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INSIDER GUARANTIES: THEIR EFFECT ON THE BANKRUPTCY PREFERENCE "REACH BACK" PERIOD AND POSSIBLE USE IN GETTING AN "ORDINARY COURSE" EXCEPTION FROM AVOIDANCE

Thomas D. Buckley*

I. INTRODUCTION

IN 1990 the Sixth Circuit decided two bankruptcy preference cases, Ray v. City Bank & Trust Co. (In re C-L Cartage Co.)¹ (“Cartage”) and Gosch v. Burns (In re Finn)² (“Finn”), that will have important consequences in the administration of bankruptcy proceedings and will also influence the way lenders and borrowers do business with each other in the future, whether or not a bankruptcy ever ensues.³ In Cartage the court followed the famous (and to lenders infamous) Deprizio⁴ decision from

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1. 899 F.2d 1490 (6th Cir. 1990).
2. 909 F.2d 903 (6th Cir. 1990).
3. There were also two less significant preference decisions: Belknap, Inc. v. Shaler Corp. (In re Belknap, Inc.), 909 F.2d 879, 884 (6th Cir. 1990) (holding that when payment is made by check, transfer occurs when the creditor receives the check); Taunt v. Fidelity Bank of Michigan (In re Royal Golf Prods. Corp.), 908 F.2d 91, 95 (6th Cir. 1990) (holding that when a debtor provides security to a creditor, the value of the security and the effect on the debtor’s estate of its transfer are to be determined as of the time the security is given, not the date of bankruptcy).
4. Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989). The debtor in Levit was the V.N. Deprizio Construction Co.; the case was known as In re Deprizio before it reached the Seventh Circuit and is commonly referred to in the literature as Deprizio. See Borowitz, Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio, 45 Bus. Law. 2151 (1990). Deprizio had already been followed by the Tenth Circuit in Manufacturers Hanover Leasing Corp. v. Lowrey (In re Robinson Bros.
the Seventh Circuit establishing a one year preference "reach back" period for loans guarantied by "insiders"; in Finn it held that repayments on long term debt may qualify for the "ordinary course" exception from avoidance.5

In both cases the Sixth Circuit interpreted the text of the Bankruptcy Code in the same literal, straightforward way. Yet the results as far as preference law is concerned point in different directions: Cartage significantly increases the bankruptcy trustee's preference avoiding power; Finn, decided a few months later, undercuts the first decision, diminishes the trustee's power, and makes preference law in general less significant. Yet each decision fairly reflects the preference law that Congress wrote.

This article first describes briefly the mechanics of preference law and the application of it in Cartage and Finn. The article then focuses primarily on the Cartage decision, because the analytic approach taken by the court in Cartage has implications for other preference issues. Cartage is evaluated in terms of the text and structure of the Bankruptcy Code and bankruptcy policy, and the effect that the rationale for the decision will have on other preference issues. Next, the direct practical impact of Cartage is examined, and it is in that context that Finn is encountered. Finn's effect on preference law is considered, along with what lenders can do to take advantage of its holding. Finally, the article suggests what lenders can do to lessen the impact of Cartage.

Drilling, Inc.), 892 F.2d 850 (10th Cir. 1989).


5. Finn is in direct conflict with the Ninth Circuit's decision in CHG Int'l, Inc. v. Barclays Bank (In re CHG Int'l, Inc.), 897 F.2d 1479 (9th Cir. 1990). Perhaps the Supreme Court will eventually resolve the conflict.
II. PREFERENCE MECHANICS

A bankruptcy trustee is responsible for collecting a debtor's assets, liquidating them, and distributing the proceeds among the debtor's creditors. In gathering the assets the trustee can exercise certain "avoiding" powers. The power to "avoid" a transfer is the power to nullify a transfer of assets that the debtor made before going into bankruptcy. If a transfer is avoided, the assets transferred can be recovered under a separate section of the Bankruptcy Code and added to the assets in the debtor's "estate," the pool of property available for distribution. In exercising avoiding powers the trustee is acting on behalf of all the unsecured creditors, the people who share in the division of that pool.

Section 547 of the Bankruptcy Code gives the trustee the power to avoid "preferences." Subsection (b) states the five elements that the trustee must establish in order to do so; essentially they allow avoidance of transfers made to or for the benefit of a creditor with respect to antecedent debt. Section

6. 11 U.S.C. § 704 (1988). This description of preference mechanics assumes for the sake of simplicity a chapter 7 liquidation case. In a chapter 11 case, where a trustee is normally not appointed and reorganization instead of liquidation occurs, trustee powers and responsibilities are exercised on behalf of unsecured creditors by the debtor itself.

7. Id. § 541. This section provides that the commencement of a bankruptcy case creates "an estate" consisting of, inter alia, all the debtor's interests in property, and any property the debtor's bankruptcy trustee recovers under § 550.

8. Section 547(b) provides:

(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 the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) that enables such creditor to receive more than such creditor would receive if—
547(c) states a series of exceptions from avoidance—transfers that would be avoidable under the general rules of section 547(b), but which are nevertheless not avoidable because of their special nature.

In acting on behalf of the unsecured creditors when exercising the preference avoiding power, the trustee's adversary will be a former creditor, or a creditor who has already been paid in part but not in whole by the debtor, and who in either event wants to keep what it has received. In effect, the preference avoiding power makes antagonists of two categories of creditors with unsecured claims: those paid before bankruptcy, and those still waiting to be paid out of the pool of assets that the debtor still has when the bankruptcy process starts.

The Cartage case focused on sections 547(b)(4) and 550 (the separate section on liability for avoided transfers). Section 547(b)(4) provides that the trustee can avoid a transfer on account of an antecedent debt if the transfer was made by the debtor during the last ninety days before bankruptcy begins, or, if the transfer was made with respect to an "insider," if it was made between ninety days and one year before bankruptcy.9

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9. Id. § 101(30), which 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 of the debtor;
   (ii) relative of a general partner in, general partner of, or person in control of the debtor;
The transfers in *Cartage* were made to one creditor, a lender, and they benefitted other creditors, the "insiders" who had guarantied repayment and who were better off because the transfers were made. *Cartage* held that a lender whose loan is guarantied by a corporate insider may have to surrender all loan repayments received during the entire last year before the borrower's bankruptcy; were it not for the insider guaranty, an arms length lender would be exposed to the bankruptcy trustee's preference avoiding power with respect to debt repayments only if they were made during the last ninety days before bankruptcy. An insider creditor is always subject to the one year preference "reach back" period. *Cartage* applies the longer, insider, period to the arms length outsider because of the insider's guaranty that the loan will be repaid to the outsider.

The decision puts a creditor with an insider guaranty at a disadvantage once bankruptcy begins, and it stretches the period before bankruptcy during which such a creditor must remain uncertain as to whether loan repayments already received can be kept, or will have to be given up in exchange for claims against an insolvent estate.

The *Finn* case dealt with section 547(c)(2), which states an exception from avoidance for "ordinary course" transfers.

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10. *Id.* § 547(b)(4)(B).
11. 899 F.2d 1490, 1493 (6th Cir. 1990).
12. *Id.* at 1494.
13. *Id.*
14. Section 547(c)(2) provides:

The trustee may not avoid under this section a transfer—

(2) to the extent that such transfer was—

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the
Section 547(c)(2) was amended in 1984; before the amendment, the section 547(c)(2) exception applied only if the debt repaid had been incurred within forty-five days before it was repaid. The forty-five day element was dropped in 1984. Finn held that the amended section 547(c)(2) means what it says: long term debt repayments as well as short term debt repayments are eligible for exception from avoidance, provided the "ordinary course" standards of the subsection are met.

From the perspective of some creditors targeted for preference attack (those with insider guaranties), Cartage increased four-fold the range of the trustee's preference avoiding gun. But Finn wet the trustee's gun powder; the avoidance gun won't fire at all for numerous debt repayments, whether they are guarantied or not, and no matter when they were made, so long as they meet "ordinary course" standards. Such payments are not avoidable even though they were made to repay debts that were long term and therefore quintessentially "antecedent."

III. THE CARTAGE DECISION

Carlos Foster, the president and a principal in C-L Cartage, was unable to obtain loans for his company on its own credit. He learned that money would be made available by City Bank, however, if he borrowed the funds himself, his mother Della Foster cosigned, and the loans were secured with certificates of deposit owned by Della Foster. City Bank then made two advances on these terms to Carlos, one of $30,000 and one of $20,000; certificates of deposit were pledged to the bank. Carlos turned the loan proceeds over to the company for use in the business.

A year after the first loan, C-L Cartage filed a Chapter 11 bankruptcy petition seeking reorganization; that proceeding was

16. 909 F.2d 903, 906-08 (6th Cir. 1990).
17. Id. at 907.
18. Id. at 906-07.
19. 899 F.2d 1490, 1491 (6th Cir. 1990).
converted later to a Chapter 7 liquidation, and a trustee was appointed. Before the petition was filed, C-L Cartage had made ten payments that were the subject of the trustee’s avoidance efforts. Each was a scheduled installment payment on one or the other of the two loans City Bank had made to Carlos. Some payments were made directly to the bank; others were made to Della Foster who immediately endorsed the payment checks over to the bank. Some payments were made within ninety days before the bankruptcy petition was filed; others were made earlier, but within one year before the bankruptcy. The trustee sought to recover all ten payments from the bank.

The Sixth Circuit held that all ten payments were subject to avoidance under section 547 and recovery from the bank under section 550. With respect to payments made indirectly, via Della Foster, it remanded for a determination as to whether the bank as an “immediate” (not “initial”) “transferee” might have a defense under section 550(b)(1), based on good faith and lack of knowledge of avoidability.

Under section 547(b), to “avoid” transfers made more than ninety days before bankruptcy the trustee had to establish that the payments were made “to or for the benefit of a creditor” of C-L Cartage, “on account of an antecedent debt,” while C-L Cartage was insolvent, that “such creditor” was an “insider,” and that “such creditor . . . [would wind up better

20. Id.
21. Id. at 1491-92.
22. Id. at 1493.
23. Id. at 1495. 11 U.S.C. § 550(b) (1988) provides:
The trustee may not recover under section (a)(2) of this section from—

(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
(2) any immediate or mediate good faith transferee of such transferee.

Section 550(a)(2) provides for recovery from “any immediate or mediate transferee of . . . [an] initial transferee.” Id. § 550(a)(2).
25. Id. § 547(b)(2).
26. Id. § 547(b)(3).
27. Id. § 547(b)(4)(B).
28. Id. § 101(30).
off on account of the transfer than if] the transfer had not been made."  

Each payment "benefitted" the Fosters because it reduced their obligation on the $50,000 in loans the bank had made to them. And the Fosters were "insiders." But were the Fosters "creditors" of C-L Cartage? And did C-L Cartage owe them an antecedent "debt"? There was no promissory note or other writing evidencing such a debt. Nor were the Fosters listed as creditors on the schedules C-L Cartage filed with its bankruptcy petition. The $50,000 paid into the company might have been characterized as a contribution to capital, increasing Carlos' equity position but not making him (or Della) a creditor. The Sixth Circuit, however, adopted as not clearly erroneous the finding by the district court that the Fosters were in fact creditors of C-L Cartage because of their expectation that the company would make the monthly payments due on their loans from City Bank. Failure of C-L Cartage to make those payments would have given rise to a "claim" against it by the Fosters, and because a creditor is a person holding a claim, including such a "contingent" claim, the Fosters therefore were creditors.

29. Id. § 547(b)(5).
30. City Bank claimed that it was fully secured. Payment to a fully secured creditor does not benefit a guarantor. See In re Deprizio, 874 F.2d 1186, 1199 (7th Cir. 1989). There was clearly benefit to the Fosters, however, because the certificates of deposit securing the loans belonged to Della Foster, not to C-L Cartage itself; each payment from C-L Cartage to City Bank thus reduced the encumbrance on Foster property, which benefitted them.
31. 11 U.S.C. § 101(9) (1988) provides in part that ""creditor" means—(A) entity that has a claim against the debtor . . . ."
32. 899 F.2d 1490, 1493 (6th Cir. 1990).
33. Id.
34. Id.
35. 11 U.S.C. § 101(4) defines "claim" broadly:
(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; or
(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured . . . .
36. 899 F.2d at 1492-93. The court also rejected the bank's argument that the finding of a debtor-creditor relationship between C-L Cartage and the
Although the court did not make it explicit, this reasoning also established that there was a "debt" and that all ten payments were "made on account of an antecedent debt." 37

C-L Cartage’s insolvency when the transfers were made was stipulated. 38 With respect to section 547(b)(5), which makes avoidance contingent on the advantage given to the preferred creditor by the transfer, the bank argued that because its loans were fully secured, 39 it would not receive any more as a result of the pre-petition transfers than it would have received upon C-L Cartage’s liquidation in chapter 7. 40 The bank was correct that fully secured creditors usually receive no more through pre-petition payments than they would collect upon payment of their claims in a chapter 7 bankruptcy case. 41 But the court said that the "creditor" referred to in section 547(b)(5) was the same creditor referred to in section 547(b)(1)—in other words, the creditor to or for whose benefit the transfer was made. 42 The reference therefore was to the Fosters and not to City Bank. What counted under section 547(b)(5) was the Fosters’ net position as a result of the ten transfers, not the bank’s. The Fosters were better off on account of the ten payments than they would have been otherwise. Therefore, section 547(b)(5) was satisfied. The bank’s status as a secured creditor was not relevant.

Fosters was wrong because it was necessarily premised on a violation of Tennessee’s statute of frauds, requiring suretyship agreements to be in writing. The court said that when C-L Cartage paid the bank, it reduced its direct obligation to the Fosters. It had never become liable to the bank or anyone as a surety. Therefore, the suretyship provisions of the statute of frauds were irrelevant. Id. at 1493.

37. 11 U.S.C. § 101(11) provides that a "‘debt’ means liability on a claim."
38. 899 F.2d at 1492.
39. As the district court explains, it was not clear that the bank was really fully secured. Ray v. Automotive Parts Exch. (In re C-L Cartage Co.), 113 Bankr. 416, 417 (E.D. Tenn. 1988). But because of the Sixth Circuit’s rejection of the bank’s entire § 547(b)(5) argument, the question did not have to be resolved. See 899 F.2d at 1493.
41. See, e.g., Gertz v. Bancohio Nat’l Bank (In re Conn), 9 Bankr. 431 (N.D. Ohio 1981). But Cartage was not a typical case because the collateral did not belong to the debtor.
42. 899 F.2d 1490, 1493 (6th Cir. 1990).
Thus the ten loan repayment transfers were "avoidable" under section 547. Recapture of a preference by a trustee for a debtor's bankruptcy estate is a two step process, however, involving first the "avoidance" of the preferential transfer under section 547, and then the actual recovery of the assets preferentially transferred, or their value, from the party liable to the trustee under section 550. Section 550(a)(1) provides for such recovery from either "the initial transferee . . . or the entity for whose benefit such transfer was made." Since each of the ten payments benefitted the Fosters, recovery from them was clear. But the trustee sought recovery from City Bank. The court's holding on recovery from City Bank resulted "directly from an application of the unambiguous statutory language." City Bank was the recipient of seven direct payments from the debtor. City Bank was therefore the "initial transferee" of seven payments, and the trustee could recover the seven payments from the bank. Recovery from the bank of the amount represented by three checks endorsed over to it by Della Foster was governed by section 550(a)(2), which provides for recovery from an "immediate or mediate transferee of such initial transferee." Because the bank as immediate transferee had not had a chance to assert the good faith and lack of knowledge defense available to "immediate" transferees, the court remanded.

In reaching its decision, the Sixth Circuit rejected the district court's determination that it would be "inequitable" to make the bank, an outsider, surrender preferences made more than ninety days before bankruptcy and avoidable only with respect to insiders. There was no room for the exercise of such equitable

43. Id. at 1494-95.
44. 11 U.S.C. § 550(a). This section provides:

Except as otherwise provided in this section, to the extent that a transfer is avoided under section . . . 547 . . . of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.

45. 899 F.2d 1490, 1494 (6th Cir. 1990).
46. Id. at 1495.
powers when the statute spoke as plainly as did sections 547(b) and 550.47

The court also rejected as "tortured" a reading of sections 547 and 550 under which each payment would be viewed as constituting "two transfers," one to the outsider, and one for the benefit of the insider.48 Insider transfers would be recoverable under this theory if they occurred during the extended, one year, reach back period; but the other "transfer," to an outsider such as City Bank, would be avoidable and recoverable from City Bank only if it occurred within ninety days before the debtor filed its bankruptcy petition.49 In rejecting the two-transfer theory, the Sixth Circuit quoted Deprizio to the effect that the Bankruptcy Code defined the word "transfer" with respect to payments from the perspective of the debtor who paid, not from the perspective of others who received or who were benefitted: "'A single payment . . . is one transfer, no matter how many persons gain thereby.'"50 Thus, one might paraphrase both Deprizio and Cartage and say that even if one stone kills two birds, there is still only one stone—and one, not two, transfers.

Finally, the court concluded that its reading of the statutes was consistent with the policies behind sections 547 and 550. An extended one year reach back period was appropriate because insiders such as the Fosters could use their control over a debtor such as C-L Cartage to see to it that C-L Cartage would pay outsiders such as City Bank and thus simultaneously favor themselves throughout the entire one year extended preference period; prevention of such favoritism toward some creditors was the reason for enactment of section 547 in the first place.51

47. Id. at 1494.
48. Id. at 1495 (quoting, Note, The Interplay Between Sections 547(b) and 550 of the Bankruptcy Code, 89 COLUM. L. REV. 530, 540 (1989)).
50. 899 F.2d 1490, 1494 (6th Cir. 1990) (quoting In re Deprizio, 874 F.2d 1186, 1196 (7th Cir. 1989)).
51. Id.
IV. THE CARTAGE DECISION AND THE TEXT AND STRUCTURE OF THE BANKRUPTCY CODE

A. The Code Text

In evaluating the textual case for the holding reached by the Sixth Circuit in Cartage it is helpful to understand at the outset that there would have been no textual issue at all about the trustee’s power to recover all ten payments from the Fosters had the trustee sought to do so. It is clear that every element in section 547(b)’s formula for avoidance is satisfied with respect to them, and that as the persons “for whose benefit . . . [the] transfer was made” recovery of each payment from the Fosters is clearly provided for in section 550. The Fosters’ liability to the trustee, had they been called to account instead of City Bank, would have been a foregone conclusion and would have followed from an obvious, literal, straightforward, and noncontroversial reading of the text of the Code.

In Cartage the Sixth Circuit also said that such a “literal” and “straightforward” reading led inexorably to recognition of the trustee’s power to recover from City Bank.52 Thus the “avoidance” part of that argument against the bank under section 547(b) was identical to the argument the trustee would have made against the Fosters—indeed their “benefit” is what made the pre-ninety day transfers avoidable under section 547. Therefore, to the extent that a textual challenge to the holding in Cartage is focused on the text of section 547(b) and the Sixth Circuit’s reading of that text, a challenger would have to 1) reject the court’s reading of the text as it applied to non-insiders such as City Bank, and yet somehow simultaneously 2) accept the very same reading with respect to insiders such as the Fosters.Positing that “two transfers” occur when a single payment is made provides a method to accomplish that interpretive goal.

In operation, the two-transfer theory would require that each of the payments at issue in Cartage be analyzed twice: once as a transfer to an outsider creditor (City Bank) and once as a transfer for the benefit of an insider creditor (the Fosters). The

52. 899 F.2d 1490, 1495 (6th Cir. 1990).
payments occurring between ninety days and one year before bankruptcy would then be avoidable transfers with respect to the insider creditor (under section 547(b)(4)(B)), and yet simultaneously would not be avoidable transfers with respect to the outsider creditor (under section 547(b)(4)(A)). Each single payment’s status as both avoidable and non-avoidable would then be given practical significance by section 550, which provides for “recovery” by the trustee of transfers “to the extent” they are avoided. A transfer or payment avoided “to the extent” it benefitted an insider would be recoverable; but the same payment as a transfer to an outsider would not be recoverable because “to the extent” it was to the outsider it was not avoidable in the first place. Since each of the two transfers was really only a single payment, the logic of the two-transfer theory (but not the text of section 550) then requires that recovery of the payment be only from the insider who benefitted.

The Sixth Circuit’s characterization of this interpretative process as “tortured” seems fair. The two-transfer theory obviously depends on an ingenious, result-driven reading of the text of sections 547(b) and 550. If this were all there was to it, the Sixth Circuit’s summary rejection of the two-transfer analysis would appear sound.

There is more however. It has been suggested that a textual case for the two-transfer theory arises when section 547’s overall internal coherence is examined, specifically the connection between section 547(b) and section 547(d),3 a subsection that has nothing to do with insiders and that had no part to play in the actual decision-making process in Cartage. Section 547(d) provides:

The trustee may avoid a transfer of an interest in property of the debtor transferred to or for the benefit of a surety to secure reimbursement of such a surety that furnished a bond or other obligation to dissolve a judicial lien that would have been avoidable by the trustee under subsection (b) of this section. The liability of such surety under such bond or obligation shall be discharged

to the extent of the value of such property recovered by the trustee or the amount paid to the trustee.\textsuperscript{54}

This subsection operates if a debtor, before bankruptcy, had posted a bond to get a judicial lien removed from property seized by a judgment creditor, and if the debtor had granted a mortgage to the surety/bonding company to induce it to issue the bond. Under the first sentence of section 547(d) the mortgage granted to the surety can be avoided. In exchange, under the second sentence, the surety is given freedom from liability on the bond. The levying creditor winds up with neither the asset it seized in the first place, nor the protection of the bond; but that is exactly what the levying creditor would have wound up with if no bond had been issued and the trustee had avoided the (involuntary) transfer of the seized asset pursuant to section 547(b).

Why does this subsection imply that one transaction is two transfers, not just one transfer? The reasoning is clear. The granting or transfer of the mortgage to the surety benefitted the levying creditor to whom an antecedent debt was owed. If that event is but "one transfer," it is susceptible to avoidance under section 547(b) without the necessity of any special statutory treatment in the first sentence of section 547(d). On the other hand, if that event can be viewed as two transfers, one to the surety and one for the benefit of the creditor, then it is not avoidable with respect to the surety because it is not on account of an antecedent debt: the surety provides its credit in the form of the bond contemporaneously with the granting of the mortgage. If section 547(b) is to be read as dealing with "one transfer" for every payment or other event in which an interest in the debtor's property moves to another person, there would have been no need to enact the first sentence of section 547(d). Yet Congress enacted it. Ergo, section 547(b) should be read as requiring or at least allowing a two-transfer analysis.

The persuasiveness of this neat little argument depends on how one accounts for the inclusion in the statute of section 547(d)'s first sentence. Clearly Congress wanted the surety's lien avoided. But did it include sentence-one because if it had not

done so, the lien would not be avoided? Or, is there some other explanation for including it?

If the answer is the former, if sentence-one is indispensable to achieving the congressional intent and had to be there or else the surety’s lien would escape avoidance, then the two-transfer theory is strengthened because the two-transfer approach would allow avoidance versus the lien creditor while simultaneously protecting the surety. A specific negation of the implications of the two-transfer theory would thus be required in special situations where Congress wanted a certain result incompatible with its ordinary operation. The surety situation covered by section 547(d) would then be seen as one such special situation needing special statutory attention. The norm, in the absence of something like section 547(d) sentence-one, would be the two-transfer approach. This explanation for the first sentence is a possibility; it cannot be ruled out categorically. But is it a probability? That depends on what other explanation may be available to account for the subsection.

Section 547(d) is derived from section 67(a) of the Bankruptcy Act of 1898.35 Did the copying of the substance of section 67(a) into the Bankruptcy Code of 1978 carry with it a negative implication about what the law would be if it had been left out? Or, did Congress put it in the new law because section 67(a) identified the section 547(d) surety situation, and Congress wanted the law to continue to operate as before? This too is a possibility. And it is the more probable explanation for section 547(d)'s first sentence.

The latter explanation's higher probability is a function of the probability or likelihood of the premise for each possible explanation. The premise for the historical, section 67(a), explanation is simply that Congress knew about and approved the substance of section 67(a). The legislative history establishes this. The premise for the other, “two-transfer,” explanation is

55. See S. REP. No. 989, 95th Cong., 2d Sess. 88, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5874-75; H.R. REP. No. 595, 95th Cong., 1st Sess. 374, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6330. Section 67(a) gave the trustee the power to avoid preferences received by levying creditors. Such an involuntary transfer of the debtor's property was not avoidable under the main preference section of the 1898 Act, § 60. Under the broad definition of transfer in the Bankruptcy Code of 1978, voluntary and involuntary preferences are both avoidable under § 547.
that 1) Congress knew about or itself conceived the two-transfer theory, that it 2) approved of that approach for general use in interpreting section 547(b), but 3) did not explicitly say so or codify this approval, while 4) it did codify (in section 547(d)) an exception from that approach. There is no evidence to establish any of this. Therefore, given a simple (and non-circular) explanation for section 547(d)'s first sentence, it seems better to accept it instead of imputing to Congress the intent to legislate a general rule sub silentio while codifying only its exception.56

Viewed this way, section 547(d) supports rather than detracts from the Cartage decision’s rejection of the two-transfer approach. It manifests the underlying congressional intent to apply avoidance law to transferees (such as both the surety and non-insiders with insider guarantied loans) whose own status and characteristics, in isolation, would not render them vulnerable to the avoidance power.

Furthermore, this explanation for putting section 547(d) sentence-one into section 547 seems even more plausible when section 547(d)'s second sentence is considered. The second sentence states positive substantive law that can be found nowhere else in the Bankruptcy Code. The granting of protection to the surety (discharge of its obligation on the bond) can then be seen as the real addition to the law made by section 547(d). The first sentence then becomes not so much a statement of a separate avoiding power as a preface to the real substance of the subsection.

In any event, in calculating the probabilities concerning why section 547(d) appears in the Bankruptcy Code and what it means in terms of the two-transfer theory, it should be kept in mind that section 547(d) is a relatively minor provision. There is only one reported case in which it was invoked by a bankruptcy

56. There are other instances of specific statutory attention to a particular matter that do not imply that some general rule requires a different result. For example, the explicit, detailed, and particularized protection given to shopping center landlords under § 365(b)(3)(A), (B), (C), and (D) when a shopping center tenant goes into bankruptcy, does not necessarily imply that courts could not have been as generous to such landlords by applying the general rule of § 365(b)(1)(C), giving all lessors “adequate assurance of future performance” by debtors or their assignees.
trustee, and in that case the facts did not warrant its actual application to avoid a transfer.\textsuperscript{57} Collier's Treatise ignores it, skipping from coverage of section 547(c) directly to treatment of section 547(e).\textsuperscript{58} Section 547(d) is a fragile foundation on which to construct or justify the elaborate statutory interpretation edifice that is the two-transfer theory.

B. The Structure of the Code

Like the textual argument, the "structural" argument against outsider (City Bank) liability for pre-ninety day repayments has to accommodate the simultaneous liability of the insiders (the Fosters) for the same repayments. It does so by rejecting the idea that one payment is two transfers, conceding that the (single) transfer is avoidable under section 547, but then limiting the trustee's power to recover it under section 550. The argument discerns in the structure and history of the Bankruptcy Code a congressional intent that recovery under section 550(a)(1) (from initial transferees and people benefitted by the transfer) be limited to the same "creditors," whose own conduct or status was a predicate for avoidance under section 547(b). Since outsider status was not a predicate for avoidance of pre-ninety day loan repayments, outsiders would not be liable for them under section 550(a)(1). Instead, outsiders such as City Bank would always be treated as if they were "immediate or mediate" transferees from initial transferees and would therefore always qualify for the good faith and lack of knowledge defense of section 550(b).\textsuperscript{59} City Bank would therefore have qualified for the defense on all payments, not just for the three payments made via Della Foster.

The argument begins with the observation that Congress has established in sections 550(a)(1) and (a)(2) two distinct classes of persons liable for the return of avoided transfers, giving each


\textsuperscript{58} 4 L. King, COLLIER ON BANKRUPTCY ¶ 547.15-547.16 (15th ed. 1990) [hereinafter COLLIER].

class different defenses against liability. Recovery from persons liable under section 550(a)(2) is subject to the defenses of good faith and lack of knowledge of avoidability; by contrast, section 550(a)(1) states no defense for persons liable thereunder. But this does not mean that initial transferees and entities benefitted by the transfer (the persons liable under section 550(a)(1)) have no defenses. On the contrary, the legislative history accompanying what became section 550 stated that "[v]ariances [in appropriate defenses] required as to the treatment of initial transferees are handled in the avoidance sections." That is, for preferences for example, defenses available to persons liable under section 550(a)(1) would be found in section 547(b) itself and in section 547(c), which provides a list of seven exceptions from avoidability for transfers otherwise avoidable under section 547(b).

It is clear too that it would be inappropriate to give such "creditors," whose conduct is the predicate for avoidability under section 547(b), the section 550(a)(2) and section 550(b) defenses. Those defenses include lack of knowledge of avoidability; one of the significant changes in preference law worked by Congress in the Bankruptcy Code was the dropping of creditor knowledge of avoidability as a factor in avoiding a preference. To put such "knowledge" back into the calculus at the recovery stage would make no sense.

While this observation effectively disconnects the "creditors" whose conduct is the predicate for avoidance under section 547 from the entities liable under section 550(a)(2), it still leaves room for reading section 550(a)(1) as applying to more people than just those (such as the Fosters with respect to pre-ninety day loan repayments) whose conduct was the predicate for

60. See Note, supra note 48, at 541-49.
63. See 11 U.S.C. § 547(b)-(c).
64. Section 60(b) of the Bankruptcy Act of 1898 provided that a preference could be avoided only if the creditor receiving it or benefitted by it had "reasonable cause to believe that the debtor is insolvent." Act of June 22, 1938, Pub. L. No. 75-696, § 60(b), 52 Stat. 840, 870 (repealed by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, title IV, Nov. 6, 1978, § 401(a), 92 Stat. 2659, 2682). Section 547(b) has no such requirement.
avoidance. That is, even if "predicate creditors" are never to be given section 550(a)(2) and (b) treatment and are always to be liable for recovery under section 550(a)(1), why is section 550(a)(1) reserved exclusively for them? Why must the "initial transferee" be only the same creditor whose conduct is a predicate for avoidance under section 547(b), and no one else (such as City Bank)?

Here is where the structural argument apparently founders, or convinces. And it is here too that it must confront the actual words that Congress used when it enacted its structurally separate bases of liability with their separate defenses in sections 550(a)(1) and (a)(2). For the argument fundamentally rests on the persuasiveness of its analysis of "structure"—that the separation within the Bankruptcy Code of "avoidance" from "recovery," which was a change from the approach of the Bankruptcy Act of 1898, and the further separation within the Code's schema of defenses of "avoidance section" defenses from section 550(b) defenses, necessarily imply the applicability, always, of the latter defenses to "non-predicate" (non-section 547(b)) creditors.

To support this analysis, its proponents rely, to an extent, on history. Before the enactment of the Bankruptcy Code of 1979, recovery of avoided transfers was possible only from persons whose conduct was a predicate for avoidance. Structural analysis proponents argue that any departure from that old law would have been made explicit or been signaled more directly had change been intended by Congress.65 This historical argument is considerably weakened, however, because the specific preference issue raised by the insider guaranty did not exist before 1979. Under the Bankruptcy Act of 1898 there was only one reach back period, of four months, and it applied whether transfers went to or benefitted insiders or outsiders.66

The other reasons offered to buttress the structural theory are, first, that the purpose of setting up two bases for liability and recovery in section 550 was primarily to deny the section 547(b) ("predicate") creditors any defenses other than section 547 defenses, and to give the other defense (e.g., good faith

65. See Note, supra note 48, at 544; Borowitz, supra note 4, at 2160 n.26.
under sections 550(a)(2) and (b)) to other, non-predicate creditors. However, goes the argument, there is no reason to think that in limiting predicate creditors to the section 547(b) and (c) defenses Congress wanted to deny those defenses (that is, section 547(b) and (c) defenses) to other people (such as City Bank). And therefore such other creditors should be allowed to invoke them.67 Secondly, or perhaps put another way, Congress would not have intended to deny such people (City Bank) all defenses. Denying the non-section 547(b), non-predicate creditors the section 550(b) defenses, and also not letting them rely on status or facts that would insulate transfers involving them from avoidance under section 547 (e.g., non-insider status and pre-ninety day loan repayments constitute no avoidance under section 547(b)) would have the effect of depriving such people of any defense at all. It is unlikely, it is argued, that Congress would do that.68

Such is the structural case for holding that City Bank should get the defenses allowed under section 550(b). The argument then confronts the statutory words: The words, as distinct from the structure, say that the people entitled to the those defenses are “immediate and mediate transferees” from initial transferees, and that the people not entitled to those defenses are the “initial transferees.”69 City Bank took several pre-ninety day transfers directly from the debtor corporation. Is not City Bank described, inescapably, by the term “initial transferee”? And is it not difficult to characterize it as a “transferee from” anyone but the debtor (to bring it within section 550(b)(2))? Does not the structural argument, whatever its merits might be in terms of structure, fall apart when faced with the plain meaning of “initial transferee”? Not necessarily.

The term “initial transferee” may not be as self-explanatory as it appears to be. There is authority, which appears to be plausible and non-controversial, for reading “initial transferee” not to include people who take transfers directly from the debtor when those takers are mere conduits such as banks or lawyers

67. See Note, supra 48, at 546-47.
68. Id. at 547.
who happened to be the first persons to handle a preferential transfer as it was transmitted from debtor to creditor. Such conduits did not by their conduct or status provide a predicate for avoidance under section 547(b). They were akin to City Bank (for pre-ninety day transfers) in that regard. Of course those conduits were not even creditors of the debtors in their cases either; they were in that regard quite unlike City Bank. Nevertheless, when given a good reason to read “initial transferee” narrowly, courts have fearlessly done so.

The question then is whether this structural analysis provides a good enough reason for courts to narrow the meaning of “initial transferee” even further in order to protect arms length lenders such as City Bank. Or, does this structural argument actually do no more than demonstrate a possible imperfection in Congress’ treatment of defenses to avoidance? In that event, the analysis would not be “wrong.” But it would not be limpidly compelling either, in the sense that it would prove conclusively that City Bank (the only transferee of seven payments) was somehow entitled to defenses given, by the words of section 550(b)(1), to people further down a chain of successive transfers.

Thus in the end the structural argument, like the textual argument, must deal with what the law ought to be. That is, assuming Congress had actually thought about it and wanted to do the right thing, not only about appropriate defenses but also about overall liability on the part of outsider creditors for insider guarantied loan repayments made more than ninety days before bankruptcy, what would it have said? (Hopefully it would have put its intention into words instead of imbedding it deep within the structure of the Code.) That inquiry leads to the next section.

V. THE CARTAGE DECISION AND BANKRUPTCY POLICY

What reach back period should apply to City Bank—the ninety day period normally applied to “outsiders,” or the special “insider” one-year period which did apply to the insiders who

had guarantied the City Bank loans? Should City Bank be treated for preference reach back purposes as if it were an insider, because of the insider guaranty? The answer depends on bankruptcy policy on preferences in general, and on reach back periods in particular.

Understanding preference policy begins with recognizing that the reason for having bankruptcy law itself is that creditors as a group benefit from a collective administration of an insolvent debtor's affairs. A collective proceeding is better for creditors, as a group, because the debtor's assets may be more valuable if they are kept together and operated (as in a reorganization bankruptcy) or (as in a liquidation bankruptcy) if they can be disposed of in the least distressed, most orderly manner. In addition, duplication of efforts may be eliminated and other economies realized through a single focused proceeding.

The benefit to creditors is maximized since the total value of debtor's assets available for distribution among them will be greater than the sum of the values of the assets that each separate creditor would be able to realize if each creditor acted

71. As Professor Jackson stated:

The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors as a group when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their debt-collection efforts to make a bad situation worse. Bankruptcy law responds to this problem. T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 10 (1986) (emphasis added).

This sharply focused position is not unchallenged: "My view is that the central job of bankruptcy is to apportion the losses of the debtor's default, and that a variety of factors impinge on the difficult policy decision of where to let those losses fall." Warren, Bankruptcy Policy, 54 U. CHI. L. REV. 775, 810 (1987) (a debate with Professor Baird, who shares with Professor Jackson the view that bankruptcy law should not redistribute a debtor's assets, but merely maximize the assets available to be distributed according to non-bankruptcy entitlements). See Baird, Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. CHI. L. REV. 815 (1987). See also D. BAIRD & T. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 37-43 (2d ed. 1990). In a review of the first edition of the Baird and Jackson casebook, Professor Scott said that Baird and Jackson's articles "have set the terms of the scholarly debate for the next decade." Scott, Through Bankruptcy with the Creditors' Bargain Heuristic, 53 U. CHI. L. REV. 690, 692 (1986). One need not choose sides to accept the proposition that it would be desirable for bankruptcy to maximize a debtor's estate.
alone in collecting its claim.\textsuperscript{72} The idea is that the whole is greater than the sum of the parts, when the separate parts are what individual creditors would realize collecting their claims one at a time. The price paid to participate in the collective proceeding is the forgoing of pure self interest. For the chance at a share in a bigger whole, creditors in bankruptcy give up the opportunity to attempt to get 100 percent of their claims by proceeding alone.\textsuperscript{73}

If creditors did act alone, some would profit in doing so; others would not. While the total realized by all creditors as a group would be less, from the perspective of the creditors who succeeded in getting 100 percent of their claims the non-collective, non-bankruptcy approach would be better. From the point of view of the creditors who did not do better through their own non-collective enterprise, the gain to be realized in bankruptcy would be lost and they would be worse off: The "whole" available for distribution would be smaller, not bigger, if some creditors had escaped the collective proceeding.

The collective advantage of bankruptcy depends therefore on a method for preventing some creditors from escaping the collective proceeding. The creation of a debtor's "estate" consisting of all the debtor's assets, leaving nothing to be distributed outside of bankruptcy, effectively prevents some creditors from escaping the process once bankruptcy begins. A mechanism is also needed to prevent creditors from escaping before the proceeding starts. It would have to deter such pre-bankruptcy escape attempts, and undo them if not deterred.\textsuperscript{74}

Preference law is that deterrent.\textsuperscript{75} Whether creditors have grabbed assets by means of attachments, or have judicial liens,

\textsuperscript{72} T. Jackson, supra note 71, at 12-13.
\textsuperscript{73} Id. at 14-16.
\textsuperscript{74} See id. at 122-23.
\textsuperscript{75} Professor Jackson says it this way:

Preference law should . . . be concerned with postloan behavior directed at attempts to improve one's relative status in an impending collective proceeding such as bankruptcy—attempts to opt out of the class of unsecured creditors into a class of paid (or secured) creditors. It is, in short, designed to deter individual opt-out behavior that would undermine the advantages to be gained from a collective proceeding.

or have taken voluntary payments from the debtor, section 547 on preferences will require the creditors to give back to the estate what they have received from it. The advantage of taking planks and pieces of the debtor's boat is nullified. Preference law encourages creditors to act as if they were all in the same boat and will be better off in it together than floating around on its parts separately. Creditor self interest must be modulated by the realization that if vital assets are taken (perhaps putting out of business a firm that could otherwise survive), the action taken will itself precipitate bankruptcy and the operation of section 547. Hence the premature action may not be taken at all. The same creditor calculation must be made before loans are called in or other payments on debt accepted. Diligence and vigilance are not rewarded; forbearance is.

Preference law has its intended deterrent effect so long as all participants in the debtor-creditor relationship are contemplating an eventual bankruptcy. In that context, preference law serves to allay the apprehensions of creditors of a declining firm who are not getting paid, and who are not levying liens or otherwise seizing debtor property. While such patient creditors may be apprehensive that others are receiving "preferences," their mere suspicions should not be enough to make them seek immediate preferences for themselves. For if worse comes to worst, and their suspicions are valid, a little more delay in self interested action will not be fatal: they know that section 547 will undo what the more aggressive creditors have done on their own behalf.

There are limits, however, to how much forbearance is really a good idea. No one thinks that in bankruptcy a debtor's affairs back to its inception should be examined, or that every entity that ever became a creditor should be called to account for having received debt repayments when the debtor was insolvent. Not only would this not be feasible administratively, but at some point a failing firm's losses should be cut and it should be put out of business, possibly through a seizure of its vital physical assets or its working capital. The question then becomes how long a patient creditor's mere suspicions should be allayed by preference law; or, put another way, at what point should

77. See T. Jackson, supra note 71, at 123-30.
the law stop encouraging patience in the face of a declining firm whose payment practices are unknown, and instead encourage the creditors either to lose patience and put it into bankruptcy or investigate to find out if preferences are actually being paid to some creditors? Congress has chosen two time periods. One, of ninety days, for routine situations and another, of one year, for situations in which insiders are creditors. 78

Normally if a debtor is being dismembered, Congress thought creditors should be able to find out about it within ninety days and put the debtor's estate back together again by forcing bankruptcy and invoking the trustee's preference avoiding powers. 79 However, an insider will know more about the debtor's bad financial condition than outsiders; the insider will therefore be in a position to make grabs for itself, discreetly, earlier. Insiders may be dismembering the debtor before its bad condition is apparent to outsiders. Outsiders however, will know this may happen. Hence, outsiders will be more eager to take assets, even if things look fairly good and no discernable asset grabs are taking place. Appearances may be deceiving them, they know, but not deceiving the insiders. To prevent this from happening, the one-year reach back period is provided. Outsiders will rest easier knowing that even if some insider grabbing is going on, its chance of injuring the outsider is less because there is an entire year in which to discover that the debtor is going bottom up, and to recapture what the insider has taken. Thus, the one-year period deters early raids on the debtor's assets which may be harmful to creditors on the whole.

These considerations indicate that it makes sense to apply the one year reach back period to insider guarantied loans. 80 The intended deterrent effect on creditors, which should keep them from putting a debtor into bankruptcy prematurely, depends on

78. 11 U.S.C. § 547(b)(4).
79. Id. § 547(b).
80. Doing so does not create a judicial presumption that every lender with an insider guaranty is a "person in control of the debtor" and therefore itself an "insider." See id. § 101(30)(B)(ii). "Whatever tests of 'control' may evolve under the Code, they are irrelevant to a determination that, as a matter of economic and psychological reality, the personal guaranty of an insider may be better security for repayment before bankruptcy than legal interests in a debtor's property." Pitts, Insider Guaranties and the Law of Preferences, 55 AM. BANKR. L.J. 343, 354 (1981).
increasing their willingness to live with uncertainty. Creditors not getting paid regularly will be willing to do so longer (but not too long) if there is no sign of "normal" non-insider preferences and if the more invisible insider preferences, which may or may not be taking place, are not going to succeed. Forbearing creditors who know there may be guarantied loans are allowed to assume the likelihood, but not the risk, that the insiders may act in their own self interest and direct payment of such loans preferentially. Patient creditors will not assume the risk of that possibility because of the one year reach back period. Throwing debtors into premature bankruptcy will thus not be encouraged. And preference law purposes will be achieved.

These considerations about the purpose and effect of preference law should also serve to make clear what is not its main purpose: redressing wrongs and punishing bad behavior.

Preference law can be usefully contrasted with fraudulent conveyance law. The pool of a debtor’s assets is diminished by a fraudulent conveyance without any countervailing benefit to the debtor’s situation; when a preference occurs the debtor does receive the benefit of a decrease in the amount of total outstanding obligations. Harm is inevitable with a fraudulent conveyance; harm is not inevitable with a preference. A preference is undesirable not because it does harm but because it may prevent creditors from reaping the positive advantages of the collective process.

This is not to say that avarice and misbehavior are never present when a preference occurs. The point is that a preference is a preference and should be avoided whether or not the participants are "guilty" or "innocent" of anything. This is important because many of the lower court decisions in conflict with Deprizio and Cartage are based on the idea that it is somehow not "fair" or "equitable" to a non-insider lender to apply to it the reach back period intended for insider lenders. 83

81. "Preference law, unlike fraudulent conveyance law, is not a part of the arsenal of rights and remedies between a debtor and its creditors. Rather, preference law focuses on relationships among creditors in light of the advantages of a collective proceeding." T. Jackson, supra note 71, at 123-24 (emphasis added).

82. Id.

83. See, e.g., In re C-L Cartage Co., 113 Bankr. 416, 420 (E.D. Tenn.
It is a fact that there is nothing wrong with insisting that a borrower provide a guaranty from an insider. But that observation is beside the point when the question is whether the insider guaranty should have an influence on how preference law is administered. Since the law is not intended to punish, its adverse effect on the "innocent" is not a relevant criticism. In this light, the "equitable" argument against applying the one-year reach back period to outsiders with insider guaranties establishes nothing. The potential that preference law will eventually be enforced is what keeps all the creditors in line before bankruptcy; it would frustrate that law if "good" creditors could be excepted from the operation of the law. Its real point is its deterrent effect. That effect is lost to the extent some preferences are immune from avoidance.


A passage in the Collier Treatise is frequently quoted by such cases:

In some circumstances, a literal application of section 550(a) would permit the trustee to recover from a party who is innocent of wrongdoing and deserves protection. In such circumstances the bankruptcy court should use its equitable powers to prevent an inequitable result. For example . . . if a transfer is made to a creditor who is not an insider more than 90 days but within one year before bankruptcy and the effect is to prefer an insider-guarantor, recovery should be restricted to the guarantor and the creditor should be protected. Otherwise, a creditor who does not demand a guarantor can be better off than one who does.

4 CoLmit, supra note 58, ¶ 550.02, at 550-58 (footnotes omitted).

84. The Seventh Circuit made a similar point in Deprizio:

Rules of law affecting parties to voluntary arrangements do not operate "inequitably" in the business world—at least not once the rule is understood. Prices adjust. If the extended preference period facilitates the operation of bankruptcy as a collective debt-adjustment process, then credit will become available on slightly better terms.

874 F.2d 1186, 1198 (7th Cir. 1989). See also Nussbaum, Insider Preferences and the Problem of Self-Dealing Under the Bankruptcy Code, 57 U. Chi. L. Rev. 603, 614-15 (1990); Pitts, supra note 80, at 354-56.

VI. Cartage's Effect on Preference Analysis in Non-Insider Guaranty Situations

The Cartage decision has implications in other preference contexts where the "two-transfer" theory might be applied. In one, use of the two-transfer theory facilitates the defense against avoidance of a lien granted to a bank that has issued a standby letter of credit; in the other, the theory protects an oversecured creditor from preference attack. Since it is an article of faith in commercial law that letters of credit are independent of the underlying transaction out of which they arose, and since it is also virtually axiomatic that oversecured creditors have nothing to fear from preference law, an analysis such as the two-transfer analysis that produces results consistent with those expectations has a great deal of intuitive appeal. Conversely, a case such as Cartage, which rejects such a theory, seems to that extent questionable. Even if the result in Cartage with respect to the appropriate reach back period for outsiders with insider guaranties were regarded as a good one in its own right, its rationale would seem to need rethinking if it led to awkward outcomes in other cases. Examination of these other preference situations, however, reveals that the implications are not that bad—a one-transfer theory does not necessarily self destruct when put to other tests in other contexts.

A. Implications for Letters of Credit

The letter of credit situation has already arisen in two cases decided by courts of appeals, In re Compton and In re Air Conditioning. In both cases a bank had issued a standby letter of credit for debtor's account for the benefit of a creditor holding an already overdue antecedent claim. In each case the issuing bank had been granted a lien on debtor property to secure its obligation under the credit. In Compton, the

88. 831 F.2d at 589; 845 F.2d at 295.
89. 831 F.2d at 589; 845 F.2d at 295.
bankruptcy trustee successfully invoked sections 547 and 550 to recover from the creditor the amount the creditor-beneficiary had collected under the letter. The trustee did not attempt to avoid the bank’s lien. And while holding for the trustee against the creditor, the court said in dictum that the issuing bank’s lien would not have been avoidable had the trustee attacked it. Thus the issuing bank was left with a secured claim in the bankruptcy proceeding.

Air Conditioning was more complicated. After the debtor had entered bankruptcy the beneficiary of the letter of credit demanded payment from the issuing bank, and the bank filed a complaint in the bankruptcy court accusing the beneficiary of violating the automatic stay. The trustee intervened. At stake was the $20,000 certificate of deposit the debtor had pledged to the bank to secure the credit. The ultimate outcome was similar to that in Compton. The trustee got the certificate of deposit; the beneficiary got nothing; and the bank was not left with an unsecured claim in bankruptcy. The bankruptcy court had “nullified” the letter of credit, negating the bank’s obligation to honor it.

When the case was appealed to the district court, the New York Clearinghouse Association entered a friend of the court

90. 831 F.2d at 592.
91. Id. at 591, 596.
92. 11 U.S.C. § 362 (1988) provides that the filing of a bankruptcy petition, which initiates a bankruptcy case, stays, or, in effect, enjoins, all debt collection activity by a debtor’s creditors against the debtor or its property. Compton and Air Conditioning both assumed, consistently with the holdings of almost all the courts that have considered the point, that collecting under a standby letter of credit is not a violation of the automatic stay because the funds the beneficiary gets from the issuing bank are the bank’s, not the debtor’s. Contra Twist Cap, Inc. v. Southeast Bank of Tampa (In re Twist Cap, Inc.), 1 Bankr. 284 (M.D. Fla. 1979). Once collected by the beneficiary however, the funds may be recovered for the estate by the trustee, as demonstrated in Compton and Air Conditioning.
93. 845 F.2d at 295.
brief asking for reversal of the "nullification." 95 And "nullification" was reversed by the district court. 96 The district court, however, awarded the certificate of deposit to the trustee, as had the bankruptcy court. 97 It acknowledged that its reversal of "nullification" appeared to be a "revering of form over substance," but said that the decision had the effect of giving the beneficiary assurance of payment, but no assurance of getting away with a preference. 98 The court of appeals affirmed this part of the district court decision. 99 Thus the bank's duty to pay under the credit was not undermined by the rationale for decision as it would have been if the letter of credit had been "nullified." But within the compressed circumstances of the case, with all three parties in the same forum and the certificate of deposit still in the issuing bank's possession, the practical effect was the same whether the credit was "nullified" or the payment upheld: the creditor wound up with nothing and the bank had no further liability.

In Compton the bank had a fully secured claim; in Air Conditioning the bank had no claim and no collateral but had been able to use the pledged certificate to meet its letter of credit obligation. Both cases thus protected the bank while allowing recovery of the preference from the preferred creditor. Both courts endorsed the two-transfer theory, applying it to a single event—the debtor's granting of a lien to the bank. 100 The difference between the "two transfers" arising out of the single event was that the transfer for the creditors' benefit was on account of the antecedent debt, while the other transfer, to the bank, was on account of the bank's contemporaneous (not antecedent) extension of credit. Both courts emphasized that the

96. 72 Bankr. at 663.
97. Id.
98. Id. at 662.
100. Id. at 298. See Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586, 594-95 (5th Cir. 1987).
“sanctity” of the letter of credit was thus respected; its independence of the underlying transaction, and hence its usefulness in commercial transactions, was thus preserved. Yet the courts were able to give the trustee one recovery, against the creditor, which is all the trustee is entitled to anyway. The bankruptcy estate and letter of credit law both won; there were no losers. And the two-transfer theory was the key.

The holdings in Compton and Air Conditioning, making the creditors disgorge the proceeds of the letters of credit, are undoubtedly correct. But the dicta about the inviolability of the bank liens is questionable on two levels.

First, the cases overstate their success in protecting the “sanctity” of letters of credit and preserving the independence principle. Given what the courts actually held with respect to recovery from the creditors, the practical effect of Compton and Air Conditioning on letters of credit is not much different from the effect the cases would have if they had also allowed avoidance of the banks’ liens as alternative remedies for the trustees. A simple “one-transfer” approach avoiding the liens would not have undercut letters of credit much more than did the elaborate “seeing double” approach taken by the courts. In other words, the elaborate metaphysics of the two-transfer theory led to a relatively minor payoff in terms of preserving the utility of letters of credit.

The second reason why the cases’ dicta about the inviolability of the issuing banks’ liens is questionable is that the mystique surrounding letters of credit in this situation is itself questionable: why should banks issuing letters of credit be immune from laws regulating the conduct of everyone else who deals with a financially troubled firm that soon finds itself in bankruptcy? Perhaps there is a compelling reason for such immunity, but its existence should not be taken for granted.

Compton and Air Conditioning overstate the importance of their results on protecting the “sanctity” of the independence of letters of credit because the most important manifestation of that “independence” is the separation of the underlying transaction from the bank’s duty to pay, and that independent

101. 845 F.2d at 299; 831 F.2d at 595.
102. The primary purpose of the letter of credit is to support an engagement to pay money. Issuance of a letter of credit subsumes a separate
duty to pay was not at stake in the cases. No matter what the courts held or said in dicta about the banks' liens, the primary principle of payment would not have been affected. That is, the beneficiaries' right to draw under the credits and the banks' duty to honor the credits were not directly threatened. At the same time the actual holdings do undermine letters of credit because their practical effect is to strip credits of their utility in the context in which they were used in the litigated cases: what the beneficiaries got from the banks they had to disgorge to the trustees. So not much is really preserved; fewer such letters of credit are apt to be issued on the eve of bankruptcy in the future. The futility, from the creditor's point of view, of seeking a letter of credit when the debtor is already in default and heading towards bankruptcy should itself cause a decline in their use in that setting. If the liens that banks took when issuing such letters were vulnerable to the bankruptcy trustee, undoubtedly even fewer such credits would ever actually be issued. But the avoidability of the lien would only add to the existing disincentive, given the probable futility of the device from a creditor point of view.

The second reason why avoidance of an issuing bank's lien is not a disaster, as seems to be implied by *Cartage*, is that it is the right thing to do. Why should banks be encouraged to collaborate with debtors and creditors who are trying to accomplish last minute asset grabs and thus defeat bankruptcy's collective process? Such banks may indeed already be vulnerable

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arrangement under which one party has undertaken or proposes to undertake an obligation to pay money to another party. By establishment of a letter of credit, the issuer obligates himself to make payment to the obligee for the account of the obligor. The obligation is direct and primary, since it is not qualified by or dependent on performance or nonperformance by anyone other than the issuer and his obligee; it is independent, since it is exclusively defined by the terms of the letter of credit.


It is essential at the outset, however, to recognize the fundamental precept of commercial credit banking, which is that the banker approaches the mercantile transaction from the outside, remains on the outside, and is bound and governed only by the contract which he himself makes and not by the contract which the commercial parties may have made.

to the trustee, irrespective of section 547 and the two-transfer theory, under fraudulent conveyance law. The letter of credit situation has been usefully analogized to that which arose in the famous old fraudulent conveyance case of *Dean v. Davis*. In order to pacify a creditor threatening to report the debtor's forgeries to law enforcement authorities, the debtor mortgaged his assets to his brother-in-law who satisfied the threatening creditor's claims. The brother-in-law had known what was taking place. The threatening creditor was thereby preferred. When debtor shortly thereafter went into bankruptcy, the brother-in-law's mortgage on debtor's assets was avoided as a fraudulent conveyance.

The effect of the transactions in *Dean v. Davis* is similar to the effect that the letters of credit had on the debtors' estates in *Compton* and *Air Conditioning*: an unsecured creditor was paid, unencumbered assets became encumbered and no longer available to meet general creditor claims, and no new value was added to the debtor's estate. In *Dean v. Davis* the policy vindicated was the fraudulent conveyance policy against transfers made with actual intent to hinder, delay or defraud other creditors. Recovery against the brother-in-law depended on his knowledge of the underlying realities with respect to the debtor's situation, which meant he was not a purchaser in good faith. In *Compton*, the letter of credit stated on its face that it was for an antecedent unsecured debt due to the beneficiary from the bank's customer.

A letter of credit issued with respect to already past due antecedent debts is frequently a device to hold a pressing creditor at bay (although the creditor may not so frequently be able to threaten the debtor with jail, as in *Dean v. Davis*). There are undoubtedly circumstances when a debtor can be given the breathing space it needs to revive itself, if a pressing creditor can be at least temporarily satisfied. But indiscriminate encouragement of letters of credit in this situation is not a good

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104. 242 U.S. at 445.
105. *Id.* at 446.
106. *Id.*
107. 831 F.2d 586, 589 (5th Cir. 1987).
idea. Some will rescue viable debtors; others will themselves precipitate involuntary bankruptcy petitions or lead to the added expense of an avoidance proceeding in the debtor's eventual bankruptcy. Therefore, despite the relatively mechanical operation of today's preference law under section 547, as contrasted with the more subjective case-by-case analysis that was possible under the subjective "actual fraud" test used in Dean v. Davis, a rule defeating an issuing bank's mortgage on debtor property is not inherently unsound.

If rejection of the two-transfer theory automatically leads to the conclusion that banks will lose their liens if they issue letters of credit that are substitutes for direct preferences, then banks will have to make sufficient inquiry about the purpose and the current or past due status of the customer obligation they are backing up in order to stay out of that line of newly dangerous business. But why is this too onerous? Banks issuing non-standby credits presumably take into account that they will be secured if they honor drafts accompanied by negotiable documents. Such weighing of the relative perils or relative security of their undertakings is already part of banking practice, or should be. It is not too much to expect that banks find out whether their customers are already in default before issuing stand-by letters. If Cartage makes banks more cautious in that respect, the overall extra costs to the banking business are not necessarily any greater than the benefits to be gained by eliminating the costs of avoiding preferences in the bankruptcy process.

B. Implications For Fully Secured Creditors

Cartage itself is a case in which a bankruptcy trustee recovered preferences from a creditor that the court treated as fully secured. But the case is not an important precedent on such recovery. For Cartage was a special "fully secured creditor" case: the collateral that secured the creditor's claim did not belong to the debtor. The certificates of deposit that were pledged to City Bank were owned by Della Foster. This

108. City Bank in fact was probably not fully secured because it apparently did not receive all the certificates of deposit it anticipated, and its security interest in some trucks was not perfected. 113 Bankr. 416, 418 (E.D. Tenn. 1988).
109. Id.
atypical fact had significance in two ways: 1) even if there had been no insider guaranty, payments (those within ninety days before bankruptcy) made to City Bank would have been avoidable; and 2) the payments arguably "benefitted" the Foster insiders only because Della Foster, not C-L Cartage, owned the collateral.

The reason that City Bank, even though "fully secured," would have been vulnerable to preference attack is that payments to it would have depleted the debtor's estate, while payments to a fully secured creditor whose collateral is owned by the debtor do not: in that situation, every dollar paid increases the debtor's equity in the collateral.110 But if the debtor does not own the collateral, every dollar paid is simply a dollar less in the estate. In statutory terms, payments to a fully secured creditor whose collateral does not belong to the debtor satisfy section 547(b)(5) (the part of the subsection that ordinarily insulates fully secured creditors from avoidance) because the recipient does receive more on account of the payment than it would receive, in the words of section 547(b)(5), "under the provisions of this title"; if the fully secured creditor whose collateral belongs to a third party were not paid before bankruptcy, it would have to foreclose outside of bankruptcy to take advantage of its "fully secured" status, but it might get nothing from "the provisions of this title," which means the bankruptcy liquidation itself.111

Della Foster's ownership of the collateral was also critical to the trustee's entire insider preference avoidance case, although the court never explicitly worked the fact into its analysis. If C-L Cartage (not Della Foster) had owned the collateral and if City Bank had been fully secured by the debtor-owned collateral, it is arguable that none of the payments made to City Bank before bankruptcy would have been avoidable. The reason for nonavoidability vis-à-vis the Foster insiders would be that payments to City Bank would not have benefitted them, because if the collateral fully secured the claim, then the Fosters would have had no exposure to potential liability, despite their guaranty.

Therefore, they would have been no better off on account of the payments, or, in statutory terms, would have received no "benefit" by reason of the transfers.\textsuperscript{112} City Bank for its part could have successfully resisted avoidance if it were fully secured by debtor-owned collateral under the normal operation of section 547(b)(5). The ownership of the collateral by Della Foster was thus an important fact to which, as indicated above, the Sixth Circuit never alluded in its analyses of the issues; the court's actual handling of the issues, however, did give the atypical ownership circumstance its appropriate significance.

While \textit{Cartage}'s unusual facts mean that its own holding with respect to preference recovery from a "fully secured" creditor is not of large importance, rejection of the two-transfer theory has been said to have implications for at least one situation involving an "ordinary" fully secured creditor whose collateral is owned by the debtor.\textsuperscript{113} And while the affected secured party is "ordinary" in that its collateral is owned by the debtor, the circumstances in which rejection of the two-transfer theory probably could have its most baleful effect are hardly common.

Suppose a fully secured creditor's collateral is also subject to a junior lien that is undersecured. When such a fully secured creditor receives payments that reduce its lien, the junior undersecured creditor with an interest in the same collateral steps up dollar for dollar into the secured status no longer needed by the senior lender. For example, if debtor's farm worth $1,000,000 secures an obligation to Bank One in the amount of $800,000 and an obligation to Bank Two in the amount of $500,000, a $100,000 payment to Bank One will make an additional $100,000 worth of the farm available to secure Bank Two's claim. Instead of being undersecured by $300,000, Bank Two has become undersecured by only $200,000. Bank Two is better off because of the transfer. If Debtor's trustee argued that the transfer to Bank One was for the benefit of Bank Two, and therefore was avoidable and recoverable not

\textsuperscript{112} See \textit{In re Deprizio}, 874 F.2d 1186, 1199 (7th Cir. 1989).

\textsuperscript{113} Katzen, \textit{supra} note 53, at 535. The issue was presented in \textit{Deprizio}. The Seventh Circuit remanded because it had not been considered in the courts below. Its dismissive comment on remanding, that "'[t]he benefit in such a case is negligible at best, so the case for recapture is weak,'" seems to need elucidation, which the court did not supply. 874 F.2d at 1200. See Katzen, \textit{supra} note 53, at 521.
only from Bank Two but also from fully secured Bank One, a two-transfer analysis would defeat the trustee. By analyzing the transfer twice, a court could reach the desired goal of avoiding $100,000 worth of Bank Two’s lien, while also reaching the desired goal of protecting Bank One because with respect to Bank One, the creditor to which the transfer was made, section 547(b)(5) (on net gain) would not be satisfied.

If this case arose, the availability to Bank One of the two-transfer theory would clearly be convenient; but it would not be indispensable. For even if the trustee could recover $100,000 from Bank One, normal bankruptcy practice would seem to dictate that Bank One get back its claim against the estate, and “claim” in this situation should clearly mean a $100,000 “secured claim.” The avoidance exercise, if the trustee went through with it, would annoy Bank One, but if the collateral were still worth $1,000,000, Bank One, with its fully secured status in the bankruptcy proceeding, would theoretically be no worse off than if the trustee had ignored it.

A much more threatening situation, but hardly a common one, arises if it is impossible to restore Bank One to its former “fully secured” status in exchange for its return of the avoided transfer. For example, suppose that debtor pays off both Bank One and Bank Two. (A $300,000 preference to Bank Two would have occurred and should be recoverable from Bank Two, but not from Bank One if its fully secured status is really to mean what everyone wants it to mean.) Then debtor borrows $1,000,000 from Bank Three and grants Bank Three a mortgage on the farm. Now, since it is impossible to restore to Bank One its fully secured claim, the avoidance and recovery of $300,000 from Bank One would not be just annoying, but catastrophic. But again, the two-transfer theory would rescue Bank One.114

114. If the collateral is personal property it may be possible for the secured party (Bank One) to avert the worst case situation. Bank One might insist upon maintaining its Article Nine financing statement on file until after the preference reach back period has expired. Ordinarily if there is no debt to be secured, a debtor can require a former creditor such as Bank One to submit a termination statement for filing, and thus relinquish its first place in the line of priority with respect to specific collateral. See U.C.C. § 9-404 (1990). But given the bankruptcy vulnerability this might cause to Bank One, a respectable argument could be made by Bank One that it is subject to an (involuntary) “commitment to incur obligations” and therefore not subject to
Is the two-transfer theory then indispensable, and are *Cartage*, *Deprizio* and other cases rejecting it wrong, or at least questionable? Is it needed to prevent catastrophe? The answer, it is submitted, is "no," because the trustee's preference case against Bank One can be defeated (while its case against Bank Two succeeds) without contradicting the rationale in *Cartage*. This goal can be achieved through an analysis of the facts in *Cartage*, and in the Bank One-Two-Three hypothetical, which focuses on the words "antecedent debt" in section 547(b)(2). In *Cartage* there was only one debt, of $50,000. By contrast, in the hypothetical, debtor owes two distinct and different antecedent debts, one to Bank One, and the other to Bank Two. Suppose debtor pays $100,000 to Bank One. A transfer of an interest of the debtor in property (cash) to Bank One has obviously occurred. But so has a transfer of an interest of the debtor in property (its interest in the farm) to Bank Two occurred. Neither transfer was for the benefit of anyone else. There is no need to resort to the words "or for the benefit of" in section 547(b)(1). Two transfers occurred. Each was to a creditor. Each was on account of a different antecedent debt. Neither was literally "for the benefit of" anyone else. Each transfer can be analyzed separately. The transfer to Bank One was "on account of" the debt to Bank One; the transfer to Bank Two was "on account of" the debt to Bank Two. Just as *Cartage* insisted on focusing on a single creditor throughout a section 547(b) analysis, so this analysis focuses on a single debt. The transfer to Bank Two is avoidable and recoverable from Bank Two; it is not recoverable from Bank One because the transfer of the mortgage interest to Bank Two was neither to nor for the benefit of Bank One. The transfer to Bank One is not avoidable and not recoverable at all.

the § 9-404 duty to submit a termination statement. *Id.* If a financing statement remained on file, Bank Three, even though it loaned when no debt was owed to Bank One, could not attain higher priority on account of the "first to file" rule of the Uniform Commercial Code. *Id.* § 9-312(5)(a). Thus, if Bank One's financing statement were still of record, even if Bank One were forced to disgorge the payment to it as preferential, the bankruptcy court could replace the funds with a first lien of equal value. Even this might not be feasible, however, if the collateral itself had ceased to exist. Nor is it fully satisfactory to recommend that first lienors forbid debtors to grant second mortgages. Debtors might do so anyway.
Is this interpretive method just the two-transfer theory coming in by the back door? Perhaps one can put it that way, and it is obviously result driven. But it is hardly "tortured." Focusing on which particular debt a transfer is "for or on account of" limits the "for the benefit of" words to the situation for which they were intended: a three cornered debt involving a principal obligor, a surety, and a creditor. That was the situation in Cartage in which a single transfer did in fact go to one creditor and, with respect to the same debt, benefit another creditor. If seeing two transfers is seeing double in the Cartage situation, perhaps it is myopic not to see two transfers when two different "interests in property" are used to affect two separate debts, owed to two unrelated creditors. This is what happens in the hypothetical. It does not happen in Cartage. It would appear therefore that Cartage does not threaten the position of oversecured creditors.

VII. THE IMPACT OF CARTAGE AND FINN ON INSIDER GUARANTY CASES

Cartage's significance for lenders who take insider guaranties is in part a function of the significance of preference law in general. If a transfer cannot be avoided under section 547, there is no one from whom the trustee can recover under section 550, no matter what the reach back period may be. The Seventh Circuit made this point when it predicted in Deprizio that the case would have minor consequences. In Cartage the Sixth Circuit made no predictions, but within a few months it decided another section 547 case, In re Finn, in which it interpreted the Bankruptcy Amendments and Federal Judgeship Act of 1984 in a way as beneficial to lenders as Cartage appears to be detrimental. Finn, together with an earlier case, In re Fulghum, took a large number of transfers on account of antecedent debts out of reach of the trustee's preference avoiding power. Indeed, were the events in Cartage to repeat themselves

115. 874 F.2d 1186, 1198-99 (7th Cir. 1989).
116. 909 F.2d 903 (6th Cir. 1990).
118. 872 F.2d 739 (6th Cir. 1989).
now (the case was filed before the effective date of the 1984 amendments), the result would likely be different.

In *Finn* the debtor obtained a consolidation loan in order to pay several already existing debts. Her brother co-signed. During the next year debtor made regularly scheduled monthly payments on the loan totalling $1300. Then she filed a bankruptcy petition. The trustee sought recovery of the $1300 from her brother, an insider benefitted by the repayments. The brother claimed the transfers were excepted from avoidance as "ordinary course" payments under section 547(c)(2). In the bankruptcy court and district court the trustee prevailed. Both lower courts held as a matter of law that section 547(c)(2) never applied to long term debt. The Sixth Circuit reversed.

*Finn* read the post-1984 text of section 547(c)(2) literally and held that it applied not only to trade credit or other similarly short term obligations, as did the pre-1984 version, but also applied to long term debt, provided the "ordinary course" requirements were satisfied.

Before 1984, the section 547(c)(2) exception was limited to repayment of debt incurred within forty-five days before the repayment was made. When the forty-five day provision was dropped in 1984, some courts

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119. The 1984 amendments to § 547(c)(2) are only applicable to cases filed on or after October 9, 1984. Pub. L. No. 98-353, § 553(a), 98 Stat. 333, 392 (1984).


122. 909 F.2d at 906.

123. Prior to the 1984 amendments, § 547(c)(2) read as follows:

The trustee may not avoid under this section a transfer—

(2) to the extent such transfer was—

(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made not later than 45 days after such debt was incurred;

(C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(D) made according to ordinary business terms.


and commentators said the effect of the amendment was limited to expanding the exception to cover essentially recent, short term obligations, even if their billing cycle were somewhat more than forty-five days.\textsuperscript{125} Much of the case law under the old version had focused on how to compute the forty-five day period; and long term lenders had had nothing to do with lobbying for the amendment.\textsuperscript{126} Finn rejected a narrow reading of the new text based on that history.

In remanding for the "peculiarly factual"\textsuperscript{127} inquiry called for with respect to section 547(c)(2), the Sixth Circuit endorsed Congress' description of what preference law was intended to avoid: "unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy."\textsuperscript{128} And the court added that even if the transaction were the first one entered into between the debtor and the creditor, it might qualify for ordinary course treatment; it depended on whether what was done was normal for a person in debtor's position.


\textsuperscript{127} 909 F.2d 903, 907 (6th Cir. 1990) (citing \textit{In re Fulghum Constr. Corp.}, 872 F.2d 739, 743 (6th Cir. 1989)).

The court had made the same point about unusual action in *Fulghum*, a case in which it held that "ordinary course" meant what was ordinary between the debtor and the creditor.

The focus of this court's inquiry must be directed to an analysis of the business practices which were unique to the particular parties under consideration and not to the practices which generally prevailed in the industry of the parties. Even if the debtor's business transactions were irregular, they may be considered "ordinary" for purposes of § 547(c)(2) if those transactions were consistent with the course of dealings between the particular parties.\(^\text{129}\)

*Fulghum* held that section 547(c)(2) excepted from avoidance a transfer that arose from one of about a hundred short term loans incurred and repaid to a related firm to enable the debtor, a construction company, to meet its cash flow requirements when its own customers were slow to pay.\(^\text{130}\)

*Finn* did not reject *Fulghum*, but added its own dimension to the meaning of "ordinary course." Thus "ordinary course" can mean either ordinary between the parties (*Fulghum*) or ordinary in an objective sense based on what is typical for an industry or for a consumer (*Finn*). Most importantly however, under *Finn* repayments of long term debt, debt that is quintessentially antecedent, can be excepted from avoidance under either of these two different meanings of "ordinary course."

While lenders defending preference cases within this favorable legal framework will nevertheless have the burden of proving\(^\text{131}\) that their debt and its repayment\(^\text{132}\) were "ordinary" and not "unusual action" taken during a "slide into bankruptcy," many

\(^{129}\) 872 F.2d 739, 743 (6th Cir. 1989) (citing *In re White*, 58 Bankr. 266, 270 (E.D. Tenn. 1986)).

\(^{130}\) *Id.* at 745.

\(^{131}\) 11 U.S.C. § 547(g) (1988) states that "the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of that transfer under subsection (c) of this section."

\(^{132}\) The first requirement of § 547(c)(2) is that the debt be "incurred in the ordinary course of business or financial affairs of the debtor and the transferee." *Id.* § 547(c)(2)(A). The second requirement of § 547(c)(2) is that the payment of the debt be "made in the ordinary course of business or financial affairs of the debtor and the transferee." *Id.* § 547(c)(2)(C).
should succeed in doing so. As indicated, the lender in Cartage might well have been able to defeat the trustee had the case been filed a few months later, and even the Deprizio result might have been different had the case been filed later.

This may indicate that Cartage's impact will be least upon creditors with the least need for an insider guaranty, and it will be greatest on creditors who need an insider guaranty most. For the transaction apparently safest from avoidance under section 547(c)(2) is one entered into at a time when the debtor is healthy financially, and in which repayments are kept on schedule up to the time that a bankruptcy petition is filed. Taking an insider guaranty at the time such a loan is made will not itself expose a lender to section 547 problems. Then as time passes if the debtor's condition deteriorates it may help assure that the loan repayment schedule is followed. That is, the more the insider guaranty "works" by causing pressure on the debtor, through the insider, to use debtor's assets to repay the lender with the guaranty, the less irregular and more "ordinary" the repayments of guarantied long term debt will probably appear to be. Whether they are really "business as usual" or business under the gun of the guaranty will be difficult to discern.

133. If the debtor is financially healthy when the debt is incurred there is less chance that the court can find facts supporting a conclusion that the debt was incurred outside the ordinary course of business or financial affairs of the debtor and the transferee. Likewise, if the debt is repayed in a regular and timely fashion there is a greater chance that the court will determine that the payment was made in the ordinary course of business or financial affairs of the debtor and the transferee. See, e.g., Rinn v. MTA Employees Credit Union (In re Butler), 85 Bankr. 34, 36 (D. Md. 1988) (Where a long term unsecured loan is entered into by a credit union's customer and regular repayment is assured through the use of a wage withholding agreement, the debt will be said to be in the ordinary course.); Sims Office Supply, Inc. v. Ka-D-Ka, Inc. (In re Sims Office Supply, Inc.), 94 Bankr. 744, 750 (M.D. Fla. 1988) (Where transferee sold all the assets of its business to debtor in exchange for three promissory notes, and debtor made regular payments pursuant to the Asset Purchase and Sale Agreement for approximately three and one-half years prior to the preference period and then throughout the preference period, the court held the payments were within the ordinary course exception and therefore not avoidable by the trustee.).

134. Paying some creditors and not others is not automatically outside the ordinary course of business, so long as the debtor's collapse is not imminent and it is not known that other creditors will be left unpaid at bankruptcy. See Newton v. Andrews Distrib. Co. (In re White), 64 Bankr. 843, 851 (E.D.
And the trustee's possible argument that a debtor should have been less regular in its payments (given its failing circumstances) seems a difficult argument to make.

At the other end of the safety spectrum, the unsafe-to-lenders end, are creditors who enter the picture or add new money during troubled times that may later be characterized by a trustee and court as "the slide into bankruptcy." These creditors presumably need guaranties more than creditors dealing with better risk borrowers. For these creditors however, an insider guaranty may be a guaranty of a one year reach back period.

This might indicate that Cartage's biggest impact may be felt in "workout" situations, when a debtor in financial trouble and its creditors attempt to compromise their interests and together make the best of a bad situation. Were this "out-of-court bankruptcy" to devolve later, after it had failed, into a real bankruptcy proceeding, the availability of section 547(c)(2) would seem problematical because workouts are unusual in themselves, and deals struck during them in an attempt to salvage a situation are not like loan transactions entered into by wholly voluntary

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Tenn. 1986). The ordinary course payment in White was made in mid-January, when other creditors were not being paid. The bankruptcy petition was filed in mid-March.


136. J.P. Fyfe, Inc. of Florida v. Bradas Supply Corp. (In re J.P. Fyfe, Inc. of Florida), 96 Bankr. 474, 477 (D.N.J. 1988) (Supplier who suspended indefinitely debtor's antecedent debt during debtor's time of difficulty, but who continued to supply debtor with new supplies under a new payment agreement, was considered to possess debt falling outside the ordinary course of business.); Ragsdale v. Citizens & Southern Nat'l Bank (In re Control Elec.), 91 Bankr. 1010, 1013 (N.D. Ga. 1988) (A subcontractor who took out a loan to be used as long term working capital in order to pay off trade creditors in a timely fashion did not fall within the ordinary course of business exception, even though repayments were timely due to an agreement between debtor and bank that bank would automatically debit debtor's checking account.).
participants.\textsuperscript{137} Hence the insider guaranty would seem most vulnerable in that setting.

However, even this bleak outlook may be too pessimistic, given the facts in both \textit{Finn} and \textit{Fulghum}, because in both cases the debtor was in some degree of trouble when it took out the loans that the Sixth Circuit decided were ordinary course transactions. In \textit{Finn}, the debt arose from a consolidation loan, which is rarely an advisable loan for a debtor in good financial condition to take out; the giving of the brother's guaranty may also have reflected the creditor's special lack of confidence in the debtor.\textsuperscript{138} In \textit{Fulghum}, the debtor had cash flow problems. Yet in neither case is there any indication that the transaction was automatically disqualified from section 547(c)(2) treatment by reason of these difficulties. In fact in \textit{Fulghum} the court stated:

This court declines to discourage transactions of the type here at issue, which were a paradigmatic example of the type of transaction promoted by § 547(c). The primary purpose of that section was to encourage "short term credit dealing[s] with troubled debtors in order to forestall bankruptcy." [The] § 547(c)(2) exception is designed to encourage creditors to conduct business with a struggling enterprise so that debtors can rehabilitate themselves.\textsuperscript{139}

Speculation about the extent of the section 547(c)(2) exception and its effect on guaranties will continue until the Sixth Circuit

\textsuperscript{137} Congress has stated the policy behind preference law is to "discourage unusual action by either the debtor or his creditor during the debtor's slide into bankruptcy." H.R. \textsc{Rep.} No. 595, 95th Cong., 1st Sess. 373-74 (1977), \textit{reprinted in} 1978 \textsc{U.S. Code Cong. \\& Admin. News} 5963, 6329. The courts take a dim view of a change in dealing which is initiated by a creditor. In \textit{Gull Air, Inc. v. Beech Acceptance Corp. (In re Gull Air, Inc.)}, 82 Bankr. 1 (D. Mass. 1988), where the workout occurred in response to the creditor's coercive action in filing a lawsuit, the court determined that payment under a workout falls outside the ordinary course of business exception. \textit{Contra In re Magic Circle Energy Corp.,} 64 Bankr. 269 (W.D. Okla. 1986); \textit{Armstrong v. John Deere Co. (In re Gilbertson),} 90 Bankr. 1006 (D.N.D. 1988).

\textsuperscript{138} 909 F.2d 903, 905 (6th Cir. 1990). Another less significant reason might be to angle for better treatment in a potential chapter 13 case; a creditor holding a claim guarantied by an insider can qualify for better treatment in a debtor's chapter 13 plan than other creditors. 11 \textsc{U.S.C.} § 1322(b)(1) (1988).

\textsuperscript{139} 872 F.2d 739, 744 (6th Cir. 1990) (emphasis added) (citations omitted).
decides more cases on what "ordinary course" means for the incurring and repaying of debt by a failing firm. Is adherence to an installment payment schedule "ordinary course" if other debts are not being paid on time?\(^\text{140}\) If nothing is being paid on time, does "chronically late" become "ordinary course" for a particular debtor?\(^\text{141}\)

While these issues were in a sense before the courts in the past, *Finn* really creates a new area of judicial inquiry because it applies the section 547(c)(2) exception to long term as well as short term debt. This new field of inquiry, however, is disconnected from real policy moorings because allowing long term debt to qualify for exception on essentially "procedural" grounds (i.e. the regularity of its payment or whatever it takes to be in the "ordinary course") has nothing to do with protecting the eventual collective insolvency proceeding from being undercut by creditors who can escape from it by keeping what they get before it begins.

The reason for the original section 547(c)(2) exception was that it did not undermine the collective process for a short term creditor who had just put value into the asset pool, value that kept the debtor in business, to take it right back out again. The net result was neither a gain nor a loss for the other creditors. The "ordinary course" standards as applied to this short term debt were a prudential mechanism to assure that non-typical short term creditors did not get a chance to take advantage of

\(^{140}\) Newton v. Andrews Distrib. Co. (*In re White*), 64 Bankr. 843, 851 (E.D. Tenn. 1986), suggests that even a finding that the debtor has paid certain creditors on a relatively timely basis but has been substantially late or in default with respect to other creditors will not preclude a finding that the payment on the debt that has been paid in a relatively timely fashion has been made in the ordinary course.

\(^{141}\) Where the *White* court found that the debtor regularly made late payments, ranging from a few days to approximately thirty days late, payment that was only about two weeks late was held to be made in the ordinary course of business and according to ordinary business terms. *Id.* at 849-51. However, some courts take a very strict position against allowing late payments within the ordinary course of business, and therefore it is unlikely that paying chronically late will become the ordinary course in these courts. *See, e.g., Marathon Oil Co. v. Flatau* (*In re Craig Oil Co.*), 785 F.2d 1563, 1567-68 (11th Cir. 1986) ("Lateness is particularly relevant in determining whether payments should be protected by the ordinary course of business exception. . . . Thus, untimely payments are more likely to be considered outside the ordinary course of business and avoidable as preferences.").
an exception not intended for them.\textsuperscript{142} To keep only those procedural safeguards, couched in ordinary course terms, while radically changing the context in which they are to be applied, does not make sense. There is no policy reason for letting long term lenders be preferred. A rule that invites them to take preferences undercuts the whole deterrent effect that preference law is intended to have.\textsuperscript{143} Indeed, whatever the ultimate boundaries of "ordinary course" turn out to be for long term debt repayments, prudent and well advised debtors and creditors with insider guaranties will be able to adjust their behavior to meet those standards and thus maximize their chances for escaping the trustee's section 547 avoidance power. Fine tuning control over the debtor's behavior will not only mean getting paid before bankruptcy begins, but also having the best chance of keeping what has already been received outside the collective proceeding.

This strange effect of Finn on the Cartage situation comes about because while the 1984 amendment to section 547(c)(2) in one sense freed the courts from the arbitrariness of the forty-five day "rule" and substituted for that relatively inflexible "rule" a standard of conduct ("ordinary course"), the standard all by itself has no particular bearing on the purposes of preference law and the reasons for exceptions from it. The courts were left free to exercise the kind of case by case, "particularly factual," inquiry that courts are good at. But Congress forgot that the benefit it was giving to ordinary course creditors in section 547(c)(2) was supposed to be contingent on a recent benefit to the debtor's estate. Instead, people who figure out how to stay on the right side of an "ordinary course" demarcation line stand to get a benefit they do not deserve because they have not paid for it with a recent infusion of funds into a failing debtor.

\textsuperscript{142} Professor Duncan argues that the distinction made should not be short term versus long term debt, but rather should be typical versus atypical transaction. Duncan, \textit{Loan Payments to Secured Creditors as Preferences Under the 1984 Amendments}, 64 NEB. L. REV. 83, 89-91 (1985).

\textsuperscript{143} Ragsdale v. Citizens & Southern Nat'l Bank (\textit{In re} Control Elec., Inc.), 91 Bankr. 1010 (N.D. Ga. 1988), where the court noted that the elimination of the "reasonable cause to believe" requirement shifted congressional focus from a subjective view to an objective view, which in turn shifted the policy focus away from deterrence and "toward equality of distribution." \textit{Id.} at 1051. But the point of deterrence, of course, is equality of distribution in a collective proceeding.
The Sixth Circuit's decisions in *Cartage* and *Finn* are not to blame for this state of the law. *Cartage* in fact interpreted the Bankruptcy Code as written by Congress in a way that advances bankruptcy policy on a point that Congress in all probability did not actually contemplate when it wrote the law. In *Cartage* the precision with which the Bankruptcy Code was drafted paid off, perhaps accidentally, with a result consistent with underlying bankruptcy policy. *Finn*, however, exposes the dangers of a code written in terms of "rules" instead of "standards." The section 547(c)(2) exception was intended for repayments made on not-quite-contemporaneous debts. But instead of drafting toward that idea or that "standard," Congress originally wrote a "rule" in terms of forty-five-day old debts. That was too precise. It excluded too many debts that were probably intended to be covered, and it led to too much litigation. The new rule is in one sense just as precise as the old one: no matter how many days or years old a debt may be, it is still within the scope of possible exception under section 547(c)(2). Both "rules" were supplemented by ordinary course standards for the courts to develop. But the new "unlimited" day rule of the post-1984 amendment to section 547(c)(2) makes the courts' task very difficult to accomplish in a meaningful way.

VIII. LENDER RELIEF FROM *CARTAGE*

A. The Non-solution

Initially it should be noted that the most frequently suggested antidote for the one year reach back period on insider guarantied loans will almost certainly not work. That suggestion is renunciation by the insider of its claim for reimbursement against the debtor.\(^{144}\) If this right of subrogation were waived, and if the loan then had to be repaid by the insider, the insider would have no claim against the debtor for the amount it had paid on the debtor's behalf. Since the insider would never have had even

a contingent claim against the debtor, it would not be a "creditor." Payments on the loan under these circumstances would be to the outsider-creditor, but would not be for the benefit of an insider-creditor, because the insider would not be a creditor at all. Hence payments to the lender would not be avoidable preferences with respect to the insider, and the standard ninety day reach back period of section 547 would apply with respect to the outside-lender.

This idea has been thoroughly discussed, and demolished, elsewhere:

The exclusive focus on the insider guarantor’s preference exposure incorrectly assumes that, if the insider can successfully avoid classification as a creditor, any benefit the insider receives from the insolvent corporation's payment of a guarantied debt will fall into a gaping black hole in the Bankruptcy Code from which it cannot be retrieved by the bankruptcy trustee. In short, the proponents of the subrogation waiver . . . have forgotten all about the fraudulent conveyance provisions of the Bankruptcy Code.145

Waiver by the insider of its right to be subrogated to the outsider-lender’s claim against the debtor will cause fraudulent conveyance problems because were the debtor to use its assets to pay the guarantied debt and thus reduce the insider’s liability, the insider would benefit from that transaction even more than it would benefit were the debtor to pay a guarantied debt on which the guarantor had not waived its subrogation rights. The difference between the benefits to the insider-guarantor in the two transactions is akin to a dividend to the insider. Because debtor is insolvent the dividend is tantamount to a give-away of debtor assets to the insider.146 Giving away assets while

145. Borowitz, supra note 4, at 2156.
146. Borowitz explains it in terms of a stockholder/guarantor:
[When the bank requires, as a lending condition, that the stockholder/guarantor waive his subrogation rights, the bank is creating an asset for the corporation's estate, which the corporation may subsequently discard only at the peril of the stockholder and his subsequent transferee, the bank. After all, so long as the stockholder is fully exposed under its guaranty to the bank and has no claim back against the corporation, the corporation should at the very least be able to bargain persuasively with the stockholder over how much each should contribute to repay the bank. Any gratuitous surrender of that bargaining power by an insolvent cor-
insolvent is a fraudulent conveyance.147 Fraudulent conveyances are avoidable in bankruptcy under both section 548148 of the Bankruptcy Code and under state fraudulent conveyance law, which the trustee can invoke via section 544(b).149 The reach back period for fraudulent conveyances under section 548 is one year.150 The reach back period for fraudulent conveyances under state law is typically much longer.151 The insider's renunciation of its rights against the debtor, which turns the trustee's preference case into a fraudulent conveyance case, thus makes matters even worse for the outsider lender.

B. Limited Relief: Section 550(b)

If waiving subrogation rights will not be effective, what can lenders do to minimize preference exposure if their loan is guarantied by an insider? In Cartage three of the ten avoided transfers were made to Della Foster, who endorsed the payment checks over to the bank, and seven were made directly to the bank. The Sixth Circuit held that the bank was liable to the trustee for the seven direct payments (on which it was "initial transferee") but could retain the other three (which it took as "immediate transferee" from Della Foster) if it could establish, on remand, the section 550(b) defense that it took them "for value, including satisfaction or securing of a present or an

__poration would appear to constitute a transfer of an intangible asset by the corporation to the stockholder without any fair consideration in exchange therefor. Any such transfer of net worth from corporation to stockholder is again tantamount to a dividend or stock redemption and is equally subject to fraudulent conveyance attack.

_id. at 2162-63.


148. The power to avoid "fraudulent transfers and obligations" under § 548 is another one of the trustee's avoiding powers. _id_. § 548.

149. Section 544(b) provides in part: "The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim . . . ." _id_. § 544(b). The reference to "applicable law" includes state fraudulent conveyance or transfer law.

150. _Id_. § 548(a).

151. For example, Ohio has a four year reach back period. Ohio Revised Code Ann. § 1336.09 (Baldwin 1989).
insider guaranties
antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided."

Thus the most obvious lender technique in the Sixth Circuit to minimize insider preference problems is to structure the loan and particularly loan repayments so that repayments reach the lender indirectly, possibly via the insider. As indicated below however, the defense will probably be most valuable and perhaps only of value to lenders dealing with parties similar to those in the Cartage case: a debtor firm with no real credit of its own, controlled however by insiders who do have respectable credit.

To establish the section 550(b) defense a lender would have to demonstrate

a) that it was an immediate or mediate (not "initial") transferee of the preference from the debtor;

b) that it took for value;

c) that it took in good faith; and

d) that it took without knowledge of voidability.

The Cartage remand establishes that a lender can attain "immediate transferee" status by lending to the insider, on

152. 899 F.2d 1490, 1493-94 (6th Cir. 1990).

153. There is a weak inference to be drawn from the legislative history of § 550 that the deliberate diversion of funds on their way to a subsequent transferee might be an indication of bad faith. "The phrase 'good faith' in this paragraph is intended to prevent a transferee from whom the trustee could recover from transferring the recoverable property to an innocent transferee, and receiving a retransfer from him, that is, 'washing' the transaction through an innocent third party." H.R. REP. No. 95-595, 95th Cong., 2d Sess., reprinted in 1978 U.S. CODE & ADMIN. NEWS 5787, 6332.

The "laundering" described in the House Report, however, is not the same as the two-step repayment process suggested by the Cartage remand. "Washing" a transfer is bad faith according to the congressional history only if the eventual transferee had been more vulnerable to recovery at an earlier stage, and attempted to overcome that disability by two more transfers. The "good faith" requirement on which the passage seems to focus is that in § 550(b)(2), which shields from liability all subsequent transferees after the first § 550(b)(1) transferee "without knowledge." See Eder v. Queen City Grain Co. (In re Queen City Grain, Inc.), 51 Bankr. 722, 727 (S.D. Ohio 1985). It means someone "with knowledge" may not improve its position against the trustee by retaking from an innocent transferee. This is not what happened in Cartage. Nor is there any reason to believe that doing deliberately all of the time what the parties did three times out of ten in Cartage would constitute bad faith.

paper, and then collecting from the “debtor” via the insider. In Cartage, however, the form of this transaction was actually true to its substance because, from the bank’s credit-judgment perspective, the Fosters really were the borrowers. They (particularly Della) had credit; the Cartage firm did not. Lending to them, and formally ignoring the firm, was consistent with the bank’s view of credit reality. Whether a lender could attain “immediate transferee” status if it attempted to duplicate the form of the Cartage arrangement in a situation in which the “real” borrower (that is, the entity with real credit) was the firm and the insiders were, or would become, insolvent if they performed their guaranty, is somewhat problematical, as described below. More importantly, the harder the lender seemed to be trying to achieve “immediate,” rather than “initial,” transferee status, the more its good faith might be put in jeopardy.

The next section 550(b) element, “value,” will probably always be satisfied in a preference situation because an “antecedent debt” will have been satisfied. But the “good faith” requirement and lack of knowledge of voidability are matters of fact that can vary from case to case. The case law on “lack of knowledge” of voidability indicates that “knowledge” means actual, not constructive knowledge of facts that would make a transfer voidable,155 and could possibly include knowing enough about potential voidability to investigate further.156


The Seventh Circuit in Bonded Financial held that a bank did not have knowledge of voidability when it (1) followed instructions to debit an initial transferee’s account for $200,000 to reduce that transferee’s fully secured debt to the bank after the bank had earlier been aware (2) that the debtor corporation (which owed the bank nothing) had transferred the $200,000 to the initial transferee’s account. 838 F.2d at 895. It was that transfer to the initial transferee, who was the owner of the debtor firm and who had an account at the bank, that was avoidable as fraudulent. The court implied that this combination of events probably did not create a duty on the bank’s part to investigate to ascertain “voidability,” and that even if it had investigated, it would have learned nothing. Hence it lacked “knowledge” of voidability and could keep the $200,000. Id. at 898.

The Fourth Circuit in Smith v. Mixon held that an initial transferee’s father who took property as “immediate transferee” while a prior mortgage was still
Applying this to a preference context means that a lender could get the section 550(b) defense if it could show that it was in good faith and did not know any one or more of the following:

(1) that the transfer had been to or for the benefit of a creditor,  
(2) that it was made on account of an antecedent debt,  
(3) that the debtor was insolvent when it was made,  
(4) that bankruptcy would occur within one year, or  
(5) that the initial transferee would be better off on account of the transfer.\textsuperscript{157}

This analysis underscores what is evident on the face of section 550(b): to get the defense, it pays to be ignorant. But what of record might have had "constructive notice" of the mortgage, but "knowledge" was more than constructive notice. 788 F.2d at 231-32. Furthermore, transferee-father did not have knowledge of the debtor's financial difficulties. The father was not liable to the trustee for the debtor who had fraudulently transferred the property to the initial transferee. \textit{Id.}

The two lower court cases in the Sixth Circuit, both of which concerned property that had been the subject of a fraudulent transfer, say that "knowledge of voidability" in § 550(b) means knowledge of facts that would support the trustee's avoidance case. 94 Bankr. at 937-38; 51 Bankr. at 728. In a fraudulent conveyance context, for example, to be liable to the trustee a subsequent transferee would have to know that the debtor (1) had been insolvent and (2) had received less than reasonably equivalent value for what the subsequent transferee later took from the initial transferee.


157. Collier's treatment of § 550(b)(1) underlines the importance of knowledge that bankruptcy is approaching:

To be protected under § 550(b)(1), a subsequent transferee must take "without knowledge of the voidability of the transfer avoided." Neither the Code nor the legislative history interprets this standard. The language appears to be derived from section 4-609(b)(1) of the Commission's bill, and was included as surplusage to illustrate a transferee that could not be in good faith. The Commission intended the standard to mean "if the transferee knew facts that would lead a reasonable person to believe that the property [transferred] was recoverable." With respect to prepetition transfers that are recoverable only if a petition seeking relief under the Bankruptcy Code is filed, the transferee should be held to have knowledge of the voidability of the transfer if, \textit{inter alia}, he has reasonable cause to believe that a petition may be filed.

\textsuperscript{4} Collier, \textit{supra} note 58, \$ 550.03, at 550-60 (15th ed. 1990).
sensible lender will aspire to ignorance? And in what setting will ignorance be most plausible, and where will it be least plausible?

*Cartage* itself is a situation in which the lender’s ignorance would be consistent with both reasonable banking practice and subjective good faith. Since the bank was relying on the Fosters’ credit, it would not be surprising if it did not know much about the firm’s solvency, nor if and when it might file a bankruptcy petition.

The *Cartage* situation should be contrasted, however, with the relationship that exists between a lender and a large firm that has real credit, real assets, a future to be optimistic about, and insiders who if they had to perform a loan guaranty would be left insolvent. The firm in this case is the real borrower from the bank’s credit judgment perspective. Suppose, however, that the form of the *Cartage* transaction were followed. That is, on paper, an insider were the borrower and the money loaned went into the firm. If the firm later went into bankruptcy, and if the loan repayments had been determinedly funnelled back to the bank through the insider, the outward appearances of the *Cartage* situation would be duplicated.

A lender in this situation, however, would have two problems, of which the trustee’s preference case would be the lesser. In the preference recovery case, the trustee would have excellent prospects of defeating the section 550(b) defense because of the obviousness of the lender’s ploy: good faith would be hard to establish even if a wilfully ignorant lender could somehow demonstrate that it did not know the pertinent facts about its real customer, the firm. But the real problem would not be the preference case. The real problem would be trying to assert in the bankruptcy proceeding that the lender was a creditor at all, when the only borrower listed on its loan papers was the (now) insolvent insider.

Therefore, exact duplication of the *Cartage* payback method, outside the financial context that existed in *Cartage*, will probably be ineffective.

Adjustment of the *Cartage* model by making the firm a co-debtor with the non-solvent insiders would obviate the embarrassment of not having a claim in the firm’s bankruptcy case; but it would leave the lender with the same “good faith” issues to confront, based on the lender’s deliberate structuring of the repayments through the insiders. Moreover, when both
the firm and the insiders are formal borrowers, it would seem to be more difficult to characterize the lender as anything other than an "initial transferee," even if it took payments made to it via the insider.

As noted above, the Cartage remand to let the lender prove the section 550(b) defense meant that the parties in Cartage had, probably accidentally, built into their transaction the defense that the "structural argument" proponents maintain should always be available to lenders with insider guaranties when recovery of pre-ninety day preferences are sought from them. In that connection it is interesting to note that in illustrating the kind of facts to which the "structural argument" was intended to apply, its proponents used an example of the Cartage type: a small company's loan was guarantied by its president.\(^{158}\)

This is the prototype situation in which section 550(b) may do the lender some good. Even were the "structural argument" to be adopted by the courts, lenders who extracted insider guaranties from insiders whose own balance sheets were not the real basis for the loan would probably be unable to profit from the defense.

IX. Conclusion

Cartage and Finn were both correctly decided. The Sixth Circuit was right in both cases in saying that the text of the Bankruptcy Code virtually mandated the decisions reached. Cartage is also good bankruptcy law. But Finn is not.

Cartage is good law because a one-year reach back period for insider guarantied loans is consistent with the reasonable congressional purpose of deterring self-serving insider favoritism over a one-year period in order to reduce the tendency of non-insiders to act too soon in dismantling debtors who may have incurred insider guarantied debt.

The two main criticisms of the Cartage rationale are not well taken. First, Cartage does not directly undermine the central principle of letter of credit law, the issuing bank's duty to pay upon presentation of conforming documents. Cartage does, however, threaten the security of banks issuing standby letters

\(^{158}\) Note, supra note 48, at 530.
of credit for customers who are already in default. Banks will therefore have to determine the status of transactions before issuing standby letters to avoid preference vulnerability. This is not an intolerable burden. And even in the absence of *Cartage* and preference law, banks issuing such credits, which substitute for direct preferences, are susceptible to fraudulent conveyance attack. *Cartage*’s implications for letters of credit are therefore acceptable.

Second, *Cartage* should have no adverse impact on oversecured creditors. The so-called “benefit” to undersecured creditors, which has been discerned when oversecured creditors are paid, and which would then become the predicate for avoiding and recovering the payment made to the oversecured creditor, is really not a “benefit,” but a separate transfer. *Cartage* is distinguishable from the oversecured creditor situation because in the latter there are two debts and two transfers, while in *Cartage*, as the Sixth Circuit held, there was only one transfer (and only one debt).

*Finn* is bad law because if preferences are bad there is no reason to regard them as good just because they are accomplished in the “ordinary course.” Congress nodded when it changed section 547(c)(2) from a worthwhile exception for almost contemporaneous transfers, which would help stave off bankruptcy, into a loophole with no principled boundaries.

*Cartage* and *Finn* in combination are a strange pair. They challenge Sixth Circuit lenders to discover how to get the best of both worlds: an insider guaranty that can then be used to pressure the debtor not only for special favorable treatment in the form of loan repayments for the lender, but also for debtor conformity with whatever it will take to satisfy the “ordinary course” standards of section 547(c)(2) in the way those repayments are made. It will be interesting to see how the Sixth Circuit deals with lender efforts to rise to this challenge.