Judicially Excepting the Literal Login in Levit: Advocating the Implementation of the Fortuitous Recipient Exception

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JUDICIALLY EXCEPTING THE LITERAL LOGIC IN
LEVIT: ADVOCATING THE IMPLEMENTATION
OF THE FORTUITOUS RECIPIENT
EXCEPTION

Preference law, within the Bankruptcy Code ("Code"), serves two primary purposes: (1) to constrain self-interested individuals from taking action to the detriment of creditors, and (2) to promote the bankruptcy policy of equality of distribution among all the creditors.\(^1\) Essentially, a preference is a transfer that enables a creditor to receive a greater percentage of his claim than if he had participated in the distribution of the assets from the bankruptcy estate.\(^2\) A creditor's position may become preferred with respect to the other creditors in two ways: (1) the creditor may act on his own to advance his position,\(^3\) or (2) the debtor may advance the position of one creditor over another to further the debtor's interests.\(^4\) Sections 547 and 550 of the Code were enacted "to prevent a creditor from changing, alone or with the debtor's help, his existing position vis-a-vis other creditors in anticipation of a bankruptcy proceeding."\(^5\)

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1. H.R. REP. NO. 595, 95th Cong., 1st Sess. 177-78 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6138; see also Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 STAN. L. REV. 725 (1984). Mr. Jackson outlined the premise behind the Bankruptcy Code as follows: (1) to prevent creditors from prematurely ripping apart the debtor's estate and thereby causing a bankruptcy that may have been avoided, and (2) to achieve equal distribution among the creditors. Id. at 727-31, 756-68.


3. Under this scenario, a creditor may take various steps to obtain possession or control over the property of the debtor. For example, the creditor may physically seize certain assets or the creditor may force the debtor to relinquish title to certain assets. See Jackson, supra note 1, at 758.

4. Under this scenario, the debtor will try to foster a good working relationship with one or more creditors for post-bankruptcy transactions. In order to facilitate his goal, the debtor will pay his "favorite" creditors off prior to filing a bankruptcy petition. See id. at 759.

5. Id.
Section 547(b)\textsuperscript{6} gives the bankruptcy trustee the power to avoid preferential transfers.\textsuperscript{7} Section 550\textsuperscript{8} gives the bankruptcy trustee the power to recover the avoided preferential transfer from either the initial transferee or the entity for whose benefit such transfer was made.\textsuperscript{9} Absent the powers created by section 547 and section 550, creditors might be tempted to “pre-
maturely dismantle business entities whose precarious financial condition is only temporary."\textsuperscript{10}

The interaction of sections 547(b) and 550(a)(1) appears simple. However, recent judicial decisions disagree on the correct concurrent application of the two sections.\textsuperscript{11} The problem arises from the following hypothetical situation: an outside creditor lends money to a corporation and takes the personal guarantee of an "insider"\textsuperscript{12} on the note. More than ninety days before the debtor files a petition for bankruptcy and while the debtor is insolvent, the debtor makes payments to the outside creditor on the guaranteed note. Subsequently, the debtor files for bankruptcy and the trustee in bankruptcy sues to avoid the payments under section 547(b)(4)(B) and to recover the payments under section 550(a)(1).\textsuperscript{13}

\begin{itemize}
  \item[11.] See infra notes 18-56 and accompanying text for a discussion of the "two-transfers" theory, the \textit{Deprizio} literal interpretation, and the equity approach.
  \item[12.] Section 101(31) provides:
    \begin{itemize}
      \item[(A)] if the debtor is an individual—
        \begin{itemize}
          \item[(i)] relative of the debtor or of a general partner of the debtor;
          \item[(ii)] partnership in which the debtor is a general partner;
          \item[(iii)] general partner of the debtor; or
          \item[(iv)] corporation of which the debtor is a director, officer, or person in control;
        \end{itemize}
      \item[(B)] if the debtor is a corporation—
        \begin{itemize}
          \item[(i)] director of the debtor;
          \item[(ii)] officer of the debtor;
          \item[(iii)] person in control of the debtor;
          \item[(iv)] partnership in which the debtor is a general partner;
          \item[(v)] general partner of the debtor; or
          \item[(vi)] relative of a general partner, director, officer, or person in control of the debtor;
        \end{itemize}
      \item[(C)] if the debtor is a partnership—
        \begin{itemize}
          \item[(i)] general partner in the debtor;
          \item[(ii)] relative of a general partner in, general partner of, or person in control of the debtor;
          \item[(iii)] partnership in which the debtor is a general partner;
          \item[(iv)] general partner of the debtor; or
          \item[(v)] person in control of the debtor;
        \end{itemize}
      \item[(D)] if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;
      \item[(E)] affiliate, or insider of an affiliate as if such affiliate were the debtor; and
      \item[(F)] managing agent of the debtor.\textsuperscript{11}
    \end{itemize}


13. If the transfer to the outside creditor had been made within ninety days of the filing of the petition, the trustee's power to avoid the transfer is clear. Section 547(b)(4)(A) provides that the trustee may avoid all payments made to any individual as long as they were made on or within ninety days prior to the filing of the bankruptcy petition. See 11 U.S.C. § 547(b)(4)(A) (1988).
On its face, section 547(b)(4)(B) does not seem to authorize avoiding the transfer to the outside creditor. The outside creditor is not an insider and the transfer was made more than ninety days before the date of the bankruptcy petition. Nevertheless, three circuit courts have extended the preference recovery period for outside creditors to one year when a payment produces a benefit for the inside guarantor.

Nevertheless, three circuit courts have extended the preference recovery period for outside creditors to one year when a payment produces a benefit for the inside guarantor.

Part I of this Comment outlines the three different approaches the courts have adopted to address this problem. Part II discusses the proper interpretation of a bankruptcy statute and evaluates the equitable powers of a bankruptcy court. Finally, Part III discusses expanding the judicially created “mere conduit” exception into the “fortuitous recipient” exception.

I. THE JUDICIAL APPROACHES

Three theories have evolved to deal with the interaction between sections 547 and 550 of the Code in the context of the problem outlined above: (1) the “two-transfers” theory, (2) the “literal-interpretation” theory, and (3) the “equitable” theory. As developed below, the first two theories are problematic. The “two-transfers” theory unnecessarily stretches the statutory language to achieve a desired end result, and the “literal-reading” theory is too stringent in its application of the statutory language. The “equitable” theory, although it is not the ideal solution, accepts the literal

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14. Section 547(b)(4)(B) authorizes avoiding a payment made to a creditor between ninety days and one year before the filing of the bankruptcy petition if such creditor at the time of the transfer was an “insider.” See 11 U.S.C. § 547(b)(4)(B) (1988).


16. Under this scenario, the guarantor is the inside creditor benefiting from the payment to the outside creditor. As a result, the trustee avoids the payments according to section 547(b)(4)(B) and recovers the payments from the bank under section 550(a)(1) as the initial transferee of such transfer. The trustee is able to recover the transfer due to the outside creditor's linkage with the guarantor. See infra notes 37-49 and accompanying text.

17. This Comment does not address the issue of correcting this problem through the legislature. However, recently the United States Senate has proposed a bill that may effectively overrule the decision in Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989). The Senate bill proposes creating an eighth exception to section 547(c). The exception would read as follows:

(8) if the transfer sought to be recovered to an insider is on account of goods or services sold and delivered to the debtor in the ordinary course of business and the transferee is deemed to be an insider under section 101(31) solely because the transferee holds a guaranty of payment or performance from another insider of the debtor.

statutory language of section 547 on its face, but limits the reach of section 550 by applying the bankruptcy court’s equitable powers.

A. The Two-Transfers Theory

The court in Goldberger v. Davis Jay Corrugated Box Corp. (In re Mercon Industries, Inc.) was the first to recognize the two-transfers theory. In Mercon, two individuals and one corporation guaranteed payment of a debt, owed by the debtor, to G.B. Goldman Paper Company (“Goldman”). All three guarantors were insiders of the debtor. Within one year before the filing of an involuntary petition in bankruptcy, the debtor paid Goldman. Subsequently, the trustee moved to avoid the payments made to Goldman as a preference under section 547(b) of the Code.

The Mercon court viewed the single transfer of funds to a noninsider creditor as two transfers because of the secondary liability of the guarantors. First, there was a direct transfer from the debtor to the lender in satisfaction of the primary indebtedness. Second, there was an indirect transfer to the insider guarantors by reducing their contingent liability. The direct transfer to the lender was not avoidable as a preference because it was made to an outside creditor more than ninety days before filing. However, the indirect transfer was avoidable because it extinguished the contingent liability of the insider guarantors.

Although the initial transfer was a direct transfer to the lender, the liability of the guarantor under section 547(b) did not have to be based on a finding of an avoidable transfer to the lender. Each transfer was independent of the other, as opposed to derivative.

Normally, if a transfer is made to an insider, section 547(b)(4)(B) gives the trustee the power to avoid the transfer beyond the ninety day period. However, under the two-transfer theory, the lender is not an insider when the transfer is made; the guarantor is the insider. Therefore, even though section 550(a)(1) arms the trustee with the power to recover the transfer from the lender as the “initial transferee”, the trustee will not be able to do

18. 37 B.R. 549 (Bankr. E.D. Pa. 1984), aff’d, 892 F.2d 850 (10th Cir. 1989); see also Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586, 591-94 (5th Cir. 1987) (discussing the history of the direct and indirect transfer doctrine and its effect on line-of-credit cases), reh’g granted, 835 F.2d. 584 (5th Cir. 1988).
20. Id.
21. Id. at 552.
22. Id.
23. Id.
24. Id.
so. The transfer to the lender is the result of a separate action and moreover, the lender is not the "entity for whose benefit such transfer was made."

The preceding evaluation is problematic because the courts have misplaced their analysis of the definition of "transfer." Section 101(54) defines "transfer" as "parting with the property or with an interest in property." This indicates that an initial transferee must receive the same property that the transferor "parted with." As a result, the initial transfer from the debtor to the lender constitutes one single transfer.

B. The Literal Interpretation Under Deprizio

The Seventh Circuit Court of Appeals, in *Levit v. Ingersoll Rand Financial Corp.*, was the first circuit court to adopt a literal interpretation of the interplay between sections 547(b)(4)(B) and 550(a)(1). In *Levit*, the Deprizio Construction Company ("Company") borrowed money from several different creditors. Richard Deprizio ("Deprizio"), the president of Company, personally cosigned one note and guaranteed Company's debts to the other creditors. Subsequently, Company began to experience financial difficulties. Company continued to make payments to its creditors,
however, until it filed a Chapter 11 bankruptcy petition. Following the filing of the bankruptcy petition, the trustee filed adversary proceedings against the outside creditors to avoid and recover payments received more than ninety days but within the year before the filing of the bankruptcy petition.

The principal question addressed in Levit was "whether the Trustee may recover from an outside creditor under [section] 550(a)(1) a transfer more than 90 days before the filing [of the petition] that is avoided under [section] 547(b) because of a benefit for an inside creditor." Judge Easterbrook, writing for the Seventh Circuit, answered this question in the affirmative.

In reaching his decision, Judge Easterbrook interpreted sections 547(b) and 550(a)(1) literally. He began his analysis by applying four terms of art to section 547(b)(4)(B): (1) "creditor," (2) "claim," (3) "insider," and

32. The Deprizio Company made $168,000 in total payments in the year immediately prior to its bankruptcy: $54,000 to CIT; $6,000 to AMEC; $108,000 to IRFC; and unknown amounts to the Internal Revenue Service. Id. at 549.

33. The trustee also filed advisory proceedings against a pension and welfare fund and the Internal Revenue Service ("IRS"). Deprizio's payments to the IRS were for delinquent withholding taxes. This Comment will not consider the effects of avoiding the transfers to the pension fund or the IRS. See Peter L. Borowitz, Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio, 45 Bus. LAW. 2151 (1990):

In the text of the Deprizio decision, Judge Easterbrook focuses for the most part on these policy considerations, but at a critical juncture, when the insider preference provisions appear to collide with the Internal Revenue Code, he veers off course and seeks refuge in a highly technical—and ultimately misleading—distinction. The trouble is that Congress, to discourage any financially troubled company from deferring payment of withholding tax, has subjected certain corporate insiders to a 100% penalty in the event that withholding tax is not paid. This penalty in effect provides the IRS with the statutory equivalent of an insider guaranty and therefore with a potential one-year preference risk under the Deprizio logic.

Id. at 2153-54 (footnotes omitted).

34. Levit, 874 F.2d at 1194.

35. Judge Frank H. Easterbrook, who was appointed by President Reagan, began his term with the Seventh Circuit Court of Appeals on April 10, 1985. Judge Easterbrook earned a B.A. with high honors in 1970 from Swarthmore College, and J.D. cum laude from the University of Chicago in 1973. Judge Easterbrook was the Topics and Comment Editor for the University of Chicago Law Review from 1971-73, was a law clerk for the U.S. Court of Appeals First Circuit from 1973-74, was the Assistant to the Solicitor General from 1974-77, and was Deputy Solicitor General of the U.S. from 1978-79. He is also the author of two books and several law review articles. The American Bench: Judges of the Nation 29 (Marie T. Hough et al. eds., 6th ed. 1991-92).

36. Levit, 874 F.2d at 1201.

37. Section 101(10) provides:

(A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;
The argument to extend the insider recovery period to outside creditors flows directly from these interlocked provisions.41 Section 101(31)(B)(ii) renders Deprizio an "insider,"42 section 101(10)(A) states that a "creditor" is anyone that has a "claim" against the debtor.43 and section 101(5)(A) states that anyone with a contingent right to payment holds a "claim."44

Deprizio, by definition, was a creditor in Company's bankruptcy. Deprizio, as the guarantor, had a contingent right to payment from Company if the lender collected from Deprizio rather than Company. This occurs because Deprizio will succeed to the lender's right to collect from Company in the event Deprizio pays Company's debt.45 Every payment that Company makes to the lender will reduce Deprizio's exposure as a guarantor. Therefore, the payments made to the lender are avoidable under section 547(b)(4)(B) unless one of the exceptions in section 547(c) applies.46

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

38. Section 101(5) provides:
(5) "claim" means—
(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; 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.

39. See supra note 12 for a full definition of "insider."
40. See supra note 26 for a full definition of "transfer."
41. Levit, 874 F.2d at 1190.
45. Levit, 874 F.2d at 1190; see also Chittendon Trust Co. v. Sebert Lumber Co. (In re Vermont Toy Works, Inc.), 82 B.R. 258 (Bankr. D. Vt. 1987) rev'd, No. 88-44, 1991 U.S. Dist. LEXIS 19353 (D.C. Vt. Dec. 17, 1991). The Toy Works court defined a guarantee as an "[e]nforceable undertaking or promise on the part of one person which is collateral to a primary or principal obligation on the part of another, and which binds the obligor to performance in the event of nonperformance by such other, the latter being bound to perform primarily." Id. at 324-25 (footnotes omitted in original) (quoting 38 AM. JUR. 2d Guaranty § 2, at 997 (1968)).
46. Levit, 874 F.2d at 1190. Section 547(c) lists several exceptions to the avoidance power found in section 547(b): (1) transfers made as a contemporaneous exchange for new value, (2) transfers made in the ordinary course of business, (3) transfers that create a security interest in property acquired by the debtor, (4) transfers made during the preference period, by both the creditor and the debtor, are netted out—the difference being avoidable, (5) transfers during the
After a trustee avoids the transfer to the creditor under section 547(b)(4)(B), the trustee recovers the avoided transfer under section 550(a)(1). Section 550(a)(1) empowers the trustee to recover from "the initial transferee of such transfer or the entity for whose benefit such transfer was made."47 Section 547(b)(4) makes a distinction between insiders and noninsiders,48 but section 550(a)(1) does not. As a result, the trustee may require the lender to repay the transferred funds it received as the initial transferee, even though the lender received the funds more than ninety days after filing, and it is not an insider.49

· C. The Equitable Approach

Some courts have accepted the preceding literal approach when applying sections 547 and 550.50 Other courts have accepted the literal approach but have applied the bankruptcy court's equitable powers to prevent an inequitable result.51 In these cases equity is used to counter any injustice which may result if a literal application of section 550(a)(1) occurs.52

The injustice results when unequal treatment is accorded to similarly situated creditors. A creditor that obtains a guarantee from a corporate


48. Noninsider transfers are only avoidable when made "on or within 90 days before the date of the filing of the petition[.]") 11 U.S.C. § 547(b)(4)(A) (1988).

Insider transfers are avoidable when made "between ninety days and one year before the date of the filing of the petition . . . ." 11 U.S.C. § 547(b)(4)(B) (1988).

49. Levit, 874 F.2d at 1190.


The initial transfer to the lender is avoided under section 547(b) and then recoverable from the lender as the initial transferee under section 550(a)(1).


52. 4 ROBERT D'AGOSTINO ET AL., COLLIER ON BANKRUPTCY § 550.02, at 550-08 (Lawrence P. King et al. eds., 15th ed. 1992).
insider is susceptible to the "insider" time period under section 547(b)(4)(B). In contrast, a similarly situated creditor that does not obtain a guarantee may receive funds within the same time period, but this creditor will not be susceptible to the extended reach-back period.

The courts adopting the equity approach have followed the Collier's bankruptcy treatise in support of their holdings. Collier's provides:

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 property is transferred to a good faith surety or endorser as consideration incidental to the guarantee of an antecedent debt of a creditor, and the surety subsequently pays the creditor, the property or its value should be recovered from the creditor for whose benefit the transfer was made rather than from the surety or endorser to whom the transfer was made. Likewise, if a transfer is made to a creditor who is not an insider more than ninety 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.

This approach has the greatest appeal. Historically, bankruptcy courts have been given the authority to use their equitable powers when the wording of a bankruptcy statute would cause an unintended or undesirable result.

This Comment advocates using the bankruptcy court's equitable


54. D'AGOSTINO, supra note 52, at 550-8.

55. Id. (footnotes omitted).

powers to expand the "mere conduit" exception by implementing the "fortuitous recipient" exception.57

II. EQUITY'S ROLE IN STATUTORY INTERPRETATION

The court, in Levit v. Ingersoll Rand Financial Corp.,58 interpreted section 547(b)(4)(B) literally and rejected "equity's" role in the entire process. However, in doing so the court failed to recognize two important factors: (1) the proper procedure for interpreting a bankruptcy statute, and (2) equity's role in a bankruptcy case.

A. The Procedure for Interpreting a Bankruptcy Statute

The Supreme Court has laid down a distinctive procedure for the analysis of a statute in the Bankruptcy Code.59 "[T]he 'starting point in every case involving construction of a statute is the language itself.'"60 However, the Court has indicated it does not want an overly literal interpretation of the Bankruptcy Code. "In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy."61 Moreover, the "plain meaning" contained in a statute of the Bankruptcy Code will not control if enforcing that language "will produce a result demonstrably at odds with the intentions of its drafters."62

A bankruptcy court is not confined to a literal interpretation when it attempts to analyze a bankruptcy statute. The Supreme Court, in Bank of Marin v. England,63 held that "we do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction."64 Therefore, it is apparent that a court interpreting a bankruptcy statute must first look to

57. See infra notes 136-59 and accompanying text.
60. Id. at 43 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring)).
64. Marin, 385 U.S. at 103 (citing Pepper v. Litton, 308 U.S. 295, 304-05 (1939); Securities & Exch. Comm'n v. United States Realty & Improvement Co., 310 U.S. 434, 455 (1940)).
the language of the statute, while remaining conscious of the fact that equity may intervene in the final analysis. In *Midlantic National Bank v. New Jersey Department of Environmental Protection* 65 and *Kelly v. Robinson,* 66 the Supreme Court adhered to the preceding procedure when it resolved ambiguities in the Code by side-stepping a literal reading of certain bankruptcy statutes. 67

In *Midlantic,* Quanta Resources Corporation ("Quanta") processed waste oil at facilities located in New York and New Jersey. The New Jersey Department of Environmental Protection ("NJDEP") discovered that Quanta had violated its operating permit by accepting toxic waste oil. During negotiations with NJDEP, Quanta filed for protection under Chapter 11 of the Code and, after NJDEP ordered a cleanup, Quanta converted from Chapter 11 to Chapter 7. 68 Subsequently, the trustee abandoned the two properties pursuant to section 554(a) of the Bankruptcy Code, which authorizes a trustee to "abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." 69

The Supreme Court denied the trustee's abandonment claim and thereby obviated a literal reading of section 554(a). Instead, the Court looked to judicial precedent and to congressional practice. Judicial precedent revealed that a "Bankruptcy Court [could invoke] its equitable power


The majority stated that *Midlantic* and *Kelly* concerned statutory language which, at least to some degree, was open to interpretation. Each involved a situation where bankruptcy law, under the proposed interpretation, was in clear conflict with state or federal laws of great importance. In the present case, in contrast, the language in question is clearer than the language at issue in *Midlantic* and *Kelly* . . . .

Id. at 245. *Contra id.* at 249 (O'Connor, J., dissenting).

The Court characterizes *Midlantic* as involving "a situation where bankruptcy law, under the proposed interpretation, was in clear conflict with state or federal laws of great importance." Though I agree with that characterization, I think there is more to *Midlantic* than conflict with state or federal laws. Contrary to the Court's intimation, *Midlantic* did not "concer[n] statutory language which . . . was open to interpretation." The language of § 544(a) is "absolute in its terms," and the court in *Midlantic* did not attempt to argue otherwise.

Id. at 252 (alteration and omission in original) (citations omitted).

68. *Midlantic,* 474 U.S. at 497. Following Quanta's Chapter 7 filing, an investigation of the New York facility revealed that Quanta had also accepted toxic waste at the New York plant. Id.
69. Section 554(a) provides: "(a) After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." 11 U.S.C. § 554(a) (1988).

In *Midlantic,* the city and state of New York objected to the trustee's abandonment, contending that abandonment would threaten the public's health and safety, and would violate state and federal environmental law. *Midlantic,* 474 U.S. at 498.
to 'safeguard the public interest'. . . ."  

Moreover, the Court found support for restricting the abandonment power from "repeated congressional emphasis on its 'goal of protecting the environment against toxic pollution.'"  

Similarly, in *Kelly*, the Court did not adopt a literal reading of "debt" in discharging criminals seeking to avoid the penalties for their crimes.  

Robinson, the defendant, was found guilty of wrongful receipt of welfare benefits, and the state court ordered her to make restitution through monthly payments. Subsequently, Robinson filed a voluntary petition under Chapter 7 of the Bankruptcy Code listing the restitution as a debt. Even though a literal reading of the definition of "debt" would have rendered the restitution payment dischargeable, the *Kelly* Court held that restitution imposed in a state criminal action was nondischargeable in a proceeding under Chapter 7.  

The Court's determination resulted from an interpretation of Code section 523(a)(7), which excepts from discharge a debt that is "a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss." Restitution, the Court concluded, was not "for the benefit of" the state, nor was it "for . . . compensation of the victim." But rather, restitution was for "the penal and rehabilitative interests of the State." As a result, the Court abandoned a
literal interpretation of section 523(a)(7) to effectuate both congressional intent and societal interests. 79

Judge Easterbrook, in *Levit v. Ingersoll Rand Financial Corp.*, 80 addressed *Midlantic* and *Kelly* stating that the two cases resolved ambiguities in the Code in a manner that was consistent with the ideology of the rest of bankruptcy law and nonbankruptcy entitlements. 81 However, Judge Easterbrook refused to apply the same standard in *Levit*, stating that “[t]here is no similarly enduring policy concerning the length of the preference-recovery period for outside creditors or the relation between insiders’ guarantees and the preference-recovery period. An extended recovery period is consistent with the structure of the Code and does not subvert any of its functions.” 82 This interpretation is not acceptable given the congressional distinction between insiders and noninsiders in section 547.

**B. The Insider/Noninsider Distinction**

The bankruptcy court, in *Block v. Texas Commerce Bank National Ass’n (In re Midwestern Cos.)*, 83 attempted to deal with the results of a literal interpretation of the interplay between sections 547 and 550. It looked at the distinction Congress drew between insider and noninsider in section 547 and concluded that this distinction should survive the application of section 550. 84 Sections 547(b)(4)(A) & (B) differentiate between a noninsider and an insider. 85 They impose a different time limitation for avoiding preferences following the filing of a bankruptcy petition: ninety days and one year respectively. Section 550 empowers the trustee to recover the avoided preferences identified by section 547, but it makes no distinction between insiders and noninsiders. 86

79. *Id.* at 50, 53. The Court supported its position stating:
Nowhere in the House and Senate Reports is there any indication that this language should be read so intrusively. If Congress had intended, by § 523(a)(7) or by any other provision, to discharge state criminal sentences, “we can be certain that there would have been hearings, testimony, and debate concerning consequences so wasteful, so inimical to purposes previously deemed important and so likely to arouse public outrage[.]”
*Id.* at 50-51 (footnote omitted) (quoting TVA v. Hill, 437 U.S. 153, 209 (1978) (Powell, J., dissenting)).


81. *Levit*, 874 F.2d at 1197.

82. *Id.*


84. *Id.* at 173.


The problem arises when a court follows the literal reading adopted in *Levit*. The literal approach in *Levit* caused noninsider creditors to be included in the extended avoidance period established for insiders by section 547(b)(4)(B). *Midwestern* interpreted this as contrary to legislative intent—if the statutes were intended to be interpreted in this manner, the distinction between insiders and noninsiders in section 547 would be moot when the court enforces the recovery power under section 550. 87 Therefore, *Midwestern* held that “if recovery is to be made under Section 550, it must be made in light of the distinction drawn by Section 547 in designating which disbursements can be avoided and who will be liable for recovery.” 88

The *Midwestern* court’s interpretation is very convincing after a close evaluation of section 550. Section 550(a)(1) reads as follows:

§ 550. Liability of transferee of avoided transfer

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) 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. . . . 89

Nowhere in this section does it distinguish between insiders and noninsiders. The only avoidance section enumerated in section 550 that does distinguish between insider and noninsider is section 547. 90 Moreover, the legislative history is silent concerning the interplay of sections 547 and

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88. *Id.*
90. Section 550 enumerates seven sections over which the trustee may recover avoided transfers:

(1) Section 544(a) is a “strong arm” section that “gives the trustee the rights of a creditor on a simple contract with a judicial lien on the property of the debtor . . .; of a creditor with a writ of execution against the property of the debtor . . .; and a bona fide purchaser of the real property of the debtor . . . .” Section 544(b) “gives the trustee the rights of actual unsecured creditors under applicable law to void transfers.” H.R. REP. No. 595, 95th Cong., 1st Sess. 370 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6326; S. REP. No. 989, 95th Cong., 2d Sess. 85 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5871;


(3) Section 547:
[a]uthorizes the trustee to avoid a transfer if five conditions are met . . . . Fourth, the transfer must have been made during the 90 days immediately preceding the commencement of the case. If the transfer was to an insider, the trustee may avoid the transfer if it was made during the period that begins one year before the filing of the petition and ends 90 days before the filing.
Nevertheless, it seems plausible that when Congress distinguished between insiders and noninsiders in section 547 it intended that distinction to be carried through to section 550.

Even though the "plain meaning" in sections 547 and 550 can be construed to authorize extending the recovery powers to noninsiders, enforcing that language might produce a result at odds with the intentions of the drafters. As a result, a court evaluating the literal effects of the interplay between the two statutes must also look at the object and policy of the statute while keeping in mind the overriding principles of equity.


(6) Section 724(a) "permits the trustee to avoid a lien that secures a fine, penalty, forfeiture, or multiple, punitive, or exemplary damages claim to the extent that the claim is not compensation for actual pecuniary loss." H.R. REP. No. 595, 95th Cong., 1st Sess. 382 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6338; S. REP. No. 989, 95th Cong., 2d Sess. 96 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5882.


93. The degree of control asserted by the lender over the guarantor is paramount in assessing the object and policy of the interplay between sections 547 and 550. Between a lender with a guarantee and one without, absent an increased degree of control over the insider, equity should be applied to prohibit an extension of the preference recovery period. See infra notes 141-59 and accompanying text.

94. See infra notes 95-110 and accompanying text; see also Nutovic, supra note 53.

No argument based on the plain meaning of section 550(a)(1) alone is likely to prevail in the face of strong equitable considerations. When faced with the choice of enforcing the clear wording of a bankruptcy statute or avoiding an inequitable and possibly unintended result, the Supreme Court has unhesitatingly opted for disregarding the statute and doing equity. The argument that equitable exceptions to statutory commands are undesirable because they lead to situations "conducive of confusion and uncertainty, with potentialities for argument, 'bluffing', litigation, expense and delay" is apparently not sufficiently persuasive. If a particular application of the statute would be grossly unjust and was not clearly intended by the legislature, the courts will deviate from the literal reading of a statute. Therefore, one must take the respective equities of the parties into account.

Nutovic, supra note 53, at 195 (footnotes omitted).
C. Equity in the Bankruptcy Court

A bankruptcy court, for many purposes, is essentially a court of equity. As a court of equity, a bankruptcy court can exercise its powers to deal with a wide range of problems, but the public interest must always be at the heart of any decision. "A court of equity may in its discretion in the exercise of the jurisdiction committed to it grant or deny relief upon performance of a condition which will safeguard the public interest." However, this power does not "authorize a freewheeling consideration of every considerable equity." In order to effectively safeguard the public's interest, a bankruptcy court must balance the equities and consider any type of evidence relevant to the issue.

Congress effectively affirmed the role of equity in a bankruptcy proceeding when it enacted and later amended section 105 of the Bankruptcy Code. Section 105 of the Bankruptcy Code gives bankruptcy judges the power to act on their own to prevent an abuse of process. The second sentence of section 105(a) was amended in 1986 to read as follows:

§ 105. Power of court
(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate

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98. Id.
99. Section 105 provides:
§ 105. Power of court
(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.
(b) Notwithstanding subsection (a) of this section, a court may not appoint a receiver in a case under this title.
(c) The ability of any district judge or other officer or employee of a district court to exercise any of the authority or responsibilities conferred upon the court under this title shall be determined by reference to the provisions relating to such judge, officer, or employee set forth in title 28. This subsection shall not be interpreted to exclude bankruptcy judges and other officers or employees appointed pursuant to chapter 6 of title 28 from its operation.

to enforce or implement court orders or rules, or to prevent an abuse of process.\textsuperscript{100}

The addition to section 105(a) clearly indicates that Congress intended to allow courts to initiate action.

The purpose of the extended avoidance period in section 547(b)(4)(B) is to prevent a self-interested insider from transferring funds in order to improve his position when he knows insolvency is imminent.\textsuperscript{101} There may also be circumstances in which the insider transfers funds due to the control exercised by an outside creditor.\textsuperscript{102} In this case, recovering from the "initial transferee" is justified—the creditor forced the transaction. However, when a guarantee is used by an outside creditor, it is not always applied to exercise extreme control over the insider.\textsuperscript{103} The guarantee may work as insurance against a free-wheeling sole shareholder in a closely-held corporation.

The insider as sole shareholder enjoys the security of limited liability.\textsuperscript{104} In this situation, a great deal of the risk remains with the lender. If a personal guarantee is not obtained by the creditor, the insider may pursue high risk ventures and if successful, reap the rewards. However, if the venture fails and the liability reaches beyond the capital of the corporation, the insider knows that the liability chain ends with the corporation.\textsuperscript{105} A personal guarantee, on the other hand, distributes the risk and insures that the insider will not recklessly use the borrowed funds. The lender does not exercise any more control in this situation than a lender without a personal guarantee does. Nevertheless, a transfer to the lender holding a guarantee over an insider is recoverable up to a year prior to bankruptcy, while it is

\begin{itemize}
\item \textsuperscript{100} 11 U.S.C. § 105(a) (1988) (emphasis added).
\item \textsuperscript{101} See generally Jackson, supra note 1.
\item \textsuperscript{102} See supra note 3 and accompanying text.
\item \textsuperscript{104} See Robert W. Hamilton, The Law of Corporations in a Nutshell 24-25 (2d ed. 1986). "The protection against unlimited liability for business obligations provided by the corporate form is often stressed as a significant reason for incorporating a business." Id. at 24.
\item \textsuperscript{105} The general rule regarding corporations provides that liability ends at the corporate level, thus insulating the shareholders. However, this rule assumes that the shareholders have not violated any principles that would warrant piercing the corporate veil. See Consumer's Co-op. v. Olsen, 142 Wis. 2d 465, 483-84, 419 N.W.2d 211, 217 (1988) ("[B]oth inadequate capitalization and disregard of corporate formalities are significant to a determination of whether the corporation has a separate existence such that shareholders can claim the accoutrement of incorporation: nonliability for corporate debts.").
\end{itemize}
only recoverable up to ninety days prior to bankruptcy from the lender without the personal guarantee.106

Judge Easterbrook discarded the principle that personal guarantees are used to equalize the risk. He proposed that the risk factor should be compensated for by using the interest rates.107 If a longer preference period is favorable to the debt-adjustment process, or even if the longer preference period is unfavorable, interest rates will adjust to compensate for the change in risk.108 Specifically, the Levit court held that "[a] rule may injure debtors and creditors by foreclosing efficient business arrangements and increasing the rate of interest low-risk borrowers must pay, but inefficiency is not inequity."109 This proposal may compensate the bank’s risk requirements, but it does nothing for the borrower. The increased interest rate will cause otherwise plausible projects to be rejected. The higher cost of debt will require an equally higher rate of return to induce many small companies to expand. As a result, many of these companies will be forced to scratch projects because the return is too low to merit taking the risk.

It is this type of situation that equity asserted through section 105 was designed to guard against. “In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.”110 A lender who equalizes risk through a guarantee and asserts the same level of control over the debtor and the guarantor, as a lender without a guarantee, should not have to face recovery under section 550.

III. THE “MERE CONDUIT” EXCEPTION SHOULD BE EXPANDED TO ENCOMPASS THE “FORTUITOUS RECIPIENT” EXCEPTION

A literal interpretation of sections 547(b) and 550(a)(1) clearly creates situations of inequity. Recently, several courts have judicially created the “mere conduit” exception when confronted with an inequitable result from applying section 547. The remainder of this Comment will discuss the “mere conduit” exception and suggest that in the interest of equity, the

106. See D’Agostino, supra note 52, at 550-8.


108. Id.

109. Id. (citing In re Thompson, 867 F.2d 416, 419 (7th Cir. 1989); In re Patterson, 825 F.2d 1140, 1142 (7th Cir. 1987); In re Erickson, 815 F.2d 1090, 1094 (7th Cir. 1987)).

same courts should expand the "mere conduit" exception into the "fortuitous recipient" exception.

A. The "Mere Conduit" Exception

Even though several courts have adopted the literal interpretation applied in *Levit v. Ingersoll Rand Financial Corp.*, they have also accepted the "mere conduit" exception. A purely literal interpretation of the recovery powers of section 550(a)(1) seems to be too narrow to encompass all circumstances. Several circuit courts and several lower courts have agreed with this proposition. In order to prevent an abuse of the recovery powers within section 550(a)(1), these courts have followed the Supreme Court's lead in *Midlantic* and *Kelly*. These courts have created the "mere conduit" exception. The label applies to third parties that have held avoidably transferred funds in good faith and who have no real rights to, or control over, the funds which are intended to be received by another party.

1. The Lower Courts

The first court to discuss the "mere conduit" exception was in *In re Fabric Buys of Jericho, Inc.* In *Fabric Buys*, the debtor paid one of his creditors for certain goods sold and delivered prior to bankruptcy. The debtor transferred the funds to the creditor's attorney, who deposited the funds in his client escrow account and approximately two weeks later for-
warded the funds to the creditor.\textsuperscript{117} The trustee tried to avoid the payment under section 547(b) and recover the payment from the creditor’s attorney as the “initial transferee” under section 550(a)(1). The court, however, rejected the trustee’s contention that the term “initial transferee” should be read literally. The court held that the attorney, through his client escrow account, was a “mere conduit” for the funds.\textsuperscript{118} The fact that the payment “was funneled through the escrow account does not make [the creditor’s] lawyer an initial transferee.”\textsuperscript{119} As a result, the trustee was unable to recover the transfers from the lawyer.

In \textit{Metsch v. First Alabama Bank (In re Colombian Coffee Co.)},\textsuperscript{120} the bank received transfers for deposit in a customer’s account. The trustee tried to recover the funds under sections 547(b) and 550(a)(1). However, the bankruptcy court denied the trustee’s request and held that the bank was not an “initial transferee” but rather a mere “commercial conduit” of the funds.\textsuperscript{121} Similarly, in \textit{Metsch v. City National Bank (In re Colombian Coffee Co.)},\textsuperscript{122} the bank was the recipient of transferred funds, but this time the debtor controlled and dominated the bank. Nevertheless, the bankruptcy court held that the bank was a mere “commercial conduit” and denied the trustee’s request to recover the transferred funds.\textsuperscript{123}

2. The Circuit Courts

The Fourth Circuit Court of Appeals, in \textit{Huffman v. Commerce Security Corp. (In re Harbour)},\textsuperscript{124} adopted the “mere conduit” exception, but nevertheless granted recovery due to the “bad faith” of the initial recipient. In \textit{Harbour}, the debtor transferred $179,450 to the “initial transferee,” who subsequently transferred the funds to her son.\textsuperscript{125} The mother-initial transferee had not held the funds for longer than a day, nor did she ever receive any compensation for the transaction. The court first stated that it looked with approval at the line of lower courts that “recognize that the initial recipient of funds from a debtor may not always be an ‘initial transferee’ within the meaning of 11 U.S.C. [section] 550(a)(1).”\textsuperscript{126} However, in order

\textsuperscript{117} \textit{Id.} at 335.
\textsuperscript{118} \textit{Id.} at 337.
\textsuperscript{119} \textit{Id.}
\textsuperscript{121} \textit{Id.} at 645.
\textsuperscript{122} 64 B.R. 585 (Bankr. S.D. Fla. 1986).
\textsuperscript{123} \textit{Id.} at 586.
\textsuperscript{124} 845 F.2d 1254 (4th Cir. 1988).
\textsuperscript{125} \textit{Id.} at 1254-55.
\textsuperscript{126} \textit{Id.} at 1258; see Gropper v. Unitrac, S.A. (\textit{In re Fabric Buys Inc.}), 33 B.R. 334 (Bankr. S.D.N.Y. 1983); Metsch v. First Alabama Bank (\textit{In re Colombian Coffee Co.}), 59 B.R. 643
for the initial recipient to escape a literal reading of section 550(a)(1), "[the] party must have acted in 'good faith' with respect to the relevant transaction."\textsuperscript{127} Here, the initial recipient's willful ignorance and failure to investigate did not indicate good faith on her part.\textsuperscript{128} As a result, the initial recipient became an "initial transferee" within section 550(a)(1), and therefore, the trustee could recover the transferred funds.

Even Judge Easterbrook from the Seventh Circuit Court of Appeals, in \textit{Bonded Financial Services v. European American Bank},\textsuperscript{129} did not strictly interpret the "initial transferee" language in section 550(a)(1). In \textit{Bonded}, the court denied recovery from a bank that received a check from the debtor, payable to the bank's order, with instructions to deposit the check in the depositor's account.\textsuperscript{130} The bank was the initial recipient; however, the court held the bank was neither the "initial transferee" nor the "entity for whose benefit [the] transfer was made."\textsuperscript{131} The trustee, therefore, could not recover the amount of the check from the bank as a fraudulent conveyance.\textsuperscript{132} The bank received no benefit, but rather acted as an intermediary for the purpose of fulfilling the instructions of the debtor: to make the funds available to someone else. As a result, the depositor rather than the bank was the "initial transferee."\textsuperscript{133}

The judge-made "mere conduit" exception is a clear example of an equitable approach to the application of the Bankruptcy Code. This exception should be expanded to include what has been coined the "fortuitous recipient" exception.\textsuperscript{134} The "fortuitous recipient" exception would apply to "any initial recipients whose relationship to a transaction is not logically linked to the elements that allow the trustee to avoid the transfer."\textsuperscript{135}

\textsuperscript{127}Harbour, 845 F.2d at 1258.
\textsuperscript{128}Id.
\textsuperscript{129}838 F.2d 890 (7th Cir. 1988).
\textsuperscript{130}Id. at 893. The depositor was an insider of the debtor and a borrower of the bank. The depositor then directed the bank to credit the funds toward payment of his own secured loan from the bank. \textit{Id.} at 891.
\textsuperscript{131}Id. at 893-96 (interpreting 11 U.S.C. § 550(a)(1) (1988)).
\textsuperscript{132}Id.
\textsuperscript{133}Id. at 893-94. Judge Easterbrook could have stringently enforced the statutory language of section 547 and forced recovery from the bank. However, he held that both the financial and social costs upon the bank would have been too great. The initial recipient would have been required to monitor all transfers. Moreover, the initial recipient would have been liable for all transfers avoided under section 547. \textit{Id.}
\textsuperscript{134}Katzen, supra note 115, at 526.
\textsuperscript{135}Id. The phrase "fortuitous recipient" was developed and coined by Mr. David I. Katzen, a California attorney practicing with McCutchen, Doyle, Brown & Enerson in the firm's Walnut Creek and San Francisco offices. \textit{Id.}
B. The Fortuitous Recipient Exception

1. Rebutting the Presumption of "Initial Transferee"

The "fortuitous recipient" exception places the burden on the initial recipient to prove that he qualifies as a "fortuitous recipient." The evaluation would proceed under the theory of presumptions. Initially, the trustee will have the burden to prove the basic facts—the five elements of section 547(b). The establishment of the basic facts will give rise to the mandatory presumed fact—that the holder of an insider guarantee, who receives a preferential payment more than ninety days following insolvency, was in sufficient control over the guarantor to merit recovery of the payment under section 550(a)(1). Subsequently, the burden of production will shift to the initial recipient to rebut the presumed fact. If the initial recipient can produce sufficient evidence to prove that the transfer did not occur because of leverage asserted on the guarantor by the lender, "the logical link would be broken, and the creditor would be protected as a fortuitous recipient." However, if the initial recipient cannot produce enough


137. See Graham C. Lilly, An Introduction to the Law of Evidence 56 (2d ed. 1987) (footnote omitted) (“A genuine presumption is raised by a basic fact or facts that, when accepted as true by the trier, give rise to a mandatory inference, properly called a presumed fact.”).

138. This procedure will not place any additional requirements on the trustee. In order to avoid a transfer in the first place, the trustee carries the burden of proving the five conditions of section 547(b). Section 547(g) provides: “For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section . . . .” 11 U.S.C. § 547(g) (1988).

The five conditions found in subsection (b) are: (1) the transfer must be to or for the benefit of a creditor; (2) the transfer must be on account of an antecedent debt; (3) the transfer must have been made when the debtor was insolvent; (4) the transfer must have been made during the ninety days immediately preceding the filing of the petition, unless the transfer was to an insider, then the time period is one year; and (5) the transfer must enable the creditor to receive a greater percentage of his claim than he would have received under a normal distribution. 11 U.S.C. § 547(b)(1)-(5) (1988); see also H.R. Rep. No. 595, 95th Cong., 1st Sess. 372 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6328; S. Rep. No. 989, 95th Cong., 2d Sess. 87 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5873.

139. See Federal Rule of Evidence 301, which provides:

Rule 301. Presumptions in General in Civil Actions and Proceedings

In all civil actions and proceedings not otherwise provided for by Act of Congress or by these rules, a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.

Fed. R. Evid. 301.

140. Katzen, supra note 115, at 526; see also Tidwell v. Amsouth Bank (In re Cavalier Homes, Inc.), 102 B.R. 878 (Bankr. M.D. Ga. 1989). In Tidwell, the trustee claimed that the bank was an insider because of its involvement with the finances of the debtor. The bank required
evidence, he will be considered an "initial transferee" and susceptible to the recovery powers of section 550(a)(1).

The fortuitous recipient test will focus on the level of control the creditor asserts over the guarantor. Assessing the level of the lender's control over the guarantor brings the whole analysis closer to the policy of section 547(b)(4)(B). Section 547(b)(4)(B) differentiates between insiders and non-insiders. The legislative history of section 101(31) indicates that "[a]n insider is one who has a sufficiently close relationship with the debtor [such] that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor." As a result, even though the transfer to the initial recipient could be avoided, the absence of bad faith in control over the debtor would preclude recovery from the lender under section 550(a)(1).

The bankruptcy courts "could use inherent common law or equitable powers to develop norms on a case by case basis . . ." The bankruptcy courts already use common law to determine when an outside creditor's claim is equitably subordinated. The same procedure could easily be implemented in preference law.

2. The Control Factor in Equitable Subordination

The doctrine of equitable subordination developed as an equitable defense to the allowance of certain claims. "The exercise of this equitable

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141. The preference recovery period is extended from ninety days to one year if the "creditor at the time of such transfer was an insider." 11 U.S.C. § 547(b)(4)(B) (1988).


143. Katzen, supra note 115, at 529.

power is governed . . . by rules of fair play and good conscience.”

Equitable subordination is commonly applicable to inside creditors. However, when an outside creditor assumes a sufficient level of control over the debtor, that creditor will be held to the same rigid standard as that of an inside creditor. The exact point at which the creditor “tips the balance of the scales” is difficult to determine. Nevertheless, the courts have developed, vis-a-vis common law, guidelines to assess the situation.

The cases that have upheld subordination of a noninsider creditor’s claim have been influenced by several factors. In Fruehauf Corp. v. T.E. Mercer Trucking Co. (In re T.E. Mercer Trucking), the court based its decision on representation on the board of directors, veto power over daily decisions, joint control of bank accounts, power to regulate officers’ salaries, and the right to force liquidation of assets. In Bergauist v. First National Bank (In re American Lumber Company), the bank totally controlled management, cut employee salaries, forced liquidation, fired employees, supervised and restricted payments to other creditors, and assumed total control over the debtor’s bank account.

These cases seem to indicate that the level of control must be such that when the debtor becomes the mere alter ego or instrumentality of the noninsider creditor, that creditor may be treated as an insider. The noninsider creditor exercised such control and influence over the debtor that transactions between the two were not at arm’s length. However, this does not mean that a creditor cannot take any steps to monitor the business operations of the debtor. “It is only when the creditor transcends the traditional debtor-creditor relationship and controls the actual operation of the debtor that the courts have seen fit to hold the creditor to a higher standard of conduct.”

Normally, in the case of equitable subordination, the objectant to an inside creditor’s claim must come forward with evidence to support subordination, and then the burden would shift to the inside creditors.

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145. Id. at 419; see also 3 Roy Babitt et al., Collier on Bankruptcy § 510.05, at 510-15 (Lawrence P. King et al. eds., 15th ed. 1992).
146. DeNatale & Abram, supra note 144, at 432.
147. Id. at 434.
148. Id.
150. Id. at 189-90.
152. Id. at 472-74.
154. DeNatale & Abram, supra note 144, at 441.
155. Id.
creditor to show the fairness of his claim. However, in cases involving noninsider creditors, the burden remains on the objectant.

The shifting burden of production outlined above is similar to the procedure set forth in the "fortuitous recipient" exception. However, the initial burden in an equitable subordination remains with the objectant whereas the initial burden on the trustee in the "fortuitous recipient" exception shifts to the noninsider creditor.

The trustee in the "fortuitous recipient" exception has only to establish the five requirements contained within section 547(b). Thereafter, the initial recipient will have the burden of production to show that the transfer was received in good faith. Hence, if the creditor-initial recipient cannot rebut the presumption of control, its status would be elevated to an insider and therefore susceptible to the one-year extended recovery period.

IV. CONCLUSION

The literal approach taken by Judge Easterbrook in Levit v. Ingersoll Rand Financial Corp. sent shock waves through the lending community. Lenders do not know whether or not they should continue the practice of requiring guarantees. On the other hand, creditors without guarantees benefit for two reasons. First, if a loan guaranteed by an insider is paid back to the lender during the ninety days to one-year insolvency period, the lender will have to return the funds to the trustee. This occurs even if the loan was paid back to the lender in good faith. Second, the creditors

156. See BABITT, supra note 145, at 510-15.
158. See supra notes 136-43 and accompanying text.
159. See supra notes 6 and 138.
160. Judge Easterbrook, sitting for the Seventh Circuit, is not alone in this decision. Since the Levit decision, the Sixth Circuit and the Tenth Circuit have also adopted the literal-approach to the interplay between sections 547 and 550. See cases cited supra note 15.
162. See generally Borowitz, supra note 33.
163. If the guaranteed loan is paid back during the 90-day to one-year preference avoidance period, the lender will be required to pay these funds back to the trustee for redistribution. See 11 U.S.C. §§ 547(b), 550(a)(1).
164. Judge Easterbrook discounted the equity theory when he addressed the interplay between sections 547(b) and 550(a)(1) in Bonded Financial Services v. European American Bank, 838 F.2d 890 (7th Cir. 1988) stating: "There is a related, and more nettlesome, question about the use of equitable powers under [section] 550(a) . . . . We have serious doubts both about the amount of equity in Lender's position . . . and about the propriety of judges' declining to enforce statutes that produce inequitable results." Id. at 894.
without guarantees can be paid back more than ninety days from the filing of the bankruptcy petition, but cannot be susceptible to preference recovery. 165 This occurs regardless of the unguaranteed creditor’s relationship with the debtor; it occurs even if the creditor is more akin to an insider.

In order to equalize the discrepancies listed above, courts should implement the “fortuitous recipient” exception. The “fortuitous recipient” exception creates a rebuttable presumption. If the trustee can establish the five criteria within section 547(b), the noninsider creditor will be presumed to be in sufficient control to merit recovery under section 550(a)(1). The burden of proof will then shift to the noninsider to rebut the presumption. If the noninsider can prove the transfer was not caused by leverage exercised over the debtor, the logical link will be broken and the noninsider creditor will be protected from recovery as a fortuitous recipient.

This procedure is in line with the equitable powers inherent in a bankruptcy court. 166 “In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.” 167 If the trustee is empowered to recover from the guaranteed creditor but not from the unguaranteed creditor, injustice and unfairness will result.

PAUL T. WRYCHA

165. A creditor that is paid back more than ninety days from the filing of the bankruptcy petition and does not hold a guarantee from an insider of the debtor will not be susceptible to recovery under section 550. This may occur even in a situation where the transfer was made under circumstances of bad faith. For example, suppose the creditor is a close friend of the insider who controls the debtor. As long as the creditor does not have a guarantee, the payments will not be recovered.


167. Id. at 307-08.