Corporate Preferences to Insiders

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I. INTRODUCTION

Small corporations, and large ones as well, frequently borrow money from their officers, directors, or principal shareholders, parties who aptly can be labelled "insiders." Because insiders already are familiar with the borrower's financial situation, companies often can obtain loans from insiders more readily than they can from strangers. Perhaps just as commonly, companies borrow from outside creditors on the strength of the credit of insiders who guarantee repayment of the loans. Whether an insolvent company can legitimately repay loans...
from insiders, or loans guaranteed by them, while outside creditors are not similarly paid presents a nice question that has given considerable difficulty.

The insider preference problem arises in both bankruptcy and nonbankruptcy contexts, in collective proceedings, and in contests between preferred insiders and individual outside creditors. Because no unified approach to the problem exists, the courts have reached conflicting results in insider preference cases. Legislation in some jurisdictions forbids the practice. When the legislature is silent, probably a majority of the judicial decisions also condemn such payments, but the reasons given are varied and subject to criticism.1 Other courts, however, find no reason to outlaw insider preferences.2

I think that the context makes a difference in how courts decide insider preference cases, and I try to explain the reasons for this in Part II. Yet the central issue of the legitimacy of insider preferences underlies all the cases and, in my view, deserves a more critical examination than it has received.3 That question is explored in Part III. My own conclusion is that when the law does not outlaw all preferences, to inside and outside creditors alike, insider preferences should be judged by whether they are in the best interest of the debtor company. However, this approach is rarely found in the decisions and is almost never clearly articulated. If this approach to insider preferences is correct, there remains the problem of whether to deal with the question generically, by adopting a rule, or whether to make the determination on a case-by-case basis. If the latter course is more attractive, residual issues that involve the burden and standard of proof become important.

1. See 15A WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 7468-7469 (Timothy P. Bjur & J. Jeffrey Reinholtz eds., rev. vol. 1990 & Supp. 1991). For the most part the statutory prohibitions are general rather than specifically aimed at preferences to directors. See 15A id. §§ 7439-7465.1 (describing the statutes in each state). Section 5(b) of the Uniform Fraudulent Transfer Act, on the other hand, does target preferences to insiders who have reasonable cause to believe that the debtor, whether an individual or corporation, is insolvent. UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A U.L.A. 657 (1985 & Supp. 1991). The Act is discussed in Parts II and III(B). Florida and New York had statutes specifically aimed at preferences to directors. In both states the courts held that repeal of the statutes did not signify a legislative intent to preclude recovery at common law. Poe & Assocs., Inc. v. Emberton, 438 So. 2d 1082, 1084 & n.7 (Fla. Dist. Ct. App. 1983); Southern Indus., Inc. v. Jeremias, 411 N.Y.S.2d 945, 950 (App. Div. 1978).

2. 15A FLETCHER, supra note 1, §§ 7470-7471.

3. The relatively sparse commentary generally condemns these preferences. See, e.g., 2 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 386 (rev. ed. 1940); John L. Campbell, Jr., Preferences by Insolvent Corporations to Officers, Directors or Stockholders, 61 U. Pa. L. Rev. 163, 182-83 (1912); Ronald J. Kaye, Comment, Preferences to Directors of Insolvent Corporations, 21 WASH. & LEE L. REV. 353, 356 (1964).
These issues are discussed in Part IV.

II. CONTEXT

A. Bankruptcy

The legitimacy of insider preferences is least interesting in the bankruptcy context because the current Bankruptcy Code, like most of its predecessors, generally condemns preferences. With some notable exceptions it provides for the recapture of preferences given on the eve of bankruptcy whether the preferred creditor is an insider or an outsider. If the debtor, whether individual or corporate, is forbidden to prefer one outsider over another, it would seem to follow that the preference of an insider will be similarly condemned. No one, I believe, has suggested that insider preferences should be approved when preferences to outsiders are forbidden.

Yet the problem of insider preferences in bankruptcy currently is a matter of controversy. The difficulty arises because bankruptcy law differentiates insider preferences by extending the period of vulnerability of transfers from ninety days to one year before the petition. The logic behind this distinction is quite clear. The insider's position may well provide the insider with an information advantage over outsiders. By becoming aware of the debtor's financial difficulty before outside creditors, the insider may contrive, whether by pressing for payment or by arrangement, to be paid at a point further in time from the petition.

If the insider’s lengthier period of vulnerability is not itself controversial, it nonetheless is the source of a serious problem. When the payment occurs within one year of, but outside ninety days before, the petition and is to an outside creditor whose obligation has been guar-

4. 11 U.S.C. § 547 (1988). The section condemns payments on account of an antecedent debt, id. § 547(b)(2), and thus does not cover contemporaneous exchanges in which the debtor's estate gains as much as it loses. The most important, and also the most controversial, exception to preference recapture is of a payment in the ordinary course of business of debts so incurred. Id. § 547(c)(2).

5. Id. § 547(b)(4)(B). Insiders for individual, corporate, and partnership debtors are defined in § 101(31). If the debtor is a corporation, insiders include: directors, officers, persons in control, a partnership in which the debtor is a general partner, a general partner of the debtor, and the relatives of any “general partner, director, officer, or person in control of the debtor.” Id. § 101(31)(B) (Supp. II 1990).

6. DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 432 (2d ed. 1990). My colleague, John Hetherington, has suggested to me that the lengthier period of vulnerability for insider preferences may have a perverse effect. It may encourage insiders to begin withdrawing funds from an insolvent as soon as insolvency is perceived when not doing so might facilitate the company's survival.
anted by an insider, the preference can be recaptured because it is beneficial to the insider who, as guarantor, is a contingent creditor. In addition, several courts have ruled that the trustee can recapture the payment from the outside creditor who is the immediate transferee because section 550 of the Bankruptcy Code provides for recovery from either the person benefitted or the immediate transferee. This outcome, of course, is upsetting to the outsider who is targeted by the bankruptcy trustee in such circumstances. The outside creditors complain that the result makes them worse off with the guarantee than they would have been without it. This argument ignores the fact that the guarantee gives the outside creditors an alternative source of payment and might have figured in the debtor's decision to pay them rather than others.

Some suggest that the outside creditor can avoid the difficulty by persuading the guarantor to waive any claim by way of indemnity or subrogation against the debtor at the time the guarantee is given. Such a waiver would mean that the insider-guarantor is not even contingently a creditor of the debtor; therefore, no payment outside the ninety days can be set aside simply because it is a preference. Not surprisingly, this idea has spurred commentators to suggest invoking fraudulent conveyance theory as a premise for recapture in this case because the period of vulnerability for fraudulent transfers is also one year. The problem is a significant one and makes the search for a theory of invalidation all the more interesting. Preference recapture, after


11. See, e.g., Baird & Jackson, supra note 6, at 449.
all, need not be the bankruptcy trustee’s only weapon. I return to this question in Part III.

B. Nonbankruptcy Proceedings

Statutes that condemn preferences generally are not confined to bankruptcy.12 When in force, they can deprive the question of the legitimacy of insider preferences of interest in much the same way as does the bankruptcy prohibition. There is, however, a difference. Bankruptcy is always a collective proceeding. The effect of setting aside a preference in bankruptcy is that creditors, including the creditor whose transfer has been upset, share ratably in the debtor’s estate. Thus, preference recapture achieves equality of a sort in the treatment of creditors. Nonbankruptcy proceedings, on the other hand, may or may not be collective. When they are collective, the legitimacy question is the same as in bankruptcy.

When the nonbankruptcy proceeding is not collective and is brought by an individual creditor, however, the character of the problem changes materially. In that case a rule forbidding preferences, whether general or limited to insider preferences and whether legislative or decisional, can have the effect of subordinating the preferred creditor’s claim to that of the complaining creditor. The net effect of doing this is to reverse the preference because the complainant steps into the shoes of the preferred creditor. This seems an unlikely goal when the question, absent a fraud requirement, is the preference of one outsider over another. I suspect that even when statutes that generally forbid preferences are not clear on the point, collective distribution of anything recaptured must be contemplated.

It is not clear, however, that this premise holds true with regard to insider preferences. Indeed, the Bankruptcy Commission explicitly proposed subordinating the claims of insider creditors.13 Although it is not phrased in subordination terms, the Uniform Fraudulent Transfer Act provision that outlaws insider preferences has exactly that effect. It allows any other creditor, acting alone, to sue to set aside insider transfers or to levy on the property so transferred as if no transfer had occurred.14 Treating insider preferences in this fashion at the behest of

12. 15A FLETCHER, supra note 1, § 7437; see, e.g., id. §§ 7438-7465.1 (surveying state statutes).
14. Section 5(b) of the Uniform Fraudulent Transfer Act makes insider preferences fraudulent if the insider has reasonable cause to believe that the debtor is insolvent. UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A U.L.A. 657 (1985 & Supp. 1991). Section 7 allows a creditor to avoid such a transfer or, if the creditor has a judgment, to levy
an individual outside creditor, however, has troubled a number of courts. Some courts insist that the only object of avoidance is to put both the insider and the outsider on a parity. Moreover, a desire for parity has led other courts to insist that all creditors be let in on the benefits of recapture.\textsuperscript{15}

Although the subordination result is incompatible with preference recapture based on a theory of equality, it might be defended on the basis of a different underpinning. Courts could use subordination to sanction or deter perceived wrongdoing. For example, the Uniform Fraudulent Transfer Act deals with transfers labelled “fraudulent.” Of course, the so-called fraud is often constructive rather than actual, and it is not clear from the commentary accompanying the Act why an insider preference might be perceived as a wrong that merits demotion to junior status.\textsuperscript{16} Alternatively, subordination, or priority, could be justified on the basis that the subordinated claim somehow has less intrinsic merit than its competitor.\textsuperscript{17} This rationale might have been the basis of the Bankruptcy Commission’s proposal, but the Commission offered no explanation in its report. Once again, the theory of invalidation would seem an important ingredient in assessing the appropriate effect of invalidation.

The difference outside bankruptcy between individual and collective proceedings is significant in another respect. Individual creditors sue in their own right or as representatives of all creditors. In the collective proceedings, such as receiverships or assignments for the benefit of creditors, the claimant acts not only as a representative of all creditors, but also as a successor of the debtor company. As I will show, the claimant's status is germane to the question of standing.

In dealing with insider preferences, context and theory are interrelated. Yet it is far from clear that the relationship always has been perceived. The distinction between equality and priority is central to any examination of a theory that underlies the recapture of insider

\textsuperscript{15} See 15A \textit{Fletcher}, supra note 1, § 7594. In Roseboom \textit{v.} Warner, 23 N.E. 339 (Ill. 1889), the court seemed content with a preferential result favoring the outsider who began his suit by an attachment. \textit{Id.} at 341. In Williams \textit{v.} Jackson County Patrons of Husbandry, 23 Mo. App. 132 (1886), the court took an apparently intermediate position and said that a single creditor could sue and share the recovery ratably with the insider if other creditors did not intervene. \textit{Id.} at 147.

\textsuperscript{16} See infra text accompanying notes 53-63. In discussing the Bankruptcy Commission's subordination proposal, Dean Robert Clark suggested that it might have been founded on the belief that fraud was simply too difficult to establish. Robert C. Clark, \textit{The Duties of the Corporate Debtor to its Creditors}, 90 \textit{Harv. L. Rev.} 505, 538 (1977). He took no position on the wisdom of the proposal. \textit{See id.} at 536-40.

\textsuperscript{17} For example, the advance of the insider might be seen as a contribution to capital that is junior to the claims of creditors.
preferences.

III. THEORIES OF INVALIDATION

In examining the various theories on which insider preferences have been condemned, it is important to make two assumptions: 1) That the corporation is free to prefer one of two or more outside creditors, and 2) that the underlying obligation to the insider is legitimate. Unless the latter is the case, invalidation of the preference may be a response to the transaction giving rise to the obligation rather than to the payment itself. The validity of the underlying obligation is a different question.

Judicial decisions on insider preferences began to appear in the middle of the nineteenth century as corporate activity became more common and encountered financial downturns. The early cases yielded a variety of theories. The variety probably stemmed in part from the fact that the corporate form of enterprise was relatively new and problems that involved an artificial entity took time to resolve. Also, the fact that the cases arose in a number of different jurisdictions probably was a contributing factor. Many cases were decided in state courts. Federal courts were not far behind, and they applied federal common law under the aegis of *Swift v. Tyson*. Moreover, no bankruptcy statute was on the books; the 1841 Act had been quickly repealed and was not replaced until 1867. In struggling to work out a solution to a new problem, different courts quite often offered different explanations. They also arrived at different outcomes.

A third reason for the variety lies in the struggle of the courts to find an acceptable theory of liability. At the heart of this struggle is the problem of establishing what sort of duty, if any, the insider owes to the outside creditor. Once that is settled, determining whether there has been a breach of that duty is often straightforward.

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18. This point was made earlier in considering the context in which preferences are judged. If preferences are generally condemned, the illegitimacy of insider preferences automatically follows. See supra text preceding, accompanying, and following note 4.

19. 41 U.S. (16 Pet.) 1 (1842), overruled by *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938). *Swift* held that federal courts were not obliged to apply state decisional law except on matters of local law. State statutes, on the other hand, were binding in federal court. *Id.* at 18-19.

A. Fraud

The earliest cases that directly focused on insider preferences sustained their validity. At the same time these courts made it clear that fraud could vitiate such transfers. A good example is the first insider preference case that my research uncovered: Central Rail Road & Banking Co. v. Claghorn,21 which was decided in South Carolina in 1844. In Claghorn the court sustained the grant of several mortgages securing already existing obligations that were indorsed by the directors of the corporate debtor when it was not clear that the company was insolvent when the mortgages were granted.22 In regard to insider preferences the court stated, "When the question of priority arises, it must depend on the bona fides of the transaction, fraud or no fraud. If by greater diligence, and without fraud, he [the insider] has fairly gained an advantage over the other creditors, he [the insider] is entitled to retain it . . . ."23

Faithful to that prophecy, courts soon began to upset insider preferences attended by fraudulent conduct. Two decisions of the United States Supreme Court are illustrative, In Koehler v. Black River Falls Iron Co.,24 a frequently cited 1862 decision, directors mortgaged corporate property to secure antecedent debts owed to themselves. The mortgages had been authorized for the purpose of securing new loans and not for securing antecedent debts. Furthermore, the corporate seal had been improperly used on the mortgage. The Court did not hesitate to strike down the mortgage.25 It is noteworthy that the shareholders, and not the creditors, were the complainants.26

Similarly, in 1868 in Drury v. Cross,27 another often-cited decision, the directors gave $280,000 of previously unissued bonds as additional security for a $21,000 debt that was indorsed by four directors and already secured by $42,000 in bonds. This occurred while a suit on the indorsement was pending against the directors. The creditor had not sought additional security. Next, the directors persuaded the creditor

21. 17 S.C. Eq. (1 Speers Eq.) 545 (Ct. App. 1844). Not far behind in sustaining insider preferences were: (1) Massachusetts, Sargent v. Webster, 54 Mass. (13 Met.) 497, 503-04 (1847); (2) Vermont, Whitwell v. Warner, 20 Vt. 425, 443-45 (1848); and (3) Missouri, see City of St. Louis v. Alexander, 23 Mo. 483, 524 (1856) (Ryland, J.).
22. Claghorn, 17 S.C. Eq. (1 Speers Eq.) at 554.
23. Id. at 562-63.
25. Id. at 718.
26. Id. at 716. The Court said that the directors owed a duty of trust to the suing shareholders. Id. at 720-21. This idea is close to the fiduciary-duty-to-the-corporation theory discussed in Part III(F).
27. 74 U.S. (7 Wall.) 299 (1868).
to bring a foreclosure suit against the company. The directors then arranged to have confederates buy the claim and its security from the creditor for about two-thirds the amount of the claim. The Court found that the directors granted the additional security to deter bidders at the foreclosure sale. By creating a price in excess of $300,000, the directors ensured that their confederates could acquire all the debtor company's assets. This elaborate scheme was deemed fraudulent and, at the behest of a judgment creditor of the debtor company, the Court defeated the transfer to the confederates who had resold the collateral, which was all of the debtor's property, at a significant profit.

These decisions and the warnings that preceded them seem unremarkable to me. Fraud had long been actionable. What is interesting was the Court's failure to invoke fraudulent conveyance statutes. As we will see, that was to come later.

B. Fraudulent Conveyance

It is only a small step from fraud to fraudulent conveyance and a natural one as well because the insider preference necessarily involves a transfer. Surprisingly, however, courts were slow to invoke fraudulent conveyance legislation against insider preferences. Other theories were available outside bankruptcy that did not present the problems of proof inherent in showing fraud. Bankruptcy law might have seemed to restrict avoidance to fraudulent conveyances or preferences, at least when the analysis was limited to the duty owed to a creditor, but no bankruptcy law was in effect between 1878 and 1898. Ultimately, however, and perhaps because of the 1898 Bankruptcy Act, such provisions became the basis of avoidance, on both actual and constructive fraud grounds.

1. Actual Fraud

Another possible explanation for the delay lies in the distinction

28. Id. at 303-04.
29. Id. at 305.
between preferences and fraudulent conveyances, at least as fraudulent conveyance law stood in the nineteenth century. A preference distributes the debtor’s assets to a favored creditor. The prohibition of preferences is based on a principle of equality among creditors. An insolvent debtor contemplating bankruptcy should not pay one creditor at the expense of another. However, preferential payments to a creditor before bankruptcy are usually valid at the time of payment. Preference avoidance makes sense only when the debtor’s financial failure is thereafter dealt with collectively. There the recaptured preference is distributed ratably to all creditors, thus achieving equality.

On the other hand, a fraudulent conveyance keeps the debtor’s assets from creditors. The idea underlying fraudulent conveyance law, as far as actual fraud is concerned, is that debtors should not try to keep nonexempt assets for themselves, or try to give their assets away before paying their obligations. Debtors who transfer property with the intention of keeping value for themselves or of giving value away while insolvent commit an offense at the time the transfer is made. A creditor who is disadvantaged by actual fraud rightly can seek to avoid the fraud’s effect by recapturing the transferred property.31 The difficulty with using fraudulent conveyance law in insider preference cases is that by paying a legitimate debt, the debtor is neither keeping value for itself nor giving it away in disregard of its other obligations.

However, if one ignores the proposition that corporations and insiders are separate entities, with the former owing the latter, the insider transfer becomes a method by which insiders keep property for themselves rather than applying it to their obligations. Treating the insider and the corporation as a single entity is most tempting when the inside creditor is also the sole owner of the corporation. I believe that thinking of the corporation and the insider as one is what led courts to use fraudulent conveyance theory to attack insider preferences.

In the twentieth century courts began, albeit somewhat grudgingly, to use fraudulent conveyance theory in insider preference cases. Virginia case law provides a good illustration. Confronted in 1884 with a case in which a company paid an obligation indorsed by a director, the Virginia Supreme Court of Appeals followed a line of cases that upheld insider preferences in the absence of actual fraud.32 In 1907 and 1908, however, the court held that the intent to prefer any creditor in contemplation of bankruptcy was actual fraud in violation of the bank-

31. The distinction between preferences and fraudulent conveyances is drawn in essentially the same way in THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 123-26 (1986).
ruptcy provision banning fraudulent transfers.\textsuperscript{33} Yet in a 1921 case that involved an individual debtor, rather than a corporate debtor, the court refused to find that the intent to prefer certain creditors always will amount to actual fraud.\textsuperscript{34} Finally, in 1963 the court found that a corporation had an actual intent to defraud and had violated the state’s fraudulent conveyance statute, the equivalent of the Statute of Elizabeth,\textsuperscript{35} when the insolvent corporation transferred its accounts receivable to an officer-director to satisfy an obligation owed to the officer-director.\textsuperscript{36} The court could not point to any fraudulent behavior of the sort detected in Koehler or Drury. Apparently, the actual fraud turned solely on the fact that an insider was preferred.\textsuperscript{37} Curiously, Virginia continues to uphold as legitimate payments to creditors whose obligations are guaranteed by insiders.\textsuperscript{38}

The difficulty with attacking insider preferences as actually fraudulent is precisely what had troubled the Virginia court. Is an intent to prefer an intent to hinder, delay, or defraud? Certainly the intent to prefer is not a debtor’s attempt to retain property rather than pay its debts, for the debtor is paying a legitimate debt. To use the words of Dean Robert Clark, insider preferences do not violate the “ideals of Truth and Respect toward creditors”\textsuperscript{39} that fraudulent conveyance law reflects. Insider preferences offend only the less rigorously enforced an-

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\item \textsuperscript{33} Webb’s Trustee v. Lynchburg Shoe Co., 56 S.E. 581, 582-83 (Va. 1907), aff’d on reh’g, 60 S.E. 130 (Va. 1908) (holding that bankrupt’s intent to hinder, delay, or defraud is a question of fact).
\item \textsuperscript{34} Surratt v. Eskridge, 108 S.E. 677, 680 (Va. 1921) (holding that intent to prefer is not necessarily intent to “hinder, delay or defraud” creditors within the meaning of § 67(e) of the 1898 Bankruptcy Act).
\item \textsuperscript{35} 15 Eliz. c.5 (1570) (Eng.).
\item \textsuperscript{36} Darden v. George G. Lee, Co., 129 S.E.2d 897 (Va. 1963) (holding that an insider preference violates § 55-80, Va. Code Ann. § 55-80 (Michie 1986), which requires an intent to delay, hinder, or defraud creditors). The Fourth Circuit followed Darden in Regal Ware, Inc. v. Fidelity Corp., 550 F.2d 934 (4th Cir.), cert. denied, 434 U.S. 824 (1977), a case in which a parent company received a preference from its subsidiary.
\item \textsuperscript{37} See Darden, 129 S.E.2d at 899-900. The court stated: “The obvious and inevitable effect of this transaction was to delay and hinder the creditor, the company, from satisfying its claim. . . . Under Sec. 55-80 of the Code, a conveyance or assignment may be made with intent to hinder or delay, without any intent absolutely to defraud.” Id. at 900 (quoting lower court opinion); cf. Duberstein v. Werner, 256 F. Supp. 515 (E.D.N.Y. 1966) (discussing actual fraud under § 67d(2)(d) of the Bankruptcy Act (codified as amended at 11 U.S.C. § 548(a) (1988)) and noting that some question about the legitimacy of the underlying debt existed).
\item \textsuperscript{38} Bank of Commerce v. Rosemary & Thyme, Inc., 239 S.E.2d 909 (Va. 1978). For a helpful analysis of the Virginia cases, see Joseph E. Ulrich, Fraudulent Conveyances and Preferences in Virginia, 36 Wash. & Lee L. Rev. 51 (1979). Professor Ulrich discussed the theory that insider preferences are a breach of fiduciary duty to creditors. Id. at 65-67. This theory is discussed in Part III(F).
\item \textsuperscript{39} Clark, supra note 16, at 511.
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tipreference ideal of "Evenhandedness toward creditors." 40

2. Constructive Fraud

The most prominent form of constructive fraud is a transfer by an insolvent debtor for inadequate consideration. This ground for setting aside transfers, which was the creation of Chancellor Kent, 41 is based on the combination of two ideas: Asset depletion injures creditors even in the absence of actual fraudulent intent, and transferees can be required to relinquish the property without injury if they are given a lien on the property that secures repayment of whatever consideration they gave in exchange for the property. The concept is a compromise that steers a course between the extremes of no avoidance and total avoidance. 42 Its application to insider preferences is not obvious because the release of the claim by the transferee-creditor would appear to be adequate consideration for the transfer regardless of whether the transferee-creditor is an insider or an outsider who is guaranteed by an insider.

In codifying the constructive fraud concept, the Uniform Fraudulent Conveyance Act 43 and later the Bankruptcy Act, as amended by the Chandler Act, 44 added an additional limitation, the requirement of good faith. 45 Courts soon discovered that they could rule that a transfer to an insider was not made in good faith and therefore was constructively fraudulent. Perhaps the best known, although not the first, 46 case to use this concept of good faith was Bullard v. Aluminum Co. of America, 47 a 1972 Seventh Circuit decision. It set aside the payment by an insolvent company of a debt that the company's principal

40. Id. Dean Clark acknowledged that the ideal of evenhandedness expressed by preference law "has never been considered as important to the functioning of the commercial system, which constitutes the essence of our culture, as the ideals of Truth and Respect." Id. at 515.

41. See Boyd & Suydam v. Dunlap, 1 Johns. Ch. 478 (N.Y. Ch. 1815).

42. For a discussion of the history and development of this aspect of constructive fraud, see John C. McCoid, II, Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration, 62 Tex. L. Rev. 639 (1983).


45. Good faith was part of the definition of fair consideration in the Uniform Fraudulent Conveyance Act, § 3(a), 7A U.L.A. 427, 448 (1918), and the Chandler Act, § 67d(1)(e), ch. 575, 52 Stat. 840, 877 (1938).

46. The earliest known case was Tacoma Ass'n of Credit Men v. Lester, 433 P.2d 901 (Wash. 1967) (using lack of good faith in the context of fraudulent conveyance law because the transfer was more than four months before the appointment of a receiver).

47. 468 F.2d 11 (7th Cir. 1972).
owner had guaranteed. Why the payment of a legitimate obligation is not a good faith transaction is not immediately apparent from this line of cases. To say that it involves taking unconscionable advantage of other creditors begs the question.

The 1984 revision of the uniform law and the 1978 Bankruptcy Code omitted the good faith requirement, which was the key to invalidation under this statutory theory. The Uniform Fraudulent Transfer Act, however, explicitly condemns insider preferences by an insolvent debtor, whether individual or corporate, if the insider had reasonable cause to believe that the debtor was insolvent when the transfer was made. The commentary that accompanies the provision does not provide an underlying thesis. It merely cites three cases, Garrett Glenn's Treatise, and a Harvard Law Review case note. Two of the cases involved behavior that smacks of actual fraud. In Mitchell v. Travis (In re Jackson Sound Studios, Inc.) it was not clear that the corporation had authorized the transfer of a security interest, and in any event, the corporation had withheld the transfer from the public record for almost two years. Twentieth St. Bank v. Sharitz (In re Lamie Chemical Co.) involved mortgages that were withheld from the public record with the intent of bolstering the company's credit. The third case, Stuart v. Larson, was based on a breach of fiduciary

48. Id. at 13-14 (stating that lack of good faith alone can void a transfer and finding that transfers made to benefit third parties are not made for fair consideration within the meaning of the Bankruptcy Act); see Burroughs v. Fields, 546 F.2d 215 (7th Cir. 1976) (holding that payments of commissions to the president while the corporation was insolvent were not made in good faith).

49. The Lester court determined that the "intend to take unconscionable advantage of others" indicated a lack of good faith. 433 P.2d at 904; accord Southern Indus., Inc. v. Jeremias, 411 N.Y.S.2d 945, 949 (App. Div. 1978); see Note, Good Faith and Fraudulent Conveyances, 97 Harv. L. Rev. 495, 499-502 (1983).


52. See 4 Collier on Bankruptcy, supra note 7, ¶ 548.01, at 548-14 n.12 (recognizing that cases such as Bullard are modified).


54. Id. at 658 cmt. 2.

55. 473 F.2d 503 (5th Cir. 1973).

56. Id. at 504-05.

57. 296 F. 2d (4th Cir. 1924).

58. Id. at 28.

59. 296 F. 223 (8th Cir. 1924).
duty to creditors. Garrard Glenn was willing to support the condemnation of insider preferences either on the breach-of-fiduciary-duty-to-creditors theory or on the theory that the preference impairs corporate credit. As Glenn acknowledged, the impairment-of-credit argument was advanced in the student note, which was the additional source cited by the uniform act commentary.

3. Recharacterization

Since the Levit v. Ingersoll Rand Financial Corp. decision, commentators have advanced still another fraudulent conveyance theory that is applicable when an insider has guaranteed the company’s obligation to an outsider. Under the rubric of recharacterization, they suggest that the company’s payment to the outsider amounts to a gift to the insider at the expense of other creditors. Underlying this argument is the view, best expressed by my colleague Thomas Jackson, that a fraudulent conveyance is a transfer that depletes the assets available to creditors while a preference is a distribution of the debtor’s assets among creditors. In Jackson’s view the debtor’s payment to the guaranteed creditor falls in the former category because it deprives the creditors as a group, including the guaranteed creditor, of the funds that could be extracted from the insider guarantor and thus reduces the pool of funds available to all creditors. On the other hand, if the guaranteed creditor, who is indifferent as to the source of payment, gets payment from the guarantor, more of the debtor’s assets will be available to all creditors. Essentially, recharacterization requires the guaranteed creditor to look first to the security of the guaranty. In that respect recharacterization bears a clear resemblance to marshaling, although the marshaling doctrine is normally confined to secured claims and operates to benefit junior secured creditors.

60. Id. at 227-29. For a discussion of this theory, see infra part III(F)(1).
61. 2 GLENN, supra note 3, § 366, at 667.
63. See supra note 54 and accompanying text.
64. 874 F.2d 1186 (7th Cir. 1989).
65. See BAIRD & JACKSON, supra note 6, at 449; Borowitz, supra note 10, at 2155-56; Cullina, supra note 10, at 149-80. For a slightly different characterization of insider preferences, see Andrew J. Nussbaum, Comment, Insider Preferences and the Problem of Self-Dealing Under the Bankruptcy Code, 57 U. CHI. L. REV. 603 (1990) (combining concepts of actual fraud and self-dealing).
67. See BAIRD & JACKSON, supra note 6, at 449.
It is not clear that the other creditors should have the right to force the guaranteed creditor to seek payment first from the insider-guarantor. Unlike junior secured creditors in marshaling, unsecured outside creditors have no property interest in the debtor's assets that is depleted if the debtor pays the guaranteed creditor from them. More importantly, it is noteworthy that a direct payment by a debtor company to an insider creditor does not fit the recharacterization mould because it simply would be a distribution to a creditor, albeit a preferential one. Because I can see no difference in principle between a payment to an insider creditor and a payment to a creditor who is guaranteed by an insider—a view I think Jackson shares— I doubt the theory. Its defect, I think, is that it ignores the fact that the debtor company owed the outside creditor and was the true beneficiary of the credit that the outsider originally extended. Viewed in this way, the debtor's payment to the guaranteed creditor hardly seems more a gift to the insider than a payment to a creditor, even if the insider has waived indemnity and subrogation rights. It is, I believe, just a mal-distribution among creditors.

In short, in the absence of additional circumstances that go beyond a simple insider preference, fraudulent conveyance theory does not seem to provide a satisfactory explanation for setting aside these transfers. Neither the actual fraud nor constructive fraud label adequately differentiates the ordinary preference to an outside creditor, which is usually accepted as proper outside a collective proceeding. Recharacterization ignores the fact that the debtor's payment is made on account of an antecedent obligation.

C. Inequity

Some courts have tried to address insider preferences in simpler and more straightforward terms. The Minnesota Supreme Court, for example, said that outlawing insider preferences was based merely "[u]pon the plainest principles of right, fair dealing, and common honesty." The Eighth Circuit put the matter in much the same fashion: "The law applicable to this situation is not difficult. It is merely com-

69. Id. at 727.
70. See BAIRD & JACKSON, supra note 6, at 448-49 (noting that the insider benefits from both transfers).
71. This problem with recharacterization was identified in Nussbaum, supra note 65, at 625. The author resorted to a theory of actual fraud as a means of getting around the fact that a creditor is paid. Id.
mon sense and common honesty, applied in the interest of fair dealing.\textsuperscript{73}

Such statements are not very revealing about what makes an insider preference unfair or dishonest. After echoing these comments an Indiana federal judge, in \textit{Howe, Brown & Co. v. Sanford Fork & Tool Co.},\textsuperscript{74} was able to point to exactly why he thought directors should be restricted:

It seems to me enough to say that a sound public policy and a sense of common fairness forbid that the directors or managing agents of a business corporation, when disaster has befallen or threatens the enterprise, shall be permitted to convert their powers of management and their intimate, and it may be, exclusive, knowledge of the corporate affairs into means of self-protection to the harm of other creditors.\textsuperscript{76}

Thus, in the court's view a director's informational advantage and control of the debtor company are the factors that make insider preferences inequitable. One contemporary authority even asserts that these factors are still the chief explanation for banning insider preferences.\textsuperscript{78}

Others have looked at these same factors, however, and reached the opposite conclusion. In 1848 the Vermont Supreme Court recognized these positional advantages and said:

The stockholder and the stranger, who are both creditors of a corporation, no doubt stand in very unequal positions. But it is an inequality which the law allows, and which is understood by those who contract with corporations, and one which will always tend, more or less, to bring in doubt the credit of such bodies. But it is a subject, with which this court [will] have nothing to do.\textsuperscript{77}

The author might well have noted that life in general is unfair because it equips some better than others for meeting vicissitudes. Some run faster. Some jump higher. Some are smarter. Some are simply in the

\textsuperscript{73} Jackman v. Newbold, 28 F.2d 107, 111 (8th Cir. 1928).
\textsuperscript{74} 44 F. 231 (C.C.D. Ind. 1890) (finding it unnecessary to accept a trust-fund-for-creditors theory), rev'd, 157 U.S. 312 (1895).
\textsuperscript{75} Id. at 233. The Wyoming Supreme Court also identified these positional advantages in Harle-Haas Drug Co. v. Rogers Drug Co., 113 P. 791, 796 (Wyo. 1911).
\textsuperscript{76} 15A FLETCHER, supra note 1, § 7469.
\textsuperscript{77} Generally, the rule prohibiting preferences to directors is not founded upon the trust fund doctrine, but upon the theory that it is inequitable that directors, whose knowledge of conditions and power to act for the corporation give them an advantage, should be permitted to protect their own claims to the detriment of others at a time when it is apparent that all the unsecured debts of the corporation are equally in peril and that all of them cannot be paid. Id. at 262.
\textsuperscript{77} Whitwell v. Warner, 20 Vt. 425, 444-45 (1848).
right place at the right time.

If one is prepared to allow preferences between outside creditors, information and power may not be persuasive reasons for prohibiting insider preferences. Some outsiders, a bank with setoff power and knowledge of the status of the debtor company’s account for example, have similar control and informational advantages. Moreover, it is difficult to see how insider preferences are any more injurious to the disfavored creditors than preferences to other outsiders. They are different only in the sense that one might expect insider preferences, if held legitimate, to occur more often because of the positional advantages that insiders enjoy. It is easier, perhaps, to imagine the insider quickly saying “I choose me” than it is to visualize the insider picking and choosing between outsiders. Yet I suspect that the choice between outsiders is often easy enough. For example, choosing the indispensable trade creditor over the tax claimant is not a hard choice. Self-interest guides both decisions. Surely, it explains most conscious decisions to prefer or be preferred. Even if the frequency of insider preferences is greater, frequency alone is not a sufficiently satisfying distinction between legality and illegality.

D. Agent-Trustee

According to my research, the first case to hold an insider preference invalid was the 1861 decision of Richards v. New Hampshire Insurance Co.\textsuperscript{78} The court’s analysis was different because it focused on the insiders’ special relation to the outsiders. In Richards the insured plaintiffs sued the directors of an insurer who, with the proceeds of an assessment, had paid claims of other insureds on which the directors were personally liable. Although the preferred claims apparently had arisen before the plaintiffs’ claims, the New Hampshire court gave no priority to claims first in time and held that the company should have applied its assets ratably to all claims. The court stated that “when the corporations become embarrassed or insolvent, the directors may not apply the assets to exonerate themselves and leave the other creditors without remedy.”\textsuperscript{79} The court acknowledged, however, that an individual debtor can prefer one creditor over another.\textsuperscript{80}

Why the distinction? The court was not completely clear on this point, but an explanation may be inferred from an earlier New Hampshire case that the court cited. In Colby v. Copp\textsuperscript{81} the court required a

\begin{itemize}
\item \textsuperscript{78} 43 N.H. 263 (1861).
\item \textsuperscript{79} Id. at 265.
\item \textsuperscript{80} Id. at 264.
\item \textsuperscript{81} 35 N.H. 434 (1857).
\end{itemize}
creditor who held both an individual claim and a claim owed jointly to another and himself to apply ratably a payment received from the debtor, who had not designated how to allocate his payment. The Colby court characterized the recipient of the payment as an agent or trustee for his fellow creditor and stated that "every agent and trustee, who has claims of his own, must be regarded as agent for himself and others, and bound to give his diligence and care equally to all the claims in his hands . . . whether of his own or others, in just proportion to their amounts." The fact that Colby dealt with the allocation obligation of a recipient rather than a payor did not give the Richards court pause. Nor did the court explain why the directors were considered agents or trustees of outside creditors. The court simply stated that the "defendants were such agents and trustees" and then announced the rule.

Richards also became a much-cited case. Its creation of a special relationship between the preferred insider and the complaining outsider provided a new approach. Moreover, its characterization of the directors as trustees was prophetic because the trust-fund theory became the dominant justification for setting aside insider preferences.

E. Trust Fund for Creditors

The theoretical basis for upsetting insider preferences that dominated the balance of the nineteenth century was the proposition that the assets of an insolvent corporation are a fund held in trust for the benefit of creditors. In Bradley v. Farwell, an 1874 decision by a federal circuit court sitting in Massachusetts, bankruptcy assignees sued to set aside an insolvent company's transfer of bonds to secure the antecedent claim of a partnership because one of the insolvent

82. Id. at 436.
83. Id. at 436-37.
84. See Richards, 43 N.H. at 264. A joint obligee who receives a payment from the obligor surely would have at least a fiduciary obligation to the other obligee to apply the payment ratably between the two obligations. RESTATEMENT (SECOND) OF CONTRACTS § 259(3) (1979). The corollary, a right of the debtor to pay one of the joint obligees with the expectation that the payee will share with the other obligee, is assumed in 4 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 941 (1951 & Supp. 1991) (stating that rendering performance to one joint obligee reduces or satisfies the obligation for all joint obligees).
85. Richards, 43 N.H. at 265.
86. In 1880 dictum the United States Supreme Court described an insolvent corporation as "so far civilly dead, that its property may be administered as a trust-fund for the benefit of its stockholders and creditors." Graham v. Railroad Co., 102 U.S. 148, 161 (1880).
87. 3 F. Cas. 1146 (C.C.D. Mass. 1874) (No. 1,779). The transfer was outside the period in which all prebankruptcy preferences were vulnerable. Id. at 1148-49.
company's directors was also a member of the partnership. The court invoked the trust-fund theory to overrule the defendants' demurrer to the assignees' bill in equity. The court cited Curran v. Arkansas, an 1853 United States Supreme Court decision that did not concern insider preferences and was part of a line of precedents that originated with an 1824 opinion by Justice Story.

While sitting on circuit, Justice Story, in Wood v. Dummer, formulated the trust-fund theory to control the question of the legitimacy, as against creditors of an insolvent bank, of the bank's distribution to shareholders. Based on the trust-fund theory, he ruled that such a distribution was impermissible. The capital stock of the bank was, he said, "to be deemed a pledge or trust fund for the payment of the debts contracted by the bank."

Even in its original context, the trust-fund theory generally has been rejected. It is one thing to say that, upon insolvency, creditors have priority over shareholders. It is quite different to insist that a corporation be managed for the sole benefit of creditors, even when the corporation is insolvent. After all, the shareholders are still the legal and equitable owners.

In the context of preferences the trust-fund theory has at least two further difficulties. If carried to its logical end, the trust-fund theory also would prevent a preference of one outsider over another, for a trustee cannot prefer one trust beneficiary over another without the authorization of the trust instrument. In fact, some courts that applied the trust-fund theory to insider preferences implied that it extended as well to outsider cases. Moreover, in bankruptcy it would condemn preferences without regard to the preference's proximity in time to the

88. Id. at 1148.
89. Id. at 1150-51.
90. 56 U.S. (15 How.) 304 (1853). The Bradley court also cited Koehler v. Black River Falls Iron Co., 67 U.S. (2 Black) 715 (1862), and Drury v. Cross, 74 U.S. (7 Wall.) 299 (1868). These cases are discussed in Part III(A) of this Article and involve actual fraud. There was no indication of actual fraud in Bradley, and the court disclaimed any intent to invoke constructive fraud. Bradley, 3 F. Cas. at 1149, 1150.
91. 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944).
92. Id. at 436-37.
93. Id. at 436.
94. E.g., Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 383-86 (1893); George T. Smith Middlings Purifier Co. v. McGroarty, 136 U.S. 237, 241 (1890); Fogg v. Blair, 133 U.S. 534, 541 (1890); Wabash, St. L. & P. Ry. v. Ham, 114 U.S. 587, 594-96 (1885); 15A FLETCHER, supra note 1, § 7369 (noting that the trust-fund theory has been repudiated and is merely a term used to describe the equitable duties imposed on a receiver or court in assignments for the benefit of creditors).
95. See, e.g., Beach v. Miller, 22 N.E. 464, 466 (Ill. 1889); Haywood v. Lincoln Lumber Co., 26 N.W. 184, 186 (Wis. 1885).
filing of the petition.

Whatever its merits, the trust-fund theory caught on in both creditor-shareholder priority cases and insider preference cases. It was used over and over and is a good example of how a catchy phrase or the reputation of a jurist sometimes can stand in the way of thoughtful inquiry. Even today, the theory is not entirely dead, although its defects are widely recognized.

F. Fiduciary Duty

1. Owed to Creditors

If the assets of an insolvent corporation are treated as a fund held in trust and if the corporation's creditors are the beneficiaries of that trust, then the officers and directors, who are the managers of the corporation, are the trustees. Trustees, of course, have fiduciary obligations to beneficiaries that must be observed. It was, I believe, precisely this line of thought that frequently led courts to the proposition that an insider preference is a breach of fiduciary duty owed by directors to creditors.96 A number of courts began to justify voiding insider preferences on both the trust-fund-for-creditors theory and the fiduciary-duty-to-creditors theory. Haywood v. Lincoln Lumber Co.,97 an 1885 Wisconsin case, is an early example of a court linking the fiduciary-duty concept and the trust-fund idea in the insider preference arena.98 Similarly, Beach v. Miller99 and Roseboom v. Warner,100 from Illinois in 1889 and 1890 respectively, and Olney v. Conanicut Land Co.,101 an 1889 Rhode Island decision, combined talk of trust fund and fiduciary duty concepts.

If the two ideas initially were intertwined, they did not remain so. As the trust-fund theory withered, courts increasingly talked simply of

96. An intermediate formulation was that the directors were "trustees for the creditors," which left out the fund aspect and implied a fiduciary duty. E.g., Bird v. Magowan, 43 A. 278, 280 (N.J. Ch. 1898). English courts were divided on whether directors were trustees for creditors even without Justice Story's influence. Compare Gaslight Improvement Co. v. Terrell, 10 L.R.-Eq. 168, 175-76 (1870) (describing an insider preference as a "breach of trust" owed to creditors) with In re Wincham Shipbuilding, Boiler, & Salt Co., 9 Ch. D. 322, 328 (1878) ("[D]irectors are not trustees for the creditors of the company.").

97. 26 N.W. 184 (Wis. 1885).

98. Id. at 186-87. Victor Morawetz's treatise was an early and influential secondary authority connecting the trust fund and fiduciary duty concepts. 2 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 787-788 (2d ed. 1888).

99. 22 N.E. 464, 466 (Ill. 1889).

100. 23 N.E. 339, 341 (Ill. 1890).

a fiduciary duty, usually owed to both shareholders and creditors. An early example is Taylor v. Mitchell,\textsuperscript{102} a Minnesota case, which spoke of unfairness but also talked of the directors' fiduciary obligation.\textsuperscript{103} Twenty-four years later the Eighth Circuit, in Stuart v. Larson,\textsuperscript{104} could simply state that directors owed a fiduciary duty to shareholders and creditors.\textsuperscript{105} Many similar pronouncements were made in the interim.\textsuperscript{106}

Perhaps the best-known case to announce that corporate officers and directors owe a fiduciary duty to creditors is Pepper v. Litton.\textsuperscript{107} In that case the United States Supreme Court subordinated the claim of an insider thought to be guilty of "a scheme to defraud creditors reminiscent of some of the evils with which 13 Eliz. c. 5 was designed to cope."\textsuperscript{108} But Justice Douglas went well beyond a fraud justification for his decision:

[A] sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis.\textsuperscript{109}

Although the language contained clear overtones of fraud and inequity, Justice Douglas ultimately rested the result on a breach of fiduciary duty.

\textsuperscript{102} 83 N.W. 418 (Minn. 1900).
\textsuperscript{103} Id. at 420.
\textsuperscript{104} 298 F. 223 (8th Cir. 1924).
\textsuperscript{105} Id. at 227.
\textsuperscript{106} E.g., City Nat'l Bank v. Goshen Woolen Mills Co., 69 N.E. 206, 210 (Ind. App. 1903), transferred to the supreme court by specification, 71 N.E. 652 (Ind. 1904) (per curiam).
\textsuperscript{107} 308 U.S. 295 (1939).
\textsuperscript{108} Id. at 296.
\textsuperscript{109} Id. at 310-11 (footnote omitted).
Unfortunately, the cases that rely on the fiduciary-duty-to-creditors theory often do not explain why a fiduciary obligation to creditors arises apart from the trust-fund concept. Individuals do not owe a fiduciary duty to their creditors. Why should corporations and their employees be different? Two explanations have emerged. In 1894 the senior Justice Harlan, while sitting on the Seventh Circuit, was among the first to assay a justification. In Sutton Manufacturing Co. v. Hutchinson,110 he cited the trust-fund cases, but acknowledged that there was no trust. He also conceded that individual debtors are free to prefer whomever they choose. But he thought that insolvent corporations were different.111 Elaborating on a more cryptic statement of the West Virginia Supreme Court in 1884,112 he wrote:

[A]s . . . creditors of a private corporation cannot look for their security to the private estate either of the corporators or of those who manage its property, the only recourse of creditors, when a corporation is dissolved or becomes insolvent and ceases to prosecute its business, is the property in the hands of its managing officers. The law in effect says to all who deal with private corporations that they must look to its property as the only security for the fulfillment of its obligations; and, if the law gives this assurance to creditors of a corporation, those who are authorized to represent it in its dealings with the public, who control and manage its property, and upon whose fidelity and integrity the public as well as creditors rely, ought not to be permitted, when the corporation becomes insolvent and abandons the objects for which it was created, to appropriate to themselves as creditors any more of the common fund in their hands than is ratably their share.113

For Justice Harlan the underlying rationale for the fiduciary-duty-to-creditors theory was the rule of limited liability of corporate owners and managers that is derived from treating the corporation as a separate entity. This rationale does not seem persuasive to me. In the first place, it is not as easy as he suggested to differentiate between individual and corporate debtors on the basis of limited liability. Essentially, limited liability of corporate owners and managers is like the discharge in bankruptcy for individuals.114 Both confine creditors to an existing and limited pool of assets. Even if the individual-corporate difference were accepted, would not his argument about corporate behavior in insolvency be applicable to all preferences, to outsiders as well as insid-

110. 63 F. 496 (7th Cir. 1894).
111. Id. at 499-503.
112. Lamb v. Laughlin, 25 W. Va. 300, 322 (1884) (stating that when a corporation becomes insolvent, directors who fail to immediately close the business and "execute their trust" commit a "fraud upon the public").
113. Sutton Manufacturing, 63 F. at 503.
ers? The limited pool is depleted as much by preferences to outsiders as by those to insiders. Finally, the question remains why limited liability should translate into a fiduciary, i.e., other than arm’s length, relationship. The existence of limited liability is known to the creditor when the debtor-creditor relationship is established. Therefore, it should be possible for the creditor to address this risk contractually in terms of price or covenant.

In 1903 an Indiana intermediate appellate court advanced a different idea. It argued in support of the proposition that corporate directors are trustees for creditors, that insolvency eliminates the interests of stockholders, and that, if the directors do not thereafter represent creditors, they have no one to represent. Although the court’s argument was not accepted in Indiana, it caught on elsewhere and is still made by both courts and commentators in what might be thought more persuasive terms. In 1982 the Fourth Circuit stated that “when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors.” Some scholars maintain that when a corporation becomes insolvent, its creditors “are in fact the owners of the firm—the ones who gain or lose as the firm’s fortunes rise or fall.” Creditors of an insolvent firm have been called its “residual owners.”

As a way of stating the rule that creditors’ claims enjoy priority over the investments of shareholders and will exhaust the assets of an insolvent company, the residual ownership proposition is unobjectionable. But it is not truly accurate to say that the interests of shareholders cease or pass to creditors merely because of insolvency. In the absence of proceedings that lead to the appointment of a receiver, a bankruptcy trustee, or the like, the shareholders’ interests survive in-

116. Id. at 209-10.
117. After transfer of the case from the intermediate court, the Indiana Supreme Court chose to adhere to its earlier decision in Nappanee Canning Co. v. Reid, Murdock & Co., 64 N.E. 870 (Ind. 1902) (allowing an insolvent company to prefer a creditor whose claim was guaranteed by the company’s directors), and affirmed a trial court judgment for the directors. City Nat’l Bank v. Goshen Woolen Mills Co., 71 N.E. 652 (Ind. 1904) (per curiam).
119. BAIRD & JACKSON, supra note 6, at 211.
120. Id. at 1127; accord In re Central Ice Cream Co., 836 F.2d 1068, 1073 (7th Cir. 1987) (describing creditors in bankruptcy as the “principally affected persons, the new residual claimants”).
121. This formulation is similar to the seductive theory that the assets of an insolvent corporation are a trust fund for creditors. See supra part III(E).
solvent. Furthermore, insolvency does not entitle corporate creditors to have the firm managed solely for their benefit. That plight alone does not entitle the creditors to elect directors; nor should it alter the nature of the directors' obligation to act in the best interest of their principal. At bottom, the question of fiduciary duty is really a question of principal and agent. For whom are the directors the agents? Are they agents for the company? Yes. Are they agents for the shareholders? Yes, at least in some contexts. Are they agents for creditors? I do not believe that the requisite agency relationship arises merely because of the insolvency of the company. For example, could the existing creditors of an insolvent company complain if the directors, on behalf of the company, borrow additional funds on terms excessively favorable to the new creditor? I think not. Yet the company or its shareholders would have the right to complain. The corporation and the shareholders are principals; the creditors are not.

It is the formality of a receivership, a bankruptcy, or an assignment for the benefit of creditors, not merely insolvency, that changes the relationships between the parties. These juristic events put the assets of the company in the hands of a legally constituted entity that immediately becomes the company's successor and is charged with representing the interests of both shareholders and creditors. At that point a fiduciary duty to creditors certainly arises, but not before.

122. Section 7.21(a) of the Revised Model Business Corporation Act provides that "[o]nly shares are entitled to vote." Revised Model Business Corp. Act § 7.21(a) (1984). Official Comment 2 notes that statutes of some states permit bondholders to vote in specified circumstances. It also states that creditors can attain the power to vote if the corporation gives them, or their trustee, voting shares; or pledges them shares with voting rights; or grants them share proxies. Id. cmt. 2.


124. E.g., Ward, 111 F. at 787. Judge Easterbrook, in In re Central Ice Cream Co., 836 F.2d 1068 (7th Cir. 1987), stated that "[c]reditors outside of bankruptcy may not challenge the firm's decisions; in bankruptcy they may do so, because they are (presumed to be) the principally affected persons, the new residual claimants." Id. at 1073. It is noteworthy that Justice Marshall's statement in Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 (1985), that the directors of a company owe a fiduciary duty to shareholders and creditors, was made in reference to a debtor in possession's duties in a Chapter 11 case. Id. at 355; see also Wolf v. Weinstein, 372 U.S. 633, 649-50 (1963) (holding that a Chapter X debtor in possession has the same fiduciary obligation to creditors as the bankruptcy trustee).

125. Perhaps no case demonstrates the significance of instituting a bankruptcy case or the like better than In re Martin Custom Made Tires Corp., 108 F.2d 172 (2d Cir. 1939). In Martin the court allowed a debtor in possession to set aside an unrecorded chattel mortgage that would have been effective against the debtor outside of bankruptcy. Id. at 173. The court explained its ruling in this fashion: "A debtor in possession
Not all contemporary analysts of corporate jurisprudence are willing to assert that directors have a fiduciary obligation to creditors. Recent decisions in Delaware and in the Southern District of New York have rejected the idea because the creditor has neither a property interest nor an equitable interest in the company. Section 8.30(a) of the American Bar Association's Revised Model Business Corporation Act requires that a director's dealings be "in the best interests of the corporation." Section 8.61(b) makes a director's "conflicting interest transaction" legitimate if it is "fair to the corporation." The American Law Institute's Principles of Corporate Governance acknowledges its powers in trust for the benefit of the creditors. The creditors have the right to require the debtor in possession to exercise those powers for their benefit." In contrast to Martin is McDonald v. Williams, 174 U.S. 397 (1899), in which the United States Supreme Court stated:

Insolvency is a most important and material fact, not only with individuals but with corporations, and with the latter as with the former the mere fact of its existence may change radically and materially its rights and obligations. . . . Although no trust exists while the corporation is solvent, the fact which creates the trust is the insolvency, and when that fact is established at that instant the trust arises . . . .

Hence it must be admitted that the law does create a distinction between solvency and insolvency, and that from the moment when the latter condition is established the legality of acts thereafter performed will be decided by very different principles than in a case of solvency.

*Id.* at 404-05 (emphasis added).


128. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989). The court indicated, however, that the rule may be different in the case of an insolvent company. *Id.* at 1524 n.33.


130. *Id.* § 8.61(b)(3).
edges that officers and directors owe a duty of loyalty to the corporation and, on certain occasions, to the shareholders.\textsuperscript{131} Any obligation to creditors, however, is "left to the law of creditors' rights and bankruptcy and to the protection offered under the law of contracts."\textsuperscript{132} Curiously, the Reporter's Note\textsuperscript{133} cites only \textit{Bayliss v. Rood (In re West Virginia Industries Development Corp.)}\textsuperscript{134} for the view that a duty to creditors exists. In \textit{Bayliss}, however, the Fourth Circuit simply ruled that an argument that no duty to creditors existed was not germane because the bankruptcy trustee had succeeded to the rights of the debtor company.\textsuperscript{135}

2. Owed to the Corporation

As the \textit{Bayliss} case implied, a clear basis for condemning insider preferences, even when outsider preferences are allowed, can be founded on the fiduciary duty of officers and directors to the corporation.\textsuperscript{136} There is no doubt that directors, as agents, have such an obligation to the company, their principal. Indeed, recognition of that duty made it necessary to determine at the outset whether a director could become a creditor of the company. Several courts soon answered this question in the affirmative.\textsuperscript{137} There is no reason why a loan from a director to the corporation, if on fair terms, should be deemed improper. Such loans may be necessary and mutually beneficial.

The decision regarding the repayment of an insider loan, however,
presents a different issue. If the company's decision, which is formulated by the directors, to prefer one of their number is grounded, not on what is in the best interest of the corporation, but rather on what is the preferred director's interest, then there is a breach of the duty of loyalty that is owed to the company. I say "is" rather than "can be" because it seems likely that there are no situations in which the company properly can be described as indifferent on the subject. Surely, an insider preference impairs corporate credit unless there is some overriding reason for it.\(^\text{138}\) In the absence of such a reason, those obligated by law to make what is best for the company paramount in their decisions have sacrificed the company's interests.

There was an early hint of this line of thought in *Buell v. Buckingham & Co.*\(^\text{139}\) an 1864 Iowa case. In *Buell* the company, which may or may not have been insolvent, transferred its plant to its director-president while a judgment creditor's execution sale was pending. In exchange for the plant, the president agreed to cancel a preexisting debt that the company owed him and to provide the company with funds to pay some, but not all, of its other obligations. The president in turn sold the plant to the plaintiff who successfully sought to enjoin the execution sale.\(^\text{140}\) The court recognized that the interests of the company and the president might have been in conflict. It ruled, however, that at most this conflict made the transaction voidable, rather than void, and not even that at the instance of a creditor whom the court labelled a "*mere stranger.*"\(^\text{141}\) Similarly, in *Stuart v. Larson*\(^\text{142}\) the court prefaced its discussion of insider preferences by noting the conflict-of-interest danger that is involved when directors deal with their company.\(^\text{143}\)

It must be acknowledged that insider preferences are rarely condemned on the ground that they involve a breach of fiduciary duty *to the corporation*. Most of the cases that invoke fiduciary duty have talked of a duty owed to shareholders and creditors rather than to the corporate entity.\(^\text{144}\)

138. The threat to credit that is premised on a breach of duty to the corporation was assigned by a student writer as the basis for invalidating insider preferences. Recent Case, *supra* note 62, at 521-22.
139. 16 Iowa 284, 291-93 (1864).
140. *Id.* at 285-86.
141. *Id.* at 293.
142. 298 F. 223 (8th Cir. 1924).
143. *Id.* at 225.
144. See *supra* part III(F)(I).
3. Why It Matters

The distinction between duties is important for four reasons: First, it determines who can seek to set aside the preference. Second, it regulates the time within which a party can seek recapture. Third, it bears on who may be targeted in a recapture proceeding. Most importantly, breach of duty is more likely to be in issue if the duty is one owed to the company.

The Buell court suggested the problem of standing: who can object to the preference? A creditor, it thought, would have no right to assert a breach of duty owed to the corporation. The objection belongs to the company. Of course, if the company does not complain, a shareholder could do so in a derivative suit. Standing would not be significant in bankruptcy because the trustee, or the debtor in possession, is the successor to the debtor and can enforce the debtor's causes of action. Nor is standing material in nonbankruptcy collective proceedings, such as an assignment for the benefit of creditors, because, again, the assignee is a successor to the debtor company.

Standing is an obstacle, however, when an individual creditor of the corporation brings a nonbankruptcy adversarial action. Lack of standing might be regarded as a mixed blessing. On the one hand, it avoids the problem, posed by an individual creditor's suit, of replacing one preference to the insider with another to the successful suitor. On the other hand, for those who regard the outside creditor, rather than the company, as the true victim of an insider preference, the creditor's inability to seek individual redress is objectionable because the company is not likely to challenge an insider preference.

Treating an insider preference as a breach of duty owed to the debtor company also would free the bankruptcy trustee from the time constraints of preference or fraudulent conveyance recapture that are fixed by the Bankruptcy Code. Whether the transfer was within ninety days or a year of the petition would be of no moment because the nonbankruptcy statute of limitations applicable to the corporate cause of action would be the measure of timeliness. Actually, there is

145. Buell, 16 Iowa at 293.
146. Id. at 293-94.
147. The commencement of a bankruptcy case creates an estate that includes all the debtor's legal and equitable interests in property. 11 U.S.C. § 541(a)(1) (1988). The trustee in bankruptcy, or the debtor in possession, is the representative of the estate. Id. § 323(a).
150. In fact, 11 U.S.C. § 108 may extend the trustee's time limit for bringing suit. If the debtor is not time-barred, the trustee may bring an action within the remaining time.
less to this point than first appears. If the theory of recapture is based on breach of a fiduciary duty owed to creditors, the bankruptcy trustee, who is subrogated to the rights of any actual unsecured creditor under section 544(b) of the Bankruptcy Code, is similarly subject to a nonbankruptcy limitation period.151

If breach of fiduciary duty to the corporation is the appropriate theory, then the obvious target of a recapture action is the party guilty of the breach, the insider. What, then, of a case like Levit v. Ingersoll Rand Financial Corp.,152 in which the payment was made to an outside creditor who had a guarantee from the insider? Does the fiduciary-duty-to-the-company theory immunize the outsider from attack? The answer, I think, is both yes and no. As a matter of nonbankruptcy law directed to the breach of a duty owed to the company, the outsider probably cannot be sued for a breach of duty committed by the insider.153 The outsider's debt makes the outsider a bona fide purchaser in the absence of fraud. But that does not fully solve the Levit problem because bankruptcy law also condemns preferences and does so generally, whether to an insider or outsider. Bankruptcy preference law only differentiates creditors in terms of the period of vulnerability.154 The question of an appropriate target, therefore, depends on whether breach of fiduciary duty or preference is the basis of attack. If preference is the basis, then the appropriate target is determined by bankruptcy law and may well include outsiders.155

Finally, although an insolvent company's payment to an insider is always contrary to the outside creditor's interest, it is possible that such a payment is not contrary to the interests of the company. In light of this possibility, a decision must be made about what to do if fiduciary duty to the corporation is the operative theory. This issue is addressed in Part IV.

One further point must be emphasized. As a matter of nonbankruptcy law, liability for insider preferences varies from jurisdiction to jurisdiction. One state may accept the fiduciary-duty-to-creditors thesis. Another may accept the equity argument based on informational advantage and control. A third may rely on fraudulent conveyance law. I simply have tried to suggest the deficiencies in all of these theories of

or within two years after the order for relief, whichever is later. 11 U.S.C. § 108 (1988).

151. Id. § 544(b). Thus, trustees commonly invoke § 544(b) and sue under state fraudulent conveyance law to avoid the one-year limit of § 548.

152. 874 F.2d 1186 (7th Cir. 1989).

153. Curran v. Arkansas, 56 U.S. (15 How.) 304 (1853), seems to have established long ago that bona fide creditors and purchasers are not appropriate targets in recapture actions. Id. at 311.


155. See supra notes 6-8 and accompanying text.
invalidation except fiduciary duty to the corporation. These theories, though defective, are nonetheless accepted. When insider preferences are outlawed by statute, as under the Uniform Fraudulent Transfer Act, or by some judicial theory other than fiduciary duty to the corporation, that law will govern nonbankruptcy proceedings and bankruptcy proceedings alike. In any case, however, a theory of breach of duty to the debtor company can provide another weapon in the arsenal of a debtor's successor.

IV. Theory Applied

Constructively fraudulent conveyance, recharacterization, inequity, trust fund for creditors, and fiduciary duty to creditors are theories that make all insider preferences by an insolvent company voidable at the instance of a complaining creditor. Once a duty is recognized, the mere fact that an insider preference occurred justifies its recapture. There is no question of breach. In contrast, a theory of actual fraud or of fraudulent conveyance based on actual fraud poses no question of duty. No one doubts that insiders have a duty to refrain from fraudulent acts. Establishing a breach of this duty, however, is problematic.

Similarly, the analysis of insider preferences in terms of fiduciary duty to the debtor company presents no questions about the existence of a duty, for that is not controversial. The only question is whether there is a breach of that duty. For a breach to exist the interests of the company must have been sacrificed. To say that the interests of the company and the insider may diverge is not to say that they will diverge in all cases. In some circumstances giving a preference directly to an insider, or to an outside creditor who is guaranteed by an insider, can be in the company's best interest. For example, the insider, or the outsider who is guaranteed by the insider, could be the company's principal supplier whose continued supply is indispensable to the further operation of the company. In this situation a preference might be exactly what a management that considers only the company's best interests would choose. Because insider preferences can be either good or bad for the company, the question becomes whether it makes more sense to deal with the problem of potentially conflicting interests with a rule that either condemns or authorizes156 all insider preferences, or to examine insider preferences on a case-by-case basis to determine whether a conflict existed and whether corporate interests were

sacrificed.

Two objections that are based on cost confront anyone arguing for a case-by-case inquiry.157 Determining what prompted the preference introduces the additional question of whether the company’s interest was subordinated and proof on this issue would take time and money. Moreover, this additional element of proof increases the risk of error and the costs associated with error. Both proof and error costs are compounded because the legitimacy of the underlying obligation also must be examined.

In contrast, a rule that either condemns or authorizes insider preferences eliminates the costs of proof and error associated with the case-by-case inquiry and is therefore at least superficially attractive. A rule, however, may have its own costs. The effect of a rule on decisions about both extension of credit and repayment should be taken into account. From the company’s point of view, an approach that does not have the overall effect of chilling the availability of credit is the most desirable one. A rule that requires recapture in all insider preference cases is likely to reduce the amount or increase the cost of credit available from insiders because they will either refuse to extend credit or charge a higher rate of interest. Arguably, such a rule simultaneously enhances outsiders’ willingness to extend credit, but it is not clear whether these effects cancel each other.158 On the other hand, a rule that immunizes payments to insiders would seem to have a comparable chilling effect on grants of credit by outsiders that may be offset by the increased willingness of insiders to extend credit to the company. In the absence of a firm basis for believing that one source of credit is clearly more important to debtor companies in general,159 analyzing either rule’s effect on a company’s potential creditors provides no basis for choosing between the two possible rules. It may provide an argument, though perhaps only a modest one, in favor of case-by-case inquiry. If one believes that chilling tends to outweigh encouragement because people respond more to negative than to positive signals and

157. See Posner, supra note 114, § 21.1, at 517-18 (identifying error and direct costs as the costs of a procedural system).

158. Some of the literature suggests that “losses loom larger than gains in human judgment when the prospects of either are equally probable.” Robert E. Scott, Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the Management of Choices, 59 S. Cal. L. Rev. 329, 338 (1986). If this means that positive signals are less powerful than negative ones, avoiding the chilling effect on available credit might be more important to the company than providing encouragement to creditors.

159. It is consistent with the view that insiders may be a better source of credit for troubled companies than outsiders to conclude that generalization about inside credit is impossible because the decision to extend credit is not always made when the company is in trouble.
one thus emphasizes minimization of chilling and deemphasizes encouragement, the case-by-case form of resolution becomes more attractive because it would seem to have a much smaller negative effect on the credit available to the company from both insiders and outsiders.

What would be the effect of the competing rules or the case-by-case inquiry on the company’s decision whether to pay the insider? An ideal approach for the company is one that encourages payments that benefit the company and discourages payments that do not. A rule that immunizes insider preferences would encourage, if not guarantee, payment to insiders. Some of these preferential payments would be in the best interest of the company and some would not. On the other hand, a rule of recapture would seem to discourage payments to insiders that are in the best interest of the company as well as payments that are not. It is not clear, however, that this is the case. I once expressed doubt about the efficacy of recapture in deterring preferential behavior. I thought that because recapture only required that the preference be returned to the common fund, debtors and creditors were not much discouraged from making such transfers by the threat of a return to the status quo. Whatever the effect of a recapture rule on such transfers, it seems clear to me that the threat of recapture will not prevent payments to insiders that are thought to be in the company’s best interest. If such payments succeed in reversing the company’s bad fortune, there will be no occasion for recapture. As between the competing rules, therefore, a rule of recapture seems preferable to me because it is at least somewhat more likely to produce a mix of payments that further the company’s interests than is a rule that authorizes insider preferences.

It seems clear, however, that a case-by-case inquiry, even with some errors, will produce an even more favorable mix of payments. Those found to be in the company’s interest will stand; those that are not, will fall.

Moreover, in parallel cases involving transactions between directors and their companies, the corporate law tradition seems to have moved from a condemnatory rule to a case-by-case examination. At one time these transactions could be set aside at the instance of the company without an inquiry into fairness. Later, they came to be vulnerable for unfairness only when interested directors approved

161. See Marsh, supra note 132, at 36-48.
162. Professor Marsh labels this the rule of “prohibition” and asserts that it was the general rule in 1880. See id. at 36-39.
them. The rule seems to be that, assuming disclosure of interest and authorization, these transactions are valid if they were fair at the time they occurred or if they are approved, authorized, or ratified by a majority of the disinterested directors. The fairness issue, when called into question, is dealt with case by case.

If there is a reason to treat insider preferences by insolvent companies differently, it seems that it would have to lie in the proposition that the owners of an insolvent company have no incentive to challenge preferential transfers. This proposition does not hold up, however, in collective proceedings in which a bankruptcy trustee, a receiver, or an assignee for the benefit of creditors succeeds to the rights of the debtor company. As successors of the debtor company, they have standing to challenge insider preferences, and because preferences affect the creditors whom they represent, they have an incentive to inquire.

Shifting the burden and standard of proof in insider preference cases may offer an opportunity to reduce the costs associated with the case-by-case inquiry. If the preferred insider were required to show by clear and convincing evidence that the preference was in the best interest of the company, it might cut down on the number of instances in which this position is taken and thus reduce overall proof costs. I do not believe, however, that changing the standard of proof affects error costs. A trier can as easily go wrong with a clear and convincing standard as with a preponderance of the evidence standard. The standard of proof merely reflects a bias, or the lack of a bias, in favor of a particular outcome. Allocating the burden of proof in accordance with a pre-

163. According to Marsh, this rule of “approval by a disinterested majority” was firmly in place by 1910. See id. at 39-43.

164. “Judicial review of the fairness of the transaction” is Professor Marsh's label for this rule, which he asserts was the general rule in 1960. See id. at 43-48. It continues to be the operative approach. See Del. Code Ann. tit. 8, § 144(a)(3) (1991); American Law Institute, supra note 131, § 5.02(a)(2)(A); Revised Model Business Corp. Act § 8.61(b)(3) (1984). These sources provide other ways to sustain a transfer: authorization, approval, or ratification by directors or shareholders. All three require that the affirming directors or shareholders be disinterested. Del. Code Ann. tit. 8, § 144(a)(1), (2) (1991); American Law Institute, supra note 131, § 5.02(a)(2)(B), (C); Revised Model Business Corp. Act §§ 8.62, 8.63 (1984). Professor Marsh had previously acknowledged that shareholder ratification would suffice. Marsh, supra note 132, at 48-50.

165. Judge Posner asserts that the higher standard of proof beyond a reasonable doubt reflects the fact that an erroneous conviction has higher social costs than a mistaken acquittal. Posner, supra note 114, § 21.3, at 521. Erroneous convictions reduce the “net expected punishment costs of the guilty” by increasing the cost of acting lawfully. Id. This in turn reduces the effectiveness of criminal laws in deterring criminal behavior. Id. It is not clear to me that this analysis can be transferred to the insider preference situation in which the burden is on the insider. It is, to me, implicit in Posner’s discussion that the standard of proof does not affect the likelihood of error.
diction of the probabilities, however, can affect, albeit very modestly,\textsuperscript{166} the chance of error. If the intuition that insiders more often act according to their self-interests is correct, then requiring insiders to disprove it will reduce the likelihood of error. Not surprisingly, current corporate law puts the burden on directors to prove the fairness of their dealings with the company, at least when the transaction has not been authorized by disinterested directors.\textsuperscript{167} There is not much authority on the standard of proof that directors must meet, but there is some support for the clear and convincing standard.\textsuperscript{168}

The choice between a rule or the case-by-case inquiry is frequently a perplexing one about which reasonable people may differ. The insider preference case is no exception. I would opt for a case-by-case inquiry in insider preference cases because I believe it less costly than a rule and because insider preferences seem indistinguishable from other corporate conflict-of-interest situations. One can argue that the other theories dealing with insider preferences, such as fiduciary duty to creditors, really are based on a different assessment of the relative costs associated with the rule and inquiry methods. I doubt, however, that this is correct. The course of development of the law in this area indicates to me that courts have viewed the insider preference problem, not as insider versus the company, but as insider versus outsider.\textsuperscript{169} Actual fraud aside, this perspective involves no rule or inquiry choice at all because the outsider does not have to show a breach of duty. One need only decide whether a duty is owed to creditors, an issue which does not vary from case to case. If a duty exists, granting a preference is surely a breach of it.

V. Conclusion

There was never any doubt that officers and directors have a duty to refrain from fraudulent acts that injure outside creditors. The problem with that theory was that, more often than not, there was no fraud and therefore no breach. Receiving an insider preference was done openly; no deception was involved. Given the limitations of the early rule, it perhaps was natural that courts continued to search for some other duty owed to outside creditors that did not present the proof problems associated with actual fraud. What made the search difficult

\textsuperscript{166} Allocating of the burden of persuasion is significant only when the trier is in equipoise, \textit{i.e.}, when the trier cannot decide one way or the other. Although we cannot be certain about the frequency of equipoise, presumably it is relatively rare.

\textsuperscript{167} See supra note 164.

\textsuperscript{168} See Pappas v. Moss, 393 F.2d 865, 868 (3d Cir. 1968) (construing New Jersey corporation law).

\textsuperscript{169} See supra parts III(A), (B), (C), (D), (E), and (F)(1).
was that it had to be conducted in the context of the debtor's freedom to prefer one outside creditor over another. Outside bankruptcy, a duty not to prefer at all was rare. Apart from preference theory, I do not believe that the courts have successfully established a basis for imposing a duty on directors that is owed to the outside creditors. There is no persuasive case for the proposition that insiders owe a fiduciary obligation to outside creditors or that insiders should be forbidden from utilizing the power and informational advantages of their positions. The theories of constructive fraud and recharacterization seem equally unsatisfying.

By concentrating on the puzzle of the insider's duty to the outsider, courts have tended to ignore the other available direction: the relationship between the insider and the company itself. The insider's duty to the company is beyond cavil; the problems lie in establishing a breach. The largest problem is whether to conclusively presume a breach or to consider the question case by case. If the case-by-case inquiry is chosen, there is the further problem of how to fix the burden and standard of proof. Nonbankruptcy law's solution to these problems can be found in the parallel situations that involve corporate conflict of interest. The insider preference case does not seem different enough to warrant distinctive treatment. The parallel cases use the case-by-case inquiry and put the burden on the insider to prove, by clear and convincing evidence, that the transaction was in the best interest of the debtor company.

Considering insider preferences as a problem of the director's fiduciary duty to the corporation has an additional virtue. By identifying the wrong as one done to the debtor company, it avoids the inequity posed when one outsider, suing individually, seeks to displace an insider preference and appropriate its benefit. In this situation one preference simply replaces another. If recapture occurs only when the insider has breached a duty to the company, the fruits of the recapture will benefit all creditors.