

The Intersection of Bankruptcy and Family Law and Managing an Asset Chapter 7 Case

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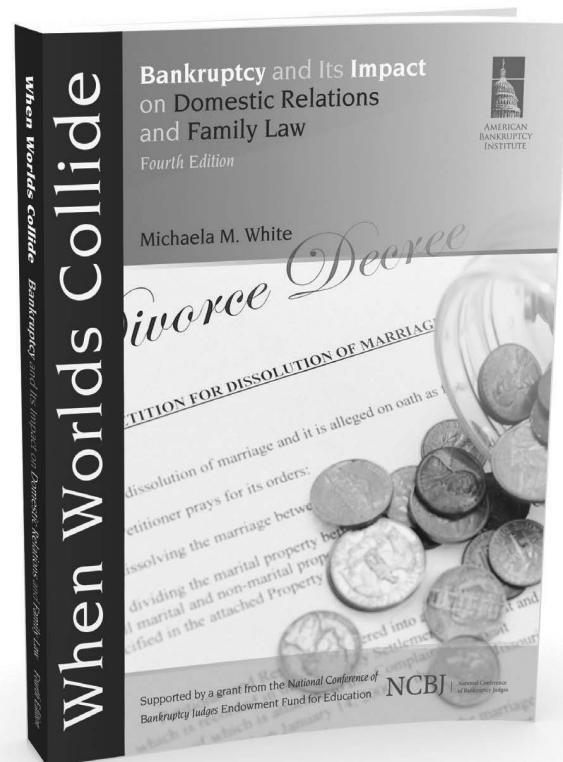


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**THE INTERSECTION OF
FAMILY & BANKRUPTCY LAW
&
MANAGING A
CHAPTER 7 ASSET CASE**

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17th Annual Southeast Bankruptcy Workshop

The Ritz-Carlton

Amelia Island, Florida

July 25-28, 2012

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I. Introduction

Given that financial and marital problems often go hand in hand, it is important for bankruptcy practitioners to possess a firm understanding of the intersection of bankruptcy and family law. Some common issues bankruptcy attorneys encounter in this area include:

- a) The priority and protections given to Domestic Support Obligations (DSOs) in the bankruptcy process;
- b) The dischargeability of certain divorce-related obligations and debts;
- c) The applicability of the automatic stay to attempts by former spouses and government entities to collect alimony, maintenance, child support and property settlements and pursue contempt actions;
- d) The ability of the Trustee to avoid transfers between spouses;
- e) The ability of debtors to avoid judicial liens and certain other non-consensual liens that impair the debtor's bankruptcy exemptions; and
- f) The unique twists associated with Post-bankruptcy divorce actions.

II. What is a Domestic Support Obligation (DSO)?

According to 11 U.S.C. § 101(14A), a debt qualifies as a **DSO** if it is:

1. Owed to or recoverable by a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative; or a governmental unit

2. **In the nature of alimony, maintenance, or support** (including assistance provided by a governmental unit) of such spouse, former spouse, or child of the debtor or such child's parent, ***without regard to whether such debt is expressly so designated***
3. Established pursuant to
 - (i) a separation agreement, divorce decree, or property settlement agreement;
 - (ii) an order of a court of record;
 - (iii) a determination made in accordance with applicable nonbankruptcy law by a governmental unit

If the debt meets the above-listed criteria, it is a DSO regardless of whether it accrues before, on or after the date the bankruptcy petition is filed. The amount of the DSO may include interest accrued on the debt as provided under applicable nonbankruptcy law.

A debt assigned to a nongovernmental entity is not a DSO **unless** the debt was voluntarily assigned by the spouse, former spouse, debtor's child or that child's legal guardian and meets the other criteria set forth above.

III. What priority are DSO claims given in the bankruptcy process? And what protections are afforded to DSO claimants?

a. In a Chapter 7 Case...

The law changed in 2005 to elevate DSO claims from 7th priority to 1st. **This means that a DSO claim is paid after the trustee's fees and expenses but before most other unsecured creditors' claims.** See 11 USC 507 (a)(1). Also, Chapter 7 Trustees are required to send a **DSO letter** to the DSO recipient that notifies them that the debtor filed a Chapter 7 petition.

If there are assets in the case, the DSO claimant should promptly file a proof of claim to ensure they receive payment as a priority.

b. In a Chapter 12 and/or 13...

A debtor's plan cannot be confirmed over the objection of priority claimants unless the plan calls for full payment to all priority claimants. This means the debtor must pay the prepetition claims over the life of the plan—36 to 60 months.

While prepetition DSO arrears generally must be paid during the plan, an exception exists where the debtor has negotiated a better deal either with the claimant or the governmental unit assigned to collect the debt. For example, suppose the debtor owes a great deal of back due support. The Superior Court judge allows him to make the current payment plus a certain amount on the back due payment. The Chapter 13 trustee will allow that agreement to stand although the arrears portion of the order technically should be stopped and all arrears to be paid through the plan.

As part of the 2005 Amendments, wage withholding DSO payments are not stayed. A debtor cannot get a discharge unless all support obligations are paid in full. 11 USC 362 (b)(2)(C).

c. In a Chapter 11...

An individual debtor can confirm a plan over a DSO creditor's objection only if the plan pays the DSO creditor in full on the effective date of the plan.

IV. WHAT DIVORCE-RELATED DEBTS AND OBLIGATIONS ARE DISCHARGABLE UNDER THE BANKRUPTCY CODE?

a. Alimony, maintenance and support

Under the 2005 Amendments debts for alimony, maintenance and support, and DSO's are nondischargeable in all cases.

b. Property settlements

(i) In Chapter 7, 11 and 12 cases after 2005, the general rule is that property settlements are **NOT** discharged in bankruptcy.

(ii) In Chapter 13 cases, property settlement obligations, but not alimony and support, **ARE** dischargeable. This is one of the last vestiges of the Chapter 13 “super discharge” that was eviscerated by the 2005 bankruptcy reform laws.

c. How are property settlements distinguished from alimony/support?

Although parties frequently label or characterize a claim in the state law venue, the labels are not necessarily binding on the bankruptcy court.

Instead, the bankruptcy court will examine a list of factors, including:

- What is the *intent* of the parties?
- How was the debt *characterized in the state court*?
- How is the debt treated for *tax purposes*?
- Which spouse has *custody* of the children?
- When does the *obligation terminate*?

V. Examples of how courts have distinguished property settlements from alimony/support.

i) In re McCollum, 415 B.R. 625 (Bankr. M.D. Ga. 2009).

The facts are straightforward in this Chapter 13 case.

The issue was the dischargeability of a DSO debt.

The McCollums were married for 30 years and divorced in 2008. Their settlement agreement, incorporated into their divorce decree, provided for alimony, property division, and debt resolution.

With respect to the marital home, jointly owned by the parties, the agreement provided that wife receive as her sole and absolute property full fee simple title to the real estate subject to existing deeds to secure debt, but free and clear of the rights and claims of the debtor.

The monthly payments to the mortgagees were to be treated as *indirect alimony* and the debtor was directed to execute a limited warranty deed to wife.

With respect to the car driven by the wife, she was awarded full title to the vehicle subject to existing liens and again, as indirect alimony, the debtor was directed to make the payments to the secured lender until paid in full.

The agreement divided other property including a time share and retirement accounts. Debtor did not dispute this division.

Debtor stated his understanding was that the car and house payments would continue until the debts were *paid in full*. When filing their taxes, the ex-wife called him and told him not to list those payments as alimony because to do so may trigger an audit. So, this property was not alimony for tax purposes.

11 USC 523(a)(15) applies to debts that do not fall within the definition of a DSO but were incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court. This generally applies to property settlements. The question was whether they can be discharged under 11 USC 1328 (a)(2) and 523 (a)(5).

The burden of proof in this case was on the debtor who initiated the adversary proceeding, which is the term for a lawsuit filed in connection with a bankruptcy case.

The Court determined that both debts were dischargeable. The court noted that the following facts were important in reaching this conclusion:

- a. The cash alimony and health benefits terminated upon death or remarriage of ex-spouse.

- b. The house payments and car payments had to be paid in full with no termination provision.
- c. The court could not determine the intent of the parties from their testimony.
- d. The ex-spouse received more income than the debtor.
- e. The tax treatment for income tax purposes was not for alimony.

(ii) In re Benson, 441 Fed. Appx. 650; 2011 U.S.App. LEXIS 19742 (11th Cir. 2011)

This 11th Circuit case followed the reasoning of McCollum but reached a different result.

Under the terms of the Bensons' divorce decree, the husband was required to make the house payments and the wife kept the house. The husband quit making the payments, declared Chapter 13 bankruptcy and sought to discharge the mortgage obligation.

Both lower courts held the debt to be a DSO and, consequently, nondischargeable.

The 11th Circuit affirmed for the following reasons:

- a. The agreement supported wife's position that the parties intended the payments to be a DSO.
- b. The wife waived cash alimony in consideration for husband making the house payment.
- c. The agreement required husband to maintain life insurance to cover the mortgage.
- d. The husband could claim minor children as tax exemptions so long as he paid the house mortgage

(iii) Take away from McCollum & Benson.

Whether a divorce-related obligation can be discharged is a fact and case specific inquiry. Courts will look to the agreement itself, the parties' financial position when the agreement was made, the amount of the division, whether the obligation ends upon death or remarriage of the beneficiary, the frequency and number of payments, whether the agreement waives other support rights, and whether the obligation can be modified or enforced in state court and how the obligation is treated for tax purposes.

VI. The Impact of the Automatic Stay on Divorce Proceedings

The automatic stay can create headaches for attorneys attempting to secure alimony or support from a ex-spouse who is also a debtor in bankruptcy.

As an initial matter, it is worth noting that 11 USC 363 (b)(2) provides that the stay does not apply to the commencement or continuation of actions or proceedings :

- a. to establish *paternity*;
- b. to *establish or modify* an order for a DSO;
- c. concerning *child custody or visitation*;
- d. to *dissolve a marriage*, as long as it doesn't determine the division of property of the estate;
- e. regarding *domestic violence*;
- f. withholding income that is *property of the estate or property of the debtor* for payment of a DSO;
- g. withholding, suspending or *restricting a driver's license*, a professional or occupational license, or a recreational license under state law, as provided by the Social Security Act;

- h. *reporting overdue support* as specified in the SSA;
- i. *intercepting a tax refund*, as required by the SSA or under an analogous state law;
- j. *enforcing a medical obligation* as specified by the SSA; and
- k. *criminal actions* –if debtor in bankruptcy was the target of or a defendant in a pending criminal action that was related to a DSO, *or was the subject of a criminal as opposed to a civil contempt for failing to obey court orders*.

Note that the analysis of how these rules apply can change depending on which type of bankruptcy the debtor spouse files. For example, in a Chapter 7 case, the automatic stay does not apply to a creditor collecting a DSO from property that is not property of the estate. So, a garnishment for post-petition wages may continue. Also, any property claimed as exempt by the Debtor is not property of the bankruptcy estate and is therefore not protected by the automatic stay.

In contrast, post-petition wages in a Chapter 11, 12, or 13 case are property of the estate. Thus, 11 USC § 363 (b)(2)(k) does not apply and any attempt to garnish the debtor's wages would violate the automatic stay!

What if it is difficult to determine if the debt is a DSO or a property settlement?? **The best course of action is to always seek permission from the bankruptcy court to proceed by filing a Motion for Relief from Stay. When in doubt, seek relief from the automatic stay!!**

VII. Avoidance of Transfers Between Spouses

One of the impacts of bankruptcy is seen in the avoidance powers given to the trustee or the debtor-in-possession in bankruptcy cases. The trustee might,

for example, seek to avoid and recover preferential payments made to one creditor under § 547; to avoid and recover fraudulent transfers, either actually or constructively fraudulent as to creditors, under § 544 or § 548; or to use other avoidance powers found in Bankruptcy Code or state law.

Not surprisingly, transfers that have been made by a debtor to a spouse or other family member, even when made in conformity to a consensual agreement or court order, may come under scrutiny by the bankruptcy trustee or creditors. When this occurs, the focus for constructive fraud purposes often will be upon whether the debtor received adequate consideration for the transfer. If the transfer to the spouse is a sham or an effort to conceal assets from the reach of creditors, the possibility of actual fraud and collusion between the parties will be examined.

Fortunately for debtors, former spouses, and dependent children, the Bankruptcy Code at 11 U.S.C. § 547(c)(7) contains an exception from preference attack for payments or other transfers that were bona fide alimony, maintenance or support in nature, and that were made in connection with a separation agreement, divorce decree or other order of a court of record. If such payment were recovered, it would increase the nondischargeable debt to the recipient of the payment.

VIII. Bankruptcy Exemptions: Special Considerations in the Domestic Relations Context

a. Property that is exempted from the bankruptcy estate is subject to claims by ex-spouse

A debtor in bankruptcy can keep property out of the hands of the bankruptcy trustee by claiming allowed exemptions under applicable state or federal law. However, bankruptcy practitioners representing debtors in divorce should remember to advise their clients that such exempt property remains claims from support creditors who fall under § 523 (a)(5). Attorneys

representing creditors claiming alimony, maintenance or support who wish to pursue collection from exempt property should first obtain a determination that those debts are in fact excepted from discharge by §523(a)(5). At present, the Bankruptcy Code does not provide the same protection for property division debts that may be excepted from discharge under §523(a)(15).

b. Debtors may not avoid certain domestic-relations judgments and liens on a theory that the liens impair their exemptions.

Under § 522(f) a debtor may avoid a prior judicial lien and certain other non-consensual liens that impair the debtor's otherwise exempt property. This power, however, excludes the ability to avoid judicial liens that are security for a debt to a spouse, former spouse, or child of the debtor for actual alimony, maintenance or support and in connection with a separation agreement, divorce decree, or other order of a court of record. Like the priority and preference provisions, this exception from judicial lien avoidance tracks the language of § 523(a)(5).

IX. Post-bankruptcy Divorce Actions

While the typical bankruptcy and domestic relations intersection will arise in the context of a divorce that has been concluded prior to the bankruptcy filing, or that is pending at the time of the bankruptcy filing, there are cases in which the bankruptcy debtor will become involved in a divorce or separation after the filing of the bankruptcy case. In those instances, some unique twists may be seen in the legal issues discussed above.

For example, assuming that the automatic stay is still in existence in the bankruptcy case, the parties may need relief from that stay to initiate a divorce proceeding that will impact property of the bankruptcy estate. While there may be no doubt that the state court action should not be stayed insofar as it affects only divorce or custody, when that action will affect the monetary obligations of the debtor or of the bankruptcy estate, relief from stay should be sought. The stay would need to be modified in order to resolve any questions about the collection

of support or other funds from property of the bankruptcy estate. Since claims against the bankruptcy estate are generally those that arose before the bankruptcy was filed, the initiation of a divorce after the filing of a bankruptcy case also may introduce questions as to what are pre-petition claims against the bankruptcy estate. In many domestic and support cases there are, in reality, two claims, one against the debtor individually, which may be nondischargeable in the bankruptcy, and the second, for example, for pre-bankruptcy support arrearages, which is against the bankruptcy estate.

Once the stay in a pending bankruptcy is lifted to allow the divorce proceeding to continue, the debtor must consider that the state court has concurrent jurisdiction with the bankruptcy court to make the determination of dischargeability for §523(a)(5) obligations but does not have concurrent jurisdiction to make the § 523(a)(15) determinations. If the debtor fails to seek a §523(a)(5) determination in such a setting before the state court, or if the state court proceeds to make a §523(a)(5) determination, the debtor or other interested parties may be precluded from doing so later by *res judicata* or collateral estoppel.

MANAGING A CHAPTER 7 ASSET CASE

“Procrastination is the worst enemy of a Chapter 7 Asset case.”

- Author unknown.

Immediately upon returning from the 341(a) meeting, the trustee should make a decision whether to open or close the case. In asset cases, the trustee should deal with issues promptly, not months down the road when it is difficult to remember why the case was opened.

Here are some helpful tips for efficient and effective management of a Chapter 7 asset case:

1. **Well before the 341(a) Meeting of Creditors, examine the schedules carefully to earmark assets suitable for liquidation.**

Try to avoid “Dodge Neon” cases. These are cases where a title on a vehicle may be avoidable but the vehicle is worth less than the cost to liquidate it. After paying the court costs, attorney fees, and the auctioneer’s commission, the net recovery to the estate is too small to justify going after the asset.

2. **Complete Form 1 accurately.**

Make sure your description of the assets is detailed and complete.

3. **Develop a list of case actions (a “to do” list).**

This will allow anyone in your office to pick up the case file and complete the tasks.

4. **Hire professionals who will represent the trustee.**

Do this at the beginning of the case. Hire accountants, attorneys, and auctioneers and other professionals.

5. **If the asset is real estate**, refer to the “Real Estate Checklist” and complete each applicable section. (Exhibit A)

If the asset is a vehicle, refer to the “Vehicle Checklist” and complete each applicable section. (Exhibit B).

Make additions to Exhibits “A” and “B” as necessary.

6. **Always consider the tax consequences** of the sale of real or personal property before actually selling the asset. In rare cases, the sale may generate a taxable gain greater than the cash on hand to pay the taxing authorities.

7. **Schedule regular meetings with professionals and staff at least twice a month to review case progress.**

Waiting until the annual report is due is too late. At the conclusion of the meeting, you will be thankful for having found issues that may have been overlooked earlier.

Print the list of all asset cases in numerical order. Begin at the beginning and review the status of each asset. If nothing has been done since the last meeting, corrective action should be outlined. With a large inventory of cases, it may take several meetings to complete the review. Be sure to mark where you left off last time.

8. **Request a bar date** from the bankruptcy court clerk as soon as you discover an asset worthy of liquidation.

Remember, the government's bar date is always 90 days after the general bar date. There is no point in checking claims until the government bar date has passed. If a governmental entity holds an allowed claim, there may be no need to check the rest of the claims and waste time and money on objections.

If objections are necessary, review the rules of service of process in Contested Matters including those pertaining to service on individuals, corporations, and government entities. Follow up with any responses to your objections. Make sure that you have prepared and upload orders disallowing the objectionable claims.

9. **If a tax return is required**, ask the CPA to prepare the return and obtain the tax clearance letter from the Internal Revenue Service.
10. When all tasks are completed, **close the case as soon as possible**.

Case Name: _____ Date Filed: _____
Case Number: _____ Date Converted: _____

- Real Estate Sales Check-list:
- | | | | |
|-----|--|---------------------------|-------------------------|
| 1. | Check GSCCCA for all deeds and check lien index - (tax liens, judgments, assessments, etc.) | _____ | Date: _____ |
| 2. | Check exemptions for proper claim of exemptions - (residency, ownership, state resident, etc.) | _____ | _____ |
| 3. | Get KLB appointed | Docket #: _____ | _____ |
| 4. | Get BPO | _____ | _____ |
| 5. | Order Title Opinion | From whom: _____ | _____ |
| 6. | Appoint CPA - (determine tax liability) Firm appointed: _____ | Docket #: _____ | _____ |
| 7. | Application to Employ Rowell/Listing Agreement with Special Terms | Docket #: _____ | _____ |
| 8. | Get proof of insurance dec. page with Tee listed as loss payee | _____ | _____ |
| | Agent Contact Info: _____ | _____ | _____ |
| 9. | Draft Motion to Sell (include co-owner language if applicable) | Docket #: _____ | _____ |
| 10. | Motion for Turnover & Authority to Remove Remaining Personality | Docket #: _____ | _____ |
| 11. | Send 60 letter to debtor- ONLY IF DEBTOR DOESN'T LIVE THERE! | _____ | _____ |
| 12. | File Lis Pendens | County where filed: _____ | Book: _____ Page: _____ |
| 13. | Set POC bar date | Reg: _____ | Govt. _____ |
| 14. | Set follow up to make sure claims filed-(if needed, file w/in 30 days of bar date)-RC | _____ | _____ |

Exhibit A

- 15. Determine auction date Date: _____
- 16. Set hearing on Motion to Approve Sale (after auction date set) Hearing Date: _____
- 17. Prepare Trustee's QCD for closing
- 18. Report of Sale Docket #: _____
- 19. Check Claims
- 20. Cancel Insurance
- 21. Cancel Lis Pendens

If Litigated:

- 22. Complaint filed _____
- 23. Complaint settled _____
- 24. Complaint dismissed _____

Auto Sales Check-list:

- 1. Run Vin- make sure debtor owns 100% _____
- 2. Obtain Executed Title or apply for Duplicate Title _____
- 3. File AP against lien holder _____
- 4. Get KLLB appointed – RC _____
- 5. Appoint Henderson & Godbey – RC _____
- 6. Have Dale Baxter appointed - RC _____
- 7. If debtor to abandon: arrange with debtor's attorney to have Dale pick up vehicle _____
 -OR- _____
- 7. If debtor wants to keep, arrange for turnover BUT only after bank files answer (Notify D's Atty of potential title problem (Reaff.)) _____
- 7. If Debtor keeps car, we need proof of insurance w/ Fee as loss payee _____
- 8. Set POC bar date – RC _____
- 9. Set follow up to make sure claims filed – RC _____
- 10. Try to compromise with bank to release lien and give unsecured claim _____
- 11. Draft Motion to Compromise (9019) _____
- 12. Draft Motion to Sell at Auction _____

Exhibit B