Bankruptcy and Divorce

Concurrent Session

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Breaking up is Hard to Do: When Bankruptcy Meets Divorce

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I. Introduction

It is no secret that financial difficulty often causes marital conflict, and that marital conflict often causes financial difficulty. At some point in your bankruptcy practice you will encounter a client who is considering a divorce, or has recently finalized a divorce. The following materials offer a scenario-based, practical approach on how to resolve issues that commonly arise when bankruptcy meets divorce.

II. Scenario #1

A potential client enters your office having recently finalized his divorce. Pursuant to the Judgment of Divorce, he is ordered to pay the outstanding balances on several credit cards that are held jointly with his former spouse. He has made no payments on these debts yet. The Judgment of Divorce contains an "anti-bankruptcy" clause that states that the assumption of these debts is to be classified as a "Domestic Support Obligation" and shall survive a bankruptcy discharge.

a. **The client inquires whether these obligations can be discharged in a Chapter 7 and/or Chapter 13 bankruptcy.**

In order to determine whether a debt or obligation that arises pursuant to a divorce decree is dischargeable, you must first determine whether the debt can be classified as a "domestic support obligation (DSO)" or a property settlement. This distinction is very important when determining what chapter your client should file under. Section 523(a)(5) of the Bankruptcy Code excepts DSO's from discharge, regardless of whether the debtor has filed a Chapter 7 or a Chapter 13 bankruptcy. Section 523(a)(15) excepts all other debts arising from a divorce or settlement

agreement from discharge, but only in a Chapter 7. However, 523(a)(15) debts are dischargeable in a Chapter 13 under 11 U.S.C. 1328(a)(2).

In reading 11 U.S.C. 523(a)(15), it is safe to assume that almost all debts or obligations that arise under a divorce decree are non-dischargeable in a chapter 7. Further, an adversary complaint is not required to be filed in order for these debts to be excepted from discharge. *See 11 U.S.C 523(c)*. However, only domestic relations debts that qualify as a DSO are excepted from a Chapter 13 discharge. So while a DSO creditor is given priority status in a Chapter 13 and must be paid in full over the life of the Plan (*see 11 U.S.C. 507(a)(1)*) your client can potentially pay a debt that is owed pursuant to a Judgment of Divorce that is not classified as a DSO at pennies on the dollar. However, under 11 U.S.C. 1328(a), a Chapter 13 discharge will only be granted if the Debtor certifies that all amounts payable under a DSO since the time of filing have been paid in full, and that all past-due amounts due before the petition was filed are paid in full, but only to the extent provided for in the Chapter 13 Plan.

So what is a domestic support obligation? The Bankruptcy Code defines a domestic support obligation as a debt that accrues before, on, or after the date of the order for relief that is owed to or recoverable by a spouse, former spouse or child of the debtor or such child's parent, legal guardian, or responsible relative. 11 U.S.C.S. § 101(14A)(A). The debt must be owed to or recoverable by a governmental unit or a person with a specific relationship to the debtor, the underlying obligation must be in the nature of support, the obligation must arise from an agreement, court order, or as otherwise defined, and the debt must not be assigned to a nongovernmental entity unless voluntarily done. 11 U.S.C. 101(14A).

It is important to note that just because a Judgment of Divorce defines an obligation as a DSO, does not mean that it really is one. In the alternative, a debt does not have to be specifically designated as a DSO in order for it to qualify as one. (*See 11 U.S.C. (14A)(B)*). Sixth Circuit case law outlines specific factors to consider when determining whether a debt is actually in the nature of support. In the case *Sorah v Sorah*, 163 F.3d 397, 401 (6th Cir. 1998), the court stated that bankruptcy courts should first consider whether it "quacks like support," and to look for the presence of such factors as, a label such as alimony, support, or maintenance in the decree or agreement, a direct payment to the former spouse, as opposed to the assumption of a third-party debt, and payments that are contingent upon such events as death, remarriage, or eligibility for Social Security benefits. Other circumstances to be considered include the nature of the obligations assumed, the structure and language of the parties' agreement or the court's decree, whether other lump sum or periodic payments were also provided, the length of the marriage, the age, health and work skills of the parties, whether the obligation terminates upon the death or remarriage of the parties, the adequacy of support absent the debt assumption, and evidence of negotiations or other understandings as to the intended purposes of the assumption. *Luman v. Luman* 238 B.R. 697, 706 (Bankr. N.D. Ohio 1999).

b. Does the fact that the debts are owed to a third party have any bearing on whether or not they are dischargeable in a Chapter 7 or Chapter 13?

Given today's bleak economy, it is very common that couples seeking a divorce have loads of marital debt that needs to be divided. At some point you will most likely find yourself dealing with a potential client that has been required to pay a third party creditor, such as a credit card company, pursuant to a divorce decree. Would this be considered a DSO even though the debt is not owed to a "spouse, former spouse or child of the debtor or such child's parent, legal

guardian, or responsible relative" as defined in 11 U.S.C.S. § 101(14A)(A)? The 6th Circuit BAP held in the case *Gibson v Gibson,* 219 B.R. 195 (B.A.P. 6th Cir. 1998), that an obligation incurred in connection with a separation agreement was excepted from discharge as a support obligation notwithstanding that the debt was payable to a third party. The court also stated that for a debt to qualify for treatment under 11 U.S.C.S. § 523(a)(15), the critical issues are the nature of the debt, not the payee, and whether under state law the debt was incurred in the course of a divorce or separation. *Id.* at 203.

c. Assume your client is already in a bankruptcy and wishes to have the Judgment of Divorce entered by the family law court. What are the implications of this under the Automatic Stay?

The automatic stay does not apply to an action to grant a divorce to the extent such action does not also involve the division of property that is property of the bankruptcy estate. 11 U.S.C. 362(b)(2)(A)(iv).The automatic stay also does not apply to actions to establish paternity, establish or modify a domestic support obligation, matters concerning child custody or visitation, and matters regarding domestic violence. 11 U.S.C 362(b)(2)(A)(i),(ii),(iii) and (v).

When in doubt, it is best to file a Motion for Relief from the Automatic Stay to request that the Stay be lifted for the limited purpose of entering a marital property settlement.

Further, if your client is currently in a bankruptcy and wishes employ outside counsel to represent them in a family law matter, it is best to obtain court approval by way of a "Motion to Employ Outside Counsel", or similarly titled Motion.

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II. Scenario #2

Mary and Bill are married and have 2 minor children who are 7 and 10 years old. They live in a house with 2 mortgages - the first mortgage balance is $150,000 and the second mortgage balance is $50,000. The approximate value of the house is $125,000. Both parties are responsible on the mortgages of the house.

The couple has filed for divorce, but it has not been finalized. The couple will share legal custody of the children, they will reside with Mary and Bill will have parenting time every other weekend and as the parties agree. Mary wants to retain the home for the children. Mary and Bill are amicable at this time and have been married 15 years. Mary and Bill each earn $60,000 per year.

The couple has $25,000 of unsecured debt which is predominantly in Bill's name only. You currently represent them both in their Chapter 13 bankruptcy in which the plan proposes to strip the second mortgage lien off the marital home. They are 1 year into their 5 year plan. The parties have come in to discuss how to proceed in their bankruptcy.

a. Is one bankruptcy attorney able to represent each party in their bankruptcy proceedings?

Only married couples may file a joint bankruptcy case, if a divorce is final prior to filing then the couple must file individually. 11 U.S.C. §302. In this situation the couple's divorce proceeding is still pending so it was appropriate for them to file jointly. However, bankruptcy counsel contemplating representing a couple undergoing a divorce needs to consider the obligations to the joint clients and the risks of a potential or actual conflict of interest.

In a joint case, the attorney has an ethical duty of loyalty to both the husband and the wife. MRPC 1.7 dictates an attorney's duty of loyalty and outlines the importance of being completely loyal to clients; in this situation a lawyer must represent 100% of each spouse's interest, which could be near impossible depending on how amicable the couple is. If such a conflict arises after representation has been undertaken, the lawyer should withdraw from the representation pursuant to MRPC 1.16.

For example, a conflict that would force a bankruptcy attorney to withdraw from the case is a reaffirmation agreement. If the husband and wife are joint debtors on a note for a vehicle and the husband does not want to give it up at any cost but the wife is ready to do so, it becomes difficult for counsel to serve dual interests. In this scenario, it is clearly not in the best interest of the wife to reaffirm this debt.

Since hiring an attorney to review and proceed with a joint filing typically involves a fee equivalent to one spouse filing individually, most joint debtors will want their attorney to keep representing them both to save money. In this situation, the attorney can have the clients sign an agreement stating that they understand the potential for conflict and that the attorney will withdraw from representing either debtor in the event a conflict arises. However, in cases where

there is no secured debt or when every type of secured collateral is being surrendered to the creditors, the chance for conflict is low.

b. Should this case be severed into two individual case? Bill and Mary are amicable at this time, but that may change if one of the parties learn of infidelity, disagree about issues with the children, or any of the other endless possibilities that divorcing persons find to fight about. At that point it may be difficult for them to stay in their Chapter 13 for the remaining term. The other consideration is if they both should remain in Chapter 13 or if one of them should convert to Chapter 7.

In this case these parties should sever the case so that Mary will remain in Chapter 13 as she wants to keep the house. Converting Bill to Chapter 7 would allow him to not only discharge his obligation on the marital home as well as discharge the majority of the unsecured debt that is just in his name. Mary can file objections to the proof of claims for unsecured debt just in Bill's name and possibly reduce her Chapter 13 payment.

The case is severed by filing a Motion to Sever and asking that a new case number be assigned to the party not remaining in the Chapter 13.

c. **Can Mary still strip the 2nd mortgage lien if Bill converts to Chapter 7?**

Unlike in personam (which is against a person and its property) in rem means "against a thing or property. *In rem* jurisdiction permits the court to determine all claims held by anyone against the debtors' property. The automatic stay provisions that are set forth in 11 USC 362(a) are limited by 11 USC § 362 which defines types of actions that are not subject to the automatic stay.In *Tennessee Student Assistance Corp. v. Hood,* the majority of the Supreme Court noted

that a proceeding to determine the dischargeability of a debt by a bankruptcy court is premised on the court's *in rem* jurisdiction over the debtor's property and the estate, and the bankruptcy court does not assert *in personam* jurisdiction over nonparticipating creditors.

In Rem Orders, are provided for in 11 U.S.C. § 362 and state that, if the court finds that the case was filed as a part of a scheme to delay, hinder, and defraud creditors, either by the transfer of all or part of an interest in real property without the creditors consent, or by multiple filings that affect real property, the court may grant in rem relief from the stay. Such an order is binding immediately upon parties with notice like any other order. The order is binding on any subsequent case filed within 2 years of the entry or the order if the order is recorded in compliance with state real estate noticing law. § 362(b)(20) no stay of action to enforce liens or security interests following an in rem order unless the debtor in the new case successfully moves for relief from the in rem order- the debtor must demonstrate a change in circumstance or other good cause.

A court is permitted to enter an "in rem" order regarding the automatic stay as to a particular parcel of property under 11 U.S.C. § 362(d). Under § 362(d), bankruptcy courts will be able to enter "in rem" orders terminating, annulling, modifying or conditioning the automatic stay with respect to actions by secured creditors against particular parcels of real property if the court finds a bankruptcy petition to be part of a scheme to delay, hinder, and defraud creditors involving either 1) the transfer of full or partial ownership interests in the subject real property without the consent of the secured creditor or court approval; or 2) multiple bankruptcy filings affecting the subject real property. 11 U.S.C. § 362(d)(4)(a)(A) and (B). If entered and recorded in accordance with applicable state law, an "in rem" order is binding in any

bankruptcy case that would affect the subject real property filed within two years after the "in rem" order is entered. A debtor may seek relief from an "in rem" order in a subsequent bankruptcy case based upon changed circumstances or for good cause shown.

Below are the USC sections that outline this subject:

In Rem Orders 11 USC §362(b)(20) and 11 USC §362(d)(4):

1) 11 USC §362(d)(4): if the court finds that the case was filed as a part of a scheme to delay hinder, and defraud creditors, either by the transfer of all or part of an interest in real property without the creditor's consent ("due on sale" clauses), or by multiple filings that affect the real property (not necessarily by the *same* debtor), the court may grant in rem relief from the stay.

(a) Order is binding immediately upon parties with notice like any other order.

(b) Such an order is binding on any subsequent case filed within 2 years of the entry of the order if the order is recorded in compliance with state real estate noticing laws (MCLA 565.1, et. seq).

(c) Government units must accept a certified copy of the order for "indexing and recording."

2) 11 USC §362(b)(20): No stay of actions to enforce liens or security interests following an "in rem order" described in §362(d)(4) *unless* the debtor in the new case successfully moves for relief from the in rem order.

(a) debtor must demonstrate change of circumstances since entry of order, or

(b) "other good cause."

The Order on the Adversary Complaint which is required to be filed by local rule in the Eastern District of Michigan has the following language:

IT IS ORDERED that upon completion of the debtor's Chapter 13 plan and the entry of a Chapter 13 discharge order in bankruptcy case number __-_____, the mortgage ("Mortgage") dated _____, _____, covering the following described property (add legal description) and as recorded in the _____ County Register of deeds on _____, ____, at Liber ____, Page __, will be stripped from the property and discharged.

The Adversary Complaint was filed in the original Chapter 13 case, which is Mary's case number after the cases were severed. Upon her discharge in Chapter 13 the Adversary Order may be filed with the Register of Deeds to strip the lien off the real property.

Mary's liability on the note is discharged in her Chapter 13 and Bill's liability on the note is discharged in his Chapter 7.

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III. Scenario #3

Mary and Bill have been married for 15 years. Their first purchase as a couple was their home that is now worth $225,000 with an outstanding mortgage balance of $45,000. Bill's business hasn't been doing well, and he (alone) has guarantied nearly $250,000 in business debt. Bill has hidden his business troubles from Mary.

In an effort to generate new business, Bill recently took a business trip to France. Although the trip didn't produce any new customers, he met Gabrielle, a French heiress. It was love at first sight for both of them. On his way home from France, Bill bought a lottery ticket and it turned out to be a winner: he received a $100,000 cash payment from the Michigan Lottery. He deposited the $100,000 in a new bank account in his name alone.

Bill interpreted the winning lottery ticket as a "sign" that his true destiny is to divorce Mary and marry Gabrielle. So, Bill filed for divorce—although he felt guilty about divorcing Mary and wanted to make sure that she doesn't suffer financially from the divorce. As part of the court-approved property settlement agreement, Bill: (i) signed a quit claim deed conveying his interest in the house to Mary (who will continue making the

mortgage payments), and (ii) gave Mary the $100,000 in lottery winnings. Bill remains liable on all his business obligations.

The divorce proceedings were amicable and the divorce case was closed 4 months ago. Now, Bill plans to file Chapter 7 to discharge his obligations to the business creditors, then move to France to marry Gabrielle. Bill wants you to handle his Chapter 7, but he wants to make sure that Mary isn't somehow dragged into his bankruptcy proceeding. In other words, he wants to make sure that his quit claim deed and $100,000 payment to Mary "survive" his bankruptcy. What do you tell him?

a. Will a Chapter 7 Trustee be able to avoid Bill's quit claim deed to Mary?

Transfers made as part of a court-approved divorce decree or court-approved property settlement, are *not* automatically protected from being attacked as fraudulent transfers. Cases such as *Corzin v. Fordu (In re Fordu),* 201 F.3d 693 (6th Cir. 1998); *Estes v. Titus,* 481 Mich. 573, 751 N.W.2d 493 (2008); Mejia v. Reed, 31 Cal. 4th 657, 74 P.3d 166 (2003); *Dowell v. Boyer*, 998 P.2d 206 (Okla. Civ. App. 1999); and *Greeninger v. Cromwell,* 140 Ore. App. 241, 915 P.2d 479 (1996) all stand for the proposition that fraudulent transfer laws *can* be used to avoid or undo transfers made pursuant to court-approved divorce decrees or property settlements—***especially those based on the agreement of the parties***. A divorce decree does not have preclusive effect on a bankruptcy trustee because the trustee is *not* a party to the divorce nor is a trustee in privity with any party to the divorce. (Instead, the trustee "represents" the *creditors* of the debtor.) And, the *Rooker-Feldman* doctrine (which provides that lower federal courts are precluded from exercising appellate jurisdiction over final state-court judgments) does not apply against the trustee because the trustee was not a party to the divorce proceeding or in

privity with a party. *See Lance v. Dennis,* 546 U.S. 459, 463, 126 S. Ct. 1198, 163 L.E.2d 1059 (2006).

In *Kardynalski v. Fisher,* 135 Ill. App. 3d, 482 N.E. 2d 117, the court explained *why* agreed-upon property settlements are susceptible to avoidance as fraudulent transfers, even if they are "blessed" by the divorce court:

> Special scrutiny is applied to transfers between spouses where the debtor spouse is thereby rendered insolvent and unable to satisfy the claims of his creditors. ... The incorporation of the parties' agreement into a judicial decree does not alter this result. While judicial approval in such circumstances may represent a determination that the agreement is fair and equitable as between the parties to the divorce, it does not represent a determination that the agreement perpetrated no fraud upon the creditors of one spouse, particularly where the claims of the creditors are not made known to the court or provided for in the decree.

Where, however, the transfer to a spouse (or former spouse) is made in the context of a fully litigated property settlement, the general reluctance of bankruptcy courts to undo state court decrees makes it less likely that a bankruptcy trustee's fraudulent transfer claim will succeed, unless there is evidence of collusion, "sandbagging" or some irregularity. *See, e.g., Ingalls v. Erlewine (In re Erlewine),* 349 F.3d 212-213 (5th Cir. 2003).

So, if Bill files bankruptcy within two years after the quit claim deed is recorded[1], a bankruptcy trustee is likely to pursue a fraudulent transfer action against Mary under Bankruptcy Code §548, claiming that Bill transferred his interest in the house (worth about $90,000, assuming that Bill's interest in the house was one-half of the $180,000 equity therein).

Because Bankruptcy Code §548 only permits the trustee to "claw back" transfers made within two years before the petition date, the trustee cannot use §548 to attack the quit claim

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[1] Bankruptcy Code §548(d)(1) provides that a transfer is made when it is perfected so that it cannot be challenged by a *bona fide* purchaser. In the case of a deed, the recording date would be the transfer date.

deed as a fraudulent transfer ***if Bill waits more than two years from the date the deed was recorded before he files bankruptcy.*** In that event, the trustee will be forced to use Bankruptcy Code §544 and Michigan's version of the Uniform Fraudulent Transfer Act ("UFTA") (MCL 566.31 *et. seq.*) to try set aside the deed to Mary.

If Bill is willing to wait and file Chapter 7 more than two years after the deed's recording date, he might be able to ***defeat*** the trustee's §544 fraudulent transfer attack on the deed. Bankruptcy Courts are required to apply *state* law when the trustee uses Bankruptcy Code §544. *See, e.g. In re Image Worldwide, Ltd.,* 139 F. 3d 574 (7th Cir. 1998); *Cinncinnati Ins. Co. v Federal Ins. Co.,* 166 F. Supp. 2d 1172, 1177 (E.D. Mich. 2001). In *Estes v. Titus,* 481 Mich. 573 (2008) the Michigan Supreme Court held that, because Michigan's version of the UFTA defines "assets" to *exclude* property held as tenants by the entireties[2], the transfer of entireties property from one spouse to another as part of a divorce cannot be a fraudulent transfer under Michigan's fraudulent transfer statute, except with respect to a creditor that has a claim against *both* spouses. *Estes v. Titus,* 481 Mich. 573, 580, 751 N.W.2d 493 (2008). The Michigan Supreme Court was careful to explain that this rule applies even when property held as tenants by the entireties is disposed of in a divorce judgment—even though that divorce judgment ends the tenancy by the entireties. *Estes v. Titus, Id.* at 582. In Bill's case, the only creditor with a claim against *both* Mary and Bill is the mortgage holder—and Mary will be making the mortgage payments, so that creditor is happy.

[2] MCL 566.31(b)(ii) states: (b) "Asset" means property of a debtor, but the term does not include any of the following:...(iii) An interest in property held in tenancy by the entireties to the extent that it is not subject to process by a creditor holding a claim against only 1 tenant.

Consequently, if Bill can keep his business creditors at bay for more than 2 years after the quit claim deed is recorded, then the quit claim deed to Mary will be beyond the reach of a bankruptcy trustee's fraudulent transfer attack under Bankruptcy Code §548, and the trustee will be forced to sue under Bankruptcy Code §544. The bankruptcy court will then apply Michigan law (rather than bankruptcy law) to the trustee's fraudulent transfer lawsuit—including the Michigan Supreme Court's ruling in *Estes v. Titus,* which could actually defeat the trustee's fraudulent transfer challenge to the deed that Bill gave Mary as part of the divorce. Thus, by waiting more than two years after the deed's recording date, Bill might be able to protect the deed even from trustee's fraudulent transfer challenge under Bankruptcy Code §544.

b. Will a bankruptcy trustee be able to avoid Bill's transfer of $100,000 to Mary?

Clearly, a bankruptcy trustee will use Bankruptcy Code §548 in an attempt to recover the $100,000 if Bill files bankruptcy within two years after Bill paid it to Mary.

Even if Bill waits more than two years to file bankruptcy, a bankruptcy trustee can use Michigan's version of the UFTA to try to "claw back" transfers made within *six years* before the fraudulent transfer case is filed. The $100,000 in lottery winnings was never entireties property—so Bill's payment of his lottery winnings to Mary does not enjoy the "entireties exception" embodied in MCL 566.31(b)(iii) or described in *Estes v. Titus, supra.*

Consequently, Bill would have to delay his bankruptcy filing for more than *six years* after the date he paid the $100,000 to Mary in order to protect that transfer from the trustee's fraudulent transfer action.

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IV. Scenario # 4

Mary and Bill are married and have 2 minor children who are 7 and 10 years old. The live in a house with 2 mortgages - the first mortgage balance is $150,000 and the second mortgage balance is $50,000. The approximate value of the house is $125,000. Both parties are responsible on the mortgages of the house. The couple has filed for divorce, but it has not been finalized. The couple will share legal custody of the children, they will reside with Mary and Bill will have parenting time every other weekend and as the parties agree. Mary and Bill are amicable at this time and have been married 15 years. Mary earns $50,000 per year and Bill earns $75,000 per year. The couple has $25,000 of unsecured debt.

a. Mary would like to keep the house for the kids to grow up in. Can Mary file a Chapter 13 Bankruptcy and strip the second mortgage without filing a joint bankruptcy with her soon to be ex-husband ?

This issue was recently decided by the court in *Strausbough v. Co-op Services Credit Union (In re Strausbough),* 426 B.R. 243 (Bankr. E.D. Mich. March 25, 2010). The opinion

issued by Judge Rhodes, consolidates two separate cases and concludes that an individual debtor can avoid a junior lien on entireties property.

In reaching its conclusion, the Court looked to § 506(a) and first questioned the estate's interest in the property. After a review the applicable case law, the Court found that the bankruptcy estate's interest in the property was "whatever equity is available in the entireties property that can be liquidated for the benefit of the joint creditors of the debtor and the non-filing spouse." *Id.* at 246. In the instant cases, the properties at issue were worth less than the amount owed on the first mortgages. Therefore, the Court found that "these estates have no interest in the entireties properties of the debtors and their non-filing spouses." *Id.*

The Court next questioned the creditor's interest in the estate's interest in the property. The Court easily found that the creditor's had no interest as the bankruptcy estate itself did not have an interest in the property.

The Court went on to say that Chapter 13 bankruptcy cases often benefit non-filing spouses. The most common of these benefits comes when the non-filing spouse benefits from a Chapter 13 bankruptcy that is filed to maintain possession of the entireties property while curing the default on the mortgage. The Court found that the benefits of lien avoidance under § 506(a) and (d) were no different. *Id.* at 250.

Finally, the Court pointed out that nothing in the law prohibits one of the parties to an entireties estate from acting to enhance that estate. The Court found no difference between one

spouse avoiding a junior lien on entireties property, and one spouse making a payment on a joint debt on the entireties property. *Id.*

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