Public Service Announcement: Don't Take Money Out of Your 401K to Pay Back Your Mom When Filing

Remember that a Chapter 7 bankruptcy is referred to as a liquidation bankruptcy and involves forfeiting your non-exempt assets to a trustee in exchange for a discharge of debts. The trustee will liquidate you assets for cash in a trustee sale and distribute the balance (less a percentage and administrative costs) among your creditors.

A preference is payment made within 90 days of bankruptcy on a debt that is accrued or acquired prior to the debtor making a payment to the creditor on account of the debts that allows the creditor to receive a larger portion of its claim that it would had it been compensated only through the bankruptcy proceedings. That is, if you make a large payment preferentially to one creditor prior to filing bankruptcy, it alters the fair distribution of your assets among all creditors and is thus considered a preference.

An insider preference is a preference made to creditor that is also an insider; that is a relative of the debtor or of a general partner of the debtor; partnership in which the debtor is a general partner; general partner of the debtor; or a corporation of which the debtor is a director, officer, or person in control. In simple terms, this refers to situations where you owe money to your mom, a business partner, or any other individual with whom you have a personal relationship. An insider preference occurs if you attempt to pay off that debt prior to filing bankruptcy.

A trustee will look for insider preference for up to a year prior to filing bankruptcy. And remember, it is their job to find these things. A trustee will look at bank statements, records of real property and numerous other documents for such payments. If they find one, the trustee will likely demand for the return of the asset so that it can be equitably distributed among the creditors. But remember, the trustee also has the ability to file a civil suit against the creditor in an attempt to obtain a judgment in the amount of the preference. So, while your mom may be upset that you didn't pay back the loan she gave you, she will be down right ticked off if she gets slapped with a lawsuit.

Often times, one of the largest misgivings a client has regarding filing bankruptcy is how it will affect their friends or family members to whom they owe a debt. Clients are often interested in repaying these debts prior to filing, however the above issue of preference often prohibits this. Again, it is more than likely that a trustee will take note of such a payment, and demand its return to the bankruptcy estate.

Time and time again, to rectify the situation, a client will take money out of one of their few remaining assets to pay off their friend or family member. Please, Do not do this. One of the most frusterating mistakes a client can make is to remove funds from an exempt asset, perhaps an IRA or a 401K account, to pay off the insider creditor. I realize that this is an emotional decision, but you have to avoid it.

These funds would have been exempt and thus not available to the trustee to include in the bankruptcy estate. However, if you liquidate them and use the cash to make a preference payment to a colleague or family member I guarantee that that person will be receiving a phone call from the trustee.