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Tax Penalties Subordinated?

Can a debtor in bankruptcy subordinate the repayment of tax penalties to the repayment of other obligations? Not likely anymore. In a pair of cases decided this spring, the Supreme Court of the United States rebuffed attempts to deprive the IRS of priority for tax penalty claims.

Normally, claims for taxes due (including interest and penalties) have priority of repayment under bankruptcy law. However, in a liquidation under Chapter 7, the statute specifically subordinates the repayment of penalties to general claims.

Prior to this year, the federal courts of appeal had generally permitted the subordination of tax penalties in Chapter 11 reorganization cases, reasoning that the same policies in favor of subordinating penalties applied even in the absence of explicit statutory authority. The Supreme Court halted this trend and ruled that courts could not use their general equitable subordination power to reorder the priority of an entire class of claims, such as tax penalties.

Although the statutory priority of tax penalties appears to be secure from the encroachments of bankruptcy judges unsympathetic to the IRS, the Supreme Court left open the possibility of a different result in a Chapter 11 case where subordination of the tax penalty is necessary to ensure that creditors receive more than under Chapter 7 liquidation. *United States v. Noland*, 116 S.Ct. 1524 (1996); *United States v. Reorganized CF&I Fabricators*, 64 U.S.L.W. 4548 (June 20, 1996).

Retention of Preferential Payments

Creditors paid within 90 days prior to a debtor's bankruptcy are at risk of having to return the money as a preferential transfer. However, earlier this year, a federal appeals court in New York improved the creditor's chances of retaining the payment.

While Congress gave a bankrupt debtor the power to recover payments to creditors made within 90 days prior to the bankruptcy filing, Congress also provided certain exceptions to that power. One of those exceptions applies where the payment was made and received "in the ordinary course of business." The appellate court broadened the definition of "ordinary course of business," by deciding that a payment under a workout agreement after a default on the original debt could qualify as a payment in the ordinary course of business. The court explained that if the terms of the workout are not so unusual as to fall outside the normal range of workout arrangements within a particular industry, the payments under the workout would not be recoverable as preferences.

Lawson v. Ford Motor Co. (In re Roblin Industries), 78 F.3d 30 (2d Cir. 1996).

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