



# Unusual Issues in Preference Litigation

Prepared by:  
Randy Nussbaum  
*Sacks Tierney P.A.*

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## **Unusual Issues in Preference Litigation**

### **A. The Danger of Involuntary Cases**

For reasons that are not totally clear, often little attention is paid to the impact on a creditor pursuing an involuntary debtor when that creditor has received payments on account by the debtor. This may be the result of involuntary cases rarely being brought or simply an ignored topic. Nevertheless, it's definitely worth considering.

Normally, an involuntary petition is filed in that rare instance in which the petitioning creditor or creditors have determined that the debtor is insolvent and is disposing of its assets. If an involuntary petition is granted, then a trustee is appointed to administer the bankruptcy estate and the offensive payments come to a grinding halt. Once the monetarily irresponsible party is in bankruptcy, the petitioning creditors can then participate in whatever is available in the estate.

A petitioning creditor needs to conduct proper due diligence before ever participating in an involuntary filing. Such an action should never be brought unless the petitioning creditor engages in an in-depth analysis of all payments that may have been received within 90 days of the involuntary bankruptcy filing. Determining whether an involuntary bankruptcy would be beneficial to the creditor or creditors requires a complex calculation as to what that creditor may have to relinquish in return for what that creditor may ultimately receive. If a creditor's exposure on preferential payments is a nominal amount of a few thousand dollars, but its overall claim is half a million dollars, deciding whether to bring an involuntary bankruptcy is probably relatively easy. In instances in which hundreds of thousands of dollars may have flowed to the petitioning creditor within 90 days of bankruptcy, that creditor must engage in a mathematical calculation, while also utilizing

clairvoyant powers to determine whether it is better having to return a certain amount already in its pocket versus an indefinite recovery in the bankruptcy case.

B. Domestic Relations Claim

The Bankruptcy Code, Section 547(c)(7), provides that a debtor's domestic support obligations are not preferential. The broad scope of the pertinent statute can lead to certain gamesmanship by friendly husbands and wives who are divorcing, but also trying to maximize bankruptcy exemption planning. For example, if a husband writes a check to his ex-wife for \$50,000 right before he files for bankruptcy protection because he needs to pay a priority and non-dischargeable debt and he wants to make sure his trustee doesn't grab that money, are there any circumstances in which such a payment can be reversed? The case law is fairly vague in this area, though in those rare instances in which the court concludes that the payment was only made for improper purposes, the payment was successfully challenged. See the following cases:

- § 547(c)(7) does not apply to exclude avoidance of debtor's payment of residence expenses such as a mortgage, taxes, insurance, improvements, repairs, and maintenance where divorce did not specifically obligate ex-spouse to make those payments. *In re Raynor*, 2008 WL 2487867, at \*3 (Bkrcty.D.Neb.,2008)
- SNAP benefits that Chapter 7 debtor received prepetition qualify as support of debtor's children, but debtor's obligation to the state for overpayment of such benefits did not retain its character as support obligation, and state could collect since overpayment excepted from avoidance under

§ 547(c)(7).

*In re Halbert*, 576 B.R. 586 (Bankr. N.D. Ill. 2017).

- The attorney's fees incurred by debtor's former spouse in protecting her child support award were nondischargeable as a domestic support obligation under § 547(c)(7) and therefore not collectable. *In re Johnson*, 445 B.R. 50 (Bankr. D. Mass. 2011), amended in part, No. 09-19214-JNF, 2011 WL 1467913 (Bankr. D. Mass. Apr. 18, 2011).

### C. Tax Claims

Debtors facing non-dischargeable tax claims who may have available funds to pay them don't want to see those payments reversed. However, in certain instances, the debtor cannot wait to file for bankruptcy and therefore has to do so in the face of such payment. Unlike the provision regarding domestic relations orders, the preference exception for tax payments was not enacted.

If the debtor can't wait more than 90 days before filing for bankruptcy, the debtor should not make such a payment unless the payment is also entitled to priority. If it is, then since it would normally be paid in advance of all other creditors, some trustees will not bother to try to seek recovery of the amount. However, the case law is not totally clear, and some decisions allow such a recovery, while others do not, depending on the specific amounts involved and whether the money that may be recovered from the taxing authority may have to be shared with other priority creditors or for administrative purposes.

Although there is no preference defense for tax payments, Section 547(a)(4) does provide some guidance. That Section provides that for the preference purposes "a debt for a tax is incurred on the day when such tax is last payable without penalty, including any extension." Simply put, this definition



guides as to when a tax debt qualifies as an antecedent debt for purposes of a preference action.

D. When is the Payment Actually Made?

Actual money rarely changes hands anymore in today's society. Therefore, it can be complicated and confusing to determine exactly when the recipient actually receives the payment. Because preference law is absolute in that a payment that is received 90 days and one minute from when the debtor files for bankruptcy is not a preference, but a payment received one minute within the 90 days is a preference. Determining when the money is actually in the third-party creditor's hands is crucial.

The Court looks at the ninetieth (90th) full day in determining whether the payment was received within 90 days of the bankruptcy filing. In simplest terms, if the debtor files first thing in the morning and the payment is received by the recipient at 11:59 on the ninetieth day, even though technically more than 90 days may have passed from the time of the filing until the receipt of the payment, the payment is still preferential. On the other hand, if the recipient shows that the actual payment was received in the recipient's account at 12:01 a.m. on the ninety-first day, the payment is not preferential.

E. Collectability Issues

In many cases, the recipient of the alleged preferential payment received the payment because it was applying pressure on the debtor due to economic necessity or because the debtor recognized that the creditor could not withstand the loss of the payment. From the onset, a party pursuing a preference claim has to devote substantial attention to this analysis because if the recipient truly has limited resources, no public purpose is served

by either putting that entity out of business or forcing it into bankruptcy.

### **Debtor's Strategies**

#### **A. When Preference Recoveries can be Detrimental to a Debtor**

In most situations, a bankruptcy debtor either is unconcerned about a preference recovery or will benefit from it. But there are situations in which a debtor would want to avoid filing for bankruptcy to prevent a preferential payment from being recovered. Recognizing those instances in which a debtor should delay the filing can be very advantageous for the debtor.

The debtor may be dealing with a friendly creditor which the debtor doesn't want to see facing a preference recovery. The debtor may have a long-term relationship with that creditor and either doesn't want to see that creditor hurt or wants to continue that relationship. Creating aggravation and monetary loss for that creditor may cost the debtor a strong relationship it does not want to lose.

Occasionally, with an individual Chapter 7 debtor, a recovery of a preferential payment may trigger a non-dischargeability Complaint under Section 523 either because of excessive credit card use, for fraud, or willful and malicious conduct. By paying a creditor who possesses such a claim, the debtor would normally eliminate such a claim being brought, but if the payment is then reversed as being preferential, the creditor may then be motivated to bring an adversary. Of course, all of this can be avoided if the payment is determined to not be preferential. Obviously, when a creditor possesses a non-dischargeable claim, the debtor doesn't ever want to see such payments reversed.

## B. Benefits of Preferential Recoveries

Oftentimes in a reorganization case, the debtor is desperately in need of cash. In situations in which the payment is clearly preferential and the defendant is willing to settle quickly, recovering this money can help fund a reorganization. Those monies could be earmarked for desperately needed administrative expenses or eventually used to pay priority claims. In instances in which the recovered monies were used to pay taxes which otherwise could be assessable against the principals of a Chapter 11 debtor, timing the bankruptcy to ensure maximum recovery is a crucial and very helpful strategy.



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