Insider Guaranties

A Two-edged Sword?

It is a common practice of creditors, when dealing with a financially troubled debtor, to accept guaranties from third parties in exchange for extending or modifying payment terms on a debt or forestalling the initiation of proceedings to collect the debt.

In the case of a corporate debtor, personal guaranties are often obtained from officers or shareholders of the corporation, and, in the case of an individual debtor, the personal guaranties are often obtained from the relatives of the debtor. The advantage to be obtained from such guaranties is obvious—they provide additional security for the debt. In light of a recent opinion rendered by the United States Court of Appeals for the Seventh Circuit, however, creditors accepting guaranties from such persons or entities also may be obtaining problems for which they did not bargain.

In the case of *Levit v. Ingersoll-Rand Financial Corp.*, 874 F.2d 1186 (7th Cir. 1989), the Circuit Court ruled that because certain creditors of a corporation in bankruptcy held guaranties from "insiders," the bankruptcy trustee could recover preferential transfers made to such creditors within one year of the filing of the bankruptcy, as opposed to the usual 90-day limitation. In order to understand the significance of this ruling, it is necessary to review some general rules regarding preferential transfers.

A preferential transfer is a transfer of an interest of an insolvent debtor in property to or for the benefit of a creditor, for or on account of an antecedent debt, that enables the creditor to receive more than it would receive, absent such payment, under a standard Chapter 7 liquidation. Sections 547 and 550 of the Bankruptcy Code permit a trustee to avoid (invalidate) a preferential transfer and recover the value of the property transferred from either the transferee or the entity for whose benefit the transfer was made.

As a general rule, an action to avoid and recover a preferential transfer can be brought by a trustee against a creditor only for transfers which occurred within the 90 days immediately preceding the filing of the bankruptcy petition.

In the case of a transfer to or for the benefit of a "insider," however, the trustee may bring an action to avoid and recover any preferences occurring within one year prior to the filing of the bankruptcy petition. Where the debtor is a corporation, an "insider" includes a director, officer, controlling person, partner, or a relative of one of the foregoing. Where the debtor is an individual, an insider includes a relative, partner, or corporation in which the debtor is an officer, director or controlling person.

Even prior to the *Levit* decision, it was widely understood that a preferential transfer made to an insider up to one year prior to the filing of a bankruptcy could be recovered from the insider. The *Levit* decision is significant in that it extends the time limitation from 90 days to one year prior to the filing of the bankruptcy petition to creditors who are not insiders with respect to the debtor if those creditors hold guaranties from insiders.

In reaching its decision the Seventh Circuit reasoned that a guarantor is a creditor of the debtor because it has a contingent right to payment from the debtor. If the debtor defaults and the guarantor is forced to make payments to another creditor pursuant to its guaranty, the guarantor, under the doctrine of subrogation, has a right to assert a claim against the debtor for the amounts paid pursuant to the guaranty.

The Circuit court further reasoned that if a creditor holds a guaranty from an insider of the debtor, a payment by the debtor to the creditor constitutes a benefit to the insider/guarantor because it reduces the insider/guarantor's exposure on the guaranty. Because the transfer to the creditor constitutes a benefit to an insider, the one-year, rather than 90-day, time limit for avoiding preferences should be applied.

Section 550 of the Bankruptcy Code, the Circuit Court observed, governs from whom an avoidable transfer may be recovered. It provides that the trustee may recover a preferential transfer from either (1) the transferee, or (2) the entity for whose benefit such transfer was made. Because the creditor holding the individual guaranty is the "transferee" of the above-described transfer, the trustee is permitted to recover the preferential transfer from it.

In light of the *Levit* decision, a creditor who is not an insider, but who holds a personal guaranty from an insider, may be forced to turn over to the debtor's estate any preferential transfers it received within one year

prior to the filing of the bankruptcy petition. In contrast, a creditor who is not an insider and who does not hold a guaranty from an insider, will only be required to return preferential transfers made within 90 days prior to the filing of the bankruptcy petition.

Despite the *Levit* decision, in most situations creditors who hold guaranties from insiders will be better off with the guaranty than without it. This is so because even if such a creditor is forced to return a preferential transfer to the debtor's estate the creditor will have a right to assert a claim against the guarantor for any deficiency on the debt owed by the debtor. It is conceivable, however, that a creditor holding a guaranty from an insider may be placed in a worse position than a similar creditor with no guaranty, if the guarantor does not have sufficient assets to pay the full amount of the debt he or she guaranteed. Here is an example:

Two creditors, Creditor A and Creditor B, are owed $150,000 each by a debtor in bankruptcy. Creditor A holds a guaranty from an insider whose personal assets total $25,000. Six months prior to the filing of the bankruptcy, Creditors A and B each received $100,000 from the debtor, which payments (aside from any time limitations) constitute preferential transfers.

When the bankruptcy trustee seeks to recover preferential transfers, Creditor B, without the guaranty, will be permitted to retain the $100,000 payment because it was received more than 90 days prior to the filing of the bankruptcy petition, and it will receive its allocable share of any distribution from the debtor's estate. Creditor A, with the insider guaranty, on the other hand, will be required to return the $100,000 to the debtor's estate and will receive only its allocable share of any distribution.

If the distribution from the debtor's estate is 25 cents on each dollar owed, Creditor A will receive $37,500 from the debtor and will be forced to pursue the guarantor, which has only $25,000 in assets, for the $112,500 deficiency, leaving an unpaid balance of $87,500. In contrast, Creditor B's unpaid debt will be $37,500, as it will have retained the $100,000 preference plus a distribution of 25 cents on the dollar on the remaining $50,000 from the debtor's estate.

This publication is not a legal opinion of Greene & Cooper nor any partner thereof. You should consult with legal counsel prior to relying on any information contained herein.