DEPRIZIO'S HONOR: LENDERS, INSIDER GUARANTORS AND THE PRISONERS' DILEMMA

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I. Introduction

One of the primary goals of bankruptcy law is "the equitable distribution of a troubled company's assets through the equal sharing of losses of creditors of equal rank."[1] To this end, the Bankruptcy Code (the Code)[2] prevents debtors approaching bankruptcy from exercising favoritism towards any creditor. An insolvent debtor cannot circumvent the Code by preferentially transferring an interest in property to, or for the benefit of, one creditor over others so as to grant that creditor more than it would have otherwise received in the debtor's liquidation or reorganization under the Code. If such a transfer, or "preference," has been made within *90 days* of the debtor's filing for bankruptcy, it is recoverable by the bankruptcy trustee for more equitable distribution to creditors.[3]

Given the ability of insiders of the debtor to predict and control the timing of the debtor's bankruptcy, an even more stringent "preference period" applies to transfers benefiting insiders. A preferential transfer made to or for the benefit of an insider of the debtor must be returned if made within *one year* preceding the debtor's bankruptcy filing.[4]

The one-year preference period applies to an insider who causes the debtor to repay loans to the insider before the debtor repays loans to other creditors. In that situation, the insider directly receives the benefit of the transfers. Under the terms of the Code, the one-year period should also apply where an insider guarantees a loan made to the debtor by a lender or other non-

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[1] M. Bienenstock, Bankruptcy Reorganization 1 (1988). The other goal is identified as "the restructuring of a business to preserve jobs, to pay creditors, to produce a return for owners," and to benefit the nation's economy. *Id.* These policies are clearly interdependent.

[2] 11 U.S.C. §§ 101-1330 (1988).

[3] *See id.* § 547(b)(4)(A).

[4] *See id.* § 547(b)(4)(B).

insider creditor[5] and then causes the debtor to repay that loan preferentially.[6] Since the insider guarantor is a contingent creditor of the debtor (i.e., may be liable for paying the debtor's obligations to the lender and would then be able to assert claims against the debtor for reimbursement), the debtor's loan repayments are essentially transfers made for the benefit of the insider. Here, recovery can be made either from the lender, as initial transferee, or from the insider guarantor who receives the benefit of the transfer.

Until recently, however, courts found it inequitable to invoke the one-year preference period to recover from lenders transfers made by the debtor for the benefit of its insider guarantors.[7] The first court of appeals decision to reverse this trend was *Levit v. Ingersoll Rand Financial Corp.* (*In re V.N. Deprizio Construction Co.*).[8] Because the circuits are split on the application of this "extended" preference period, *Deprizio* has generated nationwide concern within the lending community. A personal guarantee of a corporate insider, once taken as a matter of course, may now result in a lender's being forced to disgorge payments made within one year, as opposed to within ninety days, of the debtor's filing for bankruptcy.

Behind the "equity" arguments advanced against *Deprizio*, and the literal statutory arguments in its favor, lie economic realities illuminated by game theory's well-known problem of the Prisoner's Dilemma. By mathematically modeling the relative expectations of the insider guarantors and of the lenders, the consequences of *Deprizio* can be more clearly identified and examined.

II. The Case Law

A. *Pre-Deprizio-"Equity" Considerations*

Section 550(a)[9] provides that, to the extent that transfers made by the debtor are avoidable under Section 547, they are

[5] Subsequent references to "lenders" shall assume that such creditors are not insiders of the debtor.

[6] *See id.* § 547(b)(1).

[7] *See infra* notes 9-27 and accompanying text.

[8] 874 F.2d 1186 (7th Cir. 1989).

[9] Code section 550(a) provides that:

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

recoverable either from the lender, as the initial transferee, or from the guarantor, as "the entity for whose benefit such transfer was made."[10] Thus, under section 547(b)(4)(A),[11] the debtor's trustee in bankruptcy could recover from either the lender or the guarantor the preferential repayments made by the debtor within ninety days of its filing for bankruptcy.

Until 1983, however, courts were reluctant to impose the one-year preference period of section 547(b)(4)(B) to recover, from non-insider lenders, repayments secured by the guarantees

> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a) (1988).

[10] Section 101(30)(B) of the Code defines an "insider" of a corporate debtor as:

> (i) director of the debtor;
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> (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.

11 U.S.C. § 101(30)(B) (1988). Under Section 101(30)(E), insiders of a corporate debtor also include its affiliates, and insiders of its affiliates. An affiliate includes, generally, an entity owning or controlling twenty percent or more of the voting securities of the debtor, a corporation twenty percent or more of whose voting securities are owned by the debtor, an entity whose business or substantially all of whose property is operated under a lease or operating agreement by the debtor, and an entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement. 11 U.S.C. 101(2) (1988).

[11] Section 547(b) provides that:

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

11 U.S.C. § 547(b) (1988).

of the debtor's insiders.[12] Although both the lender and the guarantor would qualify as "creditors" of the debtor,[13] it was seen as unfair to recover the loan payments from a lender that in good faith had sought the guarantee of an insider.[14] Was it not the insider that had manipulated the debtor into making preferential payments to an innocent lender? In the oft-quoted words of a leading treatise:

> In some circumstances, a literal application of section 550(a) would permit the trustee to recover from a party who is innocent of wrongdoing and deserves protection. In such circumstances the bankruptcy court should use its equitable powers [under section 105(a) and 28 U.S.C. § 1481] to prevent an inequitable result. For example . . . if a transfer is made to a creditor who is not an insider more than 90 days but within one year before bankruptcy and the effect is to prefer[entially benefit] an insider-guarantor, recovery should be restricted to the guarantor and the creditor should be protected. Otherwise, a creditor who does not demand a guarantor can be better off than one who does.[15]

Thus, to defeat recovery from the lender as an "initial transferee" of preferential repayments made between ninety days and

[12] *Id.*

[13] The insider guarantor holds a contingent right to payment from the debtor, because the guarantor may proceed against the debtor for any amounts that the guarantor pays to the lender under his guarantee. The insider thus has a "claim" under section 101(4)(A), which defines claim as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, *contingent*, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(4)(A) (1988) (emphasis added). As holder of a claim, the insider guarantor is a creditor under Section 101(9), which defines a "creditor" as an:

> (A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;
>
> (B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or
>
> (C) entity that has a community claim.

11 U.S.C. § 101(a) (1988).

[14] *See, e.g.*, Bakst v. Schilling (*In re* Cove Patio Corp.), 19 Bankr. 843, 844 (S.D. Fla. 1982).

[15] 4 COLLIER ON BANKRUPTCY ¶ 550.02, at 550-58 (15th ed. 1990). Section 105(a) authorizes the bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title [as well as], sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process." 11 U.S.C. § 105(a) (1988). 28 U.S.C. § 1481 (1988) provides that "[a] bankruptcy court shall have the powers of a court of equity, law, and admiralty, but may not enjoin another court or punish a criminal contempt not committed in the presence of the judge of the court or warranting a punishment of imprisonment." 28 U.S.C. § 1481 (1982), *ineffective by* Pub. L. No. 98-454, § 1001, 98 Stat. 1745 (1984).

one year preceding the debtor's bankruptcy, one court found that the dual recovery provision of section 550(a)(1) "[i]mplied . . . a necessity for the exercise of discretion by the court," because the equities did not favor recovery from non-insider lenders.[16] Another court noted in dictum that "even if a preferential transfer did occur, no recovery should be had against the defendant" lender.[17] A third court declined to apply the extended preference period to a good faith transferee, even though the trustee alleged that the transfer was made by the debtor for the benefit of insiders: the "obvious purpose" of section 550(a)(1) would not permit the recovery of a preference that "admittedly would not be recoverable under § 547," since the good faith transferee was not an insider.[18] Finally, a fourth court would not permit the lender to be "penalized for its prudence in seeking a guarantor of the debt . . . ."[19]

While these decisions invoked the somewhat nebulous grounds of equity, it fell to the bankruptcy court in *Goldberger v. Davis Jay Corrugated Box Corp.* (*In re Mercon Industries, Inc.*),[20] to advance a more elaborate "two-transfer" theory concerning payments on guaranteed loans.[21] The single transfer of funds from debtor to lender, according to the court, actually "effected two transfers under section 550(a)(1) of the Code":[22] one transfer to the "initial transferee" and the other to "the entity for whose benefit such transfer was made."[23] The first of these transfers, from the debtor to the lender, reduced the balance of the indebtedness. The second and simultaneous transfer, from the debtor to the guarantor, reduced

[16] Backhus v. Central Trust Co. (*In re* Duccilli Formal Wear, Inc.), 8 Bankr. Ct. Dec. (CRR) 1180, 1183 (Bankr. S.D. Ohio 1982).

[17] Seeley v. Church Buildings and Interiors, Inc. (*In re* Church Buildings and Interiors, Inc.), 14 Bankr. 128, 131 (Bankr. W.D. Okla. 1981).

[18] Bakst v. Schilling (*In re* Cove Patio Corp.), 19 Bankr. 843, 844 (S.D. Fla. 1982).

[19] Schmitt v. Equibank (*In re* R.A. Beck Builder, Inc.), 34 Bankr. 888, 894 (Bankr. W.D. Pa. 1983); Ray v. City Bank & Trust Co. (*In re* C-L Cartage Co.), 70 Bankr. 928, 933-34 (Bankr. E.D. Tenn. 1987), *aff'd*, 113 Bankr. 416 (E.D. Tenn. 1988), *rev'd*, 899 F.2d 1490 (6th Cir. 1990) (agreeing with "majority" of courts that "insider preferences outside the 90 days can be recovered only from the insider"); *In re* Aerco Metals, Inc., 60 Bankr. 77, 82 (Bankr. N.D. Tex. 1985) (declining "to punish the Bank for the prudence it exercised in obtaining a guaranty" from an insider).

[20] 37 Bankr. 549 (Bankr. E.D. Pa. 1984).

[21] *Id.* at 552.

[22] *Id.* (footnote omitted). Section 101(50) defines a "transfer" to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest. . . ." 11 U.S.C. § 101(50) (1988).

[23] *Mercon*, 37 Bankr. at 552 n.6 (quoting 11 U.S.C. § 550(a)(1)).

the guarantor's exposure on its guarantee, thereby reducing the guarantor's contingent liability to the lender.[24]

Under *Mercon*, the extended preference period of section 547(b) would not apply to the first transfer, because neither the lender nor the debtor was an "insider." Only the second transfer would involve an insider (the guarantor, as a "mediate transferee"[25]) to invoke the extended preference period: thus, "a finding of liability on one transfer is independent of the other, rather than derivative."[26]

The two-transfer approach was further endorsed by the bankruptcy court in *Deprizio*.[27] The *Deprizio* court declined to apply the extended preference period to recover from a construction company's commercial creditors the repayments made by the company on debts guaranteed by the company's insiders. The bankruptcy court's decision, however, would soon be reversed.

B. *The Literal Approach: Deprizio, its Ancestors and its Progeny*

In 1983, the established equitable resistance towards applying the extended preference period to non-insider lenders began to crumble. In *Mixon v. Mid-Continent Systems, Inc. (In re Big Three Association)*,[28] the court "refuse[d] to overlook the unambiguous language" of section 550(a)(1), which specifically allows recovery from the lender as "initial transferee" as well as from the guarantor as the "entity for whose benefit such transfer was made."[29] To replace the favored quotation of the courts that had previ-

[24] *Id.* at 552. Strictly speaking, the "two-transfer" theory refers to two *types* of transfers, not to the *number* of those transfers that can be identified in each situation. For example, where there are three insider guarantors, there will be four identifiable transfers corresponding to each payment made by the debtor — one to the lender and one to each of the guarantors.

[25] The *Mercon* analysis predicated the liability of the guarantors on section 550(a)(2), as "immediate or mediate transferees of [the lender, the] initial transferee," rather than under section 550(a)(1), as "the entity for whose benefit [the initial] transfer was made." *Id.* at 552-53.

[26] *Id.* at 552. Another way to phrase this test is that "the reference to 'initial transferee' in § 550(a) of the Code must be construed to mean an initial transferee *with respect to whom the transfer was preferential.*" Block v. Texas Commerce Bank Nat'l Ass'n (*In re* Midwestern Companies, Inc.), 96 Bankr. 224, 227 (Bankr. W.D. Mo. 1988), *aff'd*, 102 Bankr. 169 (W.D. Mo. 1989). Under the two-transfer analysis, the lender as initial transferee is not an insider, and thus does not qualify for the extended preference period.

[27] 58 Bankr. 478 (Bankr. N.D. Ill. 1986), *rev'd*, 86 Bankr. 545 (D. Ill. 1988), *aff'd*, 874 F.2d 1186 (7th Cir. 1989).

[28] 41 Bankr. 16, 20 (Bankr. W.D. Ark. 1983).

[29] *Id.* at 20-21.

ously addressed this issue, *Big Three* extracted its own shibboleth from the relevant legal scholarship:

> As hard as one searches, one is unable to uncover any material evidence in the Code or its legislative history that Congress intended paragraph 550(a)(1) to operate less than literally merely because one of the potential defendants designated in that paragraph supplies the factual predicate for avoiding a transfer. In fact, in the original bills approved by the Senate and the House of Representatives, each version of Section 550 mandated recovery from the "initial transferee" alone.[30]

This literal view was adopted by the district court in *Deprizio*.[31] The references in section 550 of the Code to both the "initial transferee" and "the entity for whose benefit the transfer was made" were perceived as the statutory acknowledgment that one transfer could benefit both the lender and the guarantor. Such an analysis precluded consideration of the two-transfer theory.[32]

The two-transfer theory was further discredited by the *Deprizio* bankruptcy court's observation that the Code's definition of "transfer," with its emphasis on the "disposing of or parting with property," was clearly based on the perspective of the single transferor, and not on that of the one or more transferees.[33] Finally, as the

[30] *Id.* at 21 (quoting Pitts, *Insider Guaranties and the Law of Preferences*, 55 AM. BANKR. L. J. 343, 347 (1981)) (citing S. 2266, 95th Cong. 2d Sess. § 101 (1978) (proposed 11 U.S.C. § 550(a)(1); H.R. 8200, 95th Cong. 1st Sess. § 101 (1977) (proposed 11 U.S.C. § 550(a)(1)).

The *Big Three* court noted that: "In the precursor to Section 550 proposed by the Commission on the Bankruptcy Laws of the United States, the primary target of the trustee's recovery was likewise the initial transferee. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 93-137, 93rd Cong. 1st Sess., pt. II, at 178 (1973). In explaining this section, the Commission stated that it "covers all initial transferees of recoverable property, *not just those preferred*. *Big Three Assoc.*, 41 Bankr. at 21 n.1. (emphasis supplied)."

[31] 86 Bankr. 545, 550 (N.D. Ill. 1988), *aff'd*, 874 F.2d 1186 (7th Cir. 1989).

[32] In *Deprizio*, the district court held that "Where Congress has crafted an unambiguous comprehensive statutory scheme, such as it has in the Code, we are extremely hesitate to tamper with that scheme by use of vague equitable powers." *Deprizio*, 86 Bankr. at 552. *See also* Ray v. City Bank and Trust Co. (*In re* C-L Cartage Co.), 899 F.2d 1490, 1495 (6th Cir. 1990) (straightforward application of statutory language consistent with policies that Code sections were enacted to further); *In re* Installation Services, Inc., 101 Bankr. 282, 284 (Bankr. N.D. Ala. 1989) (favoring literal reading of section 550(a)(1) "to express Congressional policy favoring equality in distribution, a desirable goal in the management of debtors' estates"). *Cf.* Reigel v. Mahajan (*In re* Kumar Bavishi & Assoc.), 906 F.2d 942 (3d Cir. 1990)(declining to apply method analogous to two transfer analysis to debtor-guarantor transactions). *Reigel* is analyzed in greater depth in Effross, *Doorway to Deprizio*, N.J. STATE BAR ASSOC. CREDITOR AND DEBTOR RELATIONS SECTION NEWSLETTER, Vol. XII, No.1, at 8 (Feb. 1991).

[33] *Deprizio*, 86 Bankr. at 551. District Judge Plunkett posited that "[i]f Congress

bankruptcy court noted in *Coastal Petroleum Corp. v. Union Bank & Trust Co.* (*In re Coastal Petroleum Corp.*),[34] Congress had not altered the clear language of section 550(a)(1) on either of the two occasions that the Code had been amended since its enactment in 1978.[35]

Further, the courts that espoused a literal translation of section 550 were not responsive to the concerns of creditors that would be forced to disgorge payments received during the extended preference period. While the courts emphasizing "equity" had hesitated to penalize a lender "prudent" enough to obtain an insider's guarantee,[36] the *Deprizio* district court, in affirming the bankruptcy court, instructed

> [a] prudent creditor [to] extensively investigate the guarantor's financial situation and [to] continue to monitor the guarantor's finances to make sure he or she can pay in the event of debtor's default. A creditor can [also] adjust the rate of interest it charges to its debtor to reflect the risk of default by both the debtor and guarantor.[37]

Similarly, the *Big Three* court observed that "drafters of loan guaranty agreements will have to consider the literal meaning of section 550(a)(1) in advising their lending institution clients."[38] The court in *Coastal Petroleum Corp.* agreed that "[a]ny failure of the creditor to adequately investigate the credit worthiness of the debtor or its insider guarantors should not be viewed as a statutory deficiency but, rather, as an inherent business risk."[39]

Significantly, the district court in *Lowrey v. First National Bank of Bethany* (*In re Robinson Brothers Drilling, Inc.*)[40] emphasized that lenders wary of the extended preference period were free to find non-insider guarantors, and that creditors could still resort to section 547(c) defenses.[41]

had wanted a transfer to occur whenever someone receives a benefit, it could have defined 'transfer as receiving or acquiring property or an interest in property.' . . . But Congress did not; thus, we must conclude that a transfer is an act disposing of or parting with property." *Id.*

[34] 91 Bankr. 35 (Bankr. N.D. Ohio 1988).

[35] *Id.* at 38.

[36] *See, e.g.*, Schmitt v. Equibank (*In re* R.A. Beck Builder, Inc.), 34 Bankr. 888, 894 (Bankr. W.D. Pa. 1983).

[37] *In re* V. N. Deprizio Constr. Co., 86 Bankr. 545, 553 (N.D. Ill. 1988), *aff'd*, 874 F.2d 1186 (7th Cir. 1989).

[38] 41 Bankr. at 21.

[39] *In re* Coastal Petroleum Corp., 91 Bankr. 35, 37 (Bankr. N.D. Ohio 1988).

[40] 97 Bankr. 77 (W.D. Okla. 1988), *aff'd*, 892 F.2d 850 (10th Cir. 1989).

[41] *Id.* at 82. Section 547(c) of the Code provides that a trustee may not avoid transfers that were made: for contemporaneous exchanges of value; in the ordinary

It was the Seventh Circuit's opinion in *Deprizio*, however, that was the most explicitly and articulately unsympathetic to the plight of the lender whose files of insider guarantees had suddenly become potential liabilities:

> Rules of law affecting parties to voluntary arrangements do not operate "inequitably" in the business world—at least not once the rule is understood. Prices adjust. If the extended preference period facilitates the operation of bankruptcy as a collective debt-adjustment process, then credit will become available on slightly better terms. If a longer period has the opposite effect, creditors will charge slightly higher rates of interest and monitor debtors more closely. In either case creditors will receive the competitive rate of return in financial markets—the same risk-adjusted rate they would have received with a 90-day preference-recovery period.[42]

Thus, the Seventh Circuit posited that it would not be inequitable to apply the extended preference period in recovering from lenders moneys that would be more equitably distributed among all creditors under the Code.[43] Indeed, in the wake of such a recovery, the

course of business; that create a purchase money security interest; that were given for new value, or that created a perfected security interest in inventory or a receivable or in the proceeds of either. 11 U.S.C. § 547(c) (1988). *Cf.* Ray v. City Bank and Trust Co. (*In re* C-L Cartage Co.), 899 F.2d 1490, 1495 (6th Cir. 1990) (remanding case for evaluation of section 550(b)(1) defenses for lender as mediate transferee under 550(a)(2)).

[42] 874 F.2d 1186, 1198 (7th Cir. 1989).

[43] *Id.* Recent decisions have only continued the split among the Circuits. *See, e.g.*, Harrison v. Brent Towing Co. (*In re* H&S Transp. Co.), 110 Bankr. 827 (M.D. Tenn. 1990) (agreeing with the *Deprizio* court in rejecting the theory that a debtor's payment to a single creditor can result in "two transfers" under the Code). Unlike *Deprizio*, *H&S* did not involve a bank or an insider-guarantor, and its analysis incorporated considerations of "new value" given to the debtor by creditors who were supplying fuel on credit); *In re* Smith Materials Corp., 108 Bankr. 784, 786 (Bankr. M.D. Fla. 1989) (declining to determine whether a lien given less than one year prior to a bankruptcy filing, and purportedly reducing the personal liability of an insider principal as guarantor of the debtor, represented a *Deprizio*-type preference).

In Billings v. Zions First Nat'l Bank (*In re* Granada, Inc.), 110 Bankr. 548 (Bankr. D. Utah. 1990), the bankruptcy court upheld a trustee's *Deprizio* one-year preference period action against a lender's motion to dismiss and examined the avoidability of other insider-debtor transactions. *Id.* at 549. The trustee brought a "triangular preference" action to recover from a non-insider lender Granada's payments on loans "allegedly guaranteed by an insider, or secured by real property owned by insiders." *Id.* at 550. Citing *Deprizio* and *In re Robinson Brothers Drilling*, the court held that these transfers "could be found to have benefitted the insider-creditors because they reduced their potential exposure to liability," and thus that the trustee had alleged facts "sufficient to state a claim under §§ 547(b) and 550(a) upon which relief can be granted." *Granada*, 110 Bankr. at 550-51.

Similarly, the court in Cambridge Meridian Group, Inc. v. Connecticut Nat'l affected lenders could resort to the benefit of their bargain by bringing an action against the insider guarantors for the amounts due.[44]

The effect of *Deprizio,* then, is to pit lenders against insider guarantors during the period from ninety days through one year before the debtor's filing for bankruptcy. During this "extended" preference period, the debtor's preferential payments to a lender can be recovered either from the guarantor or from the lender. What are the relative effects on these actors? How do they reflect, or differ from, the relationship among other creditors?

A parallel to this situation may be found in game theory's situation of the Prisoner's Dilemma.

III. The Prisoner's Dilemma

A. *Background*

Since its original publication in 1950,[45] the Prisoner's Dilemma has since been extensively analyzed as "an abstract formulation of some very common and very interesting situations in which what is best for each person individually leads to mutual defection [i.e., non-cooperation], whereas everyone would have

Bank (*In re* Erin Food Serv., Inc.), 117 Bankr. 21 (Bankr. D. Mass. 1990) applied *Deprizio*'s extended preference period to interest repayments made by a restaurant-operating corporation on a loan personally guaranteed by a corporate insider, notwithstanding the lender's protest that, because the guarantee was non-recourse to the insider (i.e., was supported only by assets not owned by the insider), the insider had not benefitted from these repayments. *Id.* at 29-30.

In contrast, the district court in Kroh Bros. Dev. Co. v. National Fidelity Life Ins. Co. (*In re* Kroh Bros. Dev. Co.), 115 Bankr. 1011 (Bankr. W.D. Mo. 1990), indicated in dictum that the Eighth Circuit currently stood against *Deprizio*. *Id.* at 1015. Because the debtor failed to establish the elements of a preference, the court did not address the applicability of an extended preference period to an outside creditor. *Id.* In opposition to *Deprizio*, however, the lender had cited "the highest authority in the Eighth Circuit." *Id.* (citing Block v. Texas Commerce Bank Nat'l Ass'n (*In re* Midwestern Cos., Inc.), 102 Bankr. 169 (W.D. Mo. 1989)). In a footnote, the court noted that it would not have been required to follow the *Midwestern* decision, but acknowledged that "adherence to the highest authority in one's own Circuit cannot be lightly abandoned." *Id.* at n.2.

Finally, in Rubin Bros. Footwear, Inc. v. Chemical Bank (*In re* Rubin Bros. Footwear, Inc.), 119 Bankr. 416 (S.D.N.Y. 1990) the Southern District of New York perfunctorily rejected *Deprizio*, characterizing it as "a much criticized case, whose reasoning has not been followed outside of the Seventh Circuit." *Id.* at 425. Apparently, the court was unaware of *C-L Cartage* and *Robinson Brothers Drilling*. The court stated that the *Deprizio* rule "would likely impede the availability of credit to ailing businesses," and thus declined to adopt *Deprizio* "[b]ecause of its potential policy implications, and because the Second Circuit has not yet adopted it." *Id.*

[44] *Deprizio*, 874 F.2d at 1198.

[45] *See* R. Axelrod, The Evolution of Cooperation 216 n.2 (1984).

been better off with mutual cooperation."[46] The Prisoner's Dilemma has been used to model group behavior ranging from trench warfare strategies[47] and international politics[48] to "the relative savagery of the driving environment in the Boston area."[49]

Not the least of the situations susceptible to this analysis is that of creditors seeking to recover assets from a bankruptcy estate. It has been suggested that the "single most fruitful way to think about" the Code is to view it as providing "a way to override the creditors' pursuit of their own remedies and to make them work together" toward a common solution.[50] Nonetheless, the reality is that "[e]ach creditor, unless assured of the other's cooperation, has an incentive to take advantage of individual collection remedies, and to do so before the other creditor acts."[51]

Each creditor, whether insider or non-insider, is thus in the position of a prisoner in the Prisoner's Dilemma. In the most popular formulation of this problem, two fellow conspirators are apprehended by the police and held in separate interrogation rooms. Each prisoner is given the choice of whether or not to implicate himself and his associate by confessing. Further, each is given the following information:

> (i) If neither prisoner confesses, each will be sentenced to two years' imprisonment;
>
> (ii) If only one prisoner confesses, he will be sentenced to one year's imprisonment, and his fellow prisoner will be sentenced to five years' imprisonment;
>
> (iii) If both prisoners confess, each will be sentenced to four years' imprisonment.[52]

[46] *Id.* at 9. Citing the "hundreds of articles" on the Prisoner's Dilemma that have appeared, Axelrod has noted that the "iterated Prisoner's Dilemma has become the *E. coli* of social psychology." *Id.* at 28. *See also* D. HOFSTADTER, *The Prisoner's Dilemma Computer Tournaments and the Evolution of Cooperation*, in METAMAGICAL THEMAS: QUESTING FOR THE ESSENCE OF MIND AND PATTERN 715-34 (1985) (summary and commentary on Axelrod's work).

[47] *See, e.g.*, R. AXELROD, *supra* note 45, at 73-87 (examining the emergence of cooperation among opposing trench warfare forces during World War I in firing *pro forma* salvos not intended to injure).

[48] *Id.* at 150-54 (discussing deterrent effect of reputation for retaliation).

[49] D. HOFSTADTER, *supra* note 45, at 732 (exploring the tendency of drivers confronted with selfish driving behavior of others to adopt such behavior themselves, even towards drivers who have not offended them).

[50] T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 16-17 (1986).

[51] Jackson, *Bankruptcy, Non-Bankruptcy Entitlement and the Creditors' Bargain*, 91 YALE L.J. 857, 862 (1982).

[52] R. AXELROD, *supra* note 45.

In addition, each prisoner is informed that the other prisoner has been posed the same choice, with the same possible outcomes.[53]

In matrix form, the Prisoner's Dilemma appears as follows:

DIAGRAM 1

The Prisoner's Dilemma

	Fellow Prisoner Confesses	Fellow Prisoner Does Not Confess
Prisoner Confesses	Prisoner Sentenced to Four Years. Fellow Prisoner Sentenced to Four Years. [3]	Prisoner Sentenced to One Year. Fellow Prisoner Sentenced to Five Years. [1]
Prisoner Does Not Confess	[4] Prisoner Sentenced to Five Years. Fellow Prisoner Sentenced to One Year.	[2] Prisoner Sentenced to Two Years. Fellow Prisoner Sentenced to Two Years.

The rational prisoner will inevitably be led to "defect," i.e., to confess.[54] He knows that whether his fellow prisoner confesses or not, his own better option is to confess. Suppose his fellow prisoner confesses (first column of Diagram I): if the prisoner does not himself confess (Situation [4]), he will be sentenced to five years, but if he confesses (Situation [3]), he will spend only four years in prison. Likewise, if his associate has not confessed, the prisoner will spend only one year in prison if he himself confesses (Situation [1]), but two years if he does not confess (Situation [2]).

Of course, if the prisoners could only communicate with and

[53] *Id.* It is important to note that in the general situation the payoffs to the two "prisoners' do not have to be the same, or even measured in comparable *units* (e.g., the payoff for one player might be in dollars and for another in increased reputation). The payoffs for each player, however, must be in the following *decreasing order*: sole defection, mutual cooperation, mutual defection, sole cooperation. *See id.*

[54] The terminology of the analysis in Axelrod, *supra,* clearly reflects the moral superiority postulated for the "cooperator." In the context of the Prisoner's Dilemma situation, regardless of society's interest in eliciting confessions and imposing maximum punishment, a premium is placed on the ability to be a "stand-up guy," i.e., not to confess, even at the risk of being the prisoner punished most harshly. Cf. Liddy, WILL: THE AUTOBIOGRAPHY OF G. GORDON LIDDY 348 (1980) (recounting conversation with defense attorney: "If I'm thrown in this thing [the Watergate prosecution], . . . I'll have to sit still, shut up, and take the weight. It's my job.").

trust each other, they could "cooperate" by agreeing that neither would confess: they would thus minimize the total time that they would spend in prison. In the absence of such communication and trust, however, each should rationally confess, and the two should thus face the harshest total punishment.[55]

Similarly, creditors find themselves pitted against each other for a troubled debtor's assets. Each creditor would, in the absence of preference rules, be tempted to enter into a deal with a troubled debtor to have its own loan paid off before all others. The relative desirability of the four outcomes of the Prisoner's Dilemma is the same for each individual creditor as it is for each of the two prisoners:

> [1] if the actor in question defects (i.e., if the creditor grabs for the debtor's assets, or if the prisoner confesses) and the other actors do not, he does best;
>
> [2] if all actors cooperate (i.e., if creditors allow the debtor's assets to be distributed under the Code, or if neither prisoner confesses) all do reasonably well;
>
> [3] if all actors defect (i.e., if the creditors all grab for the debtor's assets, or if both prisoners confess), all end up doing poorly; and
>
> [4] if the individual creditor is the sole cooperator (i.e., the only creditor that does not make a grab, or the one prisoner that does not confess), he does worst.[56]

[55] While there is little mystery about the optimal resolution (mutual "cooperation") and likely outcome (mutual "defection") of the above situation, the "iterated" Prisoner's Dilemma, in which the "prisoners" face each other again and again in the same environment, has been extensively studied. Of central concern to game theorists is the strategy (i.e., reaction to an opponent's choice of defection or cooperation in the previous rounds) that most successfully leads to extended mutual cooperation. As discussed in Axelrod's THE EVOLUTION OF COOPERATION, computerized tournaments enabling multiple encounters among various strategies have demonstrated that the best such strategy seems to be Axelrod's "TIT FOR TAT": "the policy of cooperating on the first [trial] and then doing whatever the other player did on the previous [trial]." R. AXELROD, *supra* note 45, at 13. "What accounts for TIT FOR TAT's robust success is its combination of being nice, retaliatory, forgiving, and clear." *Id.* at 54.

[56] Although two prisoners were all that were necessary to populate the universe of the Prisoner's Dilemma, where the matrix in Diagram 2 is used in the creditor context, the "adversary" creditor that the individual plays against does not represent just one creditor, but all other creditors of the estate. In the simplest case, the bankruptcy estate would contain only two creditors, equally aware of the troubled debtor's circumstances. In more realistic situations, however, with dozens if not hundreds or thousands of creditors, the matrix does not represent the decision of one creditor to cooperate with another's grab for assets, but instead portrays the struggle of an individual creditor against all other creditors, both insiders and non-insiders, all of whom are presumed to be acting the same. (Of course, in more

In the Prisoner's Dilemma, mutual defection results where each prisoner knows all relevant information about his situation, except for the decision of the other prisoner. In the bankruptcy analog, where much more information is available and relevant to the creditors' obtaining a debtor's assets, insiders and other creditors with access to the best information about the debtor's financial prospects will be the least likely to pursue the equality of the collective process. Indeed, the true threat of an insider creditor is that it is not actually in a Prisoner's Dilemma relationship with the general mass of insider and non-insider creditors. The insider, who enjoys a great informational advantage over non-insiders, would prefer having all creditors to grab for assets (Situation [3], above) rather than all creditors to allow the debtor's assets to be distributed under the Code (Situation [2], above). However, the insider guarantor may well be in a Prisoner's Dilemma situation with respect to other insider guarantors, or, generally, other insider creditors.

One commentator has cited three factors that might lead even insider creditors to abandon their individual efforts: they may lose a race among all creditors, while still having to incur the costs of participation in such a race; the remedies (e.g., foreclosure) that they secure on their own may not be immediately available; and there would remain "elements of uncertainty and associated increased costs."[57]

But these factors should be of little importance to an insider of the debtor. Indeed, an insider is supplied, at little or no extra cost to itself, with the most current information about the corporation's financial health. Thus, the insider is in the best position to determine the risk involved in its own investments and to take steps to reduce that risk. Moreover, the insider's uncertainty can be reduced to a minimum. Whether or not remedies are immediately available, the insider can begin to protect its interests before other creditors realize that their own investments are jeopardized. It is precisely these dangers that justify the extended preference period for insiders:

> Insiders pose special problems. Insiders will be the first to recognize that the firm is in a downward spiral.
>
> [I]nsiders bent on serving their own interests . . . could do so by inducing the firm to pay the guaranteed loans preferen-

complicated models, a certain percentage of the other creditors could be seen as cooperating or defecting, and this would proportionately affect the payoffs for the lone creditor on whose actions this analysis focuses).

[57] Jackson, *supra* note 51, at 864.

> tially. If the preference-recovery period for such payments were identical to the one for outside debts, this would be an attractive device for insiders. While concealing the firm's true financial state, they would pay off (at least pay down) the debts they had guaranteed, while neglecting others. To the extent that they could use private information to do this more than 90 days ahead of the filing in bankruptcy, they would make out like bandits.[58]

Additionally, an extended preference period for insiders

> contribute[s] to the ability of the bankruptcy process to deter last-minute grabs of assets. The outsiders who must kick into the pool when the trustee uses the avoiding powers retain their contractual entitlements; all the trustee's recovery does is ensure that those entitlements (as modified by any statutory priorities)—rather than the efforts of insiders to protect their own interests, or the cleverness of outsiders in beating the 90-day deadline—determine the ultimate distribution of the debtor's net assets.[59]

B. *Application to Modeling the Deprizio Situation*

The insider guarantor is not in a typical Prisoner's Dilemma position with respect to the lender that has made the guaranteed loan. While each prisoner faced the possibility that he would confess and his fellow prisoner would not, in the preferential payment context effective action must be mutual: the lender and the insider guarantor either both "cooperate" by not having the debtor pay the bank preferentially on its loans, or both "defect" by allowing such preferential payments to be made. It makes no sense for the insider to arrange for the debtor to pay the lender preferentially if the lender does not accept these payments, or for the lender to make plans to accept these payments if they are not

[58] Levit v. Ingersoll Rand Fin. Corp. [*In re* V.N. Deprizio Constr. Co.], 874 F.2d 1186, 1195 (7th Cir. 1989). *See also* Levit v. Ingersoll Rand Fin. Corp. (*In re* V.N. Deprizio Constr. Co.), 86 Bankr. 545, 552 (N.D. Ill. 1988) ("An insider usually knows sooner than an outside creditor whether the debtor is likely to sink or swim. When bankruptcy becomes likely or even possible, insiders have enormous incentive to compel the debtor to prefer insiders to outsiders. Obviously, the insider would prefer to receive one hundred cents on the dollar outside of bankruptcy rather than take his chances in the bankruptcy proceeding."); Block v. Texas Commerce Nat'l Assoc. (*In re* Midwestern Cos.), 102 Bankr. 169, 170-73 (W.D. Mo. 1989) (justifying extended preference period on grounds that "insiders ordinarily can foresee financial trouble before non-insider/creditors," and recognizing probability that insider will "be able to influence when debt payments are made and when bankruptcy is filed").

[59] *In re* Deprizio Constr. Co., 874 F.2d 1186, 1195 (7th Cir. 1989).

forthcoming.[60]

The insider guarantor's situation vis-à-vis the lender thus collapses into the following two-cell matrix representation. This mode of analysis reflects the perception of the "two-transfer" theory that the same preferential loan repayment from debtor to lender benefits both the guarantor and the lender. As will be demonstrated, the key is to determine how much benefit is expected by the lender and the insider guarantor from each preferential payment.

DIAGRAM 2

Reduced Prisoner's Dilemma
(Bankruptcy Context)

	Lender Accepts Preferential Payment	Lender Does Not Accept Preferential Payment
Insider Guarantor Arranges for Debtor to Make Preferential Payment	Insider Guarantor Gains. Lender Gains. [I]	▨
Insider Guarantor Does Not Arrange for Preferential Payment	▨	[II] Insider Guarantor Neither Gains Nor Loses. Lender Neither Gains Nor Loses.

The relative positions of the lender and the insider guarantor, both before and after *Deprizio*, can be reflected by an elaboration of this model.

1. The Ground States: "Zero"

"Zero" will be used as a reference point, to stand for the financial positions of the lender and the insider guarantor *without* anticipating preferential payments, whether or not those payments are recoverable from the lender under *Deprizio*. The "zero" of the lender actually represents the time-value of the ex-

[60] The lender, it should be noted, might not be making a special effort to accept a preferential payment. Indeed, the lender may not be aware of a troubled debtor's financial condition, and thus may not realize the potentially preferential nature of a given payment.

pected set of non-preferential repayments on the loan, whether such payments come from the debtor itself or whether the lender must pursue the guarantor for the payments. Thus, the lender's zero incorporates both the probability that at some point during the collection process the lender will have to pursue the guarantor and the probability that in such a situation the guarantor will not fulfill its obligation under the guaranty.

The "zero" of the insider guarantor represents the guarantor's anticipated liability on the loan. The insider guarantor's zero includes the guarantor's expectations that the guarantor itself will actually be held liable on its guaranty and the guarantor's estimate of its then being able to fulfill this obligation. Similar to the lender's "zero" position, the insider guarantor's does not incorporate the possibility of preferential repayments.

Many subsidiary factors are involved in these calculations. For the purposes of this analysis, it is unnecessary to know the exact values of the lender's and insider guarantor's "zeroes." In fact, the "zeroes" may represent different dollar values.[61] This article addresses the *change* from these "ground states" that the preferential payments, and then the *Deprizio* "correction," will accomplish. For instance, when the lender is said to expect to gain an amount, that amount is the expected increase over the initial expected amount which has been calibrated as "zero" for the lender.

In Diagram 2 above, Situation [II] reflects that, by definition of the actors' "zeroes," the certainty that a preferential payment will not be made has no effect on the actors' expected payoffs from the loan transaction. A preferential payment would, how-

[61] For example, if both the lender and the insider guarantor are certain that the debtor will make complete and non-preferential repayment, the "zero" of each should actually be a positive number. The lender's "zero" will reflect the interest that the lender will gain on the loan transaction, and the insider guarantor's "zero" will indicate the positive value that the guarantor attaches to having the loaned money available for use by the debtor. There is no reason, however, that these "zeros" should be the same number. Indeed, while the lender's expectations, involving the time value of money, are fairly quantitative, the guarantor's must be more speculative, as they involve calculations of the benefits that will accrue to the guarantor from the debtor's use of the borrowed funds.

The lender's and the insider guarantor's "zeroes" will diverge even more sharply where both are unsure that the debtor will make complete repayment. Here, because of their differing access to inside information, the lender and the guarantor will necessarily attach different probabilities to the possibility of the debtor's going bankrupt within any given time period, as well as to the guarantor's ability to repay the loaned amounts during any such period. The insider guarantor's estimates of these probabilities should be the more accurate.

ever, benefit both the insider guarantor and the lender. That is, such a payment would raise the expected gains from the loan above these "zeroes": the insider guarantor's anticipated liability on its guarantee would more quickly be reduced, and the lender would receive repayment earlier than expected.[62]

In this reduced Prisoner's Dilemma situation, both the insider guarantor and the lender have an incentive to do the wrong thing: the guarantor, to offer the preferential payment, and the bank, to accept it. In fact, the dissimilarities to the Prisoner's Dilemma make it even more likely that such "mutual defection" will occur in this situation. In the Prisoner's Dilemma, the prisoners knew that, in any possible outcome, at least one of them would experience a negative outcome (i.e., would go to jail). In the preferential repayment situation, there is no negative outcome from the attempt to make a preferential payment — at worst, the payment will be avoided as a preference. Further, there is a chance that the debtor will in fact not go bankrupt within a year of the payment date. In that case, the payment would not qualify as a preference under section 547(b) of the Code and the lender could retain the funds conveyed.

Thus, it is necessary to factor into the model the expectations of the insider guarantor and of the non-insider lender that the debtor will file for bankruptcy protection during various periods in the year after the date of transfer.

2. Timing of Bankruptcy

Probability theory expresses the expected payoff of a preferential transfer for the lender and the insider guarantor as the sum of the expected payoffs of that transfer in the following three cases: (1) the debtor's filing for bankruptcy within ninety days of the transfer; (2) the debtor's filing after ninety days but within one year of the transfer; and (3) the debtor's not filing for bankruptcy within one year after the transfer. Variables b90, b365, and b999 shall stand for the respective probabilities that each of these events shall occur.[63]

[62] For various reasons, the certainty of receiving a non-recoverable preferential payment in the amount of X may not be expected to benefit the lender or the insider guarantor by the exact amount X. For example, the payment may benefit the lender by the amount X plus interest. The simplifying assumption has been made, however, that the benefit would indeed be X, and that the benefit is the same for both guarantor and lender.

[63] Note that b365 does not equal the probability that the debtor will go file for bankruptcy within a year after the transfer, but instead stands for lesser probability

Each of these three probability variables can take on a value from zero (representing the expectation that the given event definitely will *not* occur) to one (representing the expectation that the event definitely *will* occur). Because one of the three events discussed above must happen (i.e., the debtor will either go bankrupt within ninety days, within ninety days to a year, or not within the year), the sum of the three probabilities is equal to one.[64]

Within each of these three timing situations, the payoff potentials for the insider guarantor and for the lender must be evaluated. Assuming that if the debtor goes bankrupt within a year, recovery will be made from either the guarantor or the lender, the probabilities of recovery from each party can be represented as follows. Variable g90 will represent the expected probability that, if the debtor goes bankrupt within ninety days, recovery will be made from the guarantor. Because we have posited that if recovery is not made from the guarantor it will be made from the lender, (1 - g90) will then stand for the probability that recovery will be made from the lender if the debtor goes bankrupt within ninety days. Similarly, g365 and (1 - g365) will stand for the expectations that if the debtor goes bankrupt more than ninety days but less than a year after bankruptcy, recovery will be made from the insider guarantor and from the lender, respectively.[65]

If a preferential payment in the amount of X is recovered from the insider guarantor or the lender that actor's payoff should be zero. Likewise, the payoff to the actor(s) from whom the payment is not recovered is X. Thus, without taking the guarantor's right of subrogation against the debtor into account, the expected payoff for the insider guarantor from a preferential transfer in the amount of X can be expressed as the sum of the expected payoffs from all possible situations resulting from this transfer. Each situation has its own associated probability, as set forth above, and would result in payoff X (if the transfer is not recovered from the party in question) or O (if the transfer is re-

that that the debtor will file its bankruptcy petition between ninety days and a year after the transfer. Of course, the lender and the insider guarantor may attach very different values to these variables; as noted *supra* at n.62, the insider guarantor's values will usually be the more accurate.

[64] In mathematical terms, b90 + b365 + b999 = 1.

[65] If the debtor goes bankrupt more than a year after the payment is made, the payment is not preferential and cannot be recovered from either the guarantor or the bank. Thus, the corresponding variable g999 will not be used explicitly since its value would be zero. Likewise, any representation of the probability that the payment would be recovered from the lender in this situation would also be zero.

covered from the party in question). Thus, the insider guarantor's expected payoff from the transfer can be represented as:

INSIDER GUARANTOR'S EXPECTED PAYOFF FROM TRANSFER=

Expected payoff if debtor does not file for bankruptcy within a year after the transfer = $X(b999)$

+ Expected payoff if debtor files for bankruptcy within ninety days of the transfer and the payment is recovered from the lender = $X(b90)(1 - g90)$

+ Expected payoff is debtor files for bankruptcy within ninety days after the transfer and the payment is recovered from the insider guarantor = $0(b90)(g90) = 0$

+ Expected payoff if debtor files for bankrupty within ninety days to a year after the transfer and the payment is recovered from the lender = $X(b365)(1 - g365)$

+ Expected payoff if debtor files for bankruptcy within ninety days to a year after the transfer and the payment is recovered from the insider guarantor = $0(b365)\ (g365) = 0$.

Thus,

INSIDER GUARANTOR'S EXPECTED
PAYOFF FROM TRANSFER =
$X[b699 + b90(1 - g90) + b365(1 - g365)]$

Similarly, the expected payoff to the lender can be expressed as:

LENDER'S EXPECTED PAYOFF
FROM TRANSFER = $X[b999 + b90g90 + b365g365]$

If the lender or the insider guarantor is certain that there will be a bankruptcy within a year and that recovery of preferential payments will be made from the guarantor, that party will expect the guarantor's payoff from the transfer to be zero.[66] That is, the lender will be expected to keep the preferential payment made by the debtor, and thus to reduce by this amount the guarantor's liability on the guarantee. The guarantor will, however, be expected to disgorge this amount by the trustee of the debtor's estate. In this situation, the lender will be expected to gain the amount of the preferential payment, because it will not itself have

[66] That is, where $b999 = 0$, $g90 = 1$ and $g365 = 1$, the insider guarantor's expected payoff from the preferential transfer, $X[b999+b90\ (1-g90)+b365(1-g365)] = X[0+0+0]=0$.

to disgorge the transfer that it received.[67]

If, on the other hand, there is a certainty that the transfer will be recovered from the lender as a preference, the lender's expected payoff will be zero: it will have neither gained nor lost from the transaction.[68] Here, the guarantor's expected payoff would be X, the full value of the preferential payment, because the guarantor's exposure would be reduced by this amount without his having to pay any of the amount out of pocket.[69]

3. The *Deprizio* Effect

a. *Non*-Deprizio

In those circuits rejecting *Deprizio*, all recovery of preferential payments made during the period from ninety days through one year after a preferential payment is made would come from the insider guarantor, rather than from the lender. In the terms of the mathematical model, g365 = 1.

This would affect the payoffs for the bank and the guarantor as follows:

INSIDER GUARANTOR'S EXPECTED PAYOFF FOR
TRANSFER (NON-DEPRIZIO) =
X[b699 + b90(l - g90) + b365(l - g365)] =
X[b999 + b90(l - g90)].

The insider guarantor's expected payoff would thus depend on b999, the expectation that the payment would not turn out to be preferential (i.e., that the debtor would not file for bankruptcy within the year after the transfer), as well as the expectations that the debtor would go bankrupt within ninety days after the transfer (b90) and that collection in this case could be made from the lender (l - g90).

Because in those circuits rejecting *Deprizio* recovery during the extended preference period could be made only from the guarantor, the lender's expected payoff, if the debtor did not file

[67] If the parameter values of footnote 66, *supra*, are applied to the expression for the lender's expected payoff for a preferential transfer, X[b999 + b90g90 + b365g365], that expression takes on the value X[0 + b90 + b365], or X, because, if the bankruptcy is expected to occur in one year, b90 + b365 = 1.

[68] Where b999 = 0, g90 = 0, and g365 = 0, the lender's expected payoff for a preferential transfer, X[b999 + b90g90 + b365g365], reduces to X[0 + 0 + 0], or 0.

[69] The values given in footnote 68, *supra*, will impart a value of X to the insider guarantor's expected payoff for a preferential transfer, X[b999 + b90(1-g90) + b365(1-g365)], because b90+b365=1 if a bankruptcy is expected within one year of the transfer.

for bankruptcy within ninety days of the transfer, would be the entire amount of the preferential payment. That is, because the lender would be receiving this payment from the debtor and would not have to disgorge it in any event, the whole amount of the payment would be gained by the lender.

LENDER'S EXPECTED PAYOFF FOR TRANSFER
(NON-*DEPRIZIO*) =
$X[b999+b90g90+b365g365] =$
$X[b999+b90g90+b365]$

Thus, where *Deprizio* has not prevailed, the insider guarantor has an incentive to make a potentially preferential payment if it believes that (a) the debtor can remain out of bankruptcy for one year after the transfer or that (b) the debtor will go bankrupt within ninety days after the transfer and that collection in this case could be made from the lender. The lender will have incentive to accept such a payment if it believes that (a) the debtor can remain out of bankruptcy for ninety days after the transfer or that (b) if the debtor goes bankrupt before ninety days have expired, collection will be made from the guarantor. Because any payment, preferential or not, would redound to the lender's advantage, however, the lender has reason to encourage preferential payments.

b. *Deprizio*

By introducing the possibility that preferential payments made during the extended preference period may be recovered from the lender rather than from the guarantor during the extended preference period, *Deprizio* lowers the value of variables g90 and g365 from one to some positive fraction less than or equal to one. The expected payoff equations resume their unreduced form, as none of the variables can be given a firm value.

INSIDER GUARANTOR'S EXPECTED PAYOFF
FOR TRANSFER (*DEPRIZIO*) =
$X[b999+b90(1 - g90) + b365(1-g365)].$

LENDER'S EXPECTED PAYOFF FOR TRANSFER
(*DEPRIZIO*) =
$X[b999 + b90g90 + b365g365].$

The total of both the bank's and guarantor's expected gains from a preferential payment is not affected by the application of *Deprizio*.[70] *Deprizio*, however, redistributes the expected benefits

[70] The difference is

of a preferential transfer from the lender to the guarantor. The guarantor's expected payoff for a preferential payment is raised by the amount that the guarantor expects to recover if the debtor files for bankruptcy within ninety days to one year after the preferential transfer and recovery is made from the lender;[71] the lender's expected payoff is lowered by the same amount.[72]

4. Implications

a. *Inside Information—Debtor's Financial Health*

As discussed above, the insider guarantor is typically better able than the lender to accurately estimate and manipulate the timing probabilities of bankruptcy: b90, and b365, and b999. If the insider guarantor knows that the debtor's filing will be made within a year following the transfer, the insider guarantor will be willing to press the idea of a potentially preferential transaction if it believes that it would not be the source of any subsequent recovery (i.e., if it assigns small values to g90 and g365). This is not the reasoning that the guarantor would care to share with the lender, however, whom the guarantor believes will be disgorging the payment to the trustee.

If the insider believes that the debtor can stay out of bankruptcy for more than a year, the insider should convey this information to the lender. If the insider's expectation is correct—if the payment allows the debtor to stay alive for another year—it will not be regarded as preferential and will not be recoverable from either the insider guarantor or the lender.

X[b999 + b90(1-g90) + b365(1 - g365) + X[b999 + b90g90 + b365g365] - [X + (b999) + X] =
X[b999 + b90(1 - g90) + b365(1 - g365) + b90g90 + b365g365 - 1] =
X[b999 + b90 - b90g90 + b365 - b365g365 + b90g90 + b365g365 - (b999 + b90 + b365)] = 0

[71] The difference between the guarantor's expected payoff for a preferential payment in a jurisdiction that accepts *Deprizio* and one in which *Deprizio* is rejected is
INSIDER GUARANTOR'S EXPECTED PAYOFF FOR TRANSFER (*DEPRIZIO*) -
INSIDER GUARANTOR'S EXPECTED PAYOFF FOR TRANSFER (NON-*DEPRIZIO*) =
X[b999 + b90(l-g90) + b365(l-g365)] -
X[b999 + b90(l-g90)] =
X(b365)(l-g365).

[72] LENDER'S EXPECTED PAYOFF FOR TRANSFER (*DEPRIZIO*) -
LENDER'S EXPECTED PAYOFF FOR TRANSFER (NON-*DEPRIZIO*) =
X[b999 + b90g90 + b365g365] -
X[b999 + b90g90 + b365] =
-X(b365)(l-g365).

b. *Inside Information— Guarantor's Financial Health*

An important factor not explicitly addressed in these calculations is the guarantor's ability to repay the preferential payment to the bankruptcy trustee. Of course, while the lender should be carefully monitoring the guarantor's financial health, the guarantor should know better than the lender the state of the guarantor's own assets.

In fact, if the guarantor knows that it will not be able to produce such an amount for recovery, it may be willing to enter into a preferential transaction whether or not it believes that recovery would be obtained from him. The lender would end up footing the bill even if the guarantor was approached first. As banks will most often not have greater assets than the insider guarantor, such lenders must use great caution and careful monitoring to avoid holding a guarantee from an insider who does not have sufficient collateral to fulfill its obligations.[73]

c. *Waiver of Subrogation Rights*

If, following the debtor's bankruptcy, recovery of a preferential payment was made from the insider guarantor, the guarantor would have a subrogation claim against the debtor in the amount of the recovery made from the guarantor. This claim, however, would most likely not be repaid in full. Assuming that the full amount, X, of the preferential payment is recovered from the guarantor, the guarantor could expect to receive the fraction X/T from the debtor's bankruptcy estate, where T represents the total amount of the unsecured claims, including X, against the estate at the time that the debtor files for bankruptcy. This effect on the insider guarantor's payoff, however, should already have been taken into account in calculating its zero.

It has been suggested by some commentators that the effects of *Deprizio* can be avoided by explicitly eliminating the insider guarantor's subrogation right against the debtor, thus removing the insider guarantor's status as a contingent creditor of the debtor.[74] Deprived of recourse against the debtor, the guarantor

[73] The lender's expected payoff equation could be adjusted for the possibility of partial recovery from the guarantor, by lowering the expected payoff amount, X, by which the probability of recovery from the guarantor is multiplied. If necessary, the bankruptcy of a guarantor forced to fulfill its obligations could additionally be taken into account.

[74] Katzen, *Deprizio and Bankruptcy Code Section 550: Extended Preference Exposure Via Insider Guarantees, and Other Perils Of Initial Transferee Liability*, 45 BUS. LAW. 511, 530-31 (1990) (suggesting that waiver of subrogration may implicate lender itself as

that has to pay the debtor's trustee X will not recover X/T. Assuming that the waiver of subrogation effectively prevents Deprizio's extended preference period from being applied,the expected payoffs for a potentially preferential payment will be as follows:

INSIDER GUARANTOR'S EXPECTED PAYOFF FOR TRANSFER (WAIVER OF SUBROGATION EFFECTIVE TO COUNTERACT *DEPRIZIO*) =

INSIDER GUARANTOR'S EXPECTED PAYOFF FOR PREFERENTIAL PAYMENT (NON-*DEPRIZIO*) - EXPECTED LOSS OF SUBROGATION VALUE IN EVENT OF BANKRUPTCY AND RECOVERY FROM GUARANTOR =

X[b999 + b90(l - g90)] - (X/T)[b90g90 + b365g365]

LENDER'S EXPECTED PAYOFF FOR PAYMENT (WAIVER OF SUBROGATION EFFECTIVE TO COUNTERACT *DEPRIZIO*) =

LENDER'S EXPECTED PAYOFF FOR PAYMENT (NON-*DEPRIZIO*) =

X[b999 + b90g90 + b365]

As of the publication of this article, no published decision has addressed whether the subrogation waiver effectively prevents a court from imposing *Deprizio*'s extended preference period on a lender that has taken the guarantee of, and has accepted payments beneficial to, an insider guarantor.[75]

insider or may involve lender too deeply in borrower's affairs, not only negating defense to *Deprizio* but also handicapping lender's collection efforts in other respects).

Another author has suggested that such a waiver might also cause a loan payment to be attacked as a fraudulent conveyance, under either the subjective test of § 548(a)(1) (transfer made with intent to hinder, defraud, or delay other creditors) or the objective test of § 548(a)(2) (transfer of assets for less than reasonably equivalent value). Borowitz, *Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio*, 45 BUS. LAW. 2151, 2161-65 (1990) (At 2158 n.22, Borowitz suggests the mathematical approach used above for representing subrogation.).

[75] In those jurisdictions that have explicitly rejected *Deprizio* P may be considered equal to one: P=1. Even these jurisdictions, however, have a chance of reversing themselves. Assume that the subrogation waiver has a probability of P of convincing the court that *Deprizio* is not applicable to the transaction, the expected payoffs will be as follows:

INSIDER GUARANTOR'S EXPECTED PAYOFF FOR PAYMENT (WAIVER OF SUBROGATION) =

INSIDER GUARANTOR'S EXPECTED PAYOFF FOR PREFERENTIAL PAYMENT (*Deprizio* Found to Apply Despite Waiver) +

IV. Conclusion

In the face of the extended preference period threat posed by *Deprizio*, lenders should carefully evaluate their need for insider guarantees. Such guarantees can be released if a guarantor is not longer able to fulfill its obligation or if more reliable security is available to the lender. While the effectiveness of the insider guarantor's waiver of its subrogation rights remains untested, lenders would be well-advised to scrutinize the finanical statements of their debtors and insider guarantors. Finally, lenders could minimize the Prisoner's Dilemma aspects of their situations by dropping all insider guarantees in favor of imposing higher interest rates or additional security requirements on the debtor. Then, these "prisoners" would actually be setting their own "terms."

INSIDER GUARANTOR'S EXPECTED PAYOFF FOR PREFERENTIAL PAYMENT (Waiver Found to Counteract Deprizio) =

$$P\{X[b999 + b90(1 - g90) + b365(1 - g365)] - \frac{X}{T}(b90g90 + b365g365)\} + (1 - p)\{X[b999 + b90(1 - g90)] - \frac{X}{T}(b90g90 + b365g365)\}$$

The waiver of subrogation with uncertain effect thus enables the insider guarantor to retain higher expectations than were possible before *Deprizio* because it still permits some chance that recovery will be sought from the bank, and not the guarantor. The guarantor, however, will expect less than it would without the subrogation waiver, because its prior expectation of recovery against the debtor has been removed.