and the Problem of Insider-Guaranteed Debt, 1990 WIS. L. REV. 1155, 1169 (“[t]he only benefit surrendered by such a waiver would be the inside guarantor’s right to be subrogated to the outside creditor’s largely worthless claim to a deficiency judgment against the [bankrupt] debtor corporation”).

For a more detailed description of the proposed amendment in various bills, see infra note 107. The Bankruptcy Reform Act of 1999 was killed by a pocket veto exercised by President Clinton, due to concerns over an unrelated portion of the legislation making it harder for individuals to file for Chapter 7 protection. Bankruptcy Reform Bill Dies With a ‘Pocket Veto,’ WALL ST. J., Dec. 20, 2000, available at 2000 WL-WSJ 26620630. The Bankruptcy Reform Act of 2001 was killed over a controversial provision barring abortion-clinic protestors from using bankruptcy to avoid court-approved financial penalties. Tom Hamburger & Shailagh Murray, Bankruptcy Bill Surprisingly Fails Over Obscure Abortion Provision, WALL ST. J., Nov. 15, 2002, at A1. In the interim, revised Article 9 of the U.C.C. may help lenders avoid the drastic effect of having their liens avoided. It provides for relaxed requirements for valid financing statements. See G. Ray Warner, Lien on Me: Preferences and the Use of Revised Article 9 to Correct Perfection Defects, 2001 AM. BANKR. INST. J. 167 (2001).

For an example of this difficulty, see supra note 105. The relatively uncontroversial provisions amending § 547 have been years in the making. However, if a legislative solution were to be proposed, Congress could amend § 547 (b) (1) to read: “to or for the benefit of a creditor or insider guarantor.” Alternatively, Congress could amend the definition of “creditor” in 11 U.S.C. § 101(9) (2002) to clearly include insider guarantors.

The court in In Re: M2Direct, Inc., 282 B.R. 60 (Bankr. N.D. Ga. 2002), suggested that this would have been the easiest way for Congress to fix the problem caused by the distinction between recovery and avoidance. H.R. 833, 106th Cong. § 1116 (1999); see also S. 625, 106th Cong. § 1114 (1999). The same provision was included unchanged in the next Congressional session in both H.R. 333, 107th Cong. § 1213 (2001) and S. 420, 107th Cong. § 1213 (2001), as well as in the current House bill H.R. 975, 108th Cong. § 1213 (2003).


As a practical matter, this recourse would have been worthless. Mrs. Williams would have simply filed for Bankruptcy along with her husband. Id.

The amendment would also moot the previous Congressional override to the Deprizio Dilemma found in 11 U.S.C. § 550(c) (2002). If the trustee were unable to avoid the transfer as a preference with respect to the non-insider creditor, there would be no need to prevent recovery of that transfer from a non-insider creditor.

Alvin L. Arnold, Bankruptcy: Waiver of Subrogation Defeats Deprizio, 22 REAL EST. L. REP. 4 (Dec. 1992). As another commentator has stated, “the insider’s motivation to cause the debtor to pay the guarantied creditor ahead of others is increased by a reimbursement waiver because payment by the debtor is the only way for the guarantor to avoid bearing the ultimate liability.” Marshall E. Tracht, Insider Guaranties in Bankruptcy: A Framework for Analysis, 54 U. MIAMI L. REV. 497, 542 (April 2000).


In re Fastrans, 142 B.R. at 245.

Id.

Id.

Id.

In re XTI Xonix Technologies, 156 B.R. at 826.


Id. at 175.

Id. at 177 n.3.

Id.

Id.

Id.

Id.


Id. at *6.
The trustee stated that she would be unable to establish a claim against Debtor with respect to only one of the three guarantees – the Central Leasing Guaranty. *Id.* Even under *Fastrans*, the trustee was able to recover under the other two guarantees because the language in the guarantees failed to waive all rights of subrogation – the guarantor only waived its subrogation rights until the lender was paid in full. *Id.* at *9.

*Id.* at *6.

*Id.* at *7, citing *In re Suburban Motor Freight*, 134 B.R. 617, 626 (Bankr. S.D. Ohio 1991) (“The doctrine of *stare decisis* does not bind one bankruptcy court to follow the decision of another bankruptcy court, even if that decision is from another bankruptcy judge within the same district.”) *Id.*

*Id.* at *8.

*Id.*

*Id.*