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Term Insider within Section 547(b)(4)(B) of the Bankruptcy Code

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The Term Insider Within Section 547(b)(4)(B) of the Bankruptcy Code

The United States Congress enacted the Bankruptcy Reform Act of 1978[1] because it perceived an urgent need to modernize bankruptcy law.[2] The Code contains an important concept, the "insider,"[3] which was not found in its precursor, the Bankruptcy Act of 1898[4] (the Bankruptcy Act). The insider concept's most significant use concerns voidable preferences under section 547 of the Code.[5]

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1 Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-151326 (Supp. 1978).

2 S. REP. NO. 989, 95th Cong., 2d Sess. 1, *reprinted in* [1978] U. S. CODE CONG. & AD. NEWS 5787 [hereinafter cited as 1978 Senate Rep.].

3 11 U.S.C. § 101(25) (Supp. 1978) defines the term "insider" as follows:

(25) "insider" includes—

(A) if the debtor is an individual—

(i) relative of the debtor or of a general partner of the debtor;

(ii) partnership in which the debtor is a general partner;

(iii) general partner of the debtor; or

(iv) corporation of which the debtor is a director, officer, or person in control;

(B) if the debtor is a corporation—

(i) director of the debtor;

(ii) officer of the debtor;

(iii) person in control of the debtor;

(iv) partnership in which the debtor is general partner;

(v) general partner of the debtor; or

(vi) relative of a general partner, director, officer, or person in control of the debtor;

(C) if the debtor is a partnership—

(i) general partner of the debtor;

(ii) relative of a general partner of, or person in control of the debtor;

(iii) partnership in which the debtor is a general partner;

(iv) general partner of the debtor; or

(v) person in control of the debtor;

(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;

(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and

(F) managing agent of the debtor.

4 Bankruptcy Act of 1898, 30 Stat. 544 (current version at 11 U.S.C. §§ 101-15132 (1976 & Supp. 1978)) (repealed by 11 U.S.C. § 401(a) (Supp. 1978)).

5 *See* 11 U.S.C. § 547(b). Other Code sections that include the term "insider" are: § 502(b)(5) (disallowing claims for the services of an insider or an attorney of the debtor where the claims exceed the reasonable value of the services); § 547(c)(5)(A)(ii) (extending the insider concept to the voidable preference test for floating lien); § 702(a)(3) (forbidding a creditor from voting for a trustee candidate if the creditor is an insider); § 727(a)(7) (authorizing a court to block a debtor's discharge if he commits an act provided for in § 747(a)(1)(c) during the year before the debtor's case in connection with another bankruptcy case concerning an insider); § 747(1) (subordinating insider net equity claims to all other customer

Specifically, the Code allows the trustee in bankruptcy to challenge transactions between a debtor and an insider that were made up to one year before the debtor filed a petition in bankruptcy.[6] The insider concept's primary purpose is to help achieve the goals of the Code's preference section.

This note initially will examine the Code's goals as they relate to the insider concept. Part two extensively examines the definition of insider to determine what persons risk being deemed insiders. Part three analyzes the different burdens of proof for insider and non-insider transactions in the context of voidable preferences.

I. Legislative History and Goals of Section 547

One commentator notes that there is surprisingly little legislative history explaining why Congress chose to extend preference liability for insiders to one year before bankruptcy.[7] However, examining the Code's legislative history reveals both the Code's overall goals, and the goals of its preference section 547. From this examination, the rationale for the insider provision can be discerned.

The Code's overall goals, as stated by the Senate Finance Committee, are:

> [t]o make bankruptcy procedures more efficient, to balance more equitably the interests of different creditors, to give greater recognition to the interests of general unsecured creditors which enjoy no priority in the distribution of the assets of the debtor's estate, and to give the debtor a less encumbered "fresh start" after bankruptcy.[8]

From these goals, two primary purposes of section 547 are discernable. First, by permitting the trustee to avoid certain prebankruptcy transfers, Congress wished to discourage creditors from racing to the courthouse to dismember the debtor during his slide into bank-

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claims); § 1129(a)(5)(B) (a court shall not confirm a reorganization plan if the proponent of the plan has not disclosed the identity of an insider that will be employed or retained by the reorganized debtor and the nature of any compensation for those insiders). This note focuses on the "insider" concept as it affects the statutory scheme of voidable preferences under § 547.

6 11 U.S.C. § 547(b)(4)(B) provides that the trustee may avoid any transfer of property to the debtor made:

> (A) on or within ninety days before the date of the filing of the petition; or
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> (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—
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> (i) was an insider; and
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> (ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer.

7 Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 HOUS. L. REV. 289, 293 n.10 (1980).

8 S. REP. NO. 1106, 95th Cong., 2d Sess. 1 (1978).

ruptcy.[9] Second, Congress intended to promote equality among creditors by not allowing a debtor to favor any one creditor in distributing his assets.[10] Of these two, Congress expressly declared equality among creditors to be the overriding purpose.[11]

Because the voidable preference section of the Bankruptcy Act[12] failed to advance distribution equality among creditors and failed to discourage the creditors' race to the courthouse,[13] Congress enacted a new preference section. The first weakness of the Bankruptcy Act's voidable preference section was that it required the trustee in bankruptcy to prove that the debtor was insolvent when he made the transfer to the creditor. Because the insolvency burden was difficult to meet, it did little to help deter the race among creditors.[14] A second weakness[15] was that the Bankruptcy Act's preference section required the trustee to show the creditor had "reasonable cause to believe the debtor was insolvent" when the debtor made the transfer to show a voidable preference.[16] It is absurd, however, to relate the creditor's state of mind with the policy of distribution equality among creditors. If a debtor prefers one creditor over others, he has reduced the amount of assets available to satisfy other creditors' claims, whether or not the creditor knew of the debtor's insolvency at

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9 H.R. REP. NO. 595, 95th Cong., 2d Sess. 178, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6138 [hereinafter cited as 1978 HOUSE REP.]. The report explains further that this debtor protection often enables him to work out of a difficult financial situation by being able to cooperate with his creditors. *Id.*

10 *Id.*; REPORT OF THE COMMISSION OF BANKRUPTCY LAWS, H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. I, at 202 (1973) [hereinafter cited as COMMISSION REP.].

11 1978 HOUSE REP., *supra* note 9, at 178, [1978] U.S. CODE CONG. & AD. NEWS at 6138 ("[T]he operation of the preference section to deter the 'race of diligence' of creditors to dismember the debtor furthers the second goal of the preference section . . . that of equality of distribution.").

12 Bankruptcy Act of 1898, Ch. 541, § 60, 30 Stat. 562 (1898) (current version at 11 U.S.C. § 96 (1976)) (repealed by 11 U.S.C. § 401(a) (Supp. 1978)).

13 1978 HOUSE REP., *supra* note 9, at 177, [1978] U.S. CODE CONG. & AD. NEWS at 6138.

14 *Id.* The House Report comments that the state of most debtors' books and records made the task of proving insolvency difficult. Since the burden of proof was so great, preference recoveries were difficult and, therefore, the race among creditors was not effectively deterred. *Id.* at 177-78, [1978] U.S. CODE CONG. & AD. NEWS at 6138-39. *See* text accompanying notes 83-84 *infra*.

15 Two other problems also existed in the Bankruptcy Act's preference section. First, the adoption of the Uniform Commercial Code in nearly every state so greatly altered the terminology of secured transactions that the Bankruptcy Act's language was obsolete. Second, the Bankruptcy Act's language was too complex and subject to varying interpretations. 1978 HOUSE REP., *supra* note 9, at 179, [1978] U.S. CODE CONG. & AD. NEWS at 6139-40.

16 1978 HOUSE REP., *supra* note 9, at 178, [1978] U.S. CODE CONG. & AD. NEWS at 6139.

the time of transfer.[17]

To remedy the weaknesses in the Bankruptcy Act's voidable preference section, Congress, in the Code, shortened the Bankruptcy Act's four-month preference period to ninety days[18] and created a presumption of insolvency in the ninety-day period.[19] The Code also eliminates the reasonable cause to believe requirement during the ninety-day period.[20] No presumption of insolvency exists for insider transfers between ninety days and one year of bankruptcy, and the trustee must show the creditor had reasonable cause to believe the debtor was insolvent to avoid these transfers.[21] However, the insider provision does provide a mechanism for the trustee to avoid certain transfers outside the ninety-day period.

The insider concept's effectiveness can be judged only by measuring it against the stated goals of section 547 and the impediments to these goals in the Bankruptcy Act.[22] 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."[23] The primary reason for such exacting scrutiny of insiders is that persons with a close relationship to the debtor naturally have access to more information.[24] Thus, insiders can exert greater influence on the debtor,[25] which causes insider transactions to be less vulnerable to the market pressures that help control arm's-

17 *Id. See* COMMISSION REP., *supra* note 10, at 203 ("When a preference is given within the suspect period, [the debtor's] intention should be irrelevant.").

18 *Compare* Bankruptcy Act of 1898, ch. 541, § 60 *with* 11 U.S.C. § 547(b)(4)(B) (Supp. 1978).

19 11 U.S.C. § 547(f) (Supp. 1978).

20 *See* 11 U.S.C. § 547(b)(4)(A) (Supp. 1978).

21 *See* 11 U.S.C. § 547(b)(4)(B) (Supp. 1978). For a more complete discussion of the changes in § 547, see Part III *infra*.

22 This note examines whether § 547 promotes equality among creditors, and whether any features of § 547, especially the burden of proof problem, impede this goal. For treatment of the burden of proof problem, see Part III *infra*.

23 1978 SENATE REP., *supra* note 2, at 25, [1978] U.S. CODE CONG. & AD. NEWS at 5810.

24 Note, *Avoidance of Preferential Transfers Under the Bankruptcy Reform Act of 1978*, 65 IOWA L. REV. 209, 219 (1979).

25 *Id.*; *see* Nimmer, *supra* note 7. Nimmer states:

> [T]he apparent purpose is to ameliorate the potential beneficial leverage that can be exerted by a creditor who has control (at least in part) of a debtor and is aware of the possibility of a bankruptcy petition. Presumably, such creditor might exercise his control to avoid the absolute liability of the ninety-day preference. Alternatively, the control might be used to step ahead of other creditors demanding payment.

Conceivably, an insider might use his influence to delay the filing of the bankruptcy petition so that the insider transfer will fall outside the ninety-day preference period.

length transactions.[26] Exacting scrutiny is also warranted because the insider's close relationship to the debtor may veil a potentially preferential transfer, or may even deliberately conceal the preference.[27]

Although the insider concept is new to the Code, a more exacting judicial scrutiny of those in a special relationship with the debtor is not new. The term insider "has merely regulated the sound de facto practice of those who . . . are in a position to gain a special advantage as a result of the debtor's involvement in bankruptcy proceedings."[28] The Bankruptcy Act treated as fraudulent some transfers which are now considered insider preferences.[29] The insider concept in Code section 547 directly attacks the insider preference.[30] The trustee in bankruptcy now has a mechanism available to challenge certain transfers falling outside the normal ninety-day preference period, provided that the transferee comes within the insider definition.

II. Who is an Insider—Key Definitions

An insider is one who has a sufficiently close relationship with the debtor, requiring more exacting scrutiny than people dealing at arm's length with the debtor.[31] However, section 101(25) of the Code presents only a detailed list of persons deemed insiders.[32] "[B]ecause the term [insider] is not susceptible of precise definition,"[33] the Code's definition is open-ended and merely lists examples of insider relationships.[34] This open-ended definition enables courts to use the insider concept flexibly in different situations. This will result in courts determining insider status on a case-by-case basis.[35] The term insider is thus meant to encompass more than that included in the

26 Note, *supra* note 24, at 219.

27 *Id.*

28 1 COLLIER BANKRUPTCY MANUAL ¶ 101.25 (1979).

29 Section 67d(3) of the 1898 Act purported to codify Dean v. Davis, 242 U.S. 438 (1917), and limited its definition of fraudulent transfers to those made with insolvent borrowers or incurred in contemplation of bankruptcy or liquidation of the debtor's property. 4 L. KING, COLLIER ON BANKRUPTCY ¶ 547.29 n.1 (15th ed. 1981).

30 4 L. KING, COLLIER ON BANKRUPTCY ¶ 547.29 n.1 (15th ed. 1981).

31 1978 SENATE REP., *supra* note 2, at 25, [1978] U.S. CODE CONG. & AD. NEWS at 5810.

32 *See* note 3 *supra*.

33 1978 SENATE REP., *supra* note 2, at 26, [1978] U.S. CODE CONG. & AD. NEWS at 5812.

34 *See Id.* at 28, [1978] U.S. CODE CONG. & AD. NEWS at 5814, explaining Code § 103 concerning rules of construction. Paragraph (3) expressly declares that the terms "includes" and "including" are not limiting. 11 U.S.C. § 103(3) (Supp. 1978).

35 *See* 2 L. KING, COLLIER ON BANKRUPTCY ¶ 101.25 (15th ed. 1981) (qualification as an insider is a question of fact).

section 101(25) definition.[36]

The insider definition in section 101(25) also includes a "person in control." Since the Code defines neither "person in control" nor "control,"[37] litigation will have to produce the definitions.[38] One commentator suggests that in using the word control Congress intended the same broad concept of control found in the securities law.[39] If the control concept is that broad, it would then be possible for a bank that provides the necessary financing to an insolvent firm to be deemed an insider by virtue of its control over the debtor. This is particularly true where the bank may declare the loan in default at any time, and where it holds either personal guarantees of the princi-

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36 It is not clear at this point how broadly courts will interpret the insider definition. A United States Bankruptcy Court in New York recently restricted the insider concept to those examples explicitly enumerated in § 101(25). *In re* Castillo, 7 B.R. 135 (S.D.N.Y. 1980). The court declared that "[s]ince the defendant . . . is neither a relative nor a partner of the debtors, nor are the debtors, directors, officers or persons in control of the defendant, it manifestly follows that the defendant is not an 'insider' . . . ." *Id.* at 137. The court's ruling effectively ignores the word "includes" in the insider definition and restricts the definition to its literal terms.

Another court has ruled that the debtor's attorney is not automatically an insider. Bahas v. Sagen (*In re* Durkey), 9 B.R. 58 (N.D. Ohio 1981). The court examined congressional intent as evidenced by § 502(b)(5) of the Code, which states that a claim for services by an insider *or* attorney of the debtor may be disallowed to the extent it exceeds the reasonable value of the services. The language of § 502(b)(5) demonstrates that Congress meant to distinguish the debtor's attorney from an insider. 9 B.R. at 61. Furthermore, the court noted that the examples found in § 101(25) are relationships that assume a high likelihood of control. The facts in *Bahas*, however, demonstrate that no such controlling relationship existed at the time of the alleged preferential transfer because the creditor was no longer debtor's attorney and the creditor's corporation was in the process of evicting the debtor from his home when the transfer was made. *Id.* Therefore, the debtor's attorney, though in a close relationship to the debtor, was not an insider because of the lack of any possible control over the debtor. This added requirement of possible control is consistent with the congressional intent to give closer scrutiny to the acts of people sufficiently close to the debtor. *See* text accompanying notes 20-23 *supra*.

The court in *Bahas*, unlike the court in *Castillo*, paid proper attention to the use of the word "includes" in defining the insider, and based its decision on the case's facts rather than on a restrictive reading of § 101(25).

37 "Person" is defined as including an individual, partnership or corporation, but not governmental units. 11 U.S.C. § 101(30) (Supp. 1978). Congress explicitly excluded governmental units to avoid any confusion that could arise if, for example, a municipality is incorporated and is thus both a corporation and a municipality. 1978 SENATE REP., *supra* note 12, at 25, [1978] U.S. CODE CONG. & AD. NEWS at 5811.

38 Note, *supra* note 24, at 219.

39 Queenan, *The Preference Provisions of the Pending Bankruptcy Law*, 83 COM. L.J. 465, 470 (1977). Regulations pursuant to the Securities Exchange Act of 1934 broadly define control as "possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12b-2(f) (1981).

pal or collateral vital to the business's operation.[40]

Courts should define "control" in the bankruptcy insider context in a similarly broad fashion, thus furthering section 547's goal of equality among creditors. The insider concept attempts to provide creditor equality by more closely scrutinizing people who are close enough to the debtor to influence his actions. Therefore it is reasonable to apply the securities law's broad concept of control.[41] A bank that can withhold needed financing or collateral essential to a firm's operations[42] may be easily tempted to influence the insolvent borrower's actions in the bank's favor.

Another term appearing in the insider definition that is itself defined in Code section 101(34) is "relative." A relative is defined as an "individual related by affinity or consanguinity within the third degree as determined by the common law, or an individual in a step or adoptive relationship within such third degree."[43] Whether a person is a relative of the debtor, or of a person or entity in control of the debtor, and thus is an insider, is determined at the time of the challenged transaction.[44]

One bankruptcy court applied the insider concept to the debtor's relative in *Ross v. Kaplan* (*In re Harris*).[45] In *Ross*, an insolvent debtor, though owing creditors over $800,000, placed all of his assets into a trust for the benefit of his minor children.[46] The debtor argued that the transfer was not fraudulent because he owed $200,000 to his children,[47] and that the transfer should not be set

40 Queenan, *supra* note 39, at 470.

41 Applying this broad concept of control should help the trustee to avoid more transfers as preferences. This will help achieve the goal of distribution equality by keeping more assets available for distribution to all the debtor's creditors.

42 *See* text accompanying note 40 *supra*.

43 11 U.S.C. § 101(34) (Supp. 1978).

44 1978 SENATE REP., *supra* note 2, at 26, [1978] U.S. CODE CONG. & AD. NEWS at 5812. A debtor's former spouse is not a relative if the transferee was the debtor's spouse at the time the transfer was made, even though the transferee is no longer the debtor's spouse at the time of the initiation of bankruptcy proceedings. *Id.*

In Beck v. Amato (*In re* Beck), 10 B.R. 120 (S.D. Fla. 1981), the court ruled that the debtor's daughter, who received transfers from the debtor within one year of the initiation of bankruptcy proceedings, was an insider because of her relationship to the debtor. *Id.* at 122. Because the court held that the transfers were within the ninety-day preference period of § 547, and could thus be avoided irrespective of whether the daughter was an insider, the court's discussion of the insider concept was dictum.

45 7 B.R. 456 (S.D. Fla. 1980).

46 *Id.* at 457.

47 *Id.* at 458. 11 U.S.C. § 548(a) (Supp. 1978) provides that a transfer made by a debtor within one year of filing a petition in bankruptcy makes the transfer fraudulent if he makes it with "actual intent to hinder, delay, or defraud" any entity to whom he was indebted on or

aside as a voidable preference because he transferred the assets more than ninety days before filing a petition in bankruptcy.[48] The court found no evidence that the debtor owed his children money, and set the transfer aside as fraudulent.[49] The court further stated, however, that even if the transfer was for payment of a debt to the children, it was a voidable preference because (1) the transfer occurred less than one year before bankruptcy and (2) the children were insiders.[50]

Although it may appear doubtful that a young child could influence a debtor's actions so as to be classified an insider, it is reasonable to assume that a parent would rather transfer property to his or her children than to another creditor. The child would thus be influencing the debtor's actions, albeit indirectly, and would be making less property available to the debtor's other creditors. Because the primary goal of section 547 is equality among creditors,[51] insider status should apply where a child is in a position to indirectly influence the debtor's actions to the detriment of the debtor's other creditors.

Another integral term in the insider concept is that of "affiliate," which the Code defines precisely in section 101(2).[52] The Code's definition of affiliate explicitly excludes the nominal holder of a minimal

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after the transfer date or if he "received less than a reasonably equivalent value in exchange for such transfer" if the debtor was insolvent on the transfer date or became insolvent because of the transfer.

48 7 B.R. at 458.

49 *Id.*

50 The court declared further that the children had reasonable cause to believe the debtor was insolvent, because the debtor's knowledge of his own financial condition is imputed to his children. *Id.*

51 *See* text accompanying notes 10-11 *supra*.

52 11 U.S.C. § 101(2) (Supp. 1978).

Note the definition of affiliate uses the word "means" rather than "includes." Therefore, the definition of affiliate is intended to be a precise definition. *See* 2 L. KING, COLLIER ON BANKRUPTCY ¶ 101.00[2] (15th ed. 1981).

11 U.S.C. § 101(2) defines affiliate as:

> (A) [an] entity that directly or indirectly owns, controls, or holds power to vote, 20 per cent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities:
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> (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
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> (ii) solely to secure a debt, if such entity has not, in fact, exercised such power to vote;
>
> (B) [a] corporation 20 per cent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls or holds with power to vote, 20 per cent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—
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> (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

number of shares.[53] Consequently, an entity that either acts in a fiduciary or agency capacity without the sole discretionary voting power, or holds as a pledgee without having exercised voting power, is not an affiliate.[54] Another exclusion from the affiliate definition concerns those persons substantially all of whose property is operated under a lease agreement by a debtor.[55] Where a small company that owns equipment leases it entirely to a larger, non-related company,[56] the small company is not an affiliate of the larger company.

As a result of the relatively recent Code enactments, and the flexible nature of many of the Code's key definitions, particularly that of insider, there are to date no established judicial definitions for these key terms. Thus, individual practitioners must examine for themselves the insider definition, and the key terminology within it, in order to understand the insider provision's litigation potential.[57]

III. The Trustee's Burden of Proof in Insider Transactions

Once the trustee in bankruptcy has shown that a transferee is an insider, and that the transfer occurred between ninety days and one year before the filing of the bankruptcy petition,[58] he must prove two more distinct elements. First, the trustee must show that the insider had reasonable cause to believe the debtor was insolvent. Second, the trustee must demonstrate that the debtor was actually insolvent

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> (ii) solely to secure a debt, if such entity has not, in fact, exercised such power to vote;
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> (C) [a] person whose business is operated under a lease or operating agreement by a debtor, a person substantially all of whose property is operated under an operating agreement with the debtor; or entity that operates the business or all or substantially all of the property of the debtor under a lease or operating agreement.

Note how frequently the affiliate definition uses the phrase "directly or indirectly" in referring to ownership or control. The Code's drafters used this phrase "to cover situations in which there is opportunity to control it where the existence of that opportunity operates as an indirect control." 1978 SENATE REP., *supra* note 2, at 21, [1978] U.S. CODE CONG. & AD. NEWS at 5807. Compare the similarly broad definition of control at text accompanying notes 34-36 *supra*.

The term "entity," which appears often in the affiliate definition, includes a "person, state, trust, or governmental unit." 11 U.S.C. § 101(14) (Supp. 1978). Again note the use of the word "includes" to denote the flexible character of the definition.

53 The minimal number of shares an entity or corporation must hold in a debtor is 20% of the debtor's outstanding voting securities. *See* 11 U.S.C. § 101(2)(A) & (B) (Supp. 1978).

54 This limitation on the coverage of "affiliate" also applies to a corporate affiliate under Code § 101(2)(B). *Id.*

55 124 CONG. REC. H11,089-90 (daily ed. Sep. 28, 1978) (remarks of Rep. Edwards).

56 *Id.*

57 *See* Note, *supra* note 24, at 219.

58 *See* 11 U.S.C. § 547(b)(4)(B) (Supp. 1978).

at the date of the transfer.[59] Without meeting these two burdens, the trustee cannot avoid the transfer as preferential.

In section 547, Congress enacted a two-level preference scheme. The trustee can ordinarily avoid preferences made to creditors within ninety days of filing the petition in bankruptcy. For such ninety-day transfers, the Code does not require the trustee to prove that the transferee had reasonable cause to believe the debtor's insolvency, as the Bankruptcy Act required.[60] Also, during the ninety-day preference period, the Code creates a presumption that the debtor was insolvent.[61] This insolvency presumption recognizes that most bankrupt debtors are in fact insolvent during the ninety days before the start of bankruptcy proceedings.[62] Because Federal Rule of Evidence 301 governs the insolvency presumption, the transferee must present some evidence to rebut the presumption and show that the debtor was not insolvent.[63] However, the ultimate burden of proving insolvency rests with the trustee.[64] Nevertheless, the ninety-day insolvency presumption has greatly reduced the trustee's burden, and has thus facilitated preference recoveries and furthered the goal of equality of distribution among creditors.[65] The ninety-day insolvency presumption, coupled with the elimination of the reasonable cause to believe requirement, should make it easier for the trustee to avoid preferences during the ninety-day period.[66]

The second tier of section 547 concerns avoiding transfers by the

59 The Bankruptcy Act required the trustee in bankruptcy to prove both reasonable cause to believe and the debtor's actual insolvency for all transfers within a limited four-month preference period. The Code retains these requirements only for insider transfers that occur between 90 days and one year before bankruptcy. *See* 11 U.S.C. § 547(b)(4)(B) (Supp 1978).

60 *Compare* Bankruptcy Act of 1898, *supra* note 4, *with* 11 U.S.C. § 547(b)(4)(A) (Supp. 1978).

61 11 U.S.C. § 547(f) (Supp. 1978).

62 1978 HOUSE REP., *supra* note 9, at 178, [1978] U.S. CODE CONG. & AD. NEWS at 6138.

63 FED. R. EVID 301 provides, in part: "In all civil actions . . . , a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption but does not shift to such party the burden of proof. . . ." Future litigation may concern the quantum of evidence necessary to rebut the presumption.

64 1978 SENATE REP., *supra* note 2, at 89, [1978] U.S. CODE CONG & AD NEWS at 5875.

65 *See* Note, *supra* note 24, at 217.

66 One commentator contended that in most Bankruptcy Act cases, proving insolvency did not present severe evidentiary problems. *See* Queenan, *supra* note 34, at 469. Other commentators, however, have concluded that the burden of proving insolvency made it more difficult for trustees to recover preferences. *See* Levit, *The Archaic Concept of Balance Sheet Insolvency*, 47 AM. BANKR. L.J. 215, 216-20 (1973); Note, *supra* note 24, at 216-17. The Code's legislative history reveals that Congress reached the latter conclusion. 1978 HOUSE REP., *supra* note 9, at 178, [1978] U.S. CODE CONG. & AD. NEWS at 6138.

debtor to insiders, that are made between ninety days and one year before bankruptcy.[67] Unlike the ninety-day transfers, second-level insider transfers do not benefit from a presumption of insolvency. For insider transfers, the trustee must prove that the debtor was actually insolvent at the time of transfer, and that the insider had reasonable cause to believe the debtor was then insolvent.[68] Thus, for insider transfers, the trustee faces the same burden of proof problem that he faced under the Bankruptcy Act.

A. *Reasonable Cause to Believe Debtor's Insolvency*

The reasonable cause to believe standard in section 547(b)(4)(B)(ii) of the Code is identical to the standard found in the Bankruptcy Act. As a result, one commentator has suggested that the case law that governed the reasonable cause to believe standard under the Bankruptcy Act should still apply to insider transfers under the Code.[69] A Tennessee federal district court so held, stating that "[n]othing in the legislative history of 547(b)(4)(B) indicates that Congress intended to change the state of the law concerning reasonable cause to believe the debtor to be insolvent."[70]

The judicial standard for reasonable cause to believe under the Bankruptcy Act required that the transferee have sufficient knowledge of facts to put a reasonably prudent businessman on inquiry as to the debtor's financial status.[71] The law did not require the trustee to prove the creditor actually knew of the debtor's insolvency.[72] Mere suspicion by the transferee that the debtor was having financial problems, however, was insufficient to establish reasonable cause to believe.[73] Whether the creditor had been put "on inquiry," and thus had reasonable cause to believe the debtor was insolvent, is a question of fact in each case.[74]

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67 *See* 11 U.S.C. § 547(f) (Supp. 1978).

68 *Id.* § 547(b)(4)(B)(ii).

69 4 L. KING, COLLIER ON BANKRUPTCY ¶ 547.30 (15th ed. 1981).

70 Waldschmidt v. Ranier (*In re* Fulghum Constr. Co.), 7 B.R. 629, 638-39 (M.D. Tenn. 1980).

71 Green v. A.G. Edwards & Sons, Inc. 582 F.2d 439, 443 (8th Cir. 1978); Mack v. Bank of Lansing, 396 F. Supp. 935, 942 (W.D. Mich. 1975); *In re* Cichanowicz, 247 F. Supp. 975, 977 (E.D.N.Y. 1965); Dean v. Planters Nat'l Bank, 176 F. Supp. 909, 913 (E.D. Ark. 1959).

72 582 F.2d at 443; 176 F. Supp. at 913.

73 582 F.2d at 443, 176 F. Supp. at 913.

74 582 F.2d at 442; 176 F. Supp. at 913; 4 J. HENDERSON, REMINGTON ON BANKRUPTCY § 1707 (rev'd ed. 1957). Some of the recurring factors that have indicated reasonable cause to believe in the debtor's insolvency include undercapitalization of the debtor, sales by the debtor below cost, checks which are not honored because of insufficient funds, a consistent pattern of overdrafts, operating losses, irregular or unusual conduct, criminal conduct, secre-

Aside from the mechanics of the reasonable cause to believe standard, whether the standard aids the goals of section 547 is a distinct inquiry. The reasonable cause to believe requirement has provoked criticism. One commentator finds the old case law confusing, and believes that courts have often reached inconsistent results.[75] Another criticism is that courts have placed this duty of inquiry on creditors even where one may not reasonably expect a creditor to inquire further.[76] Also, courts seem to have assumed that further inquiry by the creditor would necessarily have disclosed insolvency.[77] Despite these criticisms, some commentators have concluded that the reasonable cause to believe requirement will not pose as great a proof problem for insider transfers under the Code as it did for transfers under the Bankruptcy Act, because of the close relationship between insider and debtor.[78]

The reasonable cause to believe standard is also inherently faulty because the transferee's intent is irrelevant to whether the debtor has given a preference. Since the purpose of the insider provision is to discourage an insider from manipulating the debtor's actions to benefit the insider,[79] it *appears* that the insider's intent is relevant. The latter school of thought would argue that an insider without reasonable cause to believe that the debtor is insolvent should not be penalized merely for collecting his debts. However, the

tiveness, slow collection measures taken by other creditors, financial rescue of the debtor from embarrassment by friends or relatives and reliance on fictitious financial statements. 176 F. Supp. at 914; 4 L. KING, COLLIER ON BANKRUPTCY ¶ 547.30 (15th ed. 1981).

75 Queenan, *supra* note 39, at 468.

76 *Id.*

77 *Id.*

78 4 L. KING, COLLIER ON BANKRUPTCY ¶ 547.30 (15th ed. 1981): Note, *supra* note 24, at 219; Queenan, *supra* note 39, at 469. In fact, courts that have labelled a creditor as an insider have had little trouble finding that the insider had reasonable cause to believe the debtor was insolvent. *See, e.g.*, Beck v. Amato (*In re* Amato), 10 B.R. 120, 122 (S.D. Fla. 1981); Waldschmidt v. Ranier (*In re* Fulghum Constr. Co.), 7 B.R. 629, 639 (M.D. Tenn. 1980); Ross v. Kaplan (*In re* Harris), 7 B.R. 456 (S.D. Fla. 1980). In *Ross*, the court imputed the debtor's knowledge of his financial condition to his minor children and charged them with reasonable cause to believe that their father was insolvent.

The court's sole rationale to support its finding of reasonable cause on behalf of the minor children was that the children were insiders. It is illogical, however, to assert that such knowledge flows inexorably from a mere insider relationship. Indeed, minor children may not even understand the meaning of insolvency. Furthermore, Congress surely intended that the reasonable cause standard be a separate item of proof in insider cases from proof of insider status itself. The court in *Ross*, on the other hand, disregarded the congressional intent in § 547(b)(4)(B), and ruled that reasonable cause to believe in the debtor's insolvency followed from an insider relationship. The two requirements must be separately proven as Congress intended.

79 *See* text accompanying note 17 *supra*.

insider's intent should be irrelevant for two reasons. First, the insider transferee will have benefited from the preferential transfer at the expense of other creditors, regardless of whether the transferee had reason to believe that the debtor was insolvent. Second, even where an insider transferee does not have reasonable cause to believe the debtor is insolvent, the insider can be in a position to indirectly control or manipulate a debtor's actions without any suspicion on his part that the debtor is insolvent.[80] Because the creditor's intent is irrelevant in determining whether a preference has been given and because the reasonable cause to believe standard may frustrate the goal of distribution equality among creditors, Congress should eliminate the reasonable cause to believe standard from section 547.

B. *Actual Insolvency at Time of Transfer*

The Code does not extend the presumption of insolvency beyond the ninety-day preference period. For insider preferences falling outside the ninety-day period, the trustee must still prove that the debtor was actually insolvent when he made the transfer.

The Bankruptcy Act's balance sheet test of insolvency still applies to the Code.[81] The trustee must thus show that on the transfer date, the debtor's debts were greater than his assets, which are valued at their fair market value.[82] The trustee can establish fair valuation by using balance sheets, financial statements, appraisals, expert testimony or other affirmative evidence.[83]

Proving balance sheet insolvency at a specific date can be an

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80 An example of an insider exercising indirect control over the debtor while being unaware of the debtor's insolvency is a bank having the power potentially to withhold needed financing or collateral essential to the debtor firm's operations. A second example is a parent who repays a debt to a child who has no knowledge of his parent's financial condition. Because a parent will reasonably attempt to repay his child before another creditor, the child has exercised an indirect control over the debtor, regardless of the child's knowledge concerning the debtor's insolvency. Although the child has done nothing to directly manipulate the parent's actions, the child has influenced the parent's actions to his own advantage.

81 "The definition of insolvent is adopted from Section 1(19) of [the Bankruptcy Act]. An entity is insolvent if its debts are greater than its assets, at a fair valuation . . . . It is the traditional bankruptcy balance sheet test of insolvency." 1978 SENATE REP., *supra* note 2, at 25, [1978] U.S. CODE CONG. & AD. NEWS at 4811. *See* 4 L. KING, COLLIER ON BANKRUPTCY § 547.26 (15th ed. 1981).

82 11 U.S.C. § 101(26)(A) (Supp. 1978) requires that assets be given a "fair valuation" for purposes of the insolvency test. For most courts, fair valuation means fair market value, or that value that can be made available for debt payment within a reasonable time. *See* Waldschmidt v. Ranier, 7 B.R. 629, 633 (M.D. Tenn. 1980).

83 7 B.R. at 633. A court may also reduce the fair value of the debtor's assets if they cannot be liquidated, and are thus unavailable for debt payment. *Id.*

onerous and often impossible task.[84] The trustee must reconstruct the bankrupt's books to determine the debtor's assets and debts on the transfer date. Typically, the bankrupt's books will be in a state of disarray—noncurrent and incomplete.[85] Thus, simply showing a general picture of the bankrupt's debts and assets at the transfer date is a difficult task.

A second difficulty confronting the trustee is to establish the fair valuation of the bankrupt's assets on the transfer date.[86] Even assuming that the bankrupt has reasonably current and complete financial records, the trustee must still convert these records to their transfer date condition.[87] Finally, the general judicial standard for measuring fair valuation requires estimating what the assets could have been sold for, not to specific buyers at a specific time, but to an average capable businessman willing to buy under ordinary conditions.[88]

The balance sheet test of insolvency is out of step with the goals of section 547. The trustee's heavy burden of proof under this method may defeat the goal of equality among creditors by allowing no recovery for what otherwise would be a voidable preference. The balance sheet test hardly promotes the subsidiary goal of making bankruptcy procedures more efficient.[89]

IV. Conclusion

Although the insider provision of the 1978 Bankruptcy Reform Act is not perfect, its intent is in most part consistent with the goals of the Code, particularly the goal of treating all creditors equitably. Through section 547(b)(4)(B) on voidable preferences to insiders, Congress has provided a mechanism to directly challenge transfers made to people who are in a position to influence a debtor's actions, even when these transfers are made outside the former Bankruptcy Act's four-month preference period. This mechanism is consistent with the longstanding judicial policy of giving more exacting scru-

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84 *See* Levit, *supra* note 66, at 216-21.

85 *Id.* at 218. *See* note 14 *supra*.

86 *See* 11 U.S.C. § 101(26)(A) (Supp. 1978).

87 Levit, *supra* note 66, at 218-20. Attempting to value assets at the time of transfer by working backward or forward to the time of transfer often requires extensive preparation, including the use of expert witnesses. Experts rely on subjective valuation, which is readily susceptible to refutation. *Id.*

88 *Id.* at 218. Levit likens this valuation process to "guess[ing] what will take place in wonderland." Neither is an easy task. *Id.* (quoting McGill v. Commercial Credit Co., 243 F.2d 637 (D. Mo. 1917)).

89 *See* S. REP. NO. 1106, 95th Cong., 2d Sess. 1 (1978).

tiny to the actions of people closer to the debtor,[90] and is also consistent with the Code's goal of equality among creditors.[91]

Section 547(b)(4)(B) is not perfect. Serious problems exist, particularly relating to the burdens of proving reasonable cause to believe the debtor is insolvent and proving balance sheet insolvency. The retention of the reasonable cause to believe standard and nonextension of the presumption of insolvency for insider prefrences outside the ninety-day period can be viewed as a trade-off—Congress provides a longer period to attack insider preferences but in exchange requires the trustee to overcome a greater burden of proof.[92] This trade-off, though, may turn out to be weighted too heavily against the trustee and hinder the insider provision's effectiveness. Reasonable cause to believe the debtor is insolvent is irrelevant to whether a preference has been given, and should be eliminated from section 547. The balance sheet method of proving insolvency may prevent the trustee from avoiding what would otherwise be a voidable preference because of the proof problem it presents. Although the trade-off made in the section 547 insider provision may be viewed as necessary to help preserve certainty in commercial transactions, the insider provision is meant to reach only those people who are close enough to the debtor that they are not likely to be dealing at arm's length with the debtor.[93] While the problems in section 547 may make the insider provision less effective, at least Congress has provided a way to more closely scrutinize insiders which section 547 would otherwise lack.[94]

John Tuskey

90 *See* text accompanying notes 28-30 *supra*.

91 *See* text accompanying notes 8-11 *supra*.

92 *See* Young, *Preferences Under the Bankruptcy Reform Act of 1978*, 54 AM. BANKR. L.J. 221, 223 (1980).

93 *See* text accompanying note 23 *supra*.

94 *See also* Note, *supra* note 24, at 220.