THE RISK-SHIFTING EFFECT OF BUSINESS BANKRUPTCY: A STATUTORY SOLUTION TO PROVIDE ADDITIONAL PROTECTIONS FOR PERSONAL GUARANTORS OF DEBTS BY CLOSELY-HELD BUSINESS VENTURES

Jason Gordon[*]
Robert J. Landry, III[**]

ABSTRACT

Startups often require personal guarantors when securing credit relationships. Third parties often enter into guarantee agreements unaware of the detrimental effect of bankruptcy filing on their rights. A primary goal of bankruptcy protection is to shift the risks associated with debt arrangements among the interested parties to allow for the equitable distribution of assets among creditors of the bankrupt individual or entity. Filing bankruptcy may increase the risk to the guarantor beyond what she anticipates at the time of personally guaranteeing the debt. This Article explores the preference liability of personal guarantors of a closely-held business in bankruptcy and makes a statutory proposal to remedy the inequitable risk-shifting effect of the bankruptcy of the closely-held business.

[*] Assistant Professor of Legal Studies & Management, School of Business, Georgia Gwinnett College, Lawrenceville, GA.

[**] Associate Professor of Finance, College of Commerce and Business Administration, Jacksonville State University, Jacksonville, AL.

INTRODUCTION

Entrepreneurship and policies encouraging entrepreneurial activity are vital to the United States' economy.[1] An antecedent to the decision to pursue a new venture is the availability of financial capital.[2] Early stage entrepreneurs often rely on diverse sources of capital to fund the venture.[3] Important to this research, new ventures often cannot secure debt financing due to the high risk of business failure.[4] Individual or institutional lenders providing capital to fund startup ventures often require personal guarantees of the debt from either the entrepreneur(s) or other third parties.[5] The personal guarantee provides additional protections to lenders if the underlying business fails or defaults on the loan obligation.[6]

A calculable risk contemplated by a lender is the effect of the startup venture filing for bankruptcy.[7] This situation generally results in losses for the

1 *See, e.g.*, Duke & King Mo., LLC v. Nath Cos. (*In re* Duke & King Acquisition Corp.), 508 B.R. 107, 137 (Bankr. D. Minn. 2014) (describing the United States as "an open-market economy driven by entrepreneurship and funded by the free flow of capital").

2 *See* Arnold C. Cooper, Javier Gimeno-Gascon & Carolyn Y. Woo, *Initial Human and Financial Capital as Predictors of New Venture Performance*, 9 J. BUS. VENTURING 371 (1994) (seeking "to predict the performance of new ventures based on factors that can be observed at the time of start-up. Indicators of initial human and financial capital are considered to determine how they bear upon the probability of three possible performance outcomes: (1) failure, (2) marginal survival, or (3) high growth.").

3 *See* Gavin Cassar, *The Financing of Business Start-Ups*, 19 J. BUS. VENTURING 261 (2004) (exploring the determinants of capital structure and types of financing used around business startups, such as the influence of startup size, asset structure, organization type, growth orientation, and owners' characteristics are examined both in the choice and in the magnitude of finance use).

4 *See* Allen N. Berger, W. Scott Frame & Nathan H. Miller, *Credit Scoring and the Availability, Price, and Risk of Small Business Credit* (Fed. Reserve Bank of Atlanta, Working Paper No. 2002-26, 2002) (demonstrating that the creditworthiness of new business as measured by a credit score affects the availability, amount, average costs, and risk levels for small business loans under $100,000).

5 *See* Robert B. Avery, Raphael W. Bostic & Katherine A. Samolyk, *The Role of Personal Wealth in Small Business Finance*, 22 J. BANKING & FIN. 1019 (1998) (demonstrating through empirical evidence that personal guarantees are important for small businesses to obtain commercial credit and are generally substitutes or additions to providing collateral); *see also* James S. Ang, *On the Theory of Finance for Privately Held Firms*, 1 J. ENTREPRENEURIAL FIN. 185, 186 (1992) ("Due to unlimited liabilities (proprietorship and partnership) and incomplete limited liabilities (in the corporation form where lenders require personal guarantee or assets as collateral), business risk is no longer separable from personal risk.").

6 *See* Jay Lawrence Westbrook, *Two Thoughts About Insider Preferences*, 76 MINN. L. REV. 73, 85 (1991) (describing how creditors either require guarantees of debts based on the ability of the guarantor to repay a defaulted debt or the ability of the guarantor to influence the debtor to prioritize payments to the creditor).

7 *See* Evelyn Hayden, *Estimation of a Rating Model for Corporate Exposures*, *in* THE BASEL II RISK PARAMETERS 13, 14 (Bernd Engelmann & Robert Rauhmeier eds., 2d ed. Springer 2011).

unsecured creditors of the business.[8] Frequently, the entrepreneur will seek bankruptcy protection for herself and the business entity, as the interests and assets of the entrepreneur are frequently closely aligned with the business entity.[9] In such a situation, the liability for the business debt may fall upon third party guarantors. Like the lender, the guarantor understands that guaranteeing a business obligation assumes the risk that the business will default.[10] The guarantor may not, however, understand the extent of the risk associated with guaranteeing debt that is included in the bankruptcy estate of the debtor business. While bankruptcy serves as a "safety valve of an economy oriented around entrepreneurship and risk-taking,"[11] the presence of the personal guarantee has a risk-shifting effect that may not be fully contemplated by the parties to the agreement.

A primary goal of bankruptcy protection is to shift the risks associated with debt arrangements among the interested parties.[12] Bankruptcy law achieves this goal by providing for the equitable distribution of assets among creditors of the bankrupt individual or entity.[13] In pursuit of this objective, an important tool in the Bankruptcy Code (the "Code")[14] is the ability of a trustee or debtor-in-

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8 *See* 11 U.S.C. § 547(b) (2012) (providing generally that unsecured creditors are lower in priority than secured creditors of a bankrupt estate); *see also* Lynn LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1947–64 (1994) (reviewing and analyzing the justification for prioritizing of certain type of secured creditors above unsecured creditors involved in the continued success of the business venture).

9 *See, e.g.*, Wei Fan & Michelle J. White, *Personal Bankruptcy and the Level of Entrepreneurial Activity* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 9340, 2002) ("The U.S. personal bankruptcy system functions as a bankruptcy system for small businesses as well as consumers, because debts of non-corporate firms are personal liabilities of the firm's [sic] owners. If the firm fails, the owner has an incentive to file for bankruptcy, since both business debts and the owner's personal debts will be discharged."); *see also* James S. Ang, James Wuh Lin & Floyd Tyler, *Evidence on the Lack of Separation Between Business and Personal Risks Among Small Businesses*, 4 J. ENTREPRENEURIAL FIN. 197, 197–210 (1995) (exploring borrowing patterns, personal collateral, and guarantees in small business ventures; finding that significant numbers of small business owners have pleaded extensive personal wealth to secure business loans).

10 *But cf.* Richard E. Brennan & Christopher W. Burdick, *Does the Guarantor Guarantee? Lender, Beware!*, 11 SETON HALL L. REV. 353, 353–78 (1980) (reviewing the outcome of a unique case where the guarantor was relieved from the obligation to pay on a guaranteed debt).

11 Walker v. Sallie Mae Servicing Corp. (*In re* Walker), 406 B.R. 840, 866 (Bankr. D. Minn. 2009).

12 *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 456–57 (1991) (discussing the "risk-sharing theory" of bankruptcy).

13 *See* Simonson v. Granquist, 368 U.S. 38, 42 (1962) (Frankfurter, J., dissenting) ("[A]n important purpose of the Bankruptcy Act was to ensure an equitable distribution of assets among creditors."); *see also* Stephen C. Behymer, Note, *Not Interested? A Trustee Lacks "Party in Interest" Standing to Move for an Extension of the Nondischargeability Bar Date on Behalf of Creditors*, 82 FORDHAM L. REV. 937, 941 (2013) (noting that U.S. bankruptcy law "focuses on providing the debtor with a 'fresh start' while simultaneously facilitating the fair and orderly collection of debts owed to creditors").

14 *See* 11 U.S.C. § 101 (2012). Unless otherwise noted, all references to the Bankruptcy Code, Code, or section are to title 11 of the United States Code.

possession ("trustee")[15] to recover, for the benefit of the estate and all of its creditors, preferential payments made to individual creditors of the estate leading up to the bankruptcy filing.[16] The recovery of preferential payments is often the subject of litigation between the trustee and the creditor in receipt of an alleged preferential payment.[17] In the context of preference litigation, the guarantor of a business debt may lack the protection she anticipates under bankruptcy law. In fact, filing bankruptcy may increase the risk to the guarantor beyond what she anticipates at the time of personally guaranteeing the debt.

This Article explores the preference liability of personal guarantors of a closely-held business in bankruptcy. Following this Introduction, Part I discusses an overview of priority and preferences, Parts II and III we offer an overview of preference liability generally and then specifically to guarantors. In Part IV, we analyze the extent to which preference liability increases the risk to the guarantor beyond the parties' expectations. In Part V, we call for a statutory solution to the inequitable risk-shifting in the event that a closely-held business goes bankrupt.

I. OVERVIEW OF PREFERENCES

A. *Priority, Preferences and the Trustee*

Establishing a credit relationship is a form of lending. Inherent in this relationship is the concept of priority.[18] Priority refers to rights of creditors to payment with respect to other creditors.[19] Specifically, it provides for the order

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[15] *See generally* 11 U.S.C. § 701 (stating that a trustee is appointed under chapter 7 of the Code); 11 U.S.C. § 704(a) (stating that the trustee has certain duties and powers); 11 U.S.C. § 547(b) (setting forth avoidance powers of trustee); 11 U.S.C. § 1104(a) (stating that a trustee can be appointed under chapter 11 of the Code); 11 U.S.C. § 1106(a)(1) (stating that a chapter 11 trustee will have avoidance powers like a chapter 7 trustee); 11 U.S.C. § 1107(a) (stating that if a case is filed under chapter 11 and there is no trustee appointed, the debtor-in-possession has the certain powers of a trustee, including avoidance powers under § 547(b)).

[16] *See* 11 U.S.C. § 550(a); *see also* Leslie A. Cohen & J'aime K. Williams, *Guarantor Preference Liability*, 31 CAL. BANKR. J. 795, 795 (2011) ("[Preference liability] is a mechanism that allows the debtor or trustee to recover from creditors who received payments in the weeks or months prior to the bankruptcy so that they can be distributed to all bankruptcy estate creditors in accordance with their priority.").

[17] *See generally* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713 (1985) (discussing litigation and issues arising when a trustee asserts a preference claim).

[18] See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUDIES 1, 1–37 (1981), for a detailed discussion of the conceptual framework and justification of priority in the context of business bankruptcy proceedings.

[19] *See id.* at 2; *see also* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1143–44 (1979).

in which creditors are entitled to repayment from the debtor in the event of liquidation.[20] Priority is determined either by statute or by a contractual relationship between the parties.[21] Importantly, priority represents a level of risk as compared to other creditors, and it strongly influences the terms under which a credit relationship exists.[22] That is, creditors extend credit to obligors with an understanding of their priority of repayment and their rights upon default.

A preference refers to inequitable treatment of one party above another. In the context of bankruptcy, a preferential payment is defined as a payment:

> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made—
>> (A) on or within 90 days before the date of the filing of the petition; or
>> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider, and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>> (A) the case were a case under chapter 7 of this title . . . ;
>> (B) the transfer had not been made; and
>> (C) such creditor received payment of such debt to the extent provided by the provisions of this title . . . .[23]

Preference is, therefore, either the failure to treat creditors in accordance with their statutory or contractual priority or the inequitable treatment of similarly situated creditors with regard to their claims against the business.[24]

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[20] *See* 11 U.S.C. § 507(a) (establishing the priority of unsecured creditors of the bankruptcy estate).

[21] *See* Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396, 1396–97 (1996).

[22] *See* Phillip E. Strahan, *Borrower Risk and the Price and Nonprice Terms of Bank Loans*, *Fed. Res. Bank of N.Y. Staff Reports*, 90 (1999) (discussing the price and non-price terms of bank loans and how they are affected by the riskiness of the borrower; finding that small business owners with less assets generally garner less favorable terms in the lending relationship). *See generally* Schwartz, *supra* note 21, at 1399–1400 (discussing contractual agreements that prioritize creditor claims).

[23] 11 U.S.C. § 547(b).

[24] *See id*. See generally Isaac Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547 (c)(2), 550 (a)(1), and 546 (a)(1)*, 41 BUS. LAW. 175, 176–208 (1985), for a detailed discussion of the evolution of bankruptcy preference laws and the litigation affecting their interpretation.

The trustee in bankruptcy is charged with protecting the rights of creditors during the bankruptcy process.[25] The trustee collects assets of the bankruptcy estate for the benefit of creditors.[26] As stated above, preferential payments by a debtor diverge from the legally protected priority afforded to creditors. As such, the Code empowers the trustee to collect preferential payments by the debtor to creditors when those payments run afoul of the aforementioned priority or otherwise harm similarly situated creditors.[27]

B. Preference Challenges

As a matter of procedure, any payment of a debt made to a business creditor within ninety days prior to filing for bankruptcy is subject to challenge by the trustee as a preferential payment.[28] The trustee has standing to sue and bring a preference action.[29] The process, as with most litigation, usually begins informally with the trustee informing creditors of any suspected preferential payments and by sending out blanket claims of preferential payment to all creditors in receipt of funds within the ninety-day window. If the trustee recovers the preferential payment, then the previously preferred creditor loses all priority in payment and becomes a general unsecured creditor of the bankruptcy estate for the amount of the recovered payment.[30] This demotion in priority from paid-in-full creditor to an unsecured creditor can be devastating, as unsecured creditors generally receive pennies on the dollar for unsecured claims against the bankruptcy estate.[31]

The ninety-day period is an arbitrary amount of time created under the assumption that a debtor in bankruptcy may have prepared to file for bankruptcy by making preferential payments to creditors that hinder the rights of other business creditors.[32] A payment within the ninety-day window is not

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[25] *See In re* Antweil, 931 F.2d 689, 692 (10th Cir. 1991) (noting that the role of the trustee under § 547 is to efficiently allocate assets among creditors of the debtor).

[26] *See* 11 U.S.C. § 544 (designating the trustee as lien creditor and as successor to certain creditors and purchasers with claims against the bankruptcy estate).

[27] *See* 11 U.S.C. §§ 544, 547(b); *see also* Richard B. Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 187 (1979).

[28] *See* 11 U.S.C. § 547(b)(4)(A).

[29] *See* 11 U.S.C. § 547(b).

[30] *See* 11 U.S.C. § 507 (prescribing the order of payment among unsecured creditors).

[31] *See* Thomas Ross, *The Impact of Section 547 of the Bankruptcy Code upon Secured and Unsecured Creditors*, 69 MINN. L. REV. 39, 68–74 (1984) (explaining the negative effects of § 547 of the Code on unsecured creditors of the bankruptcy estate).

[32] *See generally* Countryman, *supra* note 17, at 726–49 (describing the conceptual approach to recovery of preferential payments under bankruptcy law).

assumed to be preferential.[33] However, the trustee's practice of sending blanket preferential payment notices shifts the burden of defending the preferential payment claim onto any creditor who received payment during the ninety-day period. While the intent of the provision is to generally protect creditors of the bankruptcy estate,[34] a blanket challenge to any payment negatively affects creditors in receipt of non-preferential payments.

C. Defenses to Preference Challenges

The creditor may assert a number of defenses against the trustee's claim of preferential payment. These defenses include the assertion that (1) the purported preferential payment was a contemporaneous exchange for new value,[35] (2) the debt and payments were made in the ordinary course of business and according to ordinary business terms,[36] (3) the debtor provided a security interest in collateral acquired with the new value,[37] (4) the debtor provided payment to a creditor providing new value,[38] (5) the payment created a perfected security interest in receivables,[39] or (6) the payment made was less than $600 for consumer debts or less than $6225 for non-consumer debts.[40] These are affirmative defenses that the creditor must raise to rebut any claim that a payment is preferential under § 547(b)(1)–(5). Asserting any of these defenses, however, may be difficult and costly to the creditor due to legal fees incurred and a lack of availability of information.[41] Faced with the prospect of losing any of the trustee's contested and incurring extensive legal costs, creditors are tempted to simply settle the claim for a lesser amount.[42]

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33 *See* 11 U.S.C. § 547 (setting forth the requirements for a payment to be considered preferential).

34 *See* Emil A. Kleinhaus & Alexander B. Lees, *Debt Repayments as Fraudulent Transfers*, 88 AM. BANKR. L.J. 307, 307 (2014) (citing Lawson v. Ford Motor Co. (*In re* Roblin Indus., Inc.), 78 F.3d 30, 40 (2d Cir. 1996) (quoting H.R. 595, 95th Cong. 177–78 (1st Sess. 1977))).

35 11 U.S.C. § 547(c)(1).

36 11 U.S.C. § 547(c)(2).

37 11 U.S.C. § 547(c)(3).

38 11 U.S.C. § 547(c)(4).

39 11 U.S.C. § 547(c)(5).

40 11 U.S.C. § 547(c)(8)–(9).

41 *See* 11 U.S.C. § 547(b)(1)–(5); Cohen & Williams, *supra* note 16, at 795–96 (highlighting the use of these basic defenses to preferences that can be asserted by a guarantor).

42 Karen Cordry, *Some "Modest Proposals" on Preferences*, 23 AM. BANKR. INST. J., June 2004, at 8, 48 ("For many creditors, being let out of difficult litigation at what seems to be a relatively low cost will likely prove appealing, and they will choose not to fight back. Only the ones with the largest amount at stake may find it worthwhile to litigate.").

D. Preference Challenges and Insiders

In furtherance of the objective to protect creditor rights, the Code affords greater protection for preferential payments made to an "insider."[43] An insider is someone in a position of authority or control within the business debtor.[44] The statutory definition leaves open the possibility for a "non-statutory insider" or an individual not specifically identified in the statute.[45] The court in *In re U.S. Med. Inc.* laid out the standard for determining whether someone is a non-statutory insider, stating that "[a]n insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's [sic] length with the debtor."[46] The court elaborated on the "closeness" standard by stating, "*Kunz* requires that the relationship between a debtor and a non-statutory insider be not only close, but also at less than "arm's length."[47]

The Code allows for additional protection of shareholders against preferential payments to insiders by allowing the trustee to examine all payments made to that creditor within the preceding twelve months rather than ninety days.[48] The one-year look-back period is a powerful tool for the trustee in identifying preferential payments.[49] If she believes the payee to be to an insider, she may challenge any payment made during the look-back period, and, if successful, recover that payment from the preferred creditor.[50]

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43 *See* 11 U.S.C. § 101(31) (defining "insider").

44 *See id.* (listing examples of authority and control).

45 *See, e.g.*, Schubert v. Lucent Techs., Inc. (*In re* Winstar Comm., Inc.), 554 F.3d 382 (3d Cir. 2009) (determining whether the closeness of the relationship between the parties gave rise to non-statutory insider status).

46 531 F.3d 1272, 1277 (10th Cir. 2008) (quoting S. REP. NO. 95-989, at 25 (1978); H.R. REP. NO. 95-595, at 312 (1977)) (quotation marks omitted).

47 *Id.* at 1278 (citing Rupp v. United Sec. Bank (*In re* Kunz), 489 F.3d 1072, 1079 (10th Cir. 2007)).

48 *See* 11 U.S.C. § 547(b)(4) (stating that if the creditor is an insider, then the time period is extended from ninety days to one year before the petition date).

49 *See* 11 U.S.C. § 704(a)(1) (obligating the trustee to "collect and reduce to money the property of the estate," including preference actions as property of the estate).

50 *See* 11 U.S.C. § 550(a) (providing that the trustee can recover avoided transfers or their value for the benefit of the estate); *see also* Field v. Insituform E., Inc. (*In re* Abatement Envtl. Res., Inc.), 307 B.R. 491, 498 (Bankr. D. Md. 2004) ("[Section 550] permits a trustee who is successful in an action under Section 547 to recover the property, or the value of the property, from either the transferee, or a creditor that benefitted from the transfer.").

II. PREFERENCES AND THE GUARANTOR

When a trustee seeks to recover preferential payments made to creditors of a closely-held business venture, the action is particularly problematic and much more complex than the typical preference litigation.[51] The complexity in the situation is due in part to the nature of the relationship among the business entity, the entrepreneur, and the guarantor of the business entity's debts. As previously stated, in a startup venture, the entrepreneur is commonly a guarantor on many business debts.[52] Further, payments by the startup to creditors made within the statutory preference period generally meet the definition of a preferential payment.[53] Startup ventures are commonly considered insolvent, as they carry extensive debt or obligations that far exceed the assets of the business venture.[54] As such, receipt of any payment by the creditor during this period would generally constitute an amount greater than the unsecured creditor would otherwise receive in the event of startup bankruptcy.[55] This structural arrangement gives rise to a complicated situation for the trustee charged with recuperating funds for the bankruptcy estate.

As previously stated, a creditor who receives a preferential payment from a business entity is unfairly advantaged above higher priority or similarly situated creditors of the business.[56] However, perhaps less evident, is the fact that the entrepreneur, as guarantor, and any third-party guarantor of the debt owed to the preferred creditor also benefit from the preferential payment.[57] The

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51 *See* Cohen & Williams, *supra* note 16.

52 *See* Jerome S. Osteryoung & Derek Newman, *What Is a Small Business?*, 2 J. ENTREPRENEURIAL FIN. 219, 227 (1993).

53 *See* 11 U.S.C. § 547(a) (enumerating the requirements for a preferential payment).

54 *See* 11 U.S.C. § 101(32) (defining "insolvent"). *See generally* Frederick D. Scherr, Timothy F. Sugrue & Janice B. Ward, *Financing the Small Firm Start-Up: Determinants of Debt Use*, 3 J. ENTREPRENEURIAL FIN. 17 (1993) (providing empirical evidence of the capital structure of startup ventures—particularly the debt/equity characteristics of these firms).

55 The foundation for this premise stems from the actual return typical unsecured creditors receive in most bankruptcy chapter 7 cases. Most unsecured creditors in chapter 7 receive no payment at all based on their claim, with a very small number of unsecured creditors receiving "a token payment on their claim." Stephen J. Lubben, *Business Liquidation*, 81 AM. BANKR. L.J. 65, 80 (2007). The likelihood of no return to unsecured creditors or only receiving a "token" return based of the value of the claim from the bankruptcy estate would be greater for a startup bankruptcy case than a non-startup bankruptcy case.

56 *See* Countryman, *supra* note 17, at 726 (examining the justification for preferential payments to creditors).

57 *See* Lawrence Ponoroff, *Now You See It, Now You Don't: An Unceremonious Encore for Two-Transfer Thinking in the Analysis of Indirect Preferences*, 69 AM. BANKR. L.J. 203, 204–05 (1995) ("Although the payment is not directly received by the guarantor, it nevertheless benefits the guarantor since it operates to terminate the guarantor's liability to the preferred creditor.").

benefit is vicarious in that the preferential payment reduces the guarantor's liability for the debt.[58] As such, the benefit to the guarantor is not based on money or property directly received by the guarantor; rather, the guarantor receives an imputed benefit from payment of the guaranteed debt because of her reduction in her secondary liability for that debt.[59] In a way, this benefit can be considered a "phantom benefit" to the guarantor.[60]

The "two-transfers theory" supports the recovery of preferential payments made to a guaranteed creditor from the guarantor.[61] The theory is that the payment made by the debtor to the creditor is a transfer from the debtor to the guarantor in partial satisfaction of the guarantor's contingent liability.[62] The drafters of § 547 of the Code assumed that closely-held business entities are prone to make preferential payments to insiders in anticipation of bankruptcy.[63] As such, extending liability for those preferential payments beyond the actual creditor to the guarantor achieves the purpose of protecting the creditors of the bankruptcy estate.[64]

The issue of whether the guarantor is a preferential payee came to the forefront of creditor concern in 1989 following the decision in *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio)*.[65] In *Deprizio*, the court held that the guarantor is, in effect, a preferred creditor and insider, and this status extends the time period for collecting the preferred payment from the creditor.[66] Congress subsequently passed the Bankruptcy Reform Act of 1994 ("Bankruptcy Reform Act"),[67] which effectively overruled *Deprizio* by

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58 *Id.*

59 *Id.*; *see also* David I. Katzen, Deprizio *and Bankruptcy Code Section 550: Extended Preference Exposure via Insider Guarantees, and Other Perils of Initial Transferee Liability*, 45 BUS. LAW. 511, 513 (1990); Cohen & Williams, *supra* note 16.

60 Our use of the phrase "phantom benefit" refers to the "phantom" income received by entrepreneurs who provide services to a startup in exchange for an ownership interest in the business entity. Glenn E. Dance & Jeff Erickson, *"I Ain't Afraid of No Ghosts": Allocating Phantom Income Amongst Partners in a Service Partnership*, 14 J. PASSTHROUGH ENTITIES, no. 5, Sept.–Oct., 2011, at 7, 7–9. The entrepreneur does not actually receive payment for her services, but income is imputed to her to the extent of the value of the business equity received.

61 *See* Official Unsecured Creditors Comm. v. U.S. Nat'l Bank (*In re* Sufolla, Inc.), 2 F.3d 977, 981–82 (9th Cir. 1993) (providing a detailed treatment of the "two-transfers theory").

62 *See id.*

63 *See* John Tuskey, *Term Insider Within Section 547 (b)(4)(B) of the Bankruptcy Code*, 57 NOTRE DAME L. REV. 726, 728 (1981).

64 *See id.*

65 874 F.2d 1186 (7th Cir. 1989).

66 *See id.* at 1200–01.

67 Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (codified as amended in scattered sections of title 11 of the U.S. Code).

providing that the trustee could recover from the guarantor, but not from the original preferred creditor.[68] This act sought to protect preferred creditors while leaving insiders who benefited from a preferential payment subject to preferential challenge by the trustee.[69]

The *Deprizio* holding and subsequent passage of the Bankruptcy Reform Act left a great deal of uncertainty with regard to the rights of the third-party guarantor of a closely-held business entity.[70] That is, considerable controversy exists over the circumstances under which a guarantor should be held liable for preferential payments to the guaranteed creditor.[71] Take for example the situation where the preferred creditor is fully secured by assets of the bankrupt debtor; is the guarantor a creditor for purposes of § 547?[72] One view is that the fully secured creditor is not receiving more than she would otherwise receive in a chapter 7 bankruptcy, and therefore is not really preferred under § 547.[73] On the other hand, another debate centers on whether the guarantor may be considered a creditor of the bankrupt debtor for purpose of § 547 preference

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[68] *See* 11 U.S.C. § 550(c) (2012) ("If a transfer made between 90 days and one year before the filing of the petition—(1) is avoided under section 547(b) of this title; and (2) was made for the benefit of a creditor that at the time of such transfer was an insider; the trustee may not recover under subsection (a) from a transferee that is not an insider."); *see also* 11 U.S.C. § 547(i) ("If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the date of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided under this section only with respect to the creditor that is an insider.").

[69] See generally Margaret Howard, *Avoiding Powers and the 1994 Amendments to the Bankruptcy Code*, 69 AM. BANKR. L.J. 259, 259–85 (1995), for a discussion of the changes to the Code affecting insider creditors.

[70] *See* Steve H. Nickles, Deprizio *Dead Yet? Birth, Wounding, and Another Attempt to Kill the Case*, 22 CARDOZO L. REV. 1251, 1256–58, 1272–74 (2000) (discussing *Deprizio*, its effect on creditor preferences, the Bankruptcy Reform Act of 1994, and a subsequent attempt to further limit *Deprizio* in the Bankruptcy Reform Act of 1999).

[71] *See* Lawrence Ponoroff, *The Dubious Role of Precedent in the Quest for First Principles in the Reform of the Bankruptcy Code*, 74 AM. BANKR. L.J. 173, 176 n.12 (2000) ("For example, the effort to overrule the *DePrizio* decision . . . has engendered a new controversy over whether the Code now eliminates both the right to *avoid* the transfer and recover the preference from the noninsider, or only the right of *recovery*, leaving the noninsider still exposed to the possibility of having its lien avoided outside of the standard ninety-day preference period.") (citation omitted); *see also* Daniel J. Bussel, *Textualism's Failures: A Study of Overruled Bankruptcy Decisions*, 53 VAND. L. REV. 887, 916 (2000) (stating that following the 1994 Amendments "[w]e are left with a statute that arguably implicitly ratifies the least defensible extensions of the *Levit* reasoning, while reversing the *Levit* result.").

[72] *See* Charles J. Tabb, *The Brave New World of Bankruptcy Preferences*, 13 AM. BANKR. INST. L. REV. 425, 455 (2005) (providing a hypothetical in which a creditor and guarantor are not creditors of the bankruptcy estate because of their fully secured status).

[73] *See id.*; 11 U.S.C. § 547(b)(5).

liability.[74] Similarly, there is an argument that a guarantor who waives any potential recourse against the debtor is not a creditor of the bankruptcy estate for purposes of § 547 preference liability.[75] While this scenario may artfully avoid the definition of a preferred creditor under § 547, it fails to cover situations where an insider guarantor maintains a non-equity interest in the bankrupt business, either through an equity option, convertible debt, or a profits interest. In any event, the uncertainty surrounding the classification of the guarantor as a creditor of the bankruptcy estate lends credence to the need for statutory reform dealing with the preferred guarantor situation.

III. Does a Bankruptcy Filing Increase the Risk Beyond the Expectation of Guarantors?

In a preference action the trustee will generally look first to the creditor in actual receipt of any allegedly preferential payment.[76] Recovery of such payment, however, is not automatic, as the creditor may assert any of the above-referenced defenses to the receipt of the payment.[77] In such event, the trustee must then look to the guarantor to recover the preferential payment.[78] The guarantor then has the ability to assert any defenses applicable to creditors.[79] As previously noted, there are significant difficulties and costs associated with asserting third-party defenses.

A. Creditor Defenses Unavailable to Guarantor

Perhaps the most effective defense available to a preferred creditor relates to the ninety-day look-back period under § 550.[80] The trustee cannot recover preferential payments made more than ninety days prior to the date of

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74 *See, e.g.*, Hendon v. Assocs. Commercial Corp. (*In re* Fastrans, Inc.), 142 B.R. 241, 246 (Bankr. E.D. Tenn. 1992) (holding that a waiver of subrogation rights against the debtor for any liability for preferential payments made to a creditor effectively defeated a preference claim against the guarantor).

75 *See, e.g.*, Peter L. Borowitz, *Waiving Subrogation Rights and Conjuring up Demons in Response to* Deprizio, 45 BUS. LAW. 2151, 2155–65 (1990).

76 *See* 11 U.S.C. § 547(b); 11 U.S.C. § 507 (prescribing the order of payment among unsecured creditors); Ross, *supra* note 31.

77 *See* 11 U.S.C. § 547(c) (setting forth nine exceptions to an otherwise voidable preference).

78 *See* 11 U.S.C. § 550(c).

79 *See* 11 U.S.C. § 547(c)(1)–(5), (8)–(9); 11 U.S.C. § 547(b); Cohen & Williams, *supra* note 16, at 795–96 (highlighting the use of these basic defenses to preferences that can be asserted by a guarantor).

80 11 U.S.C. § 550(c) ("If a transfer made between 90 days and one year before the filing of the petition—(1) is avoided under section 547(b) of this title; and(2) was made for the benefit of a creditor that at the time of such transfer was an insider; the trustee may not recover under subsection (a) from a transferee that is not an insider . . . .").

bankruptcy filing.[81] This ninety-day limitation, however, does not apply to the guarantor of the obligation to the preferred creditor if she is considered an "insider" of the debtor business.[82] Naturally, the entrepreneur is an "insider" by virtue of her control over the business entity.[83] Likewise, third-party guarantors of startup ventures are often family or friends of the entrepreneur.[84] This status may qualify the guarantor as an "insider" due to the level of influence that she has over the entrepreneur and her governance of the debtor business. Further, guarantors of obligations of early-stage ventures often exert control over the venture by assuming formal or informal advisory roles in the business. These characteristics of startup financing and governance will likely allow the trustee to look to the guarantor to recover any preferential payments made to the guaranteed creditor within twelve months of the bankruptcy filing.[85] This scenario makes evident that, due to the extended look-back period, the risk assumed by the guarantor exceeds that of the guaranteed creditor.

B. Control Provisions: Operations and Lending Creditors

A startup business typically allocates resources in the manner it deems most beneficial to business operations and financing.[86] Aware of this fact, the creditor of a business assumes a level of risk regarding how a business will prioritize payments to that creditor.[87] Capital lenders often stand at odds with operations creditors in this regard. An operations creditor, such as a supplier of material or inventory, generally desires that debts be paid as soon as possible.[88] It may employ any number of tactics to incentivize the debtor business to make payment, including purchase discounts and credit limits.[89] Capital lenders, on

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81 *See* 11 U.S.C. § 550(c).

82 *See* 11 U.S.C. § 101(31) (defining "insider").

83 *See id*.

84 *See* Tuskey, *supra* note 63, at 726–28 (explaining the common law interpretation of types of individuals who constitute insiders).

85 See generally Gordon v. Sturm (*In re* M2direct, Inc.), 282 B.R. 60, 62–65 (Bankr. N.D. Ga. 2002), for a careful analysis of the interplay between §§ 547 and 550 in the context of insider guarantor liability as preference leading to this legal conclusion with the bankruptcy court finding that a trustee can recover from insiders for up to a year based on transfers from a debtor to a creditor that benefited an insider guarantor.

86 *See* Rodolphe Durand & Vicente Vargas, *Ownership, Organization, and Private Firms' Efficient Use of Resources*, 24 STRATEGIC MGMT. J. 667 (2003) (providing an overview of strategic resource allocation in startup businesses).

87 See generally Jackson & Kronman, *supra* note 19, at 1143–44, for a discussion of priority among creditors and the recognition of increased risk with lower priority.

88 *See* Mitchell A. Petersen & Raghuram G. Rajan, *Trade Credit: Theories and Evidence*, 10 REV. FIN. STUD. 661 (1997) (exploring the use of trade credit as a business strategy in diverse firms).

89 *See id.* at 687–88.

the other hand, often discourage the prepayment of outstanding notes or other debt instruments.[90] Prepayment requires effort on the part of the lender to reinvest or find alternative allocations for the recuperated funds.[91] However, lenders do reserve the right to exercise a great deal of authority in demanding the repayment of loans. For example, they may employ default clauses,[92] collateral repossession rights,[93] or other provisions that demand payment upon certain ratios.[94]

Through the above-mentioned provisions, creditors are able to employ extensive control provisions regarding how the startup allocates its resources, including influencing the prioritization of debts.[95] This power or authority often far exceeds the amount of influence a third-party guarantor has over the business regarding the allocation of resources. This reality makes the heightened potential liability of the guarantor for preferential payments inequitable when compared to that of the actual preferred creditor.

C. *Inequitable Treatment of Guarantors Versus Creditors*

Like the creditor, the guarantor assumes a level of risk (potential liability for the guaranteed debt) commensurate with the priority of the guaranteed debt. At the time of undertaking a personal guarantee, the guarantor likely judges the risk of default by the business venture.[96] In deciding to guarantee an obligation, the guarantor knowingly assumes this risk based upon her knowledge and confidence in the business or its owners.[97] That is, prior to guaranteeing a debt, she makes assumptions about the business' intended allocation of capital. However, she may or may not consider the extensive influence of these creditors in incentivizing payment of debts.

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90 See Robert K. Baldwin, *Prepayment Penalties: A Survey and Suggestion*, 40 VAND. L. REV. 409, 414–19 (1987), for a discussion of prepayment penalties and their use by financial institutions.

91 *See id.* at 412–14 (describing general reasons behind prepayment penalties).

92 *See* Paul D. Childs, Steven H. Ott & Timothy J. Riddiough, *The Value of Recourse and Cross-Default Clauses in Commercial Mortgage Contracting*, 20 J. BANKING & FIN. 511, 512–13 (1996).

93 *See* James R. McCall, *The Past as Prologue: A History of the Right to Repossess*, 47 S. CAL. L. REV. 58, 81 (1973).

94 *See* Amy Patricia Sweeney, *Debt-Covenant Violations and Managers' Accounting Responses*, 17 J. ACCT. & ECON. 281 (1994) (providing an analysis of the accounting practices in 130 firms in response to the existence of debt-covenants).

95 *See id*.

96 *See* Paul Angoua, Van Son Lai & Issouf Soumaré, *Project Risk Choices Under Privately Guaranteed Debt Financing*, 48 Q. REV. ECON. & FIN. 123, 124 (2008).

97 *See id*.

Exposing the guarantor to liability for payments to preferred creditors up to twelve months prior to filing for bankruptcy protection (rather than ninety days) defeats any autonomy afforded to the startup in the allocation of its resources. Further, it ignores the level of influence a creditor has over the startup regarding the allocation of resources. For example, any of the strong-arm clauses used by a creditor to influence payment by the startup can be the subject of preferential payment claims in the event of bankruptcy; yet, the period during which the trustee can recover such payment is much longer for the third-party guarantor.[98] The result is that the debtor's filing for bankruptcy protection expands the obligation assumed by the guarantor.

In summary, the preferred creditor is able to retain any payments received outside of the ninety-day preference window, while the guarantor is subject to preference liability for those payments up to twelve months prior to the date of the bankruptcy filing.[99] The preferred creditor has received payment on the outstanding debt, and the guarantor is no longer liable to that creditor.[100] The guarantor is effectively liable to the other creditors of the bankruptcy estate, as represented by the trustee's preference claim. The purpose of § 547 is clearly to protect the creditors of the bankruptcy estate.[101] The effect, however, is that the guarantor no longer guarantees the payment obligation to the preferred creditor; rather, she now guarantees the debtor's payments to other creditors based upon an inequitable shifting of risk away from the preferred creditor and the guarantor.

The question becomes, does the expansion of liability exceed the guarantor's understanding and expectations at the time of guaranteeing the obligation?

IV. RE-BALANCING THE RISK: A STATUTORY SOLUTION

Sections 550 and 547 of the Code, in concert, alter the contractual understanding of the parties to a guarantee agreement. Imposing obligations on

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98 *See* 11 U.S.C. § 547(b)(4)(A)&(B) (2012) ("[T]he trustee may avoid any transfer of an interest of the debtor in property – (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 . . . .").

99 *See* 11 U.S.C. § 547(c)–(d).

100 *See* Marshall E. Tracht, *Insider Guaranties in Bankruptcy: A Framework for Analysis*, 54 U. MIAMI L. REV. 497, 529–33 (2000) (providing an analysis of the role of the guarantee and its place in bankruptcy).

101 *See generally* Countryman, *supra* note 17, at 714–25 (discussing the voidable preference and its conceptual history).

the guarantor without disclosure and outside of the common understanding of the parties runs afoul of the policy of fully informing debtors of their rights under a credit agreement.[102] This effect necessitates a statutory provision to protect the rights of guarantors of closely-held ventures.

We propose the following statutory solution by adding new subsections to § 547(c), which sets forth certain defenses to an otherwise avoidable preference.[103] First, we propose that the new § 547(c)(10) would provide as follows:

> *(c) The trustee may not avoid under this section a transfer—*
>
> > *(10) to the extent that—*
> >
> > > *(A) the transfer was to a guarantor insider;*
> > > *(B) the transfer derived from a transfer from the debtor to a transferee;*
> > > *(C) the guarantor insider did not receive a contractual interest in the debtor property to be avoided; and*
> > > *(D) the debtor did not effectuate the transfer from the debtor to the transferee with the intent to benefit the insider guarantor.*

Proposed § 547(c)(10)(D) would eliminate preference recoveries from insider guarantors based on a phantom benefit theory, unless it can be shown by the trustee that the transfer from the debtor to the transferee was done with the intent to benefit the insider guarantor. This qualification will minimize factual situations where the transfers leading up to bankruptcy were designed to manipulate the priority scheme of the Code for the benefit of the insider guarantor. Further, it would avoid allocating to the guarantor the risk of claims of preferential payment that are the result of ordinary business practices by the business or in response to oppressive business practices by creditors.

Second, we propose new § 547(d). This new subsection would create an obligation on the part of the allegedly preferred creditor to facilitate the guarantor in putting forth any defense to alleged preferential payments. This would reduce the burden on guarantors in exerting a defense to a preferential payment claim. Under the current regime, the guarantor stands in a poor position to defend a preference claim. Absent court-authorized discovery rights, she lacks access to records and information necessary to defend a preference claim by the trustee.

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102 *See* Truth in Lending Act, 15 U.S.C. § 1601 (2012).
103 *See* 11 U.S.C. § 547(c).

> *(d) Creditors in receipt of payments, which are the subject of preferential payment recovery actions by the trustee against a guarantor of the debt owed to the creditor, must provide all information reasonably required by the guarantor to assert any defenses potentially available to the creditor in asserting any statutory defenses enumerated in this section.*

Third, new § 547(e) would allow the defendant to recover the costs of successfully defending a priority challenge from the bankruptcy estate. Collection of preferential payments by the trustee is carried out on behalf of the estate creditors; as such, those creditors should bear the financial risk of losing a preferential payment claim. Unlike the risk currently incurred by the guarantor, the risk to existing creditors would be limited to the value of their claim against the debtor. This provision will further dissuade the trustee from making blanket preferential payment challenges to all creditors in receipt of payments within the ninety-day preference window.

> *(e) A guarantor in subsection (e) that succeeds in defending a claim by the trustee of preferential payment shall be entitled to recover from the bankruptcy estate the reasonable costs incurred in mounting the defense.*

Lastly, § 547(f) would impose disclosure requirements on a creditor to a guarantor explaining the guarantor's heightened liability in the event of the business's bankruptcy. Generally, there is little requirement for disclosure to guarantors of business debt.[104] Specifically, this proposed provision would require lenders to provide the guarantor with the option of foregoing a claim of right against the debtor for the guaranteed debt. As previously discussed, the guarantor's failure to make this election makes the guarantor a creditor of the bankrupt debtor and extends the ninety-day preference period for the creditor to the twelve-month period applicable to the insider guarantor.[105]

> *(f) Creditors seeking a guarantee from a third-party of a business debt must affirmatively disclose to the potential guarantor the*

[104] *See* Truth in Lending Act, 15 U.S.C. § 1601 (requiring informed use of credit and disclosure of personal property lease terms, but not the payment liabilities of the guarantor in the event of bankruptcy).

[105] *See* 11 U.S.C. § 547(b)(4) (2012) (stating that if the creditor is an insider, then the time period is extended from ninety days to one year before the petition date); 11 U.S.C. § 704(a)(1) (obligating the trustee to "collect and reduce to money the property of the estate," including preference actions as property of the estate); 11 U.S.C. § 550(a) (providing that the trustee can recover avoided transfers or their value for the benefit of the estate); *see also* Field v. Insituform E., Inc. (*In re* Abatement Envtl. Res., Inc.), 307 B.R. 491, 498 (Bankr. D. Md. 2004) ("[Section 550] permits a trustee who is successful in an action under Section 547 to recover the property, or the value of the property, from either the transferee, or a creditor that benefitted from the transfer.").

> *potential liability of the guarantor for preferential payments received by the creditor upon the filing of bankruptcy by the debtor. Failure to do so may result in creditor liability for any preferential payment received, notwithstanding any defenses to liability present in this section.*

CONCLUSION

When a closely-held business entity files for bankruptcy protection, it shifts the allocation of risk of payment among the business's creditors.[106] The guarantor of a startup venture is in a poor position to assert the creditor's defenses in the event of a preference claim.[107] Further, the guarantor may be unaware that she is guaranteeing other creditors that she will repay any preferential payments made toward the guaranteed debt for up to twelve months.[108] Extending potential liability to the guarantor for any preferential payments effectively forces the guarantor to guarantee the priority rights of all other creditors. While the effect of allowing the trustee to recover preferential payments from a guarantor has the effect of altering the contractual understanding of the parties, the idea of imposing this obligation upon a guarantor without proper disclosure runs afoul of the policy of fully informing debtors of their rights under a credit agreement.[109] This result requires a statutory solution that (1) shifts risk equitably among the parties and within the expectations of the parties at the time of entering into the guarantee agreement, (2) reduces the burden of defending preferential claims, (3) allocates the risk equitably in a preferential claim action, and (4) ensures full disclosure to guarantors of business debt.

The proposed additions to § 547 would accomplish each of these objectives by (1) requiring a trustee or debtor-in-possession to demonstrate intent to benefit guarantors through claimed preferential payments, (2) affording

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[106] *See* 11 U.S.C. § 547(b) (providing for the priority of payment to creditors of a debtor without regard to the contractual priority granted any creditor).

[107] *See* 11 U.S.C. § 547(b)(1)–(5); Cohen & Williams, *supra* note 16, at 795–96 (highlighting the use of these basic defenses to preferences that can be asserted by a guarantor); Cordry, *supra* note 42, at 8, 48 (providing for a guarantor's ability to assert creditor defenses).

[108] *See* Gordon v. Sturm (*In re* M2direct, Inc.), 282 B.R. 60, 62–65 (Bankr. N.D. Ga. 2002) (providing that a trustee can recover from insiders for up to a year based on transfers from a debtor to a creditor that benefited an insider guarantor).

[109] *See* Matthew A. Edwards, *Empirical and Behavioral Critiques of Mandatory Disclosure: Socio-Economics and the Quest for Truth in Lending*, 14 CORNELL J. L. & PUB. POL'Y, 199–240 (2005) (noting that disclosure laws generally seek to prevent the market failures and inequities that result from asymmetry of information).

guarantor's increased access to creditor records and information to defend preferential claim actions, (3) reducing the incentive on guarantors to settle preferential payment claims due to the cost of defending the claim, and (4) requiring a level of disclosure to guarantors based upon the likely effects of bankruptcy on the guarantor's obligation.