Avoidable Preferences and the Bankruptcy Code

Prepared by:
Michael R. King
Gammage & Burnham

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Published on www.lorman.com - October 2019

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AVOIDABLE PREFERENCES

I. DEFINITION OF AN AVOIDABLE PRFERENCE

The bankruptcy code allows the trustee or debtor-in-possession to bring into the bankruptcy estate certain assets transferred shortly before the filing of the case. The policy underlying this procedure is that the debtor should not be allowed to prefer certain persons or creditors over other similarly situated creditors.

The elements of an avoidable preference, under 11 U.S.C. § 547(b), are the following:

1) A **transfer** of an interest in the debtor's property. The transfer can be voluntary or involuntary. It would include not only transfer of title but also liens, such as judgment liens and security interests.

2) The transfer was **to or for the benefit of a creditor**. A creditor is anyone who holds a prepetition claim against the debtor. Moreover, if the debtor pays a debt that benefits another person, like a guarantor, then the guarantor may be liable for a preference.

3) The transfer was **for an antecedent debt.** The transfer must have been made for a debt that existed prior to the time that the transfer was made. A transfer made at substantially the same time as the debtor incurred the obligation is not for an antecedent debt.

4) The transfer was made **while the debtor was insolvent**. This means that the debtor had liabilities in excess of the value of its assets. A debtor is presumed to be insolvent during the 90 days prior to the bankruptcy filing.

5) The transfer was made **within 90 days of the filing of the bankruptcy**, or within one year of the filing if the transfer was to an "insider" of the debtor. An insider includes the relatives of an individual debtor, or an officer or director of a business entity debtor.

6) The transfer **allowed the creditor to receive more** than it would have received if the transfer had not been made and the creditor received only what it would have been entitled to under a Chapter 7 liquidation.

If the bankruptcy court finds that a particular transfer was a preference, then the transfer is "avoided." The transferred property comes back into the bankruptcy estate, or alternatively the recipient of the transfer may be ordered to pay the value of what was transferred. Anyone who repays a preferential transfer is entitled to an unsecured claim against the bankruptcy estate for the amount repaid.

In addition to preferential transfers, the trustee may avoid any fraudulent transfers by the debtor made within two years before the bankruptcy filing. A transfer is deemed fraudulent if it was made with actual intent to hinder, delay, or defraud creditors. A transfer is also deemed fraudulent if the debtor received less than reasonable equivalent value in exchange for the transfer and the debtor was insolvent following the transfer. The main difference between a preferential transfer and a fraudulent transfer is that the existence of an antecedent debt (the satisfaction of which constitutes "reasonable equivalent value") precludes the finding of a fraudulent transfer.

II. <u>EXCEPTIONS TO AVOIDABLE PREFERENCES</u>

There are several exceptions to the preference rule. First, the preferential transfer provision only applies to transfer of $600 or more for debtors with primarily consumer debts, or $5,850 or more for debtors whose debts are not primarily consumer debts. 11 U.S.C. § 547(c)(8) & (9).

Transfers are not preferences if the preferential transfer and the underlying debts were intended to be contemporaneous, and were in fact substantially contemporaneous. This applies, for example, if the debtor pays for goods C.O.D. with a check that is not cashed for several days.

Payments made for ordinary business debts are not preferences if paid in the parties' ordinary course of business (*i.e.* subjectively ordinary) or according to ordinary business terms (*i.e.* objectively ordinary). Prior to the 2005 amendments, the ordinary-course-of-business exception required the transfer to satisfy both the subjective and objective components. A payment made within an ordinary 30-day billing cycle would fall into this exception.

Finally, a creditor is also protected from liability for a preferential transfer to the extent it provided "new value" to the debtor following the transfer. Remember that the policy behind the avoidance of preferential transfers is to prevent a debtor from favoring certain creditors to the detriment of others. A creditor's contribution of "new value" to the estate offsets that detriment with a corresponding benefit to other creditors. Where a debtor and a creditor did repeat business during the preference period, the new value analysis requires a review of accounting records to determine the extent to which each preferential transfer was followed by a contribution of new value.

<u>CHAPTER 7 LIQUIDATION</u>

Most types of entities are eligible to be Chapter 7 debtors. A Chapter 7 liquidates the debtor's unencumbered non-exempt property. The cash proceeds are then distributed to unsecured creditors on a pro rata basis. The court appoints a trustee who is responsible for gathering the assets, liquidating them, and distributing the proceeds.

I. EXEMPT ASSETS

Property which is exempt from execution is not liquidated, and instead is typically released to the debtor. Arizona, like most states, has "opted out" of the exemptions listed in the bankruptcy code, making the state-law exemptions applicable. The most important exemptions are for a residence, or homestead, and for certain types of personal property. Some of the more important exemptions under Arizona law are:

- Equity in a "homestead" in the amount of $150,000.00. A homestead is an equity interest in real property in one compact body upon which exists a dwelling house in which the debtor resides. A condominium or a mobile home and the lot on which it is located can also be a homestead. A.R.S. § 33-1101. The homestead does not apply to consensual liens such as mortgages (in other words, the debtor can contract out of the homestead exemption). But the homestead exemption does come ahead of judgment liens, and the bankruptcy code contains a mechanism for the trustee to avoid such liens to the extent they impair a debtor's homestead exemption. To prevent debtors from "shopping" for exemptions, bankruptcy law prevents a debtor from claiming more than $146,450 of a homestead exemption on property that was acquired during the 1,215-day period (3 years, 4 months) preceding the filing. 11 U.S.C. § 522(p).

- Certain items of household furniture, furnishings and appliances personally used by the debtor with an aggregate fair market value not to exceed $4,000.00. A.R.S. § 33-1123. The specific items include the following:

    -- One kitchen and one dining room table with four chairs each and, if the number of household members exceeds four, plus one chair for each additional dependent of the debtor who resides in the household

    -- One living room couch and one living room carpet or rug

    -- One living room chair plus one additional chair for each dependent of the debtor who resides in the household

    -- Two beds, plus one additional bed for each dependent of the debtor who resides in the household

    -- One television set or radio or stereo plus one radio alarm clock

-- One stove and one refrigerator

-- One washing machine and one clothes dryer

-- One vacuum cleaner.

- Clothing with a fair market value not greater than $500. A.R.S. § 33-1125(1).

- Musical instruments for the debtor's individual or family use with a fair market value not greater than $250. A.R.S. § 33-1125(2).

- Domestic pets, milk cows, and poultry with a fair market value not greater than $500. A.R.S. § 33-1125(3)

- All engagement and wedding rings with a total fair market value not in excess of $1,000, plus one watch with a fair market value not greater than $100. A.R.S. § 33-1125(4, 6).

- One typewriter, one bicycle, one sewing machine, a family bible, a lot in any burial ground, and one shotgun or rifle or pistol not in excess of an aggregate fair market value of $500. A.R.S. § 33-1125(7).

- One motor vehicle with a value not in excess of $5,000. If the debtor is physically disabled, the exemption is increased to $10,000. A.R.S. § 33-1125(8).

- All money received by or payable to a surviving spouse or child upon the life of a deceased spouse or parent not to exceed $20,000. A.R.S. § 33-1126(A)(1).

- Proceeds of court-ordered child support or spousal maintenance. A.R.S. § 33-1126(A)(3).

- All benefits of health, accident, or disability insurance or any similar plan of benefits in use by any employer. These benefits are not exempt from debts for premiums for the coverage or for the obligation for which the debtor was paid under the plan. Benefits received in lieu of earnings are not exempt from debts for court-ordered support of a person, subject to whatever exemptions would have been applicable to the earnings. A.R.S. § 33-1126(A)(4).

- The cash surrender value of life insurance policy if policy maintained for two years with spouse, child, parent, sibling or other dependent family member as beneficiary. A.R.S. § 20-1131(D); A.R.S. § 33-1126(A)(6).

- $150 held in a single account in a financial institution. A.R.S. § 33-1126(A)(9).

- Any interest that the debtor has as the participant or beneficiary of a retirement plan qualified under the Internal Revenue Code, unless the funds were contributed within 120 days prior to the filing for bankruptcy. A.R.S. § 33-1126(B).

- Tools, equipment, instruments, and books of a debtor or the debtor's spouse as necessary to carry on a commercial activity trade, business, or profession, or farm machinery and implements of a debtor whose primary income is derived from farming, not to exceed an aggregate fair market value of $2,500. ("Tools" do not include a motor vehicle primarily used for personal purposes such as transportation to place of employment). A.R.S. § 33-1130.

II. MEANS TEST

The most popular revision to the bankruptcy code in the BAPCPA was the adoption of the so-called "means test." Under these provisions, an individual debtor with primarily consumer debts is not eligible for a Chapter 7 liquidation, and instead must convert to a Chapter 13 individual reorganization, if the debtor's income is over a certain amount.

Basically, if a debtor's annual income based on the six months prior to filing is below the median annual income for the state, then the means test is satisfied and the debtor is eligible for Chapter 7. But if the debtor's income exceeds the median income for the state, then deduct the debtor's average monthly living expenses (using IRS-approved numbers) and multiply by 60. If the result is over $10,000, then the debtor must convert to Chapter 13. If the result is between $6,000 and $10,000, then the debtor must convert to Chapter 13 if the result exceeds 25% of the total debt. And if the result is below $6,000, the debtor is eligible for Chapter 7, regardless of the percentage.

Obviously, the means test is a complicated endeavor, and courts are still sorting out how to interpret certain details. The discussion above is a brief overview. Fortunately, the United States Trustee or the case trustee will check the debtor's means test calculation. But a rudimentary understanding of the means test can be useful for a creditor whose individual debtor is threatening bankruptcy.