Insider Guaranties in Bankruptcy: A Framework for Analysis

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MARSHALL E. TRACHT*

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I. INTRODUCTION

The personal guaranty sometimes seems like the neglected stepchild of commercial law — ever present, but seldom noticed. It is a device of overwhelming importance in small business finance and real estate development, areas that account for well over half of the United States' economy¹ and an overwhelming proportion of the country's business bankruptcy caseload.² Despite this fact, the literature on guaranties

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¹ The Small Business Administration credits small business with employing approximately 54% of the nongovernmental workforce and making more than half of all sales. See United States Small Business Administration, Pub. No. FS0040, The Facts About Small Business (1996). Real estate enterprises, excluding construction, employed more than 1.4 million people in 1995. See U.S. Dep't of Commerce, Bureau of the Census, Statistical Abstract of the United States 511, Table 793 (118th ed. 1998). The value of commercial mortgages outstanding in 1997 was in excess of $800 billion. See id. at 521, Table 816.

² See Hon. Lisa Hill Fenning & Craig A. Hart, Measuring Chapter 11: The Real World of

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is tiny compared to that generated in the last few decades on other commercial law topics, like secured transactions, corporate fiduciary duties or bankruptcy theory.

This is not to say that guaranties have been completely ignored. Several problems raised by the treatment of guaranties in bankruptcy have received a great deal of attention. An extraordinary number of words have been devoted to the \textit{Deprizio} preference problem,\textsuperscript{3} and a substantial number of cases and articles have addressed questions of bankruptcy court jurisdiction and/or statutory authority to enjoin suits against third-party guarantors.\textsuperscript{4} In these discussions, however, the problems raised by guaranties have almost always been addressed on a doctrinal or ad hoc basis, without any guiding conceptual framework. Practically no effort has been devoted to developing a foundation for the analysis akin to that which has evolved in the secured transactions literature.\textsuperscript{5} Little has been done to explain the fundamental role of guaranties in commercial credit arrangements or their function in the bankruptcy process — matters logically prior to the specific issues with which the literature and cases have grappled.

The purpose of this article is to bring commercial guaranties within the common framework of agency analysis that has been so fruitful in other areas of commercial law, focusing specifically on one of the most common and problematic areas of guaranty law, the insider guaranty (that is, a guaranty from a principal shareholder or manager) in a closely-held firm. The first two parts of this article attempt to develop a general framework for thinking about insider guaranties and their role in small business finance, a theme that is further developed in the final section of the article, which considers the relationship between insider guaranties and some fundamental attributes of the U.S. bankruptcy system. Part IV shows the value of this framework in thinking through the policy and legal questions raised by insider guaranties by focusing on

\textit{500 Cases, 4 AM. BANKR. INST. L. REV. 119} (1996) (reporting that out of 510 Chapter 11 cases on Judge Fenning's docket in 1991-94, only one was a public company, and 85\% reported assets and liabilities between $100,000 and $10 million); Ed Flynn, \textit{Size of Chapter 11 Cases, 12-JAN AM. BANKR. INST. J. 22} (1994) (reporting that nearly two-thirds of all Chapter 11 cases involve less than $500,000 in assets and only about 10\% exceed $2.5 million in liabilities); Douglas G. Baird, \textit{Revisiting Auctions in Chapter 11, 36 J.L. & ECON. 633, 636-37} (1993) (stating that two-thirds or more of Chapter 11 cases are "mom-and-pop" businesses with less than $500,000 in assets; the majority of the rest are "closely held firms of substantial size"; and only ten to twenty publicly owned firms file for bankruptcy in a typical year).

3. \textit{See infra} Part IV.A.

4. \textit{See infra} Part IV.B.

5. The single, and important, exception to this is Avery Weiner Katz, \textit{An Economic Analysis of The Guaranty Contract, 66 U. CHI. L. REV. 47} (1999), which lays out a structure for considering the economic functions of guaranties. Professor Katz's article, while an important start, does not specifically address the bankruptcy issues considered here.
two important and contentious areas: the Deprizio doctrine in preference law, and bankruptcy proofing through the use of springing or exploding guaranties.

The central thesis of this article is that insider guaranties serve a critical, salutary and underappreciated function in reducing agency costs. The insider guaranty is not primarily a means of securing repayment from the guarantor should the firm default, as it is often viewed. Rather, it is a bonding device intended to align the interests of the insider with those of the creditor, thus mitigating the perverse incentives faced by shareholders as a firm nears insolvency. While this fact has been noted in the past, it has never been put in a full theoretical context that recognizes the functions of the guaranty in commercial finance and the bankruptcy system, and so it often seems to be forgotten in crucial policy debates.

Part I of this article provides a review of the financial agency problem and common strategies that parties use to ameliorate it. Over the past several decades, many ad hoc intuitions and judgments in corporate and commercial law have been harmonized and explained through the overarching concept of agency costs. This insight, dating from the seminal work of Jensen and Meckling, has allowed diverse problems to be addressed from a common framework. Thus, the scope of fiduciary duties in corporate law is commonly understood as a response to the agency problems that arise from the separation of ownership and control, and the functions of secured credit or bond covenants are typically analyzed in terms of the agency problems inherent in the separation of different classes of ownership interests.

The financial agency problem — the divergence between share-
holder and creditor interests — grows as a firm nears insolvency. As this happens, creditors share a series of related concerns that can be lumped together under the rubric of perverse pre-bankruptcy incentives. These concerns include the risks of overinvestment and underinvestment, which refer to the incentives for shareholders to be either too receptive or too averse to high-risk, high-return investments as a firm nears bankruptcy. Misappropriation, where shareholders will cause the firm’s assets to be distributed to themselves at the expense of creditors (through increased dividend payments, for example), is another possibility. Dissipation is the related concern that equity owners may prefer to avoid bankruptcy for as long as possible, even if the firm is hemorrhaging money, while dismemberment refers to the risk that creditors will enforce their remedies against the firm, breaking it up and sacrificing its going-concern value. These problems are laid out in more detail below, including a discussion on various legal and contractual devices used to control these risks, such as fiduciary duties, secured credit, debt covenants and bankruptcy rules.

Part II expands the discussion to include the role of the insider guaranty in mitigating these agency problems. The insider guaranty is a commitment from a party in a position to control or influence a firm’s decisionmaking — typically a majority or sole shareholder — to pay a debt owed by the firm should the firm default. This guaranty serves several purposes. First, it provides an additional source of assets that the creditor can reach if the firm defaults. Second, it increases the leverage that the creditor has over the firm’s management should the firm get into financial trouble. The insider may cause the firm to pay the guarantied debt, leaving other creditors out in the cold. In some circumstances, an insider might even agree to allow a viable firm to be liquidated to avoid personal liability on the guaranty. These possibilities have become the primary focus of critics, who decry the creditor’s ability to use its leverage to advantage itself at the potential expense of the firm in general, and of other creditors in particular.

This is obviously a real concern, but too often it has become the sole focus of analysis, blocking from view the vital positive functions served by the leverage inherent in an insider guaranty. The insider guaranty curiously inverts some commonly identified methods of resolving financial agency costs, particularly the acute costs that arise in insol-

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14. While the divergence between shareholder and management interests is a central theme in corporate law, given the focus of this article on insider guaranties, primarily provided by the major equity owner in a closely held firm, shareholders and managers are often addressed interchangeably.
vency. In recent years, numerous scholars have pointed out that the violation of absolute priority may be justified as a means of mitigating these incentive problems.\textsuperscript{15} Alternatively, scholars have suggested that a "chameleon equity" or "contingent equity" scheme, in which the existing equity interests are canceled and creditors automatically become the equity holders upon insolvency, could provide a contractual solution to financial distress, and have argued that this contractual solution could eliminate the need for bankruptcy reorganization provisions such as Chapter 11.\textsuperscript{16} Incentive problems can also be ameliorated through the use of preferred stock, convertible bonds or, to a lesser extent, bond covenants.

These proposals are generally made in the context of publicly held companies, and in that setting they make a great deal of sense. As shown below, however, financial agency problems are handled through a markedly different device in closely-held firms. The insider guaranty generally accomplishes the same result as the creation of chameleon equity in terms of mitigating perverse prebankruptcy incentives, but in the opposite manner. Rather than turning creditors into equity holders upon default, it puts the insider-guarantor in the position of a junior creditor.\textsuperscript{17}

Further light can be shed on the functions of the insider guaranty by comparing it with what is perhaps the most studied commercial finance arrangement, secured credit, a comparison undertaken in Part III.B. As a doctrinal matter, the two fall on opposite sides of several important categorical divides: A security interest is a property right, while a guaranty is a contract right; A security interest is a right in the borrower's property, while a guaranty is a right against a third party; The transfer effected by a security interest takes place upon the recordation of that interest (typically prepetition), while the transfer effected by a guaranty takes place only upon its enforcement (typically postpetition). Despite these difference, the two devices are more alike economically than is often recognized, and the commonalities raise interesting and important questions about their relative legal treatment.

Part III concludes with an examination of the implications of insider guaranties for the functioning of the bankruptcy system with respect to smaller firms. Although the literature seems never to have touched on the point, some of the dissatisfaction with small business bankruptcy may be attributable to the prevalence of insider guaranties, which can have adverse effects on debtor/creditor negotiations in the

\textsuperscript{15} See infra Part II.B.3.
\textsuperscript{16} See infra text accompanying notes 89-94.
\textsuperscript{17} See infra Part III.A.
subset of situations that are most likely to end up in bankruptcy proceedings.

Part IV applies the framework and insights developed in the first two sections of this article in a number of important contexts, the first of which is perhaps the most contentious area of bankruptcy law as it has been applied to insider guaranties. In the Deprizio problem, as it is known, the issue is whether payments to a creditor, who holds a guaranty from an insider, should be considered preferences for the full one-year preference period for payments "to or for the benefit of" an "insider," or just for the ordinary ninety-day preference period. This question generated an extraordinary amount of heat in both professional and academic circles until it was resolved by Congress in the Bankruptcy Reform Act of 1994. Building on the analysis presented in Part III, Part IV argues that this "fix" adopted by Congress can be expected to worsen problems associated with insider guaranties and also deprive insider guaranties of some of their inherent value.

Part IV.B. examines a problem that has garnered little judicial attention to date, but is likely to become a focus of widespread and heated litigation during the next economic downturn. During the 1990s, practitioners fastened on the concept of "springing" and "exploding" guaranties — that is, insider guaranties that take effect only if the borrower files for bankruptcy. These devices have become commonplace, even though practitioners freely admit they have no idea whether they will be enforceable. To date, there is very little case law and no scholarly analysis addressing these instruments, making them a particularly important area on which to focus before the next recession brings the

20. A search of WESTLAW's JLR (Journals and Law Reviews) database as of January 2000 discloses 365 articles that at least mention "Deprizio," and twenty-three separate articles that expressly refer to the Deprizio case in their titles.
23. See, e.g., John C. Murray, Exploding and Springing Guarantees, in COMMERCIAL REAL ESTATE FINANCING: WHAT BORROWERS NEED To KNOW Now 1999 303, 305 (PLI Real Est. Law & Practice Course Handbook Series No. 0028, 1999) ("The validity and enforceability of springing and exploding guarantees may be attacked in a bankruptcy proceeding on a number of theories (which may or may not be successful."); Sanford A. Weiner, Borrower's Counsel's Review of the Loan Commitment and Loan Documents, in COMMERCIAL SECURITIZATION FOR REAL ESTATE LAWYERS 399, 404 (ALI-ABA Course of Study, March 25, 1999) ("To the extent that it attempts to punish the borrower itself for seeking protection under the Bankruptcy Code, there are policy arguments why the springing guaranty should be unenforceable. . . . In addition to the effect of his/her client, borrower's counsel will need to address the enforceability issue in his/her opinion letter.").
issue to a head. As shown below, springing and exploding guaranties exacerbate financial agency costs, creating a disproportionate incentive to avoid bankruptcy in a way that ordinary insider guaranties do not. Moreover, they produce a negotiation problem that renders them even more troubling than simple bankruptcy waivers (which are generally held to be unenforceable). For these reasons, I argue that bankruptcy courts should bar the enforcement of springing and exploding guaranties.

Finally, Part V offers some concluding thoughts, putting the insider guaranty into a broader context that draws on Professor Skeel’s insights into the co-evolution of bankruptcy and corporate law regimes. Private and public companies handle financial agency costs in markedly different ways, yet they are generally subject to the same bankruptcy system. Insider guaranties appear to be a market-generated corrective aimed at aligning a bankruptcy system designed for public companies, and ill-adapted to the needs of closely-held firms, to the unique characteristics of these smaller but overwhelmingly numerous entities.

II. FINANCIAL AGENCY COSTS

A. An Overview of Financial Agency Costs

Corporate law and commercial law come together in their attempts to explain the legal and contractual mechanisms that shareholders, creditors, and managers use to deal with agency problems. Any time a principal must delegate authority to an agent, costs must be incurred in ensuring that the agent faithfully carries out its duties. In the public corporation, shareholders provide capital, but cannot themselves manage the enterprise in which their capital is invested. This raises the managerial agency problem. That is, shareholders must somehow ensure that the managers they hire serve the shareholders’ interests rather than their own. This problem is generally addressed through management compensation structures that try to align managerial and


25. Jensen and Meckling break agency costs down into three subcategories: monitoring costs, bonding costs, and the residual loss that is not avoided by these techniques. Jensen & Meckling, supra note 11, at 308. Monitoring costs are the costs incurred by a principal in attempting to oversee and control the behavior of her agent. See id. Bonding costs are the costs incurred by the agent to “guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if [the agent] does take such actions.” Id. Finally, because it is impossible to perfectly align the agent’s and principal’s interests, there are some remaining agency costs that must always be borne. See id. at 308 n. 9.

26. The problems inherent in the separation of ownership and control in large corporations was the central theme of a seminal work by Adolfe A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1932).
shareholder interests, and by the fiduciary duties that the board of directors owes to shareholders. When the corporation turns to creditors for additional capital, however, a new agency problem arises because the corporation will be managed for the benefit of the shareholders — at the creditors' expense, if need be.

The managerial agency problem is generally of limited importance in closely-held corporations; management can be expected to further shareholders' interests because management and equity are essentially identical. However, precisely because management interests are perfectly aligned with shareholders', the financial agency problem between shareholder and creditor interests is intensified.27

One of the central agency costs incurred as a firm approaches insolvency is the distortion of investment incentives. As a firm nears insolvency, different classes of claimants will have different preferences regarding the risk/return profile of projects that the firm should undertake, and the variability of a project's potential returns may become more important to the parties than the expected return itself. As a result, an insolvent or struggling firm may pursue inefficient investments.

The first example of this is the "underinvestment" problem — the resistance of shareholders to profitable investments that have a low variance.28 Using an illustration first provided by Franks and Torous, consider a firm with $70 in fixed assets and debt of $100.29 The firm has an opportunity to earn $50 by investing $35. Obviously, this is a worthwhile investment, having a positive net present value of $15 ($50 - $35). However, there is no reason for shareholders to bother with the investment, since the firm's assets will be worth only $85 if the project is successful. This would enhance the return to creditors, but it still leaves no value for the shareholders. To generalize, shareholders in an insolvent firm may not have adequate incentives to pursue investments that have a positive net present value, but low variance.30

27. See, e.g., F.H. Buckley, The Termination Decision, 61 UMKC L. Rev. 243, 259-60 (1992) (noting that compensation arrangements that align management interests with equity holders decrease agency costs while the firm is solvent, but may increase agency costs when the firm is in financial distress); Susan Rose Ackerman, Risk Taking and Ruin: Bankruptcy and Investment Choice, 20 J. LEGAL STUd. 277 (1991) (showing that managerial self-interest may cause managers in public companies to act in ways closer to creditor interests than shareholder interest).


30. Note that creditors have an equal and opposite set of incentives; thus, creditors may resist the firm's effort to engage in positive NPV projects where those projects are high in risk. See, e.g., Robert E. Scott, The Truth About Secured Financing, 82 CORNELL L. Rev. 1436, 1452 (1997).
The flip side of this is the "overinvestment" or asset substitution problem. Any time a firm has issued debt, equity holders have an incentive to increase the riskiness of the firm's investments because the downside risk is shared with the debt holders. As a firm nears insolvency, this incentive to shift the firm from safer to riskier investments grows. Consider an adaptation of the facts above, in which the firm has a unique opportunity to make the following investment: The firm can risk $30 of its assets on a project with a 10% chance of returning $200, and a 90% chance of returning nothing. Note that this investment has a net present value of negative $10\textsuperscript{31}; in other words, a value maximizing firm would reject the opportunity. From the shareholders' perspective, however, the investment is appealing. If the investment is not made, the entire value of the firm ($70) will go to the firm's creditors, leaving no value for the equity holders. If the investment is made, there is a 90% chance that the creditors will receive $40 and the equity holders will receive nothing, but a 10% chance that the creditors will be repaid their full $100 and the equity holders will receive $140.\textsuperscript{32} This investment reduces the expected value of the creditors' claims from $70 to $46\textsuperscript{33}, but it increases the expected value of the equity from $0 to $14.\textsuperscript{34} Thus, equity holders may be quite happy to have the firm invest in a project with a negative expected, net present value if the variance in the returns is high enough.\textsuperscript{35}

A related form of misbehavior that must be protected against is dissipation of the firm's assets through the suboptimal use of bankruptcy. For example, a firm that suffers from ongoing operating losses may choose not to file for bankruptcy even though bankruptcy would maximize the firm's value because managers are interested in preserving their jobs for as long as possible, or in order to extend equity's option in the hope of a miraculous turnaround.\textsuperscript{36} The opposite problem may exist as well. If the firm's decision-makers prefer to file for bankruptcy even when it is not in the firm's best interest (because they benefit from the

\textsuperscript{31} The investment has an expected payoff of (.10 x $200) + (.90 x $0) = 20, but a cost of $30, for a net present value of $20 - $30 = -$10.

\textsuperscript{32} That is, the firm will have a value of $200 from the investment, plus the other $40 of its initial assets, leaving $140 for equity after the creditors have received their full $100.

\textsuperscript{33} (90% x $40) + (10% x $100) = $46.

\textsuperscript{34} (90% x $0) + (10% x $140) = $14.


violation of absolute priority in bankruptcy, for example), then there may be more than the optimal number of filings. In either case, some system is needed that will tend to get firms into the bankruptcy process at an optimal time.\textsuperscript{37}

Another related category of debtor misbehavior is misappropriation of the firm's assets. Shareholder managers can be expected to use their positions to attempt to transfer wealth from the firm to themselves as bankruptcy becomes more likely. This may be done through excess dividend distributions, stock buybacks, the repayment of insider debt, or fraudulent transfers of the firm's assets. This type of misbehavior may be engaged in for the immediate gains or, more subtly, shareholders may sometimes choose actions that hurt the firm in order to induce creditors to renegotiate their rights.\textsuperscript{38}

It is not only the equity holders who may pursue suboptimal strategies in furthering their self-interest. Bankruptcy is often described as a solution to a "common pool" problem confronting creditors who, in trying to maximize their own recoveries, may destroy the firm's going concern value. Outside of bankruptcy, creditors may enforce their rights against the debtor, and the first creditor to establish a claim to an asset belonging to the firm is entitled to be paid out of that asset. Secured creditors may foreclose on their collateral and apply the proceeds to their claims. Unsecured creditors may bring suit and then levy on assets, subject only to prior liens on those assets. The result is a potentially wasteful "race to the courthouse," as each creditor seeks to beat others to the firm's limited pool of assets.\textsuperscript{39} Creditors may therefore overinvest in monitoring the debtor and enforcing their rights; moreover, the race to secure repayment by levying on the firm's assets may result in the dismemberment of the firm, sacrificing any going concern value the firm may have.\textsuperscript{40}

The contractual relationship between the firm and its creditors must somehow be designed to minimize the total cost of these various types of misbehavior, including prevention costs and the costs of losses not


\textsuperscript{40} See id. at 864-65. Moreover, the problem of dismemberment or undue creditor leverage is particularly acute in the context of small business borrowers who rely heavily on a few financing relationships — precisely the situation where insider guaranties are most prevalent. See, e.g., Jackson & Scott, supra note 36, at 170.
avoided. The major devices used to accomplish this are summarized in the next section.

B. Responses to Financial Agency Costs

1. Fiduciary Duties

One of corporate law's basic tools for controlling agency problems is the fiduciary duty of management. In its broad outlines, the structure of fiduciary duties in the corporate setting appears flexible enough to deal with the divergence of interests between shareholders and creditors. The directors of a solvent corporation owe their fiduciary duties (duties of loyalty and of care) to the corporation's shareholders, and owe creditors only the contractual duties that have been agreed to by the parties. However, as a company approaches insolvency, the directors may come to owe a fiduciary duty to creditors as well, and that duty may shift entirely to creditors once the firm is insolvent. Once a company becomes a debtor in possession in a bankruptcy reorganization case, management owes its fiduciary duties to the estate, rather than to any particular constituency.

This pattern is commonly explained by considering who holds the "residual interest" in the firm. In other words, fiduciary duties are owed to the parties who will benefit or lose from a marginal profit or loss, thereby creating an incentive to make economically efficient

41. See, e.g., Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991) ("Where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue [sic] risk bearers, but owes its duty to the corporate enterprise" as a whole, rather than any single group of stakeholders.).


43. See, e.g., Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) ("The fiduciary duty of a trustee runs to shareholders as well as to creditors."); In re Central Ice Cream Co., 836 F.2d 1068, 1072 (7th Cir. 1987) (arguing that debtor-in-possession has duty "to maximize the value of the estate, not of a particular group of claimants").


45. See, e.g., Douglas G. Baird & Thomas H. Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. CHI. L. REV. 738, 775 (1988) ("[T]he law of corporate reorganizations should focus on identifying the residual owner, limiting agency problems in representing the residual owner, and making sure that the residual owner has control
decisions. When the firm is solvent (assets exceed liabilities), creditors will receive their contractually fixed payments, and additional profits or losses will accrue to the shareholders. Once the firm becomes insolvent (debts exceed assets), creditors will receive only part of their claims, and additional profits or losses will increase or decrease the payments to these creditors.\textsuperscript{46} Thus, the directors' fiduciary duties run to the creditors upon insolvency because they become the residual claimants, the parties who stand to gain or lose based on the decisions made by management.

If the corporation continued to be run for the benefit of the firm's shareholders, rather than its creditors, the firm could be expected to make overly-risky investments.\textsuperscript{47} If these investments paid off, the firm would become solvent and shareholders would benefit; if they were unsuccessful, the loss would reduce the payments to creditors, but shareholders (who were not going to receive anything anyway) would be no worse off. Shifting the directors' fiduciary duties to the creditors is a means of controlling this incentive toward excessive risk.

This simple shift of fiduciary duties, however, is not adequate to resolve the problem of perverse pre-bankruptcy incentives. While overly-risky policies present one risk to creditors, there is a symmetrical problem if creditors are put in control: Shareholders have an incentive to take on too much risk when a firm is insolvent because they do not bear the downside, but the creditors may be too risk-averse because they do not keep the entire upside.\textsuperscript{48} When creditors of a slightly insolvent firm consider an investment that would restore solvency, they know that they would bear any losses, while the lion's share of the gains would go to shareholders. Directing fiduciary duties to creditors upon insolvency may alleviate the overinvestment problem, but it brings with it a risk of underinvestment.\textsuperscript{49}

over the negotiations that the firm must make while it is restructuring."); Frost, supra note 44, at 135-38 (suggesting that bankruptcy judges should give particular weight to the views of the residual claimants).


\textsuperscript{47} See supra Part II.A.

\textsuperscript{48} For a caveat to this generalization, see Barondes, supra note 35, at 51-59 (arguing that a lender holding debt with a below market rate of interest may prefer that the near-insolvent borrower undertake risky strategies, hoping that the debtor will violate its loan covenants).

\textsuperscript{49} See, e.g., Stuart C. Gilson & Michael R. Vetsuypens, Creditor Control in Financially Distressed Firms: Empirical Evidence, 72 WASH. U. L.Q. 1005, 1010-11 (1994) (suggesting that creditors may obtain overly restrictive covenants in debt restructurings, "causing firms to forgo risky, but profitable, investment opportunities"); Buckley, supra note 27, at 252-56; Laura Lin, Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors, 46 VAND. L. REV. 1485 (1993) (arguing that directors should have a duty to maximize
2. Contractual Covenants and Secured Credit

Contractual agreements provide the most obvious mechanism for mitigating agency costs that arise from the divergent interests of creditors and equity holders. To take the simplest example, bond indentures almost always include restrictions on the firm's ability to pay dividends, thereby attempting to stop shareholders of a troubled firm from misappropriating its value. Among the most common and important contractual devices is the provision of collateral.

Over the last two decades, a considerable literature has developed to explain the functions of secured credit. Although the story is contested, justifications for secured credit generally stress the value of col-

Fiduciary duties are not particularly effective at controlling financial agency costs. As just noted, they only deal with a subset of the incentive problems that arise on insolvency. Moreover, the justified reluctance of courts to elevate their judgment of business issues over the judgment of management leads to the remarkably lenient "business judgment rule," which renders actions for breach of the duty of care extremely difficult to win. And the situation is even worse in closely-held firms, where the equity holders are the primary decision makers. It is unlikely that the uncertain threat of a future lawsuit for breach of fiduciary duty will be sufficient to get management to place creditor interests over their own interests as equity holders. For these reasons, the vague standards of fiduciary duty law are often supplemented by specific contractual undertakings, such as bond covenants and collateral, intended to provide more effective protection for stakeholders' interests.

50. A prominent corporate law scholar recently summed up the functioning of the business judgment rule as follows: "The level of care required by the fiduciary standard is low, and the quality of judgment required is even lower. . . . Except for directors of financial institutions, claims for such violations have rarely been invoked successfully in the courts." Victor Brudney, Contract and Fiduciary Duty in Corporate Law, 38 B.C. L. Rev. 595, 599-600 n.12 (1997).


52. For an excellent recent review, see Symposium, The Priority of Secured Debt, 82 Cornell L. Rev. (1997); see also Lawrence Ponoroff & F. Stephen Knippenberg, The Immovable Object Versus the Irresistible Force: Rethinking the Relationship Between Secured Credit and Bankruptcy Policy, 95 Mich. L. Rev. 2234, 2254-63 (1997) (summarizing the debate over the efficiency of secured credit).

53. See generally Lucian Arye Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority
lateral as a means of allocating the burden of monitoring the debtor to prevent certain types of misbehavior.\textsuperscript{54} Secured credit may protect against overinvestment by limiting the debtor's ability to transfer its collateral and substitute more risky assets.\textsuperscript{55} It also may protect against underinvestment in at least two different ways. First, secured credit provides the ability to offer a priority payout to shareholders if they agree to finance a project that they would otherwise reject.\textsuperscript{56} Second, collateral provides the creditor with leverage (the threat of foreclosure) should it detect suboptimal efforts by the debtor.\textsuperscript{57} Security may also reduce the ability of a debtor on the verge of bankruptcy to dissipate the firm's assets through preferential or fraudulent transfers, by giving the secured creditor a prior claim to the potentially transferable assets.\textsuperscript{58} Alternatively, it has been suggested that collateral reduces borrowing costs by reducing the need for monitoring.\textsuperscript{59}

Debt covenants serve similar functions by allowing a creditor to call its obligation if the debtor engages in prohibited strategies.\textsuperscript{60} The

\textit{of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics}, 82 \textit{Cornell L. Rev.} 1279 (1977) (arguing that secured credit is inefficient); Lynn M. LoPucki, \textit{The Unsecured Creditor's Bargain}, 80 \textit{Va. L. Rev.} 1887 (1994) (arguing that secured credit redistributes value from unsecured creditors to secured creditors and their debtors, resulting in inefficient transactions).

\textsuperscript{54} See, e.g., Scott, supra note 30, at 1448-56 (discussing the role of secured credit in controlling debtor misbehavior).


\textsuperscript{56} To use the example from above in which the shareholders reject a $35 investment with a certain yield of $50, the shareholders would be willing to advance the $35 needed by the firm in exchange for a promised repayment of, say, $45. This repayment would take priority over the claims of existing creditors if the shareholders are able to take a security interest in the new project and its proceeds. Thus, the ability to grant collateral may ameliorate the underinvestment problem.

\textsuperscript{57} See Scott, supra note 30, at 1453-54.

\textsuperscript{58} See Bebchuk & Fried, supra note 53, at 1330.


\textsuperscript{60} See generally George G. Triantis & Ronald J. Daniels, \textit{The Role of Debt in Interactive Corporate Governance}, 83 \textit{Cal. L. Rev.} 1073 (1995); Gilson & Vetsuyens, supra note 49, at 1010-11; Bergman & Callen, supra note 38, at 157-160 (explaining the use of debt covenants to prevent management from threatening to dissipate firm assets in order to extract value from creditors).
loan agreement may provide that if the borrower acts in specified inappropriate ways (paying excess dividends, for example, or incurring additional debts), the lender may declare a default and accelerate the debt. This may enable the lender to recover its loan before repayment becomes impossible. It also imposes a cost on the borrower that discourages violations of the covenants.

Secured credit and loan covenants may prevent misbehavior not only by the debtor, but also by the firm's creditors. Monitoring by a creditor may reduce the opportunity for equity holders to misappropriate firm value or enter into overly-risky projects, benefitting all the firm's creditors. Because the benefits are shared by all creditors but the costs are borne by the monitoring creditor alone, creditors have an incentive to free ride on each other's efforts and there is likely to be an inadequate amount of monitoring. Thus, it has been suggested that one function of loan covenants and collateral is to increase the incentives to monitor by granting the monitoring creditor rights that will be triggered if it discovers misbehavior by the debtor. 61

The problem with loan covenants and collateral as control devices is that it is impossible to draft contracts that deal effectively with all opportunities for misbehavior. For example, it is very hard to draft provisions that will establish appropriate rules to govern the risk of asset substitution because many of the attributes that would need to be verified are difficult to monitor or to prove in court. 62 Thus, loan agreements are generally silent on the borrower's permissible investments. 63

3. BANKRUPTCY RULES

Fiduciary duties, secured credit, and loan covenants are all ex ante controls, aimed at deterring agency problems. They are supplemented, however, by a set of mandatory ex post rules for correcting various types of destructive pre-bankruptcy manipulation. These are the rules of bankruptcy, and this section focuses on three important categories: preference law, the control of managerial discretion during the bankruptcy case, and the violation of absolute priority.

Preference law permits a debtor to recover certain payments made

61. See, e.g., Raghuram Rajan & Andrew Winton, Covenants and Collateral as Incentives to Monitor, 50 J. Fin. 1113 (1995). Security also renders the secured creditor's monitoring more effective by giving the creditor leverage over the debtor should it discover the breach of a covenant. See Scott, supra note 30, at 1450-51.

62. See, e.g., Morey W. McDaniel, Bondholders and Corporate Governance, 41 Bus. Law. 413 (1986) (arguing that covenants restricting investments and disposition of assets are rare and trend is toward further reduction); Mitchell Berlin & Jan Loeys, Bond Covenants and Delegated Monitoring, 43 J. Fin. 397 (1988).

63. See Buckley, supra note 27, at 249.
to creditors shortly before filing for bankruptcy.64 This may enhance the recovery of creditors as a whole in several ways. First, it may discourage a "race to the courthouse" that would destroy the debtor's going concern value.65 Second, it may encourage creditors to continue to do business with the debtor even though bankruptcy appears possible or likely.66 Third, preference law may actually benefit financially troubled firms by encouraging creditors to take enforcement actions sooner than they otherwise would, thus stimulating corrective action before the firm is "too far gone" to be saved.67 Finally, Professor Adler has made a persuasive case that preference law, intentionally or not, helps to mitigate the overinvestment problem.68 The effects of preference law are discussed in conjunction with Deprizio doctrine below.69

A great deal of effort has gone into addressing the ways in which the specific provisions of Chapter 11 control (or fail to control) agency conflicts.70 Under Chapter 11, the management of a corporation gener-

65. See, e.g., Union Bank v. Wolas, 502 U.S. 151, 161 (1991) ("By permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors.").
66. This is closely related to, yet distinct from, the first point. Preference law discourages enforcement actions by creditors who might be inclined to try to enforce their rights. By doing so, it actually allows other creditors to continue to do business with the debtor with less concern that they will be last in line. For this reason, preference law contains exceptions intended to shield creditors who continue to engage in ordinary course transactions with the debtor. See 11 U.S.C. § 547(c)(1)-(5) (1999).
67. See Triantis & Daniels, supra note 60, at 1094-96.
68. See Barry E. Adler, A Re-Examination of Near-Bankruptcy Investment Incentives, 62 U. Chi. L. Rev. 575 (1995). Professor Adler argues that preference law may be more important in realigning pre-bankruptcy investment incentives than in fostering an equality between creditors. By prohibiting cross-collateralization, it discourages firms from overinvestment. Without preference law, shareholders might finance these investments by borrowing from an existing creditor, who is induced to make this new secured loan through the offer of security for pre-existing debt. There is a potential underinvestment problem as well, as firms decline to invest in positive NPV opportunities because they must share gains with unsecured creditors. In reality, preference law, however, probably does less to aggravate this problem because these may be financeable on their own merit, without cross-collateralization. Moreover, Professor Adler suggests firms entering into bankruptcy are likely to be poorly managed and so may be more likely to have poor NPV options.
69. See infra Part III.A.
70. See, e.g., Edward S. Adams, Governance in Chapter 11 Reorganization: Reducing Costs, Improving Results, 73 B.U. L. Rev. 581 (1993) (arguing that in all Chapter 11 cases, fundamental decisions should be made by a trustee rather than by pre-bankruptcy management); Carlos J. Cuevas, The Myth of Fiduciary Duties in Corporate Reorganization Cases, 73 NOTRE DAME L. Rev. 382 (1998) (suggesting that Chapter 11 be amended to permit unsecured creditors to enforce the debtor in possession's fiduciary duties); David A. Skeel, Jr., Markets, Courts and the Brave New World of Bankruptcy Theory, 1993 Wis. L. Rev. 465 [hereinafter Skeel, Markets, Courts]; Lynn M. LoPucki, The Debtor in Full Control: Systems Failure Under Chapter 11 of the
ally retains control during the bankruptcy proceeding. At the same time, the automatic stay suspends the ability of creditors to use their contractual rights to monitor the debtor’s management. In their place, Chapter 11 provides a combination of creditor and judicial oversight. For example, while the debtor’s management generally retains the authority to make day-to-day decisions, those that are outside the “ordinary course of business” must be approved by the court. Chapter 11 also provides for creditor committees to monitor debtors, and if management is incompetent or dishonest, a trustee can be appointed to take control of the debtor or an examiner can be appointed to investigate the debtor’s affairs. These specific provisions are supplemented in a host of ways, including the imposition of fiduciary duties on the debtor in possession and the constant possibility that the court will end the debtor’s exclusivity period for filing a plan, lift the automatic stay, or convert the case to liquidation under Chapter 7.

In the end, however, critics remain to be convinced that bankruptcy offers an effective mechanism for controlling agency costs. It is often asserted that management control, however necessary to preserve going concern value, results in bankruptcy debtors favoring the interests of equity holders over those of creditors (and perhaps favoring the interests of management over equity). Moreover, the difficulties inherent in

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Footnotes:

74. See 11 U.S.C. § 363(b)-(c) (1999) (providing that the trustee or debtor in possession may enter into transactions in the ordinary course of business “without notice or a hearing” and, “after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate”).
77. See, e.g., Lynn M. LoPucki, The Trouble with Chapter 11, 1993 WIS. L. REV. 729 (hereinafter, LoPucki, The Trouble with Chapter 11) (arguing that Chapter 11 fails to provide appropriate incentives for managers in small business cases and that such cases take too long, and proposing reforms).
78. See, e.g., Norberg, supra note 73, at 509 (stating that the bankruptcy system of controls “fails to adequately constrain the [debtor-in-possession’s] authority, permitting the DIP to act in ways that decrease instead of maximize the value of firm assets”); Lynn M. LoPucki, Chapter 11: An Agenda for Basic Reform, 69 AM. BANKR. L.J. 573, 576-78 (1995) (discussing “excessive debtor control” in Chapter 11); Hon. Edith H. Jones, Chapter 11: A Death Penalty for Debtor and Creditor Interests, 77 CORNELL L. REV. 1088, 1091 (1992) (“The debtor is allowed to run the business, and he usually runs it for his own benefit because he does not think he has too much time left.”).
monitoring management in a bankruptcy case are substantially enhanced in many small business bankruptcies, where few if any creditors have large enough interests to justify taking an active role in monitoring the debtor or the bankruptcy proceedings.79

Finally, various scholars have suggested that the routine violation of absolute priority in bankruptcy — that is, the retention of value by shareholders even though creditors have not been paid in full — is an inducement offered to shareholders to reduce prebankruptcy agency costs.80 For example, Professor Randal Picker suggests that one risk facing unsecured creditors is the possibility that a secured creditor will foreclose on its collateral and retain its full value, even if the collateral is worth more than the debt it secures.81 The problem is that unsecured creditors are in a poor position to monitor the value of the collateral, and so cannot know if the secured creditor is being enriched at their expense. The debtor, which is in a good position to monitor the value of the collateral, has no incentive to do so if the value preserved would go entirely to the unsecured creditors. Thus, Professor Picker suggests the violation of absolute priority is an inducement offered to the debtor to file for bankruptcy and preserve value for the unsecured creditors when there is equity in the collateral. It is compensation for protecting the unsecured creditors’ interests.82

Similarly, Frierman and Viswanath show that the violation of absolute priority reduces the incentive for overinvestment by permitting


80. See, e.g., Daigle & Maloney, supra note 35 (suggesting that the violation of absolute priority is accepted by bondholders as a means of reducing the incentive of equity holders to transfer value to themselves as insolvency approaches); Robert K. Rasmussen, The Ex Ante Effects of Bankruptcy Reform on Investment Incentives, 72 WASH. U. L.Q. 1159, 1177-85 (1994) (suggesting that violations of absolute priority should reduce underinvestment and asset substitution by insolvent firms); William H. Meckling, Financial Markets, Default, and Bankruptcy: The Role of the State, 41 L. & CONTEMP. PROBS. 13 (1977); Randal C. Picker, Voluntary Petitions and the Creditors’ Bargain, 61 U. CIN. L. REV. 519 (1992). Others have criticized the violation of absolute priority for causing various types of inefficiencies. See, e.g., Michelle J. White, Public Policy Toward Bankruptcy: Me-First and Other Priority Rules, 11 BELL. J. ECON. & MGMT. 550 (1980); Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. LEGAL STUD. 127 (1986). Professor Adler has specifically challenged the view that violations of absolute priority are inherently superior to contractual resolutions of financial agency costs. See Barry E. Adler, Bankruptcy and Risk Allocation, 77 CORNELL L. REV. 439, 473-75 (1992); see generally Barry E. Adler, Finance's Theoretical Divide and the Proper Role of Insolvency Rules, 67 S. CAL. L. REV. 1107 (1994) [hereinafter Adler, Theoretical Divide] (arguing that contractual arrangements can be designed to accomplish the proposed benefits arising from the violation of absolute priority, but at lower cost).

81. Picker, supra note 80, at 531-46.

82. See id.
shareholders to share in the assets of the firm even if it is insolvent.\(^8^3\) Others have argued that the violation of absolute priority can reduce the underinvestment problem. Consider again Franks and Torous’s illustration, where an insolvent firm rejects a project with a positive net present value because the entire benefit would flow to the firm’s creditors.\(^8^4\) If bankruptcy rules reject the absolute priority rule and reduce the debt to $75, thereby allowing shareholders to keep the value in excess of this amount even though the creditors have not been repaid in full, the investment becomes worthwhile for shareholders.

Most recently, Professors Posner and Kordana have offered a bargaining model that generalizes these results.\(^8^5\) They note a tension between respecting prebankruptcy entitlements and maximizing the value of the estate because prebankruptcy entitlements make creditors the residual interest holders while Chapter 11 leaves decision making power in the hands of managers, who are presumably beholden to equity. As they explain the functioning of Chapter 11, the debtor’s exclusivity period for proposing a plan: (1) gives the debtor the power to violate prebankruptcy entitlements, putting the residual value of the firm into the hands of equity;\(^8^6\) and, (2) gives management (equity) decision making power (through agenda control), thereby reducing bargaining costs by concentrating power in one party.\(^8^7\) Thus, decision making and residual interest are brought together. Moreover, they are brought together under the control of the party who presumably has the most information, and so is best able to maximize firm value.\(^8^8\) The cost of this efficiency is the rejection of creditors’ nonbankruptcy entitlement to priority over equity in the event of insolvency.

As an alternative to the violation of absolute priority, it has been suggested that strict adherence to absolute priority, through the automatic cancellation of all equity interests upon default, could be used to mitigate financial agency costs.\(^8^9\) Professor Adler has pointed out that

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84. See supra Part II.A.
86. See id. at 187.
87. See id.
88. See id. at 188-89.
89. See Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 Stan. L. Rev. 311 (1993) [hereinafter Adler, Financial and Political Theories] (describing a contractual structure of “Chameleon Equity” as a possible alternative to bankruptcy law); Skeel, supra note 70 (critiquing Adler’s proposal); Adler, A World Without Debt, 72 Wash. U. L. Q. 811 (1994) (responding to Skeel); Adler, Theoretical Divide, supra note 80 (expanding on the idea of Chameleon Equity and distinguishing Adler’s proposal from that of Bradley and Rosenzweig); Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 Yale L.J.
the underinvestment problem could be resolved by provisions in the corporate charter permitting the issuance of limited discount, high-priority debt, combined with "chameleon equity." Consider once again the hypothetical insolvent firm in which the shareholders decline to invest $35 to pursue a venture that would return $50. Under Adler’s proposal, the charter would permit the firm’s management to issue $45 of priority debt to the old equity holders for a price of $35. The $35 in proceeds would be used to finance the investment. After the investment is successfully completed, the equity holders would receive $45 on their priority debt, leaving $75 for the firm’s creditors — the same resolution hypothesized when absolute priority is abandoned. The ability of the old equity holders to collect on their new, high-priority claim would be contingent on the cancellation of their old equity interests. New equity (worth $75) could then be issued to the old creditors (or a subset of the old creditors) in compensation for their claims.

Thus, a large number of common law, statutory, and contractual rules have been developed to deal with various aspects of financial agency costs. As shown in the following section, the insider guaranty is properly understood as another tool in this same category.

III. AGENCY PROBLEMS AND THE INSIDER GUARANTY

A. The Insider Guaranty as a Solution to Agency Problems

It is commonly said, both by courts and commentators, that the purpose of an insider’s personal guaranty is to secure an additional

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90. Adler, Theoretical Divide, supra note 80, at 1116-18. This is related to the idea first put forward by Jensen and Meckling, then formalized by Richard Green, that the issuance of convertible debt can alleviate the overinvestment problem. See Jensen & Meckling, supra note 11, at 354; Richard Green, Investment Incentives, Debt, and Warrants, 13 J. Fin. Econ. 115 (1984). But see Frieman & Viswanath, supra note 83 (showing that the improved incentive structure created by issuance of convertible debt can be partially defeated if shareholders can trade in derivative securities).

91. Adler, Theoretical Divide, supra note 80, at 1116.

92. See id. at 1116-17.

93. See id. at 1117-18.

94. See id. at 1118.

95. "Insider" is defined in 11 U.S.C. § 101(31) (1999) as "including" various parties with close relationships to the debtor. In the case of a corporation, for example, insider includes "(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor." As the legislative history of the Bankruptcy Code explains, "An 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 arms length with the debtor." H.R. Rep. No. 595, 95th Cong., 1st Sess. (1977) 312,
means of repayment should the debtor default on its obligations. While this function (referred to hereafter as “financial assurance”) is certainly one reason for taking a guaranty, it is not the only reason, and may not even be the predominant one. While it is difficult to gather reliable or detailed data on small business financing in general, and on personal guaranties in particular, we do know a few things that can help put a discussion of insider guaranties into context. First, a very large number of small business loans are made with personal guaranties. According to one recent study, for example, at least 45.7% of small business loans, accounting for more than 58.8% of the outstanding dollar amount, were personally guarantied in 1993. Anecdotal information confirms that many commercial lenders seldom extend credit to small businesses without a personal guaranty — even if the insider giving the guaranty has no net worth.


96. See, e.g., NCNB Texas Nat'l Bank v. Johnson, 11 F.3d 1260, 1266 (5th Cir. 1994) (stating that permitting the discharge of a debtor to release a guarantor would “defeat the purpose of loan guarantees; after all, a lender obtains guaranties specifically to provide an alternative source of repayment in the event that the primary obligor’s debt is discharged in bankruptcy”); R.I.D.C. Ind. Development Fund v. Snyder, 539 F.2d 487, 491 (5th Cir. 1976) cert. denied, 429 U.S. 1095 (1977) (“One of the principal purposes for obtaining a guarantor to a note is to provide an alternative source of repayment in the event that the principal obligor’s debt is discharged in bankruptcy. Accordingly, the Bankruptcy Act provides that discharge in bankruptcy will not alter the liability of a guarantor.” (footnote omitted)).

97. Indeed, there is a growing economic literature on the value and functions of guaranties given by third parties as further assurance of repayment. This is an area of the economy that has seen explosive growth in recent decades in areas such as SBA loan guarantees, mortgage insurance, default insurance on corporate or municipal bonds, and interest rate swaps. The functions of these types of contracts are far removed from those of insider guaranties. For more on the role of these financial, rather than control, guaranties, see generally, Van Son Lai, An Analysis of Private Loan Guarantees, 6 J.FIN. SER. RES. 223 (1992); T.S. Campbell, On the Optimal Regulation of Financial Guarantees, 1 J. REAL. EST. FIN. & ECON. 61 (1988); B. Hirtle, The Growth of the Financial Guarantee Market, FED. RES. BANK OF NEW YORK QUARTERLY REVIEW 10 (Spring 1987); William C. Hunter, Insurance, Incentives, and Efficiency in Small Business Lending, 50 SOUTHERN ECON. J. 1171 (1984).

98. As recently stated in one of the few empirical studies of personal guaranties, “[T]he academic literature on the role of personal collateral and guarantees in small business finance is limited, in part because few data sets include sufficient information to permit a thorough study.” Robert B. Avery, et al., The Role of Personal Wealth in Small Business Finance, 22 J. BANKING & FIN. 1019, 1020 (1998).

99. See id. at 1052. These totals include loans which are guarantied, secured by personal assets, or both. Due to limitations in the data available, certain loans that are likely to have been personally guarantied or secured by personal assets were assumed not to have been, so these numbers likely underestimate the extent of personal liability for small business debt. See id. at 1031-34. Offsetting this, 62.6% of loans with personal guaranties, and 36% of loans for which personal assets were pledged but no personal guaranty was provided, were also secured by corporate assets. See id. at 1052.

100. See id. at 1058 (reporting no consistent relationship between the use of personal guaranties and owner wealth); see also Mann, supra note 9, at 24 n.86.
The reason for taking a guaranty from a party who is likely to be judgment proof is no mystery. The goal is to obtain leverage over the firm’s decisions. This fact has often been noted in the literature and case law, usually with disapproval.\(^{101}\) The consensus view seems to be that this type of leverage is objectionable, that lenders seek it in order to obtain an unfair position vis-a-vis the debtor and its other creditors. It is true that lenders can use the leverage from an insider guaranty to obtain preferential treatment relative to other creditors,\(^{102}\) but this is not the only reason for seeking leverage through an insider guaranty, and the proper treatment of these instruments requires an acknowledgment of the positive functions of leverage.

As shown in the previous section, fiduciary duties, collateral and covenants, and various bankruptcy rules are all used to alleviate the agency costs that grow increasingly severe as a firm heads towards insolvency. These devices are used with both public and private firms, but they are clearly less effective with private firms. Secured credit may be useful if the borrower has assets to pledge, but not all small firms have significant assets to offer.\(^{103}\) Loan covenants may lose much of their effectiveness because they depend on monitoring by the creditor, which may not be worthwhile on relatively small loans. Moreover, in public companies, the ability to displace management and/or to shift management powers from one class of claim holders to another can provide creditors with significant leverage.\(^{104}\) In private companies, the knowledge and management abilities of insiders may be crucial to the value of the firm, and so displacement is not a viable threat. Thus, in the small firm context, creditors need some other way to ensure that insiders manage the firm in a value-maximizing way even as the firm

101. See, e.g., Jay Lawrence Westbrook, Clear Thinking About Insider Preferences, 77 MINN. L. REV. 1393, 1395-96 (1993) [hereinafter Westbrook, Clear Thinking] (“The leverage guaranty has only the illegitimate purpose of providing leverage for a lender preference.”); Nussbaum, supra note 9, at 614 (“In short, Bank’s ‘prudence’ in obtaining the guarantee will often be a thinly cloaked pursuit of a preference, and giving absolute protection to Bank merely encourages self-interested conduct by Insider.”); Diane Stehle Dix, Note, Avoidable Preferences in Bankruptcy: The Status of the Insider Guarantee in the Wake of Levit v. Ingersoll Rand Financial Corp. (In re V.N. Deprizio Construction Co.), 874 F.2d 1186 (7th Cir. 1989), 60 U. CIN. L. REV. 1363, 1388-89 (“To give absolute protection to the creditor [from the Deprizio doctrine] would simply encourage self-dealing and lead to abuse of power by enabling the creditor to insist on a guarantee to be used solely to pressure the debtor in making preferential payments, without regard to the debtor’s interest in preserving its integrity and paying its other creditors.”).

102. See infra Part III.A.

103. Thus, Avery, finds that firms with few tangible assets that can be pledged as security are more likely to offer lenders personal guarantees from their shareholders. Avery et al., supra note 98, at 1049.

104. See Buckley, supra note 27, at 249-50.
approaches, or has entered, insolvency. This is the role of the insider guaranty.

The insider guaranty reduces the costs of financial agency in a number of important ways. First, it may provide an important signal about the quality of the firm, reducing the cost of evaluating loan applications and improving the quality of the decisions made. Second, the threat of personal liability mitigates the perverse incentives that normally affect shareholder/creditor relations in insolvency. It provides an additional incentive for the guarantor to strive to save the debtor should the firm get into financial trouble and encourages the guarantor to make efficient decisions regarding investment policies and bankruptcy initiation. Third, even after the guarantor pays on the guaranty, subrogation or reimbursement rights place the guarantor in a position where its incentives continue to be closely aligned with those of the firm's creditors.

Thus, the first major function of the insider guaranty is as an informational and screening device.105 The logic is simple enough: a potential lender knows that the borrower has more information about its prospects than does the lender, and thus fears that important risks may be concealed. Verbal assurances obviously can do little to assuage this concern, and verification efforts (such as a detailed audit of the business) are both fallible and expensive. An insider's agreement to put personal assets at risk, however, is a strong signal that the insider believes the firm will be able to repay.106 Thus, the insider guaranty reduces the cost of the loan approval process and helps lenders avoid high risk borrowers. This, in turn, lowers default rates and allows lenders to make small business loans less expensive.107


106. See Stephen A. Ross, The Determination of Financial Structure: The Incentive Signaling Approach, 8 BELL J. OF ECON. 23 (1977) (demonstrating that an incentive structure that will penalize managers upon filing of bankruptcy can communicate nonobservable information to investors). Note that the value of the signal does not necessarily depend on what the lender may be able to recover from the insider should it ever sue on the guaranty, if the lender can inflict costs on the insider through such a suit. The "in terrorem" effect of being able to foreclose on assets of high personal value even if they have low market value, or of forcing the insider into bankruptcy gives credence to the signal even if it does little to provide additional assets to repay the lender upon the borrower's default. Cf. Robert E. Scott, Rethinking the Regulation of Coercive Creditor Remedies, 89 COLUM. L. REV. 730 (1989) (noting the potential efficiency of signaling by granting security interests in low value household goods).

107. See Katz, supra note 5, at 66, 68.
Consider next the way the insider guaranty can mitigate perverse prebankruptcy incentives, such as the incentive to delay bankruptcy in the futile hope of turning around a failing company, or the incentive to file an inefficient bankruptcy in order to extract concessions from lenders. An insider guarantor knows that dissipation of the estate will increase her liability on the guaranty, and the guarantor's position as insider presumably gives her the ability to cause a bankruptcy filing.\textsuperscript{108} Thus, to the extent that the decision to file for bankruptcy represents a choice between shareholder, manager and creditor interests, an insider guaranty becomes a means of encouraging efficient bankruptcy filings and discouraging inefficient ones.\textsuperscript{109}

A great deal of attention has been directed to Professor Adler's suggestion that the costs of financial distress could be reduced by the creation of "Chameleon Equity."\textsuperscript{110} A firm could create a capital structure that is essentially a tiered hierarchy of preferred equity, in which classes would have collection rights, but no individual creditor would be able to enforce its claim against the firm.\textsuperscript{111} Default would result in the elimination of the existing common stock and the conversion of the lowest tier of "debt" into new common stock.\textsuperscript{112} This system would eliminate the risk of inefficient dismemberment through a creditors' race to levy against the firm, thus satisfying one of the primary functions of bankruptcy.\textsuperscript{113} In addition, by eliminating the bankruptcy proceeding itself, Chameleon Equity would eliminate the costs of conflicting incentives during the bankruptcy case.

While Chameleon Equity is an interesting theoretical possibility, various factors prevent firms from creating such interests today.\textsuperscript{114} An insider guaranty, however, accomplishes essentially the same thing as Chameleon Equity, but far more simply.\textsuperscript{115} Consider the underinvest-

\textsuperscript{108} See id. at 70-71 (noting that a controlling shareholder is the residual claimant and can monitor and police debtor misconduct, and so is well positioned to guarantee firm debt).

\textsuperscript{109} In 1997, Dun & Bradstreet reported that 83,384 businesses closed down without paying their creditors in full. See Business Failures Rise for the First Time in Three Years, Business Wire, March 2, 1998. There were, however, only 10,092 business Chapter 11 filings and 31,862 business Chapter 7 filings. See Administrative Office of the U.S. Courts, Statistical Tables for the Federal Judiciary, table F-2. Thus, no more than half of the business failures in 1997 were administered through the bankruptcy courts.

\textsuperscript{110} See Adler, Financial and Political Theories, supra note 89 (proposing chameleon equity); Adler, A World Without Debt, supra note 89 (responding to critics); Adler, Theoretical Divide, supra note 80 (expanding on the idea of chameleon equity and responding to critics).

\textsuperscript{111} See Adler, Financial and Political Theories, supra note 89, at 323-33.

\textsuperscript{112} Id.; Adler, Theoretical Divide, supra note 80, at 1118.

\textsuperscript{113} Adler, Financial and Political Theories, supra note 89, at 323-24.

\textsuperscript{114} See Adler, Theoretical Divide, supra note 80, at 1129-31; Adler, Financial and Political Theories, supra note 89, at 333-41.

\textsuperscript{115} That is not to say that other contractual arrangements may not be used to align management interests with the interests of creditors when a firm is insolvent. See Gilson &
ment hypothetical presented in Part II.A., supra, in which shareholders of an insolvent firm saw no reason to invest $35 in a project that would return $50. Now assume the firm’s debt is guarantied by its sole shareholder. Without the new investment, the shareholder is liable for a $30 deficiency ($100 in debt less $70 in assets). If the investment is made, this liability drops to $15 ($100 in debt, less $70 in existing assets and $15 net profit from the new investment). The insider guaranty presents a simple contractual solution to the underinvestment problem by making the insider the firm’s residual claimant until the guarantied debt is repaid.\textsuperscript{116} Successful investments by the borrower will increase the amount of the debt the borrower can repay, thus reducing the insider’s liability on its guaranty.\textsuperscript{117}

The guaranty also bonds the insider to work for the rehabilitation of the debtor should it fall on hard times, rather than abandoning the enterprise. Particularly in businesses where individual knowledge and effort are key assets, an owner who does not face the prospect of personal liability may be tempted to use his or her human capital and goodwill to start a new enterprise in the same line of business, free from the debts incurred by the prior, failed enterprise. While a personal guaranty cannot ensure that the proprietor will not follow this path (at least as long as personal bankruptcy remains an option for discharging the personal liability), it does reduce the possibility by limiting the insider’s ability to retain personal capital with which to start the new business.

Similarly, the risk of dissipation or misappropriation of the firm’s assets is lessened. With bankruptcy approaching, shareholders may seek to extract value from the company through dividends, the repayment of insider debt, or fraudulent transfers.\textsuperscript{118} An insider guaranty reduces the guarantor’s incentive to drain the firm in these ways, and also encourages the guarantor to prevent such behavior by other insiders who may not have joined in the guaranty.\textsuperscript{119}

In the same way, insider guaranties may reduce the risk of ineffi-

\textsuperscript{116} Moreover, this may negate the basic justification for shifting fiduciary duties to the creditors upon insolvency. If the equity holder continues to be the residual claimant, the directors’ and/or managers’ fiduciary duties should continue to run to the equity holders.

\textsuperscript{117} Equivalently, if the insider has already been forced to pay on his guaranty, he gains rights against the borrower by subrogation or indemnification. Any increase in the borrower’s assets will increase the insider’s recovery on these claims.

\textsuperscript{118} See Lin, supra note 49, at 1494. Cases have held that the use of a corporation’s funds to pay guarantied debt can be a breach of fiduciary duty. See, e.g., South Falls Corp. v. Rochelle, 329 F.2d 611 (5th Cir. 1964); In re Holly Hill Medical Center, Inc. 53 B.R. 412 (Bankr. M.D. Fla. 1985); In re Ozark Restaurant Equipment Co., Inc., 41 B.R. 476 (Bankr. W.D. Ark. 1984).

\textsuperscript{119} See Katz, supra note 5, at 73-74.
cient dismemberment of the firm through a "race to the courthouse." Suppose there is a firm with $100 in debt, and assets that are worth $80 as a going concern but only $70 if they are split up and sold piecemeal. Shareholders have no stake in whether the firm is dismembered or not; either way, there is no value for equity. An insider guarantor, on the other hand, has an incentive to resist a value-reducing dismemberment. In this way, the insider guaranty may reinforce the goals of preference law by motivating insiders to resist inefficient creditor pressures.

The insider guaranty may mitigate the race to the courthouse in a second way. It reassures the guarantied creditors that the manager is interested (due to his residual liability) in maximizing the creditors' recoveries. A creditor is likely to feel substantially less need to close down the debtor if it is confident that the firm is being managed to maximize the creditor's well-being, rather than the well-being of equity holders. Indeed, this appears to be a primary reason commercial lenders take insider guaranties: They do not expect to foreclose on their collateral or force a bankruptcy filing upon default. They want to leave the firm in the borrower's hands, because the borrower should best be able to maximize the value of its assets. To do this, however, the creditor needs some assurance that the borrower will try to maximize the value

120. They may resist dismemberment in order to preserve their jobs or extend the option represented by their equity interests.

121. Note that the guarantor will not resist a value-maximizing dismemberment because resisting would increase liability.

122. See Jay Lawrence Westbrook, Two Thoughts About Insider Preferences, 76 Minn. L. Rev. 73, 85 (1991) [hereinafter Westbrook, Two Thoughts].

123. An insider guaranty may further increase the ability of the firm to resolve problems without dismemberment or bankruptcy, if paired with a blanket lien on the firm's assets. Apart from the primary creditor, there is little incentive for creditors to pursue the debtor, since all of its assets are encumbered. Thus, the threat of dismemberment is remote, and, with the collective action problem thereby minimized, the equity holders and the primary creditor can negotiate toward an efficient resolution. In other words, the combination of "all asset" financing with an insider guaranty may provide the primary benefits of a bankruptcy reorganization scheme (staying enforcement by creditors, while permitting the firm to maximize its asset values) without the need for a bankruptcy filing. Cf. Douglas G. Baird & Randal C. Picker, A Simple Noncooperative Bargaining Model of Corporate Reorganizations, 20 J. Legal Stud. 311 (1991).

124. See generally Mann, supra note 9 (arguing that foreclosure often results in losses for the lender, but the threat of foreclosure is used to induce borrowers to resolve the lending situation efficiently); Westbrook, Two Thoughts, supra note 122, at 84 n.46.

125. This is consistent with the argument, advanced by Professor Bowers, that small business debtors are normally able to liquidate their enterprises more efficiently than courts or creditors. See James W. Bowers, Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure, 88 Mich. L. Rev. 2097 (1990); James W. Bowers, Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution, 26 Ga. L. Rev. 27 (1991).
of the business for application to the debt. This assurance is provided by the personal guaranty.

It is worth noting that these beneficial incentive alignment effects exist prior to payment of the debt by either the guarantor or borrower, because the guarantor is concerned with minimizing its personal liability. It also exists after repayment of the debt by the guarantor assuming the guarantor has the right to reimbursement or subrogation to the creditor’s claim, because the insider will want to maximize his recovery from the debtor.\textsuperscript{126} In such a situation, the insider shares with other creditors in the assets of the estate and thus will want to maximize the payout to creditors.

The insider guaranty is no panacea, of course. First of all, it does not fully correct inefficient incentives unless the insider has guarantied all of the firm’s debts, because the insider is not the sole residual claimant. He must share any profits or benefits with other creditors, and thus still faces some level of inappropriate incentives.\textsuperscript{127} The beneficial incentive effects of insider guaranties can be further defeated or mitigated in several ways that are worth noting. First, there is the possibility that the guarantor will be judgment proof, or have a net worth so limited as to render the threat of deficiency liability insignificant. Second, it is always possible, particularly in the case of a small business failure, that the guarantor will go into bankruptcy and discharge the guaranty obligation. An insider guaranty will also lose its effectiveness if the guarantied creditor is able to secure repayment of its debt from the borrower prior to the preference period. That is, if a creditor can use its leverage over the insider to secure repayment from the company, the guaranty will

\textsuperscript{126} Absent an express waiver, a guarantor has a right to reimbursement from the borrower for any amounts paid under the guaranty. See Restatement (Third) of Suretyship and Guaranty §§ 22-25 (1995). If the guarantor satisfied the claim owed to the creditor, the guarantor also becomes subrogated to the creditor’s rights against the borrower. See id. at §§ 27-31.

\textsuperscript{127} For example, return again to the overinvestment hypothetical presented in Part II.A. The shareholders of a firm with $70 in assets and $100 in debt choose to invest $30 in a project with a 10% chance of returning $200 and a 90% of returning nothing — even though the investment has a negative net present value. See supra text accompanying notes 31-35. A solvent shareholder/guarantor would reject this investment in order to reduce its expected personal liability. If the investment is made, the shareholder/guarantor’s position has an expected value of negative $40: an expected guaranty liability of (10% x $0) + (90% x $60) = $54, partially offset by an equity value of (10% x $140) + (90% x $0) = $14. If the investment is not made, the guarantor faces liability of $30.

Suppose, however, that the shareholder had guarantied just half of the firm’s debt. If the investment is not made, the shareholder’s position is worth negative $15 (no equity value, liability for fifty percent of the $30 in unpaid debt). If the investment is made, the shareholder’s position is worth $14 in equity value less an expected guaranty liability of (10% x 0) + (90% x $30) = $27, for a total value of negative $13. Thus, the investment improves the guarantor’s position despite the partial guaranty of the firm’s debt, although not by as much as when the debt was unguarantied.
have accomplished its immediate purpose from the perspective of the lender, but the elimination of the insider's contingent creditor status will also destroy the beneficial incentive effects discussed above. Issues raised by these limitations are addressed in various sections below.

B. Insider Guaranties versus Other Control Devices

Light may be shed on the appropriate treatment of insider guaranties by exploring the similarities of an insider guaranty to a security interest; the analogy is much closer than is often acknowledged. This comparison is presented below, following a brief comparison of insider guaranties with the two other primary methods of controlling the shareholder/creditor conflict, fiduciary duties and loan covenants.

As described above, fiduciary duties may offer a partial solution to financial agency problems, but fiduciary duties are a very blunt tool. First, of course, the business judgment rule presents an important barrier to suits for breach of the duty of care in all but the most egregious cases. Even beyond the practical problems, however, fiduciary duties are poorly calibrated. Directors owe their fiduciary duties to the shareholders until the firm is "in the vicinity of insolvency" (whenever that is), when those duties suddenly shift to include the firm's creditors. But the perverse incentives faced by shareholders and managers do not suddenly appear; they vary smoothly, with incentives shifting proportionately as the firm's fortunes wax and wane. A dichotomous regime of fiduciary duties owed to one set of claim holders or another cannot easily accommodate these gradations. The incentive effects of the guaranty, however, vary directly with the magnitude of the agency problem. As a firm gets nearer to insolvency, the probability and likely amount of guaranty liability increase, making the insider-guarantor more like a creditor and less like a shareholder. In other words, as the agency problem grows, so does the countervailing effect of the guaranty. This...

128. Professor Mann has commented on the similarities of secured credit and insider guaranties. See, Mann, supra note 9, at 10. For an analogy between the two in the context of co-debtor stays, see Zaretsky, supra note 105, at 233.

129. See supra Part I.B.1.

130. See, e.g., Ramesh K.S. Rao, et al., Fiduciary Duty a la Lyonnaise: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm, 22 J. Corp. L. 53, 63-64 (1996) (noting the difficulty of determining when a firm is in "the vicinity of insolvency" and director's duties should shift).

131. See supra text accompanying note 50.

132. This was recognized in Credit Lyonnaise and resulted in the court's holding that "at least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue [sic] risk bearers, but owes its duty to the corporate enterprise." Credit Lyonnaise Bank Nederland, N.V. v. Pathe Communications Corp., 1991 LEXIS 215, at *83 (Del. Ch. Dec. 30, 1991). For a discussion of the difficulties inherent in identifying the "vicinity of insolvency," see Barondes, supra note 35, at 71-72.
makes the guaranty a much more finely tuned instrument than the law’s default regime of fiduciary duties.

Next, compare the insider guaranty with loan covenants. The effectiveness of loan covenants in mitigating agency problems depends directly on the ability of the parties to specify in the loan documents, in an enforceable way, the behavior that is permitted or prohibited. For various types of potential misbehavior, this may prove impossible. And to the extent that the loan documents do provide specific standards against which to measure the debtor’s activity (or prescribe a general norm such as “good faith”), the parties will be faced with the costs of monitoring the debtor for compliance, bringing an enforcement action should violations be detected, and hoping that the court can arrive at an accurate determination. The insider guaranty, in contrast, gradually realigns the incentives faced by management without the need for any legal action by the creditor, thus minimizing monitoring, enforcement and error costs.

Finally, consider the insider guaranty as compared with secured credit. As discussed above, secured credit is a means of controlling various agency problems. Although there are a number of plausible explanations for the ways in which security works, collateral reduces agency costs in large part by disabling the borrower from engaging in many actions without the consent of the secured creditor. Consequently, security interests sometimes prevent the borrower from engaging in desirable acts, preventing efficient investments by the borrower. Insider guaranties do not create inefficient restrictions of this sort.

Security may also be a method borrowers and secured creditors use to appropriate value from other creditors. Whether or not this redistri-
bution is unfair, it may induce the parties to enter into economically inefficient secured transactions. That is, the use of security may engender greater total costs than benefits but, because some of the costs are externalized onto nonadjusting creditors, the firm and lender use security anyway.

The same can be said for insider guaranties. They may alleviate various agency problems, but they may also redistribute value from nonadjusting creditors to the guarantied lender if the guarantied creditor can use its additional leverage to improve its treatment. Yet unsecured creditors are fully aware of this risk, and from the perspective of the typical unsecured creditor, an insider guaranty is far less threatening than the granting of security. After all, a guaranty does not give the lender an automatic preferred position with respect to any of the debtor's assets, as a security interest does. Moreover, a guaranty may increase the total assets available to settle the debtor's claims by bringing in the guarantor's assets (at least where the guarantor has waived its right to reimbursement from the debtor or where the guarantor will be reimbursed only in part due to the debtor's insolvency). Creditors may further benefit because the guarantor's right to reimbursement provides an incentive to maximize the payout to the creditor class to which he or she belongs.

If insider guaranties are functionally close to security interests, we

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140. This redistribution is not unfair to the extent that the creditors who lose out are aware of their risk and can on average charge a price for their credit that fully compensates them. See Bechuk & Fried, supra note 53, at 1300-03; cf. Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Corp.), 874 F.2d 1186, 1198 (7th Cir. 1989) ("Rules of law affecting parties to voluntary arrangements do not operate 'inequitably' in the business world" because parties will adjust the price of credit to reflect the effects of the rule). On the other hand, various creditors may be unable to adjust the "price" they charge the firm for "credit" such as tort creditors, and this redistribution is arguably unfair as to these nonadjusting creditors. See Bechuk & Fried, supra note 53, at 1304-07, 1313-14.


142. Indeed, as early as 1848, one state supreme court refused to condemn insider preferences on exactly these grounds: "The stockholder and the stranger, who are both creditors of a corporation, no doubt stand in very unequal positions. But it is an inequality which the law allows, and which is understood by those who contract with corporations, and one which will always tend, more or less, to bring in doubt the credit of such bodies." Whitewell v. Warner, 20 Vt. 425, 444-45 (1848) (quoted in John C. McCoid, Corporate Preferences to Insiders, 43 S.C. L. Rev. 805, 820 (1992)).

143. On the use of such waivers, see infra Part IV.A.

144. The firm's general unsecured creditors clearly would prefer the existence of guarantied unsecured debt over secured debt, because a secured creditor is guarantied repayment up to the value of its collateral and has a reduced incentive to monitor the debtor. They also may prefer that the firm's primary creditor holds guarantied unsecured debt, rather than unguarantied unsecured debt, if the increases in efficiency outweigh the risk of preferential treatment.
might expect similar rules to apply to each. Consider the differences in legal doctrine, however. Three crucial distinctions can be drawn between secured credit and an insider guaranty. First, secured credit is accorded its prior rights only if it has been recorded, and so, it may be argued, unsecured creditors are on notice. No similar recording is either required or provided for with guaranties. Second, the secured creditor obtains a well-defined priority in particular assets, while an insider guaranty merely increases the lender's leverage. This arguably results in greater uncertainty for other creditors as to the effects of the guaranty compared to the effects of security. Finally, a distinction can be and often is drawn between the "property rights" conveyed by a security interest as opposed to the mere "contract rights" created by a guaranty.

The results of these distinctions appear in the different ways security and suretyship are conceptualized temporally. That is, the transfer of a property interest in the collateral is thought of as occurring when the security interest is perfected, rather than when the leverage created by the security interest is used to obtain a payment from the borrower. Thus, the "transfer" often occurs long before the debtor gets into financial trouble. This protects payments made near bankruptcy from being considered preferential. In the case of the guaranty, the transfer is viewed as occurring when the payment is made, thus subjecting payments shortly before bankruptcy to preference law. This is a purely arbitrary conclusion, however. Conceptually, the guaranty could be

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145. Too much could be made of this argument because secured creditors do not simply foreclose when the firm gets into financial trouble. They use the leverage provided by the threat of foreclosure to influence firm decision making — the same way a lender can use an insider guaranty.

146. The limits of this distinction are pointed out by Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. CHI. L. REV. 97, 112, 114 (1984) (stating that security provides the lender with property rights in specific assets, but also noting that "the property right . . . is principally a means to an end — priority as against third parties with regard to payment. . . . The probability of repayment and not any intrinsic interest in the collateral itself is the principal element of the value of his bargain with the debtor"). This same insight is recognized in mortgage law through the "lien theory" of mortgages: that even though a mortgage may purport to transfer title to the collateral to the lender, the property right received by the lender is simply title as security for repayment of the debt. For a discussion and critique of the thesis that the fifth amendment protects the property rights of secured creditors, see James Steven Rogers, The Impairment of Secured Creditors' Rights in Reorganization: A Study Of The Relationship Between The Fifth Amendment And The Bankruptcy Clause, 96 HARV. L. REV. 973 (1983).

147. A payment can be avoided as a preference under the Bankruptcy Code only if it is made within 90 days of the bankruptcy filing, or within one year of the filing if it is made to or for the benefit of a creditor who is an insider. See 11 U.S.C. § 547(b)(4) (1999).

148. The arbitrary nature of this determination is well shown by comparison with the treatment of standby letters of credit, which are in many ways a substitute for a guaranty. When a bank issues a letter of credit on the borrower's behalf for the benefit of a lender and the lender later
viewed the same way as a security agreement: at the initiation of the debtor-creditor relationship, the debtor grants the lender a mechanism for increased leverage to obtain repayment should the debtor get into financial trouble in the future.

Under current law, the problem with this perspective is one of notice. Because of the way secured credit has been conceptualized, a mechanism has been provided for giving notice of security interests to third parties, and a security interest is only valid as against those third parties if notice has been provided. The law, however, has neither required nor created a mechanism to provide notice of guaranties, so other creditors have no easy way of knowing that a lender has obtained the leverage of an insider guaranty. Yet this distinction between secured credit and guaranties is less convincing on closer examination of the way notice operates with secured credit: after all, a secured creditor does not have priority in its collateral only as to subsequent unsecured creditors, who knew or could have known of its lien. It also has priority over prior unsecured creditors, a result defended with the observation that these creditors were on notice that the borrower might grant subsequent security interests. In the same way, however, creditors of a closely-held firm are on "notice" that insiders may guaranty firm obligations, providing leverage to the guaranteed creditor.

To the extent that insider guaranties and security interests appear to serve similar functions, it would seem that the treatment of secured credit, which has been closely studied, should provide some guidance in thinking about the appropriate treatment of insider guaranties—despite the seemingly arbitrary differences in legal categorization that could lead to inconsistent treatment. 149

To summarize, then, insider guaranties are an important device for limiting financial agency costs. They are bonding devices that help ensure that managers carry out the firm's bargain with its lenders, thus reducing the total cost of capital. Moreover, the insider guaranty has an advantage over other monitoring and policing devices because it works in a fundamentally different way. Controlling a borrower through collateral may require the imposition of restrictions that will turn out to be too

draws down the letter of credit to recover on its debt, the transfer to the lender is deemed to have occurred upon the issuance of the letter of credit, rather than upon the payment under it. See, e.g., Perlstein v. Lamber Coal Co. (In re AOV Ind., Inc.), 64 B.R. 933 (Bankr. D. D.C. 1986); Briggs Transp. Co. v. Norwest Bank (In re Briggs Transp. Co.), 37 B.R. 76 (Bankr. D. Minn. 1984).

149. This view informs the discussions of the law in Part IV, infra, but it is of even greater importance in analyzing the validity of bankruptcy court injunctions against the enforcement of insider guaranties. While I address this matter to some extent in Part IV.B., infra, discussing springing and exploding guaranties, the broader issue deserves more detailed attention than it can be given in this article.
tight, barring efficient investments or requiring expensive renegotiations. Relying on covenants or fiduciary duties requires constant vigilance by the lender because breaches must be identified and enforcement actions brought. Thus, these devices entail substantial monitoring and enforcement costs (in addition to the error costs of flawed judicial decisions).

The insider guaranty, in contrast, minimizes costs by changing the decisionmaker’s incentives, thereby reducing the desirability of misbehavior without barring any specific course of conduct.\(^\text{150}\) Enforcement is relatively inexpensive, because a guaranty suit requires no proof that a condition or legal duty has been violated. All that a plaintiff must show is that the borrower failed to make a payment when due. It is this remarkable economy, not the leverage to induce wrongful preferential conduct, that most likely accounts for the ubiquity of insider guaranties. To the extent that this benefits the firm, all of the parties with stakes in the firm — including the creditors who do not hold guaranties — should be better off.

This does leave a lingering mystery, however. Insider guaranties should often help to prevent inefficient prebankruptcy behavior and should reduce the number of inappropriate bankruptcy filings, yet observers seem to agree that small business reorganization cases are often filed when there is little or no hope of success, and that these cases often drag on beyond any reasonable limits of time and expense.\(^\text{151}\) If insider guaranties are so effective in aligning shareholder and creditor incentives, and if they are so universally used, then why is the small business bankruptcy system perceived as so ineffective? The answer lies, I believe, in exploring when a bankruptcy case will be filed despite the existence of an insider guaranty, and the effects of the guaranty on the path of the bankruptcy case.

C. Insider Guaranties and Bankruptcy Negotiation

If there is a recurring theme in commentary on small business reorganization cases, it is that they take too long, cost too much, and are

\(^{150}\) Cf. ROBERT ELLICKSON, ORDER WITHOUT LAW 126-32 (1991) (noting the efficiency of inculcated norms, compared to external monitoring and enforcement, in inducing desirable behavior).

\(^{151}\) Thus, the National Bankruptcy Review Commission could refer to "two distinct categories of small business Chapter 11 cases. . . . The first category consists of the relatively small proportion of cases in which the debtor has a reasonable likelihood of confirming a plan and succeeding as a going business . . . The second category consists of the much larger proportion of cases in which the debtor has no reasonable prospect of rehabilitation." NATIONAL BANKR. REVIEW COMM’N, BANKRUPTCY: THE NEXT TWENTY YEARS 609 (1997).
often unworthy of the effort. Indeed, the data clearly show that large firms are far more likely than small firms to succeed in reorganization. If insider guaranties are so common in the small firm setting, and if they provide appropriate incentives in insolvency, why should small business bankruptcies seem so dissatisfactory in practice? The answer lies at least partly in the selection effects created by insider guaranties.

Rationally, we can expect small businesses to file for bankruptcy, despite the existence of an insider guaranty, in either of two basic circumstances. First, where the reorganization is expected to be value maximizing, the insider will cause the firm to file in order to minimize his guaranty liability. Second, if the insider is insolvent, the guaranty will have little deterrent effect and the insider may file an inefficient case despite the likelihood of increased liability on the guaranty.

This covers the relationship between the insider guaranty and bankruptcy initiation from a rational perspective, but the irrational, emotional aspect also merits attention. It has often been noted that financially distressed debtors may cling to any straw of hope, and legal rules are imposed in a number of contexts to protect debtors from unrealistic dreams of financial recovery. This failing is also observed in the world of bankruptcy. A distressed business may file for Chapter 11 reorganization not because recovery is probable, or even possible, but because the owner is unwilling to face the economic realities — and the

152. See, e.g., LoPucki, The Trouble With Chapter II, supra note 77. For an examination of the direct costs of small business bankruptcy cases, see generally Robert M. Lawless, et al., A Glimpse of Professional Fees and Other Direct Costs in Small Firm Bankruptcies, 1994 U. ILL. L. REV. 847 (showing direct costs in excess of 26% of the distributions made to unsecured creditors). For a discussion of the total costs of bankruptcy relative to their benefits, see Marshall E. Tracht, Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law, 82 CORNELL L. REV. 301, 321-26 (1997) [hereinafter Tracht, Contractual Bankruptcy Waivers].

153. In one study of public companies in bankruptcy, for example, more than 90% of debtors confirmed reorganization plans. See Lynn M. LoPucki & William C. Whitford, Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. PA. L. REV. 125, 137-41 (1990). In contrast, a study of 260 Chapter 11 cases found that just forty-five resulted in confirmed plans, nine of which called for liquidation of the debtor. Of the remaining thirty-six, it appeared that only seventeen plans were actually consummated, for an overall rate of operating firms of just 6.5%. See Susan Jensen-Conklin, Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law, 97 COM. L.J. 297, 316-30 (1992); see also Nancy Rhein Baldiga, Is This Plan Feasible? An Empirical Legal Analysis of Plan Feasibility, 101 COM. L.J. 115 (1996) (reporting that half of the confirmed, nonliquidating plans failed to consummate, despite the required judicial finding of "feasibility").


155. Moreover, if such a case is filed, the insider guaranty may make reorganization more difficult to accomplish. See infra Part II.C.

156. See, e.g., Tracht, Contractual Bankruptcy Waivers, supra note 152, at 343 (noting that the equity of redemption and other borrower protections are often not waivable, thereby protecting borrowers from the "mirage of hope").
cost of denying reality for a few more months or years is placed largely on the firm’s creditors.\textsuperscript{157} A personal guaranty can help correct poor incentives, but it does little to cure wishful thinking.\textsuperscript{158} Thus, we can expect small business filings to be a mixture of efficient and inefficient cases, although with fewer inefficient cases than we would see absent insider guaranties.

There may be another important relationship between insider guaranties and the excessive failure rate of small business bankruptcies. While closely held firms are most likely to file for bankruptcy when insider guaranties have been rendered valueless through the insider’s lack of assets, that does not make the guaranty irrelevant to the parties’ conduct within the bankruptcy proceeding. Under plausible assumptions, an insider guaranty can destroy the borrower’s reorganization incentives and create a potentially destructive negotiating dynamic.

The problem is that, assuming the guaranty cannot be discharged through the borrower’s bankruptcy case,\textsuperscript{159} any value retained by the guarantor under the plan will be available to the creditor in a suit on the guaranty. Thus, where the assets available to the creditor under the plan and from the guarantor are not sufficient to result in payment in full, the insider guaranty can render reorganization pointless from the guarantor’s perspective, even if it is value-maximizing for creditors.\textsuperscript{160} This is sim-

\begin{enumerate}
\item[157.] One exasperated bankruptcy court judge described the situation this way:

Bankruptcy is perceived as a haven for wistfulness and the optimist’s valhalla where the atmosphere is conducive to fantasy and miraculous dreams of the phoenix rising from the ruins. Unfortunately, this Court is not held during the full moon, and while the rays of sunshine sometimes bring the warming rays of the sun, they more often also bring the bright light that makes transparent and evaporates the elaborate fantasies constructed of nothing more than gossamer wings and of sophisticated tax legerdemain.

\textit{In re Maxim Indus., Inc.}, 22 B.R. 611, 613 (Bankr. D. Mass. 1982).

\item[158.] One bankruptcy with which I am personally familiar involved a small retail establishment in an industry that is being consolidated under a few nationwide chains whose costs are substantially lower than those of independent stores. Given the underlying economics, the business was doomed, yet the owner, who had inherited the business from his parents, was emotionally unwilling to acknowledge this fact. After a two-year stay in bankruptcy court, a plan of reorganization was confirmed using the “new value exception” to the absolute priority rule. Under the plan, some debts were discharged, the owner took out a mortgage on his house (his only asset outside the company) to add capital to the business, and he personally guarantied the store lease. The end result was a “successful” bankruptcy in that a Chapter 11 plan was confirmed and consummated. In reality, the result was that the owner struggled for four additional years to save the business, working without a salary. When the store finally closed, the owner was saddled not just with the loss of the business he would have had six years earlier, but also with a six-figure mortgage on his modest home. Bankruptcy could not change the fact that the store was not economically viable. All it could do was keep a negative-present-value enterprise alive for six years longer than would have been likely without Chapter 11.

\item[159.] See infra Part IV.B.

\item[160.] From this observation, it could be argued that insider guaranties should be dischargeable in the borrower’s bankruptcy case. Indeed, several courts appear to have granted at least
ply another version of the underinvestment problem. 161

It could be argued that the guaranty does not preclude reorganization, it just reallocates bargaining power during the proceedings. The owners of a closely held firm gain substantial leverage through the negotiating structure imposed by a bankruptcy filing. Insiders retain their major threat against creditors: that they will walk away, taking all of their firm-specific human capital with them and depriving the firm of its going concern value. 162 Moreover, the Bankruptcy Code gives the debtor in possession an exclusive right to propose a plan of reorganization for a period that can be, and often is, extended indefinitely. 163 It also may permit a plan to be confirmed by "cramdown" over the objection of temporary protection to insider guarantors on precisely these grounds. Thus, in In re Northlake Bldg Partners, 41 B.R. 231 (Bankr. N.D. Ill. 1984), the bankruptcy court granted a temporary injunction staying suit on a personal guaranty given by the debtor's sole general partner, on grounds that he was crucial to managing the debtor's profitable hotel and that the debtor would be "irreparably harmed" by the loss of the guarantor/manager. Similarly, in Codfish Corp. v. FDIC (In re Codfish Corp.), 97 B.R. 132 (Bankr. D. P.R. 1988), the FDIC settled with two insider guarantors, but not with the firm's president, Mr. da Cunha, who had special expertise needed for any reorganization. The bankruptcy court granted a temporary injunction barring the FDIC from pursuing Mr. da Cunha, who stated he would have no incentive to work for the debtor if his earnings would just be subject to judgment by FDIC. See id. at 134.

These courts never address why the suit on the guaranty would cause the guarantor to stop working to save the debtor. If the court were really correct that the manager was crucial, then the creditor may have good reason to cut a deal that will keep the manager's expertise available. One suspects that the courts' reasoning involved a level of disingenuousness. In In re Northlake, the court previously had ruled that the creditor was oversecured, so the court may have been concerned that the creditor was seeking to accelerate a below market rate loan. In re Northlake, 41 B.R. at 232. Moreover, if the creditor was fully secured, the costs of a foregone reorganization would accrue entirely to unsecured creditors and equity holders, and the guarantied creditor would be indifferent between liquidation and reorganization. On these facts, actions by the secured creditor that endanger the reorganization should be stayed.

In In re Codfish Corp., the court noted that Mr. Da Cunha had no assets, so the FDIC supposedly lost nothing from the injunction. However, if he really had no assets, the injunction was unnecessary. The FDIC would have no incentive to go after him, and, if it irrationally did so, Mr. Da Cunha could file for bankruptcy with no loss. If his expertise was so crucial, the FDIC, as the firm's primary creditor, should be willing to cut a deal. After all, they compromised with the debtor and two other guarantors. Although there is no way to tell from the opinion, the FDIC may have believed the guarantor was somehow holding out, and was using the leverage of the guaranty to prevent this — in which case, the court enjoined the FDIC from using the guaranty to accomplish precisely the goals the guaranty had been intended to further. In re Codfish Corp., 97 B.R. at 97. On the other hand, the court may have believed that the FDIC had ulterior motives or was not negotiating in good faith (a thought that would probably not surprise anyone who dealt with the FDIC in midst of the savings and loan crisis) and thus was seeking to break a negotiating impasse by restraining the FDIC.

161. Moreover, by reducing the prospect that an insolvent guarantor will be able to retain a stake through reorganization, the guaranty may prevent the prospect of deviations from absolute priority from mitigating perverse prebankruptcy incentives. See supra text accompanying notes 80-88.

162. See Baird & Picker, supra note 123, at 318-24.

163. See Kordana & Posner, supra note 85, at 182-90.
This combination gives insiders control of the bargaining agenda, which can allow them to extract the lion's share of the firm's going concern value. On top of these legal advantages, insiders often have informational advantages that give them an important edge in negotiating a plan of reorganization.

Creditors, on the other hand, are deprived of their primary negotiating threat (enforcement of their contractual rights against the borrower) by operation of the automatic stay. If the firm's shareholders are liable on personal guaranties that exceed their assets, however, any value extracted by virtue of these bargaining advantages is subject to levy and attachment by the guarantied creditor. Moreover, the automatic stay, which bars creditors from pursuing remedies against the borrower once it files for bankruptcy, does not enjoin suits against third party guarantors. Thus, an insider guaranty allows additional pressure to be brought to bear on the firm's principals during the bankruptcy case, and it significantly decreases the value of "cramming down" any plan of reorganization under which they retain value without the consent of the guarantied creditor.

Chapter 11 is a bargaining process, it might be argued, and the insider guaranty simply shifts the parameters within which the debtor and creditors bargain. There is nothing sacrosanct about bargaining sans guaranty. If the insiders truly bring value to the enterprise, as they often do, and have few outside assets, the creditor may be induced to release the personal guaranties in exchange for a payout from the reorganized debtor that exceeds the liquidation dividend available if the insiders walk away plus the recovery available if they are sued on their guaranties. Moreover, guarantors with few assets have a credible response to creditor pressure — personal bankruptcy.

This natural response misses a crucial point, however. The insider guaranty not only changes the balance of leverage between the parties, it also changes the nature of the bargaining, by removing cramdown as a viable threat. Assume for the moment that it is efficient to reorganize

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164. See Baird & Picker, supra note 123, at 121; Kordana & Posner, supra note 85, at 193-96.
165. See Kordana & Posner, supra note 85, at 182-90.
166. See id. at 173-82; LoPucki, Debtor in Full Control, supra note 70, at 257.
168. See, e.g., Credit Alliance Corp. v. Williams, 851 F.2d 119, 120 (4th Cir. 1988) ("Nothing in § 362 suggests that Congress intended that provision to strip from the creditors of a bankrupt debtor the protection they sought and received when they required a third party to guarantee the debt.").
169. See, e.g., Richard F. Broude, Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative, 39 Bus. Law. 441 (1984) (arguing that cramdown is "used more as a threat [to induce settlement] than as a club actually employed in confirming a plan of reorganization"); Jack Friedman, What Courts Do To Secured Creditors in Chapter 11 Cram Down, 14 Cardozo L.
the firm. The firm is most likely in bankruptcy because a bargaining impasse between the firm and its major creditor(s) prevented an out-of-court workout. Absent the guaranty (or if the guarantor is solvent), insiders have two bargaining strategies they can use to try to reach a consensual resolution in the bankruptcy case: They can threaten either liquidation or cramdown. The threat of cramdown generally requires a demonstration of commitment to the business and strong indications that reorganization is possible. The creditor must believe that the insiders are willing to commit "new value" to the company in order to reorganize over the creditor’s objection. To make a liquidation threat credible, however, the insider may have to act in precisely the opposite manner in order to demonstrate that the insider considers the business expendable. A liquidation threat may require insiders to openly devote time to alternatives (like searching for or even taking new jobs, or starting a new company) to demonstrate their willingness to let the company die. It is not hard to picture failure as an outcome when each side is saying to the other, "Give in, or I’ll liquidate the company!" Creditors always threaten liquidation; if insiders have no alternative but to threaten liquidation as well, the negotiations will involve a level of brinkmanship that may lead to the failure of the firm even though a cramdown threat, were one available, might have led to a consensual reorganization.

D. Conclusions

The insider guaranty is not just a contract of financial assurance, providing the creditor with an additional source of recovery should the borrower default. It is a screening, bonding, and control device intended to align shareholder and managerial incentives with the interests of the guarantied creditor. To the extent that it improves over other methods addressing the financial agency problem, it can be expected to lower borrowing costs for small firms. Anything that interferes with the leverage granted to a creditor by an insider guaranty threatens these benefits. As a result, caution is appropriate in considering any bankruptcy rules that might impair the functioning of insider guaranties. On the other hand, there are situations where an insider guaranty may create inappropriate incentives. The question is whether bankruptcy law is capable of reducing the costs of these situations without causing greater harm than good. Part IV attempts to provide some guidance on that question by considering two important issues raised by insider guaranties in bankruptcy, using the agency theory framework developed above.

Rev. 1495, 1497 (1993) (noting that "[f]ear of [cramdown] causes parties to settle rather than litigate in the great majority of cases").
IV. Applications

The analysis provided in Part III can help us make appropriate decisions when legal rules are forced to confront the mixed nature—financial assurance and creditor leverage—of the insider guaranty. The following sections apply the framework developed above to two critical issues in the treatment of insider guaranties in bankruptcy. First, consider the “insider preference” or “Deprizio” problem: Under the Deprizio doctrine, payments made to a creditor who holds an insider guaranty are considered payments for the benefit of the insider. Accordingly, they are subject to the one year preference period for insiders, rather than the ninety day preference period for general creditors. This doctrine quickly became a lightning rod for commentary and Congressional lobbying, and has been the primary context in which insider guaranties have been scrutinized. An agency cost analysis of the Congressional “fix” adopted in 1994 to mollify lenders shows that Congress addressed the problem in a manner that might generously be described as “poorly conceived.”

The second application offered here is of a problem that has yet to break out into the judicial arena, although we can expect this to change rapidly come the next recession. “Springing” and “exploding” guaranties—devices that impose personal liability on insiders only if the borrower becomes subject to a bankruptcy proceeding—have become extremely common during the 1990s. These devices can be challenged on numerous grounds, including breach of fiduciary duties and violation of fundamental bankruptcy policies. As shown below, these devices are far more troubling than insider guaranties in general (and even more troubling than explicit waivers of a firm’s right to file for bankruptcy), and should not be enforced by the courts.

A. Preference Law: The Deprizio Debate

The primary objection to insider guaranties appears to be the preference concern: that the insider will direct funds to the guarantied creditor as bankruptcy looms on the horizon. The prospect of such preferential payments raises two different objections: (1) that such payments will reduce the total amount available to the firm’s creditors; or (2) that such payments will unfairly benefit one creditor at the expense of others.170

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170. These are the two concerns that lie at the heart of preference law.

The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often
The problem is easy enough to see. Consider once more the hypothetical presented in Part II.A., 171 but assume that the insider has guaranteed $50 of the firm’s $100 debt. If the firm is reorganized to realize, say, $80 in going-concern value for creditors, shared pro-rata, the guarantor will face $10 in residual liability on the guaranty. 172 However, if the guarantied creditor is able to levy on the firm’s assets before the other creditors, then this creditor will be paid in full and the guarantor’s liability will be extinguished, leaving only $20 (of the $70 piecemeal value) available to the other unsecured creditors. Thus, the insider guaranty may create an incentive for the guarantor to collude in an inefficient dismemberment if the proceeds can be directed to the guarantied obligation. The result is both unfair (viewed from a baseline entitlement of pro rata sharing) and inefficient.

The primary occasion for debate about the relationship between preference law and insider guaranties has been the Deprizio doctrine. To provide a brief overview: Absent certain defenses outside our current concern, a payment to a creditor is a preference, and can be recovered by the debtor, if the payment is made (1) to or for the benefit of a creditor; (2) on account of a preexisting debt; (3) while the debtor is insolvent; (4) within ninety days before the bankruptcy filing; and (5) if the payment allows the creditor to receive more than the creditor would have received if the payment had not been made and the debtor were liquidated under Chapter 7 of the Bankruptcy Code. 173 Thus, payments to unsecured or undersecured creditors, made within ninety days of bankruptcy, may be avoidable. 174

If the payment is to or for the benefit of a creditor who is an "insider" of the debtor, the preference period is extended to a full year.

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171. See supra text accompanying notes 28-35.
172. That is, the $80 going-concern value will be split evenly, paying $40 on the guarantied debt and $40 on the unguarantied debt.
174. Payments to fully secured creditors generally are not avoidable as preferences because a fully secured creditor would be paid in full in a Chapter 7 proceeding, although it is possible for a payment to a fully secured creditor to be an indirect preference. See, e.g., Pitts, supra note 9, at 356-57 (payment to fully secured creditor may be deemed for the benefit of an undersecured creditor with a lien on the same collateral; under section 550(a), payment could be recovered from either creditor); but see 5 COLIER ON BANKRUPTCY ¶ 550.02[5], at 550-15 (15th ed. 1990) (arguing that recovery from the fully secured creditor should not be permitted).
before the bankruptcy.175 Under the "Deprizio doctrine,"176 a payment on a debt guarantied by an insider was deemed to be "to or for the benefit of a creditor . . . [who] at the time of such transfer was an insider,"177 and was therefore subject to the full one-year preference period.178 Moreover, this preference could be recovered either from the guarantor or from the creditor itself.179 Thus, an insider guaranty could actually harm the lender if the debtor filed for bankruptcy by making it possible

175. See 11 U.S.C. § 547(b)(4)(B) (1999). Although there is no bright-line definition of insider, it includes officers, directors, general partners, or relatives of the debtor. See 11 U.S.C. §101(31) (1999). Because the definition of insider is not exclusive, it is possible to argue that, on the facts in a given case, a creditor had such extensive control over the debtor that the creditor had become an "insider" in its own right. The case law, however, has generally permitted a substantial exercise of control by creditors without deeming those creditors to have become insiders, and certainly more than is exercised merely by threatening enforcement of an insider’s guaranty. See, e.g., Carlson v. Farmers Home Admin. (In re Newcomb), 744 F.2d 621, 625 (8th Cir. 1984) ("It is conceivable that a creditor could become so involved in the day-to-day business of a debtor as to become an insider. However, the mere fact that a large creditor has 'control' over the debtor, in the sense that the creditor can compel payment of a debt, does not make the creditor an insider."); Gray v. Giant Wholesale Corp., 758 F.2d 1000, 1003 (4th Cir. 1985) (holding that creditor who controlled dispensation of debtor's checks was not an insider).

176. Named after the case that made the issue prominent, Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Corp), 874 F.2d 1186 (7th Cir. 1989). The basic reasoning — that a payment to a creditor may be avoided as a preference because it is a payment for the benefit of an insider — pre-dates the current Bankruptcy Code. See, e.g., Smith v. Totstevin, 247 F. 102 (2d Cir. 1917) (holding that payment to bank was voidable as preference to debtor's wife, who had pledged collateral to secure the loan); Bullard v. Aluminum Co. of Am., 468 F.2d 117 (2d Cir. 1972) (holding that payment transferential where benefit accrued to debtor's president).


179. See 11 U.S.C. § 550 (1999). This provision governs the recovery of an avoided transfer, and section 550(a) provides, in relevant part, that an avoided transfer may be recovered from "(I) the initial transferee of such transfer or the entity for whose benefit such transfer was made. . . ."
for the debtor to recover payments that had been made to the lender between ninety days and one year before the filing.

The Deprizio decision elicited a tremendous response. The lending community reacted with loud expressions of shock and outrage, protesting that the decision was unreasonable and unfair. Commentators defended or attacked the decision. While the precise theory on which insider preferences should be condemned has often been disputed, the common explanation is that it is unfair to permit insiders to use their superior information regarding the firm's affairs to advantage themselves at the expense of other creditors. Few, if any, of Deprizio's critics disagreed with this sentiment. Rather, they responded that it was unfair to "punish" the "innocent" lender for its prudence in taking a guaranty.


181. See, e.g., Tom Lane, Recovery of Avoidable Transfers from the "Initial Transferee" Under Section 550(a) of the Bankruptcy Reform Act of 1978, 96 COM. L.J. 457 (1991) (supporting Deprizio); Peter L. Borowitz, Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio, 45 BUS. LAW. 2151 (1990) (defending the policy basis, but not technical reasoning, of Deprizio); Pitts, supra note 9 (advocating the reading of section 550(a) that was later adopted in Deprizio); Dix, note, supra note 101.


183. See cases cited by McCoid, supra note 142, at 819-20; WILLIAM A. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §7469 (Timothy P. Bjur & J. Jeffrey Reinholzt, eds., rev. vol. 1990) ("Generally, the rule prohibiting preferences to directors is not founded upon the trust fund doctrine, but upon the theory that it is inequitable that directors, whose knowledge of conditions and power to act for the corporation give them an advantage, should be permitted to protect their own claims to the detriment of others at a time when it is apparent that all the unsecured debts of the corporation are equally in peril and that all of them cannot be paid.").

184. Many cases finding for lenders, prior to the Deprizio decision itself, relied on vague
With the widespread adoption of the Deprizio reasoning, lenders found themselves in a quandary. On the one hand, they did not want to give up the benefits of insider guaranties. On the other hand, they were seriously troubled by the risk presented by a one-year preference period. Rather than abandoning insider guaranties — and pending the outcome of a substantial lobbying effort to have the rule reversed — lenders fastened on a supposed “solution” to the Deprizio problem: having the insider guarantor waive its rights to recover from the debtor by way of subrogation or reimbursement for any amounts paid under the guaranty.185 With such a waiver, some courts have held, the insider is not a “creditor” with respect to the guarantied obligation, and so the payment does not benefit an insider “creditor” and is not subject to the one-year preference period.186

The effects of the Deprizio doctrine were substantially curtailed by the Bankruptcy Reform Act of 1994.187 Under the Reform Act's amendments to section 550 of the Bankruptcy Code, if a transfer made between ninety days and one year before the filing of the bankruptcy petition is avoided as a preference because it was made for the benefit of a creditor who was an insider, the payment may not be recovered from a transferee incantations of the “inequity” of applying the extended preference period to an outside creditor. See, e.g., In re Performance Communications, Inc., 126 B.R. 473, 477 (Bankr. W.D. Pa. 1991) (holding that it would be inequitable for the lender to suffer for its prudence); In re Aerco Metals, Inc., 60 B.R. 77, 82 (Bankr. N.D. Tex. 1985) (stating that the law should not “punish the Bank for [its] prudence”); In re R.A. Beck Builder, Inc., 34 B.R. 888, 894 (Bankr. W.D. Pa. 1983) (stating that it would be inequitable to “penalize” bank for its prudence); see also COLLIER, supra note 174, § 550.02.


186. See, e.g., In re Deprizio Constr. Corp., 874 F.2d at 1191-92; In re Northeastern Contracting Co., 187 BR 420 (Bankr. D. Conn. 1995); In re XTI Xonix Tech., Inc., 156 BR 821 (Bankr. D. Or. 1993); In re Fastrans, Inc., 142 BR 241 (Bankr. E.D. Tenn. 1992). Professor Westbrook has argued that such waivers should be held unenforceable, but no court has yet held them so. See Westbrook, Two Thoughts, supra note 122, at 88; see also Covey v. Northwest Community Bank (In re Helen Gallagher Enter., Inc.), 126 B.R. 997 (Bankr. C.D. Ill. 1991) (suggesting, in dicta, that reimbursement waiver may be unenforceable). The requirement that there be a nexus between the guaranty and the insider's status as a creditor has been criticized on both technical and policy grounds. See, e.g., Borowitz, supra note 181, at 2156 (arguing that a waiver of subrogation rights only increases the incentive for the guarantor to prefer the creditor whose obligation he guaranteed); David L. Katzen, Deprizio and Bankruptcy Code Section 550: Extended Preference Exposure via Insider Guarantees, and Other Perils of Initial Transferee Liability, 45 Bus. Law. 511, 530-51 (1990) (same); Given, Lenders Gunned Down in Gangland Killing — Preferences After Deprizio, FALKNER & GRAY'S BANKR. L. REv., Winter 1990, 53, 56 (stating that waiver of subrogation rights increases incentive to prefer the guarantied creditor, and may add merit to the contention that the payment is a fraudulent conveyance made with the intent to hinder, delay or defraud other creditors).

who was not an insider. 188

Note that this amendment does not fully remove the burden imposed by the Deprizio rule. It does not change the definition of a preference, contained in section 547, to eliminate payments made between ninety days and one year before the bankruptcy filing on obligations guarantied by an insider. These payments are still avoidable preferences and can still be recovered from the insider guarantor. Under section 550(c), however, they can no longer be recovered from the creditor.

Although the estate cannot recover these payments from the creditor, the creditor may still suffer various ill effects from the fact that these payments fall within the definition of preferential transfers. For example, section 502(d) provides that the court shall disallow the claims of any party who is a transferee of an avoidable transfer unless the party has returned the transfer. 189 Thus, if the guarantor cannot or does not repay the preference, the creditor’s claims against the estate may be disallowed. Moreover, if the preferential transfer was the granting of a lien to the creditor to secure a preexisting debt, then the transfer can still be avoided under section 547 (voiding the lien); the proscription in section 550(c) does not apply because the estate has no need to recover anything from the creditor under section 550(a). 190 To avoid these problems, many lenders continue to insist upon subrogation and reimbursement waivers from their insider guarantors notwithstanding the 1994 amendments that supposedly reversed the Deprizio doctrine.

As can be seen from this short recital, the preference analysis of debts secured by insider guaranties has received a great deal of attention. 191 By and large, however, the analysis has taken place at an historical and doctrinal level, supplemented with ad hoc judgments about the coercive effects of guaranties. In analyzing the preference issues, little

188. See 11 U.S.C. § 550 (1999). The 1994 amendments added section 550(c), as follows:

   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.

189. Section 502(d) provides in relevant part that

   the court shall disallow any claim of any entity from which property is recoverable under section ... 550 ... of this title, or that is a transferee of a transfer avoidable under section ... 547 ... of this title, unless such entity or transferee has paid the amount ... for which such entity or transferee is liable. ...


190. See, e.g., Williams v. Assocs. Home Equity Serv., Inc., 1999 WL 388210 (Bankr. D. Or. 1999) (holding that the preferential transfer of a lien may be avoided under section 547 without invoking the recovery provisions of section 550).

191. See, e.g., McCoid, supra note 142, at 806 (“Because no unified approach to the problem exists, the courts have reached conflicting results in insider preference cases.”).
or no effort seems to have been made to systematically examine the functions of the insider guaranty.

Consider an oft-cited exchange between two highly respected commercial law scholars, Professors Jay Westbrook and Peter Alces. Professor Westbrook argued that the commentary on *Deprizio* had generally overlooked two essential points, one of which was "the distinction between insider guarantees taken for their economic value, because the insider has the wherewithal to pay the debt, and those that are purely a matter of pressure on the insider to misdirect the debtor's funds." Professor Alces responded in part that this dichotomy was unrealistic, because all guaranties are a mixture, intended to accomplish both functions to greater or lesser degrees. What both points of view share is an assumption that the leverage aspect of an insider guaranty is generally improper or illegitimate. They focus on the creditor's ability to use its leverage to compel preferential treatment, minimizing the broader functions and benefits offered by insider guaranties.

Professor Westbrook notes approvingly that *Deprizio* will discourage lenders from taking "pure leverage" guaranties, meaning that the guarantor does not have wealth to make payment on the guaranty and the purpose of the guaranty is simply to provide leverage to the creditor to secure a preferential payment. What Professor Westbrook does not explain is why the preferential effect of this creditor leverage — to the extent that it exists against an impecunious guarantor — will exceed

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194. Alces, *Rethinking*, supra note 122, at 621-23
195. Neither completely ignores this fact. See Westbrook, *Two Thoughts*, supra note 122, at 84 n.46 (discussing, in a footnote, the way an insider guaranty may induce a guarantor to assist in an efficient liquidation of the debtor); Alces, *Clearer Conceptions*, supra note 192, at 1110-11 (noting the commitment aspect of the guaranty). Yet neither appears to consider it a significant element of the analysis, repeatedly seeming to assume that the only relevant function of leverage is to secure a preferential payment should the debtor get into financial trouble.
196. See Westbrook, *Two Thoughts*, supra note 122, at 80-81 ("[T]he value of this sort of guarantee to the lender lies almost completely in the exercise of precisely the sort of pressure the anti-dismemberment policy is designed to prevent.").
197. See Westbrook, *Two Thoughts*, supra note 122, at 80-81, 85.
198. Professor Alces questions whether a guaranty can pressure an insider who lacks assets to pay on that guaranty. Alces, *Rethinking*, supra note 192, at 616-18. Professor Westbrook suggests that "the leverage on a pure-leverage guarantor must consist of either the threat to seize assets of great personal value to the insider, but of little intrinsic value, or the threat of being forced into personal bankruptcy. Both aspects of the pure-leverage guarantee are in terrorem pressures that are generally regarded as quasi-legitimate at best." Westbrook, *Two Thoughts*, supra note 122, at 82.
its beneficial effects. If insider guaranties are primarily a means of screening borrowers, reducing agency costs, and ensuring the insider’s commitment to the business,\textsuperscript{199} then \textit{Deprizio}, if it discouraged the taking of such guaranties, could have significant economic costs.

Moreover, Professor Westbrook’s expectation that \textit{Deprizio} would discourage “leverage” guaranties but not “true” guaranties might have been accurate had courts agreed with him that reimbursement waivers should be held unenforceable.\textsuperscript{200} However, because the courts seem to have rejected this suggestion, lenders can continue to take leverage guaranties; they just have to change the form contracts they use. Indeed, the insider’s motivation to cause the debtor to pay the guarantied creditor ahead of others is increased by a reimbursement waiver because payment by the debtor is the only way for the guarantor to avoid bearing the ultimate liability.\textsuperscript{201} If these waivers are enforceable, as it appears they are, then one of Professor Westbrook’s primary bases for supporting the extended preference period (that it will discourage leverage guaranties) is lost.

An agency theory approach to insider guaranties provides separate and distinct bases for supporting the \textit{Deprizio} rule and opposing the creditor protection granted by Congress under section 550(c). As discussed above, an insider guaranty may improve the incentives for management to make efficient investment decisions in or near insolvency.\textsuperscript{202} The \textit{Deprizio} extension of the preference period on payments to the guarantied creditor is one means of preserving these beneficial incentive effects. If the guaranty leads the firm to repay the guarantied debt between ninety days and one year before the filing and that payment cannot be recovered from either the creditor or the guarantor, then the benefits of converting the managing equity holder into a creditor are lost. If the payment can be recovered, however, then the insider will want to maximize the value of the bankruptcy estate in order to minimize its guaranty liability. Thus, the extension of the preference period seems to further the monitoring and bonding aspects of the insider guaranty, benefitting the entire estate.

If section 550(c) renders the payment unrecoverable from the creditor, and if the guarantor lacks the funds to repay the preferential payment (a situation that is probably not uncommon), these benefits will be lost. Without section 550(c), recovery from the guarantied creditor would likely be available, and would restore the incentive effects identi-

\textsuperscript{199} See supra Part II.B.
\textsuperscript{200} Westbrook, \textit{Two Thoughts}, supra note 122, at 81.
\textsuperscript{201} See Alces, \textit{Rethinking}, supra note 192, at 626.
\textsuperscript{202} See supra text accompanying notes 95-127.
fied above.\textsuperscript{203}

Section 550(c) may drive a wedge between the interests of the insider and the interests of other creditors in a second way. If the insider lacks the funds to repay the avoided transfer, then not only is the insider not a creditor on account of the reimbursement claim for the guarantied debt (because the insider has not paid that debt),\textsuperscript{204} but any other claims held by the insider will also be disallowed, under section 502(d). But it is desirable for the insider creditor to hold general claims against the estate because they provide an enhanced incentive to maximize the return to creditors.\textsuperscript{205}

If section 550(c) can be criticized for protecting guarantied creditors too much, it can also be criticized for protecting them too little. An agency analysis supports Professor Westbrook in objecting to the effects of reimbursement waivers, because such waivers diminish the incentive alignment effects of the insider guaranty. Recall that under a traditional insider guaranty, the beneficial incentive effects exist both before payment (because the guarantor wants to reduce its liability) and after payment (because the guarantor wants to maximize its recovery on its subrogation or reimbursement claim against the debtor).\textsuperscript{206} However, if the guarantor has waived its right to recover from the debtor for payments made on the guaranty, then the incentive benefits of the guarantor’s residual claimant status are lost once the guarantor pays the creditor. Thus, reimbursement waivers reduce the ability of the guaranty to mitigate perverse prebankruptcy incentives.\textsuperscript{207} For this reason, the changes made by the 1994 amendments would probably be beneficial if they induced creditors to drop the demand that guarantors waive their reimbursement rights. Because the 1994 Amendments only partially undid the \textit{Deprizio} reasoning, however, and lenders still suffer potential risks from the extended preference period,\textsuperscript{208} lenders are continuing to

\textsuperscript{203} If the insider does not have the assets to repay the preference, then the insider may not have much at risk on its guaranty, and thus the incentive alignment will be less than perfect. The guaranty, however, is still likely to improve incentives to some extent.

\textsuperscript{204} See 11 U.S.C. § 502(e)(1)(B) (1999) (disallowing any claim for reimbursement or contribution by a guarantor if that claim is still contingent as of the time of allowance or disallowance).

\textsuperscript{205} See supra Part III.A.

\textsuperscript{206} See supra Part III.C.

\textsuperscript{207} It could be argued that the willingness of creditors to continue to take insider guaranties with the indemnification waiver indicates that the incentive alignment effects identified above are not the motivating force behind insider guaranties. I believe this overstates the case. Rather, it appears that creditors would prefer a guaranty with a waiver to no guaranty at all. This makes sense, considering that the guaranty with waiver of reimbursement still provides both bonding and screening functions, albeit less robustly, as well as an additional potential source of repayment.

\textsuperscript{208} See supra text accompanying note 190.
seek these waivers, and some of the value of insider guaranties is being lost.

Moreover, if the insider guaranty is intended to provide an incentive for the equity holders to maximize the value of the firm in periods of financial distress, a central means of doing this may be through an out-of-court restructuring. The extended preference period has been criticized as being inimical to workouts, because payments or security offered to a guarantied creditor as part of a restructuring will be avoided in any bankruptcy filed within a full year. Thus, lenders may hesitate to enter into restructurings. Viewed another way, by extending the preference period, the insider guaranty may create an opportunity for a debtor to file for bankruptcy simply to avoid concessions previously made to a guarantied lender. The concern for consensual restructurings appears consistent with the basic thrust of section 550(c): holding the insider liable for recovery of the preference, but not the lender. Properly implemented, this scheme would allow the lender to make concessions toward a workout without fear of extended liability. It would also discourage the insider from making concessions with the debtor's assets to avoid liability on the guaranty, because the insider knows it may be held liable for the recovery of those concessions. Unfortunately, section 550(c) falls short of offering this type of protection to workouts, because many concessions that would be made to a lender during the extended preference period (such as new or additional liens) are still subject to avoidance under section 547.

In short, the protection of creditors under Section 550(c) appears to be the worst of all possible worlds. The Code now prohibits recovery of the preferential transfer from the party most likely to be able to pay. This reduces the beneficial incentive effects of the insider guaranty. Section 550(c) will often damage shareholder incentives further by leading to the disallowance of insider's claims under section 502(d). And because Congress chose to address the problem through the recovery provision rather than by modifying the definition of a preferential transfer in section 547, workouts will still be discouraged and lenders will still insist on reimbursement waivers, further damaging the positive incentive effects of insider guaranties.

B. Springing and Exploding Guaranties

1. Background

   If the Deprizio debate was the first issue to put a spotlight on

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209. This argument was raised in the Deprizio opinion itself but the court discounted it, writing, "the fear of bankruptcy replacing some workouts does not lead us to shy away from an ordinary reading of the statute." In re Deprezio Constr. Corp., 874 F.2d at 1198.
insider guaranties, we can now see the outlines of the second: "springing" and "exploding" guaranties. A springing guaranty is a guaranty of an enterprise's debt, given by an insider, which will become effective only upon specified conditions.\(^{210}\) Typically, those conditions include the filing of a bankruptcy case by the borrower or failure to have any involuntary bankruptcy case quickly dismissed. An exploding guaranty is the mirror image, a guaranty that is in effect but will become void if the borrower cooperates with the lender after any default. The effect is the same: The insider will be personally liable for the debt if the borrower contests the lender's rights or remedies, or files a bankruptcy proceeding, after default. The insider will be free from liability if the borrower "rolls over" and lets the lender enforce its remedies without a contest.\(^{211}\)

These devices (hereinafter referred to as "bankruptcy-contingent guaranties") were developed in the early 1990s and have rapidly become


\(^{211}\) The same effect can be created in nonrecourse lending, which is common in commercial real estate finance, by creating a "carve-out" from the nonrecourse provisions. See, e.g., Alan Wayte, Non-Recourse Clause, reprinted in Modern Real Estate Transactions 1575, 1585-86 (ALI-ABA Resource Materials, 11 ed. 1996) which provides in relevant part:

(d) Notwithstanding the limitation of liability in subsection (a) above, Borrower shall be fully personally liable for all of Borrower's obligations under the Loan Documents, and Lender's recourse to the personal assets of Borrower and its constituent partners shall not be limited in any way by this Section X, if Borrower (A) attempts to prevent or delay the foreclosure of the Mortgage or any other collateral for the Loan or the exercise of any of lender's other remedies under any Loan Document, or (B) claims that any Loan Document is invalid or unenforceable and such a claims [sic] will have the effect of preventing or delaying such foreclosure or any other exercise of remedies. Without limitation, Borrower shall be deemed to have attempted to prevent or delay such foreclosure or other exercise of remedies if (i) Borrower files a petition under the Bankruptcy Reform Act of 1978, 11 U.S.C. § 101 et seq. (the "Bankruptcy Code"); as amended, (ii) Borrower opposes a motion by Lender to lift an automatic stay imposed pursuant to 11 U.S.C. § 362 and for leave to foreclose the Mortgage and any other collateral for the Loan, or (iii) Borrower files a proposed plan of reorganization under the Bankruptcy Code under which Lender would receive (x) less than all of the Property or (y) a lien encumbering less than all of the Property or (z) a lien having a lower priority or terms less favorable to Lender than the Mortgage as it existed immediately prior to the filing of a petition under the Bankruptcy Code. . . .
Although they raise difficult legal and policy issues, the strength of the economy through the 1990s has generally prevented lenders from having to enforce them, and so there is, as of yet, little case law on their enforceability. Bankruptcy-contingent guaranties are the clearest example of "pure-leverage guaranties." Their function is not to assure an additional means of repayment of the debt should the borrower default. Rather, they ensure that the borrower will make every effort to live up to its contractual promises and will not hamper the creditor in its efforts to enforce its rights and recover its debt. Bankruptcy-contingent guaranties are most widely used in three contexts. First, they may be used in financing for closely-held businesses, where a single or small number of shareholders, members, or partners own and control the borrower. Second, they are used in commercial real estate lending. Third, they are increasingly common as an adjunct to creating "bankruptcy remote" entities in securitized financing transactions.

The challenges to bankruptcy-contingent guaranties are likely to come from several different directions. There will be arguments that they are unenforceable as a matter of state law because they violate pub-

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212. While conversations with practitioners confirm that bankruptcy-contingent guaranties are now a standard part of commercial transactions, there is no real data on the prevalence of these devices. Indeed, to the extent a bankruptcy-contingent guaranty serves its purpose, there never will be a judicial record of its existence. Some indication of the growth of the bankruptcy-contingent guaranty may be found in the secondary literature. There are no references to springing or exploding guaranties in the WESTLAW TP-ALL database (all texts and periodicals) prior to 1996; four in 1996; six in 1997; 10 in 1998; and ten in the first half of 2000. Only in the last three or four years have form books started including bankruptcy-contingent guaranties. See sources cited supra note 210.

213. See infra at Part IV.B.2 (discussing cases on bankruptcy-contingent nonrecourse carve-outs).

214. The term is borrowed from Professor Westbrook, but note an important difference from the context in which he used it — to refer to any insider guarantee from a guarantor who is "not likely to be able to offset any shortfall in the debtor's performance." See Westbrook, Two Thoughts, supra note 122, at 80. Here, the point is that, regardless of whether or not the guarantor is solvent, the entire purpose of the guaranty is to control behavior rather than to provide additional financial resources.

215. See, e.g., Joshua Stein, Nonrecourse Carveouts: How Far is Far Enough?, REAL EST. REV. (Summer 1997); Frederick Z. Lodge, et al., Bankruptcy Remote Structures in Mortgage Loans, Prob. & Prop., June 10, 1996, 49 Russell L. Munsch, et al., The Changing Commercial Real Estate Environment - Are Commercial Real Estate Workouts Dead?, (Dallas Bar Ass'n, Nov. 5, 1997) (visited June 1999), available in <http://www.munsch.com/hottopics/environment1.html> ("The standardization of commercial real estate loan documentation nationwide, as well as structured impediments to the commencement of insolvency proceedings and bankruptcy cases (including the proliferation of 'springing guaranties'), may adversely impact upon the willingness or ability of commercial real estate owners to seek the protection of these forums."); Kenneth M. Block & Jeffery B. Steiner, Stays of 'Springing Guaranties': How Creditor Can Enforce Rights Against Non-Debtor Guarantor, N.Y. L.J., July 17, 1996, at 5 (stating that springing guaranties "are common in real estate loans and financings").
lic policy. They will be challenged in bankruptcy cases, where debtors and guarantors will seek temporary and permanent injunctions against their enforcement. These attacks will go beyond the guarantor’s liability, as debtors seek to have lenders’ claims equitably subordinated on account of the leverage created by the guaranty. In the following sections, I review the sparse caselaw on springing and exploding guaranties, then examine the fiduciary duty and bankruptcy policy arguments against their enforcement.

2. CASE LAW

Only two reported cases address bankruptcy-contingent guaranties, with each case structured as a nonrecourse carve-out in a real estate mortgage. Both found the guaranties enforceable. Consider first the Fourth Circuit’s decision in FDIC v. Prince George Corp.216 After foreclosure, the FDIC sued a joint venturer for a deficiency judgment on the joint venture’s nonrecourse mortgage note. The nonrecourse clause had a carve-out providing that the note would become recourse “to the extent that Holder’s rights of recourse to the property which is then subject to the Mortgage are suspended, reduced, or impaired by or as a result of any act, omission or misrepresentation . . . or by or as a result of any case, action, suit or proceeding to which [the borrower or any other liable party] voluntarily becomes a party.”217 In essence, the carve-out was a springing guaranty by the joint venturers.

The district court held that the borrower’s bankruptcy filing was an “act” triggering liability under this provision, but for “policy reasons”, the court declined to hold that the borrower’s actions in resisting the foreclosure itself gave rise to liability.218 The court stated that if the “lender intended to use the threat of a deficiency judgment as an incentive to induce PGC to give up its right to defend against foreclosure, such an extreme position should have been more clearly stated.”219 The district court thus awarded damages based on the sixty-three days by which foreclosure had been delayed by the borrower’s bankruptcy filing.220

On appeal, the guarantor argued that the borrower had a statutory right to bankruptcy protection and that any waiver of that right was void on public policy grounds.221 The Fourth Circuit rejected that argument, noting that the contract “did not prohibit PGC from resorting to bank-

216. 58 F.3d 1041 (4th Cir. 1995).
217. Id. at 1044.
218. See id. at 1045.
219. See id. at 1047.
220. Id.
221. See id. at 1046.
ruptcy; it merely provided that if POC took certain actions it would forfeit its exemption from liability for any deficiency. 222 Moreover, the court held that the unambiguous language imposed deficiency liability for "any act" that impaired the lender's recourse rights, language that includes the borrower's defense of the foreclosure proceeding. 223 The Fourth Circuit therefore remanded for a determination of liability based on the delays caused by both the bankruptcy case and the borrower's defense of the foreclosure action.

The second case that considers springing guaranties is similar. In *First Nationwide Bank v. Brookhaven Realty Assocs.*, 224 the debtor real estate partnership had entered into a nonrecourse mortgage with a carve-out providing that the partners would be individually liable should the partnership ever file for bankruptcy. After default, the partnership filed for bankruptcy, although the case was later dismissed. The lender then sued the partners, who argued that the bankruptcy-contingent liability was unenforceable under the Bankruptcy Code's prohibition of *ipso facto* clauses. 225 The court rejected this argument on numerous grounds, including the facts that the *ipso facto* prohibition applies only to executory contracts, not mortgages, and that once the bankruptcy cases had been dismissed, the enforceability of the agreement was a matter of state law rather than bankruptcy law. 226

While both of these cases enforced bankruptcy-contingent liabilities, they should provide little comfort to lenders. In each case, the bankruptcy proceeding had been dismissed prior to the initiation of the guaranty suit, making these poor candidates to test the robustness of springing guaranties in the face of a strong bankruptcy policy argument. Moreover, both cases were single-asset realty cases, meaning that the borrowers had few, if any, creditors other than the mortgagee. As a result, state law fiduciary duties that might have been owed to creditors were not relevant either. In other words, these were the easy cases, to which the arguments against bankruptcy-contingent guaranties do not readily apply.

3. **FIDUCIARY DUTIES**

Perhaps the most obvious argument against springing and exploding guaranties — on appropriate facts 227 — is that they are intended to create a conflict between the guarantor's self-interest and the fiduciary

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222. Id.
223. See id. at 1048.
226. See *Brookhaven Realty*, 637 N.Y.S.2d at 421.
227. This argument is factually inapposite in single asset real estate cases like *Prince George*
duties owed to all of the borrower's creditors as the borrower becomes insolvent. From this observation, it would seem only a small step to the conclusion that bankruptcy-contingent guaranties are unenforceable. Breach of fiduciary duty is a tort, and it is elementary contract law that an agreement intended to induce the commission of a tort violates public policy and is not enforceable. This argument does not rely on the Bankruptcy Code or bankruptcy policy. It simply asserts that a springing or exploding guaranty is not enforceable as a matter of state law.

This is consistent with the traditional view of the duties of corporate directors. Courts have routinely held that contracts limiting the ability of corporate directors to exercise their independent judgment are unenforceable. While this argument may prevail in some jurisdictions, the general victory of the contractarian view of fiduciary duties is likely, in many cases (depending on the jurisdiction and the type of business entity involved), to prevent it from applying. The law of business organizations now largely eschews mandatory terms — even when it comes to fiduciary duties. Mandatory terms have been derided as ineffective, because they can be avoided in many cases by explicit charter or contractual choices, by organizing in another jurisdiction that does not impose the same mandatory term, or by choosing another

228. See Restatement (Second) of Contracts § 192 ("A promise to commit a tort or to induce the commission of a tort is unenforceable on grounds of public policy."). A related argument that could be made, yet would likely fail, is that the threat to exercise a springing guaranty violates a fiduciary duty owed by the lender. While it is generally true that a lender owes no fiduciary duties to its borrowers, to the extent that a creditor is able to exercise control over a particular decision made by a debtor's board of directors, the creditor may be found to have fiduciary duties with regard to that decision. See, e.g., Anaconda-Ericsson, Inc. v. Hessen (In re Teltronics), 29 B.R. 139, 170-71 (Bankr. E.D.N.Y. 1983) ("The general rule that a creditor is not a fiduciary of his debtor is not without exception. In the rare circumstance where a creditor exercises such control over the decision-making processes of the debtor as amounts to a domination of its will, he may be held accountable for his actions under a fiduciary standard.").

229. See, e.g., 18B AM. JUR. 2d Corporation § 1487 ("A contract by a director of a corporation that limits or restricts him in the free exercise of his judgment or discretion, or that places him under direct and powerful inducements to disregard his duties to the corporation, its creditors, and other stockholders in the management of corporate affairs, is against public policy and void.") (citing cases); William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors (5th ed. 1993) § 4-20 (citing cases).

230. This is a far from settled issue, and the literature addressing the wisdom or folly of permitting fiduciary duties to be waived in the business setting has become immense. A primary resource on the debate in the corporate arena is Symposium: Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1395 (1989). A recent round in the debate, focusing on partnership and other unincorporated entities, can be found in Symposium on the Future of the Unincorporated Firm, 54 WASH. & LEE. L. REV. 387 (1997).


232. See id. at 11.
form of organization.\textsuperscript{233} They have also been criticized as inefficient, because they require investors to acquiesce to a relationship whose terms they do not believe are optimal.\textsuperscript{234}

For the moment, these criticisms seem to have largely carried the day.\textsuperscript{235} In New York, for example, the duty of loyalty does not prohibit self-dealing if the personal interest is disclosed and approved by the disinterested directors.\textsuperscript{236} Delaware has a similar provision.\textsuperscript{237} In the context of close corporations, courts have applied somewhat higher standards of loyalty as between majority and minority shareholders, given the position of dependence that minority shareholders find themselves in.\textsuperscript{238} However, there is no reason to expect these higher standards to apply when courts consider the fiduciary duties owed by shareholder managers of an insolvent close corporation to the firm’s creditors. And in some jurisdictions, such as Delaware, the discretion of board members or managing shareholders in a close corporation may be modified or controlled by written agreement of a majority of the shareholders.\textsuperscript{239}

This trend toward waivable fiduciary duties is also apparent in recent statutory enactments governing noncorporate business entities. For example, under the Uniform Limited Liability Company Act (1995) and the Revised Uniform Partnership Act (1994), a partner or manager’s duty of loyalty may not be waived; however, the partnership or operating agreement may “identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable.”\textsuperscript{240} The Uniform Acts, of course, are not binding on the states, and

\textsuperscript{233} Id.
\textsuperscript{234} See generally id.

A number of state statutes have attempted to create an entity [the limited liability company] that is entirely a creature of contract and not bound by any mandatory fiduciary duties whatsoever. Some commentators argue that the abolition of mandatory fiduciary duties will make LLCs the entity of choice among business forms, including closely held and publicly traded companies. Indeed, Delaware has paved the way for this eventuality by removing any obstacles for trading LLCs on the secondary markets and by explicitly basing its LLC laws on the contractarian model of the corporation.

\textit{Id.} at 459 (citations omitted).
\textsuperscript{236} See N.Y. BUS. CORP. LAW § 713(b) (McKinney 1986).
\textsuperscript{237} See DEL. CODE ANN. tit. 8, § 144 (1991).
\textsuperscript{239} See 8 DEL. CODE ANN. §§ 350-354 (1999).
\textsuperscript{240} § 103(b)(2)(i) (1995); REVISED UNIFORM PARTNERSHIP ACT (R.U.P.A.) § 103(b)(3)(i)
some states, most notably Delaware, have loosened the restrictions even further.\textsuperscript{241}

The defense of bankruptcy-contingent guaranties under this contractarian approach is simple enough. The question is whether the potential conflict is to be viewed from an \textit{ex ante} perspective, from which the "conflict" is a deliberate decision by the corporation to bind its managers to a particular approach to insolvency, or from an \textit{ex post} perspective, which examines the situation as a conflict of interest arising at the point of insolvency. Viewed \textit{ex post}, the decision to stay out of bankruptcy may be a breach of the duty of loyalty — unless it is permissible for the parties to enter into a defined modification of the duty of loyalty in specified future circumstances, where that modification is in the corporation’s interest at the time it is executed. What looks like a conflict of duties at the time of insolvency is really a process for bonding the entity’s decision makers to ensure that they will carry out those acts which, at the time of financing, the entity has determined best advance its goals.

As a matter of corporate law (but not necessarily bankruptcy law), this argument seems likely to prevail. While some early cases held that a director could not enter into a contract that could create a personal interest in conflict with the director’s fiduciary duty to the corporation,\textsuperscript{242} this is no longer the prevailing law. In most states today, a corporation may enter into a contract with a director if a disinterested quorum and voting majority of directors supports the transaction, or if the director shows the fairness of the transaction. Conflicts are not per se impermissible, and if appropriate disinterested parties (directors or a judge) believe the transaction is in the corporation’s interest, there is no violation.

Put in this light, bankruptcy-contingent guaranties seem unobjectionable. It is hard to argue that an insider is taking advantage of the firm when he assumes the risk of liability for the firm’s debt in order to

\textsuperscript{241}See \textit{Del. Code} § 18-1101(c) (1999), which states

\textsuperscript{242}See JAMES D. COX, et al., \textit{CORPORATIONS}, § 10.12-14.
secure financing for the firm.\textsuperscript{243} As one court has said in a different context, the fiduciary duty of a controlling shareholder "does not require self-sacrifice."\textsuperscript{244}

Under modern standards of fiduciary duty, it seems that a springing or exploding guaranty can be validated by vote of the board or subsequent judicial ratification. In some contexts, such as the LLC or partnership setting, the validation may occur through provisions in the organizing documents.

However, the fact that a manager's fiduciary duties to other equity holders are contractually defined, modified, or waived does not necessarily settle the extent of the fiduciary duties owed to creditors upon insolvency. After all, the creditors were not parties to the modification provision, nor are the shareholders or directors who ratified it the creditors' representatives. Indeed, statutory provisions governing the modification of fiduciary duties in the LLC and partnership context explicitly state that "the partnership [operating] agreement may not . . . (10) restrict rights of third parties under this [Act]."\textsuperscript{245} It is arguable, therefore, that even under a contractarian approach to fiduciary duties, the manager should not be able to enter into a bankruptcy-contingent guaranty, which attempts to modify the incentives that will be faced by the manager at a future time when he or she will owe fiduciary duties to creditors.\textsuperscript{246}

On closer inspection, however, this argument also begins to lose

\begin{itemize}
    \item \textsuperscript{243} Most cases addressing conflict of interest situations involve a fiduciary dealing with the corporation in a manner that results in a personal benefit for the fiduciary. Thus, cases on the corporate opportunity doctrine or excess compensation or self-dealing are commonplace. In the bankruptcy-contingent guaranty context, however, the insider does not gain at the expense of the corporation by entering into the guaranty; thus, most of the existing case law seems inapposite. The closest analogy is to cases that address whether it is a breach of fiduciary duty for an insider to cause an insolvent corporation to make payments on a debt owed to, or guarantied by, the insider. See McCoid, supra note 142, at 816-21 (discussing cases that have addressed whether such payments are constructively fraudulent or reversible on "equity" grounds). At least these cases present situations where an insider entered into a contract from which the insider could only lose in order to benefit the corporation. Courts have held that later actions taken to mitigate the insider's loss, at the expense of other creditors, could be a breach of fiduciary duties. Bankruptcy-contingent guaranties would seem to pose an even stronger case for condemnation. The insider preference cases concern a question that is purely distributional (which creditors will be paid from a given pool of assets), while the bankruptcy-contingent guaranty may prevent the firm from maximizing its assets, distributional questions aside.
    \item \textsuperscript{244} Getty Oil v. Skelly Oil Co, 267 A.2d 883, 888 (Del. 1970).
    \item \textsuperscript{246} I am not addressing the fiduciary duties of the manager of the debtor in possession after a bankruptcy filing, which are a matter of bankruptcy law, and presumably cannot be modified by a pre-bankruptcy contractual arrangement. Moreover, the argument against springing and exploding guaranties is not that they subvert the management of the bankruptcy case because once the guarantor has "bitten the bullet" and caused the borrower to file for bankruptcy, the guaranty, if enforceable, is indistinguishable from an ordinary insider guaranty. The threat from contingent
\end{itemize}
some of its strength. Fiduciary duties run to the creditors upon insolvency because they become the residual claimants.\textsuperscript{247} This is not true if the borrower's primary debt has been guarantied by its equity holders. If an insider has guarantied the borrower's primary debt, the insider remains one of the primary residual claimants until the guarantied debt is repaid.\textsuperscript{248}

Nonetheless, an insider subject to a springing guaranty faces a basic conflict of interest, and should therefore have to excuse herself from voting on whether the firm should file for bankruptcy. While the fact that the insider is also in the position of residual claimant mitigates the conflict to some extent, it does not make the director disinterested. If the insider does not abstain, then it is likely that the insider could be held liable for breach of fiduciary duty absent a showing of the fairness of the decision made.

4. BANKRUPTCY POLICY

As noted in Part II.B., insider guaranties can help create appropriate incentives to keep firms from filing unwarranted bankruptcy cases. This is also the purpose of a bankruptcy-contingent guaranty. It might even seem that the contingent guaranty, through its tailored structure, would be superior to an unconditional guaranty. The bankruptcy-contingent guaranty, however, is less accurate in its incentives than an unconditional guaranty, creating an inappropriate overdeterrence.

Consider once again our hypothetical firm, with a liquidation value of $70 and a reorganization value of $80.\textsuperscript{249} The firm has $100 in unsecured debt, $50 of which has been protected with a springing guaranty and $50 of which is not guarantied. Clearly the firm should be reorganized, in which case creditors will lose only $20 rather than $30. From the insider's perspective, however, the choice is between nonbankruptcy liquidation with no personal liability, and bankruptcy reorganization with a personal liability of $10.\textsuperscript{250} In other words, the incentives created by a bankruptcy-contingent guaranty may prevent efficient bankruptcy filings.\textsuperscript{251}

\textsuperscript{247} See supra Part II.B.1.
\textsuperscript{248} See supra Part III.A.
\textsuperscript{249} See supra text accompanying notes 120-122.
\textsuperscript{250} One half of the $80 reorganization value, or $40, will be applied to the $50 in guarantied debt.
\textsuperscript{251} Note that this same disincentive does not exist when the insider has entered into an unconditional guaranty. The choice would then be between nonbankruptcy liquidation, which would result in personal liability for a $15 deficiency ($50 owed to the guarantied creditor, less $35 share of liquidation value), and a bankruptcy reorganization with personal liability of just $10.
Moreover, there is reason to be concerned that waivers of post-default rights may be entered into even when they are not, *ex ante*, efficient. Particularly where these waivers are used to signal creditworthiness, as insider guaranties are, it is possible that borrowers will decline to ask for efficient terms for fear of labeling themselves as unworthy borrowers.252 While this risk exists with bankruptcy waivers and insider guaranties in general, the problem is exacerbated in the case of springing or exploding guaranties: At least in the case of an outright waiver253 or unconditional guaranty, the insider has efficient incentives regarding the bankruptcy case. Thus, once the firm is in financial trouble the insider can be expected to negotiate with the waiver holder to relinquish the waiver for some reasonable *quid pro quo*.254 In the case of a springing guaranty, however, the insider’s conflict usually means that there is no one in a position to act on behalf of the creditor body. Thus, the collective action problem is likely to cripple renegotiation. In this way, bankruptcy-contingent guaranties are more inimical to the goals of bankruptcy than a simple waiver of bankruptcy rights which the debtor could seek to renegotiate without the *in terrorem* effect of the springing liability.

If springing guaranties violate a fundamental bankruptcy policy — preventing firms that would benefit from reorganization from filing and defeating the Bankruptcy Code’s ability to cure the collective action problem faced by creditors — there is still the question of what legal doctrine, if any, a bankruptcy court could use to bar enforcement of the contract. As shown above, it seems difficult to argue that the guaranty is unenforceable under state law, and obligations that are binding under state law are normally enforceable in bankruptcy.

However, a bankruptcy court could enjoin suit on a bankruptcy-

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253. Although I have argued for the enforceability of bankruptcy waivers, I am not optimistic that courts will adopt this position. See Tracht, *Contractual Bankruptcy Waivers*, supra note 152. Accordingly, throughout this analysis I assume that waivers of the right to file for bankruptcy are void on "public policy" grounds. Nonetheless, even if courts determine that bankruptcy waivers are enforceable, for the reasons expressed in this paragraph I believe that springing and exploding guaranties are suspect.

contingent guaranty using its general equitable powers under section 105. These powers are limited to actions "necessary or appropriate to carry out the provisions of" the Bankruptcy Code, so injunctive relief of this sort is not possible except insofar as it is in aid of other specific bankruptcy provisions. Equitable relief is consistent with the policies and provisions of the Code in these cases. For example, section 362 of the Code, the automatic stay, enjoins creditor actions against the debtor or its property, but does not enjoin suits against third parties. Nonetheless, courts have repeatedly entered temporary injunctions protecting third parties (such as insider guarantors) to carry out the intent of the automatic stay. Similarly, section 365(e) of the Bankruptcy Code generally invalidates provisions that grant rights against the debtor upon the filing of bankruptcy, generally called "ipso facto clauses." This provision applies only to "an executory contract or unexpired lease of the debtor," and thus would not invalidate a bankruptcy-contingent guaranty. However, where a contract against a third party has the effect of creating additional leverage over the debtor upon the filing of the bankruptcy case, as a bankruptcy-contingent guaranty does, such a contract would seem to fall within the intended functions of section 365(e).

In short, bankruptcy courts should be willing to invoke their authority under section 105 to further the policies effectuated by sections 362 and 365(e)(1) by temporarily enjoining suits on bankruptcy-contingent guaranties. The reasoning is consistent with, but more persuasive than, other cases in which bankruptcy courts have granted temporary injunc-

255. 11 U.S.C. § 105(a) provides, in relevant part: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."
256. See Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (stating that authority under section 105 is limited because "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code").
257. See, e.g., Credit Alliance Corp. v. Williams, 851 F.2d 119 (4th Cir. 1988).
258. It generally has been held that bankruptcy courts do have the power to temporarily enjoin suits against third parties, such as guarantors, where the injunction is necessary to facilitate the reorganization. Cases in which such injunctions have been granted to protect insider guarantors include: In re Third Eighty-Ninth Assoc., 138 B.R. 144 (S.D.N.Y. 1992); Litchfield Co. of S.C. L.P. v. Anchor Bank (In re Litchfield Co. of S.C. Ltd. Partnership), 135 B.R. 797 (W.D.N.C. 1992); In re Lomas Fin Corp., 117 B.R. 64 (S.D.N.Y. 1990); First Federal Sav. & Loan Ass'n of Little Rock v. Pettit, 12 B.R. 147 (E.D. Ark. 1981); In re F.T.L., Inc., 152 B.R. 61 (Bankr. E.D.Va. 1993); Codfish Corp. v. FDIC (In re Codfish Corp.), 97 B.R. 132 (Bankr. D. P.R. 1988); In re Kasual Kreations, 54 B.R. 915 (Bankr. S.D. Fla. 1985); In re Northlake Bldg Partners, 41 B.R. 231 (Bankr. N.D. Ill. 1984). For discussions of the temporary injunction issue, see Paul H. Deutch, Note, Expanding the Automatic Stay: Protecting Nondebtors in Single Asset Bankruptcy Cases, 2 AM. BANKR. INST. L. REV. 453 (1994); G.H. Ishii-Chang, Litigation and Bankruptcy: The Dilemma of the Codefendant Stay, 63 AM. BANKR. J. 257 (1989); Elizabeth H. Winchester, Note, Expanding the Bankruptcy Code: The Use of Section 362 and Section 105 to Protect Solvent Executives of Debtor Corporations, 58 BROOKLYN L. REV. 929 (1992); Zaretsky, supra note 105.
tions against the enforcement of insider guaranties on grounds that such suits threatened the bankruptcy proceedings.261 The argument is more persuasive because of the inappropriate incentives created by the bankruptcy-contingent nature of the liability.

A more difficult question will arise when the court must consider whether to permit the bankruptcy-contingent liability to be discharged pursuant to a bankruptcy plan.262 Assuming that such injunctions are not barred by section 524(e), a matter on which courts are split,263

261. See supra cases cited at note 258.
262. A more difficult question is whether a permanent injunction should be granted if the bankruptcy of the borrower does not result in a confirmed plan of reorganization. If the bankruptcy case is converted to Chapter 7 or dismissed, that is a strong indication that the filing was inefficient, and it does not seem to threaten – and indeed may support – bankruptcy policy to enforce personal liability triggered by the inappropriate recourse to bankruptcy. This is consistent with the decisions in Prince George and Brookhaven. See supra notes 217, 225. If bankruptcy waivers were enforceable, then an absolute bar on bankruptcy-contingent liability would make sense. If bankruptcy waivers are not enforceable, the costs of disabling this second-best option may be significant.

Yet, conversion or dismissal does not prove the case should not have been filed or even that the case did not benefit creditors. Moreover, given the uncertainty of any bankruptcy case, the risk of such liability would deter some efficient cases. The distorted incentive created by the bankruptcy-contingent liability, see supra text accompanying notes 249 to 251, argues for their outright prohibition, and so relief should be available to the guarantor even absent confirmation of a reorganization plan. The appropriate limitation on release of a bankruptcy-contingent liability should not be whether or not a plan is confirmed, but whether the case was filed in good faith. Courts have properly held that a bankruptcy case filed simply in order to protect guarantors is filed in bad faith. See, e.g., In re Humble Place Joint Venture, 836 F.2d 814 (5th Cir. 1991); In re North Vermont Associates, L.P., 165 B.R. 340 (Bankr. D.D.C. 1994). Again, this appears largely consistent with Prince George and Brookhaven, situations in which the bankruptcy cases were quickly dismissed. See supra notes 217, 225. It seems appropriate for state courts to leave discharge of the liability up to the bankruptcy court, which is in a much better position to determine whether the petition was filed in good faith.

263. The Ninth and Tenth Circuits have rejected the authority of the bankruptcy courts to permanently enjoin actions against third parties (effectively discharging the third parties’ obligations), relying largely on section 524(e), which provides: “Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” 11 U.S.C. § 524(e) (1999). See Resorts Int’l v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394 (9th Cir. 1995); American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.), 885 F.2d 621 (9th Cir. 1989); Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985); see also Landsing Diversified Properties-II v. First Nat’l Bank & Trust Co. (In re Western Real Estate Fund), 922 F.2d 592, 601-02 (10th Cir. 1990) (holding that section 524(e) prohibits discharge of third party). Most courts and commentators disagree. See, e.g., Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746 (5th Cir. 1995) (bankruptcy court has “related to” jurisdiction over creditors’ suits against debtor’s insurer, but lacks power to permanently enjoin such suits); In re Specialty Equip. Inc. 3 F.3d 1043 (7th Cir. 1993) (stating, in dicta, that while section 524(e) provides that the discharge does not release third parties, it “does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party.”); SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 960 F.2d 285, 293 (2d Cir. 1992) (“In bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor’s reorganization plan.” (citing A.H. Robins)); MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.), 837 F.2d 89 (2d Cir. 1988); Menard Sanford v. Mabey (In re
should a permanent injunction be permitted over the objection of a creditor holding a bankruptcy-contingent guaranty? Even in those courts that permit them, permanent injunctions protecting third parties are viewed as extraordinary relief requiring unusually powerful justifications.\textsuperscript{264} However, a bankruptcy-contingent guaranty is not, at its core, an obligation of a third party or a contract of financial assurance; it is a bonding device used to control the business decisions of the debtor, with financial liability imposed on the principals as a penalty for breach.\textsuperscript{265} As such, it is appropriate for a bankruptcy court to enjoin enforcement as part of a reorganization plan.

Although the springing guaranties were enforced in \textit{Prince George} and \textit{Brookhaven Realty}, these cases are consistent with the arguments advanced here. In each case, the debtor had no real prospect of reorganizing and the bankruptcy case had been quickly dismissed \textit{prior} to the

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Even if such permanent injunctions are within the power of the bankruptcy court, this power is seldom if ever used to protect guarantors. Cases decline to confirm reorganization plans on the grounds that they impermissibly purport to release the liability of third party guarantors or codebtors. \textit{See American Hardwoods Inc. v. Deutsche Credit Corp, (\textit{In re American Hardwoods}), 885 F.2d 621 (9th Cir. 1989); \textit{In re Rohnert Park Auto Parts, Inc.}, 113 B.R. 610 (9th Cir. BAP 1990); \textit{In re Boston Harbor Marina Co.}, 157 B.R. 726 (Bankr. D. Mass. 1993); \textit{In re Bennett Paper Corp.}, 65 B.R. 518 (Bankr. E.D. Mo. 1986); Bill Roderick Distrib. Inc. v. A.J. Mackay Co. (\textit{In re A.J. Mackay Co.}), 50 B.R. 756 (D. Utah 1985). In the only case I have been able to find in which the bankruptcy court may (the published appellate decision is unclear) have confirmed such a plan over the timely objection of a creditor, the order was reversed on appeal. \textit{See Mellon Bank v. M.K. Siegel, 96 B.R. 505 (E.D. Pa. 1989).}


\textsuperscript{264} Such injunctions have been permitted primarily when the injunction was necessary to the reorganization. In those cases, the creditor(s) being enjoined were to receive payment in full under the plan of reorganization, and the vast majority of creditor(s) being enjoined consented to the injunction. \textit{See In re Master Mortgage Inv. Fund, Inc.}, 168 B.R. 930 (Bankr. W.D. Mo. 1994) (gathering and discussing cases).

\textsuperscript{265} I use the word "penalty" carefully here to distinguish from "damages." The principal objection to the bankruptcy-contingent guaranty is that the liability is not measured by the loss occasioned by the bankruptcy filing itself.
state lawsuit seeking to impose personal liability. As the court noted in Brookhaven Realty, "The policies of providing a debtor with a fresh start and an opportunity to reorganize its finances are not present in a foreclosure proceeding."266

It remains to be seen whether, given a viable debtor, bankruptcy-contingent liability would be found invalid on "public policy" grounds or as an unenforceable penalty. Moreover, we have not yet seen a case where a bankruptcy court, rather than a state court, has been asked to rule on the enforceability of a springing guaranty or to grant an injunction barring its enforcement in order to protect the bankruptcy proceeding.

V. CONCLUSION

The treatment of insider guaranties is not a minor technical question. It is one that has significant ramifications for the overall functioning of bankruptcy law for many small businesses. In a recent article on the interactions of corporate and bankruptcy law, Professor David Skeel observed that the forms of managerial control used during the healthy life of a business organization are inherently linked to the type of bankruptcy system available to that entity.267 The U.S. system of corporate law can be characterized as one of ex post controls.268 While countries like Japan and Germany have a system of close monitoring by shareholder/creditors (ex ante controls on management),269 the U.S. system combines dispersed shareholding with the threat of takeover (and the replacement of management) if a firm is poorly managed.270 Yet takeovers involve high leverage, and the potential threat of a takeover may induce a firm to borrow heavily.271 The ex post form of governance therefore increases the risk of bankruptcy for firms that have going concern value and should not be liquidated.272 Given that this form of corporate control involves a high risk of financial distress, it makes sense that it should be paired with a bankruptcy system that keeps management in place and is generous in its efforts to preserve going concern value — a system like Chapter 11.273

This description of the U.S. system of corporate governance, however, is accurate only insofar as we are discussing public companies. It

268. See id. at 1339-46.
269. See id. at 1337-39, 1343-46.
270. See id.
271. See id. at 1339-40.
272. See id. at 1340.
273. See id. at 1340-43.
must be modified in important respects to deal with small business, where ownership is concentrated and closely tied to management and the divide between personal assets and business assets is porous. Takeovers are not a means of disciplining small business managers, who control the stock of their companies, nor is firing a credible threat when the business depends on the personal knowledge and abilities of the manager. It may also be too costly for creditors to monitor small businesses, keeping a steady watch for signs of impending trouble. Thus, creditors turn to a more cost-effective means of monitoring and policing the firm: the insider guaranty. Supervision by the insider guarantor is less expensive than monitoring by creditors, and will be superior to monitoring by an insider not subject to a guaranty because the insider-guarantor is a residual claimholder in a way that a simple equity holder is not.

The 1978 Bankruptcy Code brought small and large businesses under a common bankruptcy framework. However, the different mechanisms of monitoring and policing large firms versus small firms call for divergent bankruptcy regimes. The forgiving, reorganization-focused, management-led bankruptcy system necessitated by our system of ex post controls over public corporations is simply inappropriate for small businesses, where the dominant means of monitoring and policing misbehavior is ex ante, through leverage over insiders.

If the bankruptcy and corporate law systems are inherently intertwined and complementary, it seems unlikely that a single bankruptcy framework would be appropriate for large and small firms. We should expect legislative, judicial, and/or market adjustments to distinguish the

274. See Mann, supra note 9, at 19-22 (noting that small business lenders generally do not monitor their borrowers).

275. If the firm's primary lender has a lien on all of the firm's assets, but is undersecured, then that creditor is the residual claimholder. See, e.g., Skeel, Markets, Courts, supra note 70, at 512 n.170. The debtor in possession retains substantial decision making authority. The insider guaranty is the mechanism for equating the interests of the two.

276. Prior to the passage of the Bankruptcy Reform Act of 1978, there were three separate chapters applicable to business reorganization. Chapter X was designed to handle cases involving public companies, Chapter XI handled most other business cases, and Chapter XII handled real estate reorganization. On the merging of these three separate regimes into a single framework, see, e.g., Hon. Leif M. Clark, Chapter 11: Does One Size Fit All, 4 Am. Bankr. Inst. L. Rev. 167, 170-75 (1996); LoPucki, The Trouble with Chapter 11, supra note 77, at 745-49; Ralph A. Peeples, Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule, 63 Am. Bankr. L.J. 65, 66-72 (1989).

277. See generally Skeel, Evolutionary Theory, supra note 24; see also Skeel, Markets, Courts, supra note 70, at 510-520 (suggesting that closely held and publicly held firms be governed by different bankruptcy regimes); LoPucki, The Trouble with Chapter 11, supra note 77 (arguing that Chapter 11 may be appropriate for large firm bankruptcies, but not for small business cases). But see Clark, supra note 276 (arguing that Chapter 11 may be an adequate structure for handling the reorganization of diverse entities, but that its functioning could be improved through greater training of bankruptcy judges).
bankruptcy treatment of these divergent business forms. These types of changes are actually taking place on the legislative and judicial fronts. For example, much attention has been paid to the judicial development of “fast track” bankruptcy for small business debtors, a system of close judicial control intended to reduce the waste and delay endemic to small business cases.\textsuperscript{278} The National Bankruptcy Review Commission has recommended extensive changes in the treatment of small business reorganizations.\textsuperscript{279} Congress has also addressed the problem of small business bankruptcy in recent years, rejecting a proposal to establish a new “Chapter 10” to govern small business cases,\textsuperscript{280} but passing several minor reforms intended to make small business cases more efficient.\textsuperscript{281}

While attention is often focused on the legislative and judicial developments, the bankruptcy system also changes through marketplace adaptations which often go unnoted. There is evidence that the 1978 Code increased lenders’ costs, which in turn raised the price of loans to small businesses.\textsuperscript{282} It should be no surprise that lenders and borrowers are responding by seeking to reduce the costs imposed by the bankruptcy system. Today, we are witnessing the rise of “bankruptcy


\textsuperscript{280} Explaining the impetus behind the proposal, the Senate Committee on the Judiciary stated:

Chapter 11 of the current Bankruptcy Code is required to handle both the corporate reorganizations of a multimillion-dollar international company and that of a small, rural grocery store. Trying to make these laws apply to vastly different corporate enterprises has created problems and inefficiencies in the handling of individual bankruptcy cases. As a result, this bill seeks to further experiment in the area of business reorganizations by establishing a small business bankruptcy chapter. Such a proposed pilot program balances the concerns of substantially rewriting the Bankruptcy Code with the need for additional information to guide congressional inquiry into problems faced by small businesses when they seek a bankruptcy reorganization.

\textsuperscript{281} The Bankruptcy Reform Act of 1994, Pub L. No. 103-394, § 217, 108 Stat. 4106 (1994), created a new definition for “small business” (now codified at 11 U.S.C. § 101(51C)). The act provided that if a debtor elects to be treated as a small business, the bankruptcy court need not appoint a creditors' committee (11 U.S.C. § 1102(3)), tightened the provision for debtor's exclusive right to file a plan (11 U.S.C. § 1121(e)). It also provided a streamlined process for combining the hearings on approval of the disclosure statement and confirmation of the plan (11 U.S.C. 1125(f)).

proofed” transactions, to name just one prominent example. Insider guaranties in general, and bankruptcy-contingent guaranties in particular, are marketplace innovations that respond to the changed cost/benefit calculations resulting from the adoption of a reorganization-biased bankruptcy system. As experience with the current Bankruptcy Code has grown, the parties are adapting their contractual relationships to minimize costs where it is a less-than-efficient device. Thus, the rise of springing guaranties — and the increasing use of insider guaranties — may well be market adjustments intended to resegregate bankruptcy options according to firm characteristics. Under the new contractual regime, if it succeeds, bankruptcy reorganization would become less available for closely-held borrowers with institutional debt, while remaining available for public companies.

Bankruptcy courts, of course, have had to deal with insider guaranties on an individual, rather than systemic, level. The prevailing paradigm has been the guaranty as a contract of financial assurance, an obligation of a third party largely outside the concern of the bankruptcy court. This approach has had its merits: By abstracting away from the interrelationship between insider guaranties and the financial agency problems that they are really intended to address, the law has permitted guaranties to remain largely unaffected by the bankruptcy of the borrower. This provides contracting parties with a high level of certainty about their rights.

The cost of this approach is that it ignores a large element of reality. Insider guaranties are not simply contracts of financial support. They are a crucial link in the managerial and financial structure of closely-held firms, bonding devices used by lenders to exercise leverage over issues that cannot easily be controlled through explicit covenants written into a loan agreement. As such, a formalistic analysis, such as the categorization of guaranties as obligations of a third party that do not involve the debtor, is simply incorrect. Insider guaranties must be addressed through the same agency cost framework that has been so productively applied to other corporate, commercial, and bankruptcy law subjects. When this is done, we can make more rigorous and reasoned


284. I have been unable to locate data on insider guaranties for the full time horizon to determine whether their use increased with the passage of the Bankruptcy Code. Other data does seem to indicate that the use of insider guaranties increased between the late 1980s and early 1990s, a period when lenders were becoming increasingly aware of the costs imposed by the Code. See Avery, supra note 98, at 1056-58.
decisions regarding the way in which reorganization of a financially troubled borrower should, or should not, be permitted to affect the liabilities of insiders on these instruments.