American Bar Association
Section of Family Law
2014 Spring CLE Conference

Game, Set, Match: The Ex-Spouse Nearly Always Wins When Bankruptcy and Divorce Collide—What Can Be Done?

Friday, May 9, 2014

Speakers: Helen Casale, Esq.
Jennie Riemer, Esq.
Shayna Steinfeld, Esq.

Game, Set, Match: the Ex-spouse Nearly Always Wins When Bankruptcy and Divorce Collide -- What Can Be Done?[1]

Shayna M. Steinfeld, Esq.[2], www.steinfeldlaw.com
Steinfeld & Steinfeld, PC, Atlanta, GA 30345

1. PARAMETERS:

• Bankruptcy is Federal Law.

• The Bankruptcy Code is found under Title 11 of the U.S. Code and all Sections referred to in this paper and in the presentation refer to 11 U.S.C. unless otherwise noted.

• The U.S. Constitution specifically allows for a right to Bankruptcy relief.

• Principles of Federalism require federal law to take priority over state law and, therefore, the collision between divorce and bankruptcy becomes interesting.

2. TREATMENT OF DIVORCE DEBT CHANGES OVER TIME

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[1]These materials are much more thoroughly treated in "The Family Lawyer's Guide to Bankruptcy" by Shayna and Bruce Steinfeld, which may be purchased through the ABA Family Law Section. The 3rd Edition of the Book will be released in 2014.

[2]Shayna M. Steinfeld, Board Certified by the American Board of Certification in Consumer and Business Bankruptcy Law, a shareholder of Steinfeld & Steinfeld, PC, practices with her husband, Bruce, a Fellow of the AAML. She has lead the Atlanta Bar Association, the Georgia Association for Women Lawyers, the Sole Practitioner/Small Firm Section of the Atlanta Bar and Bankruptcy Sections of the Atlanta Bar and the State Bar of Georgia; she is past chair of the bankruptcy committee the ABA Family Law section and currently is a subcommittee co-chair for the Litigation Section. She has received many accolades, including "Section of the Year" and "Outstanding Woman in the Profession;" and is regularly named a "Georgia Super Lawyer," one of the top 50 women and one of the top 100 Lawyers in the State. A graduate of Emory, Shayna frequently lectures and has authored many publications, including *The Family Lawyer's Guide to Bankruptcy*, which is in its 3rd edition.

• Prior to 1994: debtors[3] could eliminate non-support (property division) debt under a divorce decree.

• In 1994 Congress added §523(a)(15) creating a balancing test to determine whether non-support (property division) debts could be discharged.

• In 2005 Congress passed BAPCPA.[4] Following, BAPCPA, Debtors can no longer discharge property division debts in a Chapter 7 or Chapter 11 or Chapter 12 case. The only option to discharge non-support debts is in a completed Chapter 13 case.

• This means that attorneys need to pay attention to *stare decisis* opinions in citing cases in briefs because cases entered by Judges while different laws applied would result in different outcomes.

3. SOME BAPCPA CHANGES

• New automatic stay provisions (§362);

• New definition of "Domestic Support Obligation" (DSO) (§101(14A));

• New discharge provisions (§523).

4. BANKRUPTCY BASICS: CHAPTERS OF BANKRUPTCY

• Debtors file for bankruptcy under different Chapters of the Bankruptcy Code, found under Title 11 of the U.S. Code.

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[3]When a bankruptcy case is filed, the person filing the case is called the "debtor". §101(13) of the Bankruptcy Code specifically defines debtor.

[4]The "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005." This was an amendment to the Bankruptcy Code and not a replacement of the Bankruptcy Code. There is some research to indicate that it helped to precipitate the financial collapse that came over the next few years.

• Chapters 1, 3 and 5 apply to all Chapters of Bankruptcy.

• Chapters 7, 9, 11, 12, 13 and 15 govern different types of bankruptcy for different types of entities.

• There are different filing eligibility requirements for the various Chapters and there are pros and cons to each chapter.

• Divorce Lawyers (and individuals) generally run across Chapters 7 and 13.

• Sometimes they will see a Chapter 11 or 12.

a. Chapters 7, 11, 12 AND 13

• Chapter 7 is a "straight liquidation" proceeding whereby a Chapter 7 Trustee is appointed and non-exempt assets are turned over for liquidation and payment to creditors.

• Exemptions are determined, primarily, under state law and vary tremendously around the country (for example, Florida and Texas have, essentially, unlimited homestead exemptions; Georgia has a $21,000 homestead exemption).

• Chapter 11 is generally used by large companies and for "higher wealth" individuals (think McCourt of the Dodgers). It is a very expensive and cumbersome reorganization proceeding. An individual must pay his or her "disposable income" over a 5 year period to his or her creditors.

• Chapter 13 is an individual reorganization case and requires the payment of "disposable income" over three to five years to creditors. This is oftentimes used to recover cars from repossession, homes that are on the verge of foreclosure and/or to eliminate property settlements.

• Chapter 12 is a reorganization case for the family farmer and the family fisherman and works like a Chapter 13.

5. THE AUTOMATIC STAY: WHAT DOES IT SAY?

• §362 describes the automatic stay and should be treated as a statutory injunction against the WORLD.

• In the context of family law, the automatic stay applies to property divisions where the divorce court is trying to modify marital property between the debtor and non-debtor - thus division of property and enforcement of property settlements are probably subject to the automatic stay.

• All collection activity must cease unless there is an exception.

• Income Deduction Orders are not stopped so get one if you can!

a. Exceptions to the automatic stay §362(b)(2)

• Establishment of paternity;

• Establishment or modification of an order for domestic support obligations;

• Child custody or visitation;

• Terminating marital status;

• Domestic violence proceedings;

• Collecting DSO obligation from property that is not part of estate.

b. Concurrent Jurisdiction May exist Between the State and Federal Courts As to Which Court can decide if the Automatic Stay Applies but Getting it Wrong comes with a steep price – Sanctions under §362(k)

• If there is a willful violation of a stay - the injured party can recover actual damages including fees and potentially punitive damages;

• Courts have held that only the bankruptcy court has jurisdiction[5];

• Courts have held that there is concurrent jurisdiction between the state court and the bankruptcy.[6]

6. WHAT IS A DSO?

• Specifically defined under §101(14A);

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[5] *Gruntz v. County of Los Angeles (In re Gruntz)*, 166 F.3d 1020, *reh'g granted*, 177 F.3d 729 (9th Cir. 1999); *Rainwater v. State of Alabama (In re Rainwater)*, 233 B.R. 126 (Bankr. N.D. Ala. 1999); *In re Raboin*, 135 B.R. 682 (Bankr. D. Kan. 1991); and *In re Sermersheim*, 97 B.R. 885 (Bankr. N.D. Ohio 1989)

[6] *H.U.D. v. Cost Control Mktg. & Sales Mgmt. of Virginia, Inc.*, 64 F.3d 920 (4th Cir. 1995); *Picco v. Global Marine Drilling Co., 900 F.2d 846 (5th Cir. 1990); Brock v. Morysville Body Works, Inc.,* 829 F.2d 383 (3d Cir. 1987); *Hunt v. Bankers Trust Co.*, 799 F.2d 1060 (5th Cir. 1986); *NLRB v. Edward Cooper Painting, Inc.,* 804 F.2d 934 (6th Cir. 1986); *Erti v. Paine Webber, Jackson & Curtis, Inc. (In re Baldwin-United Corp. Litig.),* 765 F.2d 343 (2d Cir. 1985); *In re Glass*, 240 B.R. 782 (Bankr. M.D. Fla. 1999); *Pope v. Wagner* (*In re* Pope), 209 B.R. 1015 (Bankr. N.D. Ga. 1997); and *Martinez v. Buckley (In re Martinez)*, 227 B.R. 442 (Bankr. D.N.H. 1998).

• A debt that accrues before, on, or after the date of the order for relief in a case under this title, 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; or a governmental unit;

• Is 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;

• Established or subject to establishment before, on, or after the date of the order for relief in a case under this title, set forth in a separation agreement, divorce decree, or property settlement agreement; an order of a court of record; or a determination made in accordance with applicable nonbankruptcy law by a governmental unit; and not assigned to a nongovernmental entity, unless that obligation is assigned voluntarily.

7. HOW IS A DSO TREATED IN BANKRUPTCY?

• A DSO is NEVER discharged!!!! (Chapter 7, 11, 12 or 13);

• Pre-petition DSO payments are not considered a preference under §547(c)(7);

• Any DSO arrearage is afforded priority treatment under §507(a)(1);

• Any DSO must be paid in full to obtain a confirmed Chapter 11, 12 or 13 plan (§§ 1129, 1222, 1225 and 1322 and 1325);

• There are exceptions to the automatic stay to collect DSOs under §362;

• The Debtor must stay current on post-petition DSO payments in order to receive a discharge in Chapters 12 and 13; (*See,* §§ 1228 and 1328);

• The case may be dismissed or converted if on-going DSO payments are not made in Chapters 11, 12 and 13. (*See,* §§ 1112, 1208 and 1307).

a. Concurrent Jurisdiction May exist Between the State and Federal Courts as to Which Court can Decide if a Debt is a DSO and Discharged.

• Although the DSO determination is a matter of federal law, significant authority exists to grant concurrent jurisdiction to the state and federal courts to determine if a debt was discharged as one that is in the nature of support.[7]

b. The OLD LAW (1994 – 2005) – There was a "BALANCING TEST"

• Under §523(a)(5) - all support obligations were non-dischargeable;

• Under §523(a)(15) - all non-support obligations were dischargeable (presumptively) unless the creditor-spouse filed an adversary proceeding (a complaint) within a 60 day deadline to have them declared non- dischargeable by the bankruptcy court;

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[7]*See, e.g., Eden v. Robert A. Chapski, Ltd.*, 405 F.3d 582 (7th Cir. 2005); *In re Siragusa,* 27 F.3d 406 (9th Cir. 1994); *Swartling v. Swartling (In re Swartling)*, 337 B.R. 569 (Bankr. E.D. Va. 2005); *In re McGregor*, 233 B.R. 406 (Bankr. S.D. Ohio 1999); *In re Antonio*, 241 B.R. 883 (Bankr. N.D. Ill. 1999); *Henry v. Henry (In re Henry),* 238 B.R. 472 (Bankr. D.N.D. 1999); *In re LaCasse*, 238 B.R. 351 (Bankr. W.D. Mich.1999); *Hopson v. Hopson (In re Hopson)*, 216 B.R. 297 (Bankr. N.D. Ga. 1997); *Granados v. Granados (In re Granados)*, 214 B.R. 241 (Bankr. E.D. Cal. 1997); *Brennick v. Brennick (In re Brennick)*, 208 B.R. 613 (Bankr. D.N.H. 1997); *In re Ladak*, 205 B.R. 709 (Bankr. D. Vt. 1997); *Pope v. Wagner (In re Pope*), 209 B.R. 1015 (Bankr. N.D. Ga. 1997); *In re Smithers*, 194 B.R. 102, 106 (Bankr. W.D. Ky. 1996); *In re Cummings*, 201 B.R. 586 (Bankr. S.D. Fla. 1996); *Collins v. Hesson (In re Hesson*), 190 B.R. 229, 236 (Bankr. D. Md. 1995); *Adkins v. Adkins (In re Adkins*), 191 B.R. 941 (Bankr. M.D. Fla. 1996); *Brothers v. Tremaine (In re Tramaine*), 188 B.R. 380, 384 (Bankr. S.D. Ohio 1995); *In re Crawford*, 183 B.R. 103 (Bankr. W.D. Va. 1995); *In re Thaggard,* 180 B.R. 659 (M.D. Ala. 1995); and *Fidelity National Title Ins. Co. v. Franklin (In re Franklin*), 179 B.R. 913 (Bankr. E.D. Cal. 1995).

• The §523(a)(15) litigation provided the debtor with two defenses: (1) an inability to pay, and (2) that there was a greater benefit to debtor that outweighed the detriment to creditor spouse, or former spouse, or child with the discharge of the debt (a "balancing test from the discharge").

c. BAPCPA (2005) – The (a)(15) BALANCING TEST IS GONE! – Congress Decides that almost all Divorce-Related Debt should be Non-Dischargeable

• DSOs are NEVER dischargeable pursuant to §523(a)(5);

• Property Settlement or "Other" Debts under §523(a)(15) differ depending upon which Chapter the Bankruptcy was filed under:

• Chapters 7, 11 and 12 – Property Settlement and other divorce-related debt is NOT dischargeable, automatically! No adversary complaint is needed;

• Chapter 13 – Property Settlement and Other (non-support debt) can be discharged in a completed Chapter 13 case. (60-70% national failure rate – only about one-third of all Chapter 13 cases make it to discharge).

8. HOW DO YOU KNOW IF ITS REALLY A DSO?

• DSO's are "in the nature of support."

• Old cases are still valid on this issue:

• A debt is in the nature of support and consequently non-dischargeable under §523(a)(5) only when it is "in substance support."

• The court must determine if the obligation is "actually in the nature of alimony, maintenance or support" in order to determine if the obligation is a domestic support obligation for all purposes under the Bankruptcy Code.

• Federal Law is used to make determination and it is measured at the time of the divorce.

9. HOW DOES THE COURT MAKE ITS DETERMINATION?

• No one factor is controlling.

• Generally, if the obligation is essential to enable a party to maintain basic necessities, the payment of the debt is in the nature of support – support usually looks forward and nonsupport usually splits items and looks backwards.

• Recent cases indicate that the bankruptcy courts understand that a divorce settlement involves "horse trading." Your client may have been willing to give up alimony because they are getting a greater property division. But this is not consistent in its application.

10. FACTORS THE COURTS TYPICALLY CONSIDER TO DETERMINE DSO

(1) The amount of alimony, if any, awarded by the state court and the adequacy of any such award;

(2) The need for support and the relative income of the parties at the time the divorce decree was entered;

(3) The number and age of children;

(4) The length of the marriage;

(5) Whether the obligation terminates on death or remarriage of the former spouse;

(6) whether the obligation is payable over a long period of time;

(7) the age, health, education, and work experience of both parties;

(8) whether the payments are intended as economic security or retirement benefits;

(9) the standard of living established during the marriage.

(10) the express language of the divorce agreement; there are no magical words, however. So be descriptive: "Having considered the relative financial circumstances of the parties, including, but not limited to . . ., the Court finds . . . "

(11) the relative financial positions of the parties at the time of the agreement;

(12) the amount of the property division;

(13) the number and frequency of payments;

(14) whether the agreement includes a waiver of support rights;

(15) whether the obligation can be modified or enforced in state court; and

(16) whether the obligation is treated as support for tax purposes.

• Some of these factors may be controlling – such as tax treatments on a "judicial estoppel" argument.

11. SPECIFIC EXAMPLES OF DSO DEBTS:

a. ATTORNEY FEES TO OPPOSING COUNSEL

• Awards Payable to Opposing Counsel: Generally, attorney's fees due to the ex-spouse's counsel are determined to be in the nature of support, and the award will be

nondischargeable, even though payment may be to a third party rather than to the debtor.

• The majority rule is that an obligation to pay the spouse's attorney's fees is "so tied in with the obligation of support as to be in the nature of support or alimony and excepted from discharge." *In re Booch,* 95 B.R. 852 (Bankr. N.D. Ga. 1988).

• Notably, in the cases where the courts have found that the attorney's fees are not "in the nature of support," courts have generally determined that the obligation has failed the first prong of the "Domestic Support Obligation" test and have focused on the fact that the debt is due directly to the lawyer or firm. Other courts have focused on the actual need for the underlying fees or the statute that authorized the state court to award the fee in question in the first place. Post-BAPCPA, some of these cases then hold, at least in the non-chapter 13 context, that the fees are still non-dischargeable under §523(a)(15). *Griefer LLP v. Prensky (In re Prensky)*, 416 B.R. 406 (Bankr. D. N.J. 2009)(attorney's fees awarded to debtor's ex-wife were not DSO but were non-dischargeable under §523(a)(15)).

b. ATTORNEYS FEES OWED TO THE PARTY'S OWN ATTORNEY

• Attorney's fees to a party's own attorney. These fees are not a DSO and are dischargeable on the same basis as any other unsecured general debt. "Every court that has published a decision on this issue has held that a debt due from a debtor for his or her own attorney fees incurred in connection with matrimonial and related proceedings are dischargeable." *In re Dean*, 231 B.R. 19 (Bankr. W.D. N.Y. 1999).

• Attorneys are free to secure their debts, which would change their treatment. This, of course, is not common practice, but does happen on occasion.

c. … AND FOR A REALLY CREATIVE APPROACH

• An attorney who was owed attorneys fees filed a Complaint under §523(a)(2)(A) for fraud, misrepresentations and/or false representations because her client failed to pay her fees. The first Circuit B.A.P. (Bankruptcy Appellate Panel) determined that the attorney failed to show that the debtor's actions rose to a level beyond mere inability to repay. The Court left open the possibility that the attorney/creditor could have shown facts and circumstances to prove a case under §523(a)(2)(A) if the evidence had been more in line with the statute. *See, deBenedictis v. Brady-Zell (In re Brady-Zell)*, 500 B.R. 295 (1st Cir. B.A.P. 2013).

• There are other provisions of non-dischargeability that creditors can (and have) considered and pursued, including, but not limited to, §§ 523(a)(2)[8] (fraud), (4)[9] (breach of fiduciary duty, embezzlement or larceny) and (6)[10] (willful and malicious conduct) so be mindful, and review, of other options when the situations arise for non-support debt.

d. EXAMPLE: RETIREMENT ACCOUNT DIVISION

• Divisions of retirement or pension funds pursuant to a Qualified Domestic Relations Order

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[8]"523(a)(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
(B) use of a statement in writing—
(i) that is materially false;
(ii) respecting the debtor's or an insider's financial condition;
(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
(iv) that the debtor caused to be made or published with intent to deceive; or
(C)(i) for purposes of subparagraph (A)—
(I) consumer debts owed to a single creditor and aggregating more than $500 for luxury goods or services incurred by an individual debtor on or within 90 days before the order for relief under this title are presumed to be nondischargeable; and
(II) cash advances aggregating more than $750 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 70 days before the order for relief under this title, are presumed to be nondischargeable; and
(ii) for purposes of this subparagraph—
(I) the terms "consumer", "credit", and "open end credit plan" have the same meanings as in section 103 of the Truth in Lending Act; and
(II) the term "luxury goods or services" does not include goods or services reasonably necessary for the support or maintenance of the debtor or a dependent of the debtor;"

[9]"523(a)(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;"

[10]"523(a)(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;"

(QDRO) are as close to sacrosanct as anything in bankruptcy.

• The courts generally hold that "claims" do not arise under a QDRO as the QDRO transfers title under the state court order and, accordingly, does not constitute a debt subject to discharge.

• Alternatively, courts determine that the divorce order impresses a constructive trust against the retirement asset or that the asset belongs to the nonfiling spouse as of the time of entry of the divorce order. *Patterson v. Shumate*, 112 S. Ct. 2242 (1992)

• Military retirement benefits granted to a party within a divorce decree are also generally protected by the bankruptcy court. Courts generally find that these obligations are nondischargeable support or conclude that the wife's interest was not property of the estate. The divorce decree must contain a provision dividing the military retirement benefits. *Ziemski v. Ziemski (In re Ziemski)*, 338 B.R. 802 (B.A.P. 8th Cir. 2006) and *Albert v. Albert (In re Albert)*, 194 B.R. 907 (D. Kan. 1996).

e. EXAMPLE: EDUCATION EXPENSES

• Education Expenses are generally considered a form of support. This is true, even for post-majority education expenses ("the nature of debtor's promise to pay educational expenses and child support is not determined by the legal age of majority under state law. The bankruptcy court characterized the agreement to pay educational expenses as in the nature of support, and the only ground on which debtor has challenged that characterization on appeal relates to the state law legal duty as determined by the age of majority." *In re Harrell*, 754 F.2d 902 (11th Cir. 1985)).

f. EXAMPLE: MEDICAL AND HEALTH INSURANCE

• Courts typically examine the relative financial circumstances of the parties to determine whether an obligation to pay health insurance is a support obligation. (“In addition to the Final Decree's assessment of $400.00 per child as monthly child support, the Interlocutory Orders of the court ordered the Debtor to pay any and all existing debts related to the medical care of the four children. Like the creation of the Debtor's direct support obligation, the assessment of responsibility for these debts formed part and parcel of an unmistakably clear program by the state court to insure the present and future well-being of the children. As such, to the extent that these debts still remain outstanding, the Debtor may not discharge responsibility for them in bankruptcy.” *In re Robinson,* 193 B.R. 367 (Bankr. N.D. Ga. 1996).

g. EXAMPLE: GUARDIAN AD LITEM FEES

• When a state domestic relations court appoints a *guardian ad litem* to protect the interests of a child, the services provided by the *guardian ad litem* have the effect of providing support and it is, therefore, nearly impossible to escape payment of those fees. The parents or other parties who created the dispute requiring the appointment of the guardian ad litem must bear the cost of that support. Equity requires—and the clear weight of case law authority holds—that fees incurred by a *guardian ad litem* be classified as a support obligation that may not be discharged by the parent or other party responsible for the fees. “[T]he attorney fees were awarded in a proceeding concerning the health and welfare of the Parties' children. As such, it is impractical to sever the

award of attorney fees from the needs of the children." *In re Kassicieh*, 467 B.R. 445 (Bankr. S.D.Ohio, 2012).

h. OTHER EXAMPLES

• Mortgages: *In re Herbert*, 321 B.R. 628 (EDNY 2005)(debtor's obligation to make lump sum payments for shelter was non-dischargeable support even though parties waived support under the separation agreement).

• Birth expenses. *Williams v. Kemp (In re Kemp)*, 232 F.3d 652 (8th Cir. 2000).

• College expenses. *In re Pheegley*, 443 B.R. 154 (8th Cir. BAP 2011)(Chapter 13 debtor's obligation to former spouse to continue her education so that she could become a teacher and earn an income sufficient to support herself was a non-dischargeable DSO).

• Day care expenses. *Rouse v. Rouse (In re Rouse)*, 212 B.R. 885 (Bankr. E.D. Tenn. 1997).

• Car Payments. *In re Merrill*, 252 B.R. 497 (B.A.P. 10th Cir. 2000); and *In re Krueger*, 457 B.R. 465 (Bankr. D.S.C. 2011

12. PROPERTY TRANSFERS: THE PREFERENCE PROBLEM

• The division of assets prior to a bankruptcy may be considered a "preference" in violation of §547 (1 year look back from insiders) or a fraudulent transfer in violation of §548 (2 years under Code, 4 year look back under UFTA).

• Some courts conduct a "surface determination" asking are the transfers contained in the

settlement agreement a reasonable reflection of what would have happened at trial? *In re Dunham*, 2000 WL 33679421 (Bankr. D.N.H.)and *In re Sorlocco*, 68 B.R. 748, 753 (Bankr. D. N.H. 1986).

• The Bankruptcy Code uses the term "reasonably equivalent value" which does not contemplate the equities of the parties. *In re Hinsley*, 201 F.3d 638 (5th Cir. 2000) (intangible benefits do not constitute reasonably equivalent value) *See also, In re Neal*, 461 B.R. 426 (Bankr. N.D. Ohio 2011) (debtor's agreement to property division that favored former husband in exchange for avoiding litigation was not reasonable equivalent value); *In re Perts*, 384 B.R. 418 (Bankr. E.D. Va. 2008) (transfer to former spouse pursuant to marital settlement agreement fell outside reasonable range). However, in *In re Bledsoe*, 350 B.R. 513 (Bankr. D. Or. 2006), aff'd, 569 F.3d 1106 (9th Cir. 2009) the court held that a state court property division without evidence of fraud or collusion established reasonably equivalent value.

• Cases that are tried are rarely (if ever) reviewed.

13. THE THIRD PARTY PROBLEM

• Joint debt creates the most confusion.

• The Divorce Decree is a contract between the two divorcing parties. It does not impact third party creditors.

• If a bankruptcy is filed, the underlying creditor has every right to collect from any other individual that signed on the debt and to negatively report on that person's credit.

• Hold harmless language can be crucial!

• But – watch out for cases where both parties need to file bankruptcy and then avoid hold harmless language or use it deliberately and sparingly.

• In a recent case, Judge Sacca, in the Bankruptcy Court, N.D.Ga. allowed the discharge of co-signed business debts in a Chapter 7 case because there was no hold-harmless clause between the divorcing parties with regard to an SBA loan for the business. There is a very thoughtful and thorough discussion of the history and purpose of hold harmless provisions in this case. *Sherman v. Proyect (In re Proyect)*, Case No. 12-81457-JRS, A.P. No. 13-05121-JRS [Doc. No. 21], December 11, 2013 (cases do go both ways on this though).

14. IS BANKRUPTCY IN YOUR CLIENT'S FUTURE?

• The parties may be able to handle the debt if non-mortgage debt is at less than half of income. If the non-mortgage debt is more than half of income, and as it approaches and exceeds 100% of income, the bankruptcy may be inevitable.

• If you contemplate a bankruptcy case in one or both of the parties' future – state so, precisely, in the divorce decree in an effort to avoid divorce-related obligations being ones that will then be non-dischargeable under BAPCPA and avoid hold-harmless clauses. Be specific about contemplating a later bankruptcy case.

• It may be appropriate to consider the timing between divorce and bankruptcy. Generally speaking, unless there are no assets of substance to divide and significant debt, it may be prudent to complete the divorce before the bankruptcy filing so as to ascertain all the variables but a bankruptcy lawyer's opinion may be very beneficial in this analysis during the divorce. A

bankruptcy mid-stream during a divorce can really complicate things so file bankruptcy deliberately and with bankruptcy counsel input.

15. SUMMARY

• Bankruptcy law is fairly technical.

• Not all bankruptcy lawyers understand divorce issues

• Proceed with caution!

• Consider a consultation at a minimum to get input.

DIVORCE
When A Spouse Files Bankruptcy

Shayna M. Steinfeld, Esq.

Steinfeld & Steinfeld, P.C.
Attorneys at Law

TREATMENT OF DIVORCE DEBT CHANGES OVER TIME

- Pre-1994: Debtors could eliminate non-support (property division) debt
- 1994: Congress adds 11 USC 523(a)(15) creating a balancing test to determine whether non-support (property division) debts could be discharged
- 2005: Congress passes BAPCPA. Debtors can no longer discharge property division debts in a Chapter 7 case. The only option to discharge non-support debts is in a completed Chapter 13 case.

BAPCPA CHANGES

- New automatic stay provisions (11 USC 362)
- New definition of “Domestic Support Obligation” (DSO) (11 USC 101(14A))
- New discharge provisions (11 USC 523)

BANKRUPTCY BASICS
CHAPTERS OF BANKRUPTCY

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- Chapters 1, 3 and 5 apply to all Chapters of Bankruptcy
- Chapters 7, 9, 11, 12, 13 and 15 govern different types of bankruptcy for different types of entities
- There are different filing eligibility requirements for the various Chapters and pros and cons to each chapter.
- Divorce Lawyers (and individuals) generally run across Chapters 7 and 13.
- Sometimes they will see a Chapter 11 or 12.

CHAPTERS 7, 11, 12 AND 13

- Chapter 7 is a “straight liquidation” proceeding whereby a Chapter 7 Trustee is appointed and non-exempt assets are turned over for liquidation and payment to creditors.
- Exemptions are determined, primarily, under state law and vary tremendously around the country
- Chapter 11 is generally used by large companies and for “higher wealth” individuals (think McCourt of the Dodgers). It is a very expensive and cumbersome reorganization proceeding. An individual must pay his or her “disposable income” over a 5 year period to his or her creditors.
- Chapter 13 is an individual reorganization case and requires the payment of “disposable income” over three to five years to creditors. This is oftentimes used to recover cars from repossession, homes that are on the verge of foreclosure and/or to eliminate property settlements.
- Chapter 12 is a reorganization case for the family farmer and the family fisherman.

THE AUTOMATIC STAY: WHAT DOES IT SAY?

- 11 USC 362: “Except as provided in subsection (b) of this section”
- The filing operates as a stay as to the “commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the bankruptcy case or to recover a claim against the debtor.”
- All collection activity must cease unless there is an exception
- Lessons for family law practitioners
  - Proceed cautiously!
  - Division of property and enforcement of property settlements are probably subject to the automatic stay
  - IDOs are not stopped so get one if you can!

Exceptions to the automatic stay §362(b)(2)

- Establish paternity
- Establish or modify a domestic support obligation
- Child custody or visitation
- To dissolve a marriage (but not property division if the property is part of the bankruptcy estate)
- Domestic Violence issues
- To collect a DSO from property that is not property of the estate
- A pre-petition IDO may continue post-petition
- License withholding permitted under State Law (but can be reinstated in a Chapter 13)
- Interception of tax refunds

WHAT IS A DSO? 11 USC 101(14A)

- A DSO is a debt that may include interest . . .which is
- (A) owed to or recoverable by
  - (i) a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative; or
  - (ii) a govermental unit;
- (B) in the nature of alimony, maintenance or support . .
- (C) established or subject to establishment before, on or after the bankruptcy case . . . by reason of
  - (i) a separation agreement, divorce decree or property settlement

HOW IS A DSO TREATED IN BANKRUPTCY?

- NEVER discharged!!!! (Chapter 7, 11, 12 or 13)
- Pre-petition payments are NOT considered a preference under §547(c)(7)
- Any arrearage is afforded a priority under §507(a)(1)
  - Must be paid in full under a confirmed Chapter 13 plan
- Must stay current on POST petition payments in order to receive a discharge in Chapters 11, 12 and 13.

Discharge Rules: Chapters Matter!!
The Difference between 523(a)(5) and 523(a)(15)

- (5) For a domestic support obligation.....

- (15) to a spouse, former spouse, or child of the debtor and not of the kind described in paragraph (5) that is 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 of record or a determination made in accordance with State or territorial law by a governmental unit.

OLD LAW (1994 – 2005)
THE "BALANCING TEST"

- 523(a)(5) obligations non-dischargeable

- 523(a)(15) obligations *were* dischargeable unless the creditor-spouse filed an adversary proceeding within a 60 day deadline to have them declared non- dischargeable.

- The 523(a)(15) litigation provided the debtor with two defenses: (1) inability to pay, and (2) greater benefit to debtor outweighs detriment to creditor spouse, or former spouse, or child for the discharge of the debt.

BAPCPA (2005)
BALANCING TEST IS GONE!

- DSO are NEVER dischargeable 11 USC 523(a)(5)

- Property Settlement or “Other” Debts (11 USC 523(a)(15) differ by chapter
  - Chapter 7 – Property Settlement/Other is NOT dischargeable
    - No adversary complaint is needed

  - Chapter 13 – Property Settlement/Other can be discharged in a completed Chapter 13 case. (60-70% national failure rate)

HOW DO YOU KNOW IF ITS REALLY A DSO?

- DSO's are "in the nature of support"
- Old cases are still valid on this issue:
- A debt is in the nature of support and consequently non- dischargeable under 11 U.S.C. §523(a)(5) only when it is "in substance support."
- The court must determine if the obligation is "actually in the nature of alimony, maintenance or support" in order to determine if the obligation is a domestic support obligation for all purposes under the Bankruptcy Code.
- Federal Law is used to make determination. Measured at the time of the divorce.

HOW DOES THE COURT MAKE ITS DETERMINATION?

- No one factor is controlling.
- Generally, if the obligation is essential to enable a party to maintain basic necessities, the payment of the debt is in the nature of support – Support usually looks forward and non-support usually splits things and looks backwards.
- Recent cases indicate the bankruptcy courts understand that a divorce settlement involves “horse trading.” You client may have been willing to give up alimony because they are getting a greater property division. But this is not consistent in its application.

FACTORS THE COURTS TYPICALLY CONSIDER

- (1) The amount of alimony, if any, awarded by the state court and the adequacy of any such award;
- (2) The need for support and the relative income of the parties at the time the divorce decree was entered;
- (3) The number and age of children;
- (4) The length of the marriage;
- (5) Whether the obligation terminates on death or remarriage of the former spouse;

MORE FACTORS

- (6) whether the obligation is payable over a long period of time;
- (7) the age, health, education, and work experience of both parties;
- (8) whether the payments are intended as economic security or retirement benefits;
- (9) the standard of living established during the marriage.
- (10) the language of the divorce agreement;
  - BUT NO MAGIC WORDS!!!!!
  - Be descriptive: “Having considered the relative financial circumstances of the parties, including, but not limited to . . ., the Court finds . . . “

EVEN MORE FACTORS

- (11) the relative financial positions of the parties at the time of the agreement;
- (12) the amount of the property division;
- (13) the number and frequency of payments;
- (14) whether the agreement includes a waiver of support rights;
- (15) whether the obligation can be modified or enforced in state court; and
- (16) whether the obligation is treated as support for tax purposes.

SPECIFIC EXAMPLES: ATTORNEY FEES TO OPPOSING COUNSEL

- Awards Payable to Opposing Counsel. Generally, attorney's fees due to the ex-spouse's counsel are determined to be in the nature of support, and the award will be nondischargeable, even though payment may be to a third party rather than to the debtor. The majority rule is that an obligation to pay the spouse's attorney's fees is "so tied in with the obligation of support as to be in the nature of support or alimony and excepted from discharge." *In re* Booch, 95 B.R. 852 (Bankr. N.D. Ga. 1988).
- Notably, the cases where the courts have found that the attorney's fees are not "in the nature of support," courts have generally determined that the obligation has failed the first prong of the "Domestic Support Obligation" test and have focused on the fact that the debt is due directly to the lawyer or firm. Other courts have focused on the actual need for the underlying fees or the statute that authorized the state court to award the fee in question in the first place. Post-BAPCPA, some of these cases then hold, at least in the non-chapter 13 context, that the fees are still non-dischargeable under §523(a)(15). Griefer LLP v. Prensky (*In re* Prensky), 416 B.R. 406 (Bankr. D. N.J. 2009)(attorney fees awarded to debtor's ex-wife were not DSO but were non-dischargeable under §523(a)(15))

ATTORNEYS FEES:
OWED TO THE PARTY'S OWN ATTORNEY

- Attorney's fees to a party's own attorney. These fees are not a domestic support obligation and are dischargeable on the same basis as any other unsecured general debt. *"Every court that has published a decision on this issue has held that a debt due from a debtor for his or her own attorney fees incurred in connection with matrimonial and related proceedings are dischargeable." (In re* Dean, 231 B.R. 19 (Bankr. W.D. N.Y. 1999). Attorneys are free to secure their debts, which would change their treatment. This, of course, is not common practice, but does happen on occasion.

… AND FOR A REALLY CREATIVE APPROACH

- An attorney who was owed attorneys fees filed a Complaint under 11 U.S.C. § 523(a)(2)(A) for fraud, misrepresentations and/or false representations because her client failed to pay her fees. The first Circuit B.A.P. (Bankruptcy Appellate Panel) determined that the attorney failed to show that the debtor's actions rose to a level beyond mere inability to repay. The Court left open the possibility that the attorney/creditor could have shown facts and circumstances to prove a case under §523(a)(2)(A) if the evidence had been more in line with the statute. *See, deBenedictis v. Brady-Zell (In re Brady-Zell)*, 500 B.R. 295 (1st Cir. B.A.P. 2013).
- There are other provisions of non-dischargeability that creditors can (and have) considered and pursued, including 11 U.S.C. §§ 523(a)(2), (4) and (6) so be mindful of other options when the situations arise.

EXAMPLE: RETIREMENT ACCOUNT DIVISION

- Divisions of retirement or pension funds pursuant to a Qualified Domestic Relations Order (QDRO) are as close to sacrosanct as anything in bankruptcy. The courts generally hold that "claims" do not arise under a QDRO as the QDRO transfers title under the state court order and, accordingly, does not constitute a debt subject to discharge. Alternatively, courts determine that the divorce order impresses a constructive trust against the retirement asset or that the asset belongs to the nonfiling spouse as of the time of entry of the divorce order. Patterson v. Shumate, 112 S. Ct. 2242 (1992)
- Military retirement benefits granted to a party within a divorce decree are also generally protected by the bankruptcy court. Courts generally find that these obligations are nondischargeable support or conclude that the wife's interest was not property of the estate. The divorce decree must contain a provision dividing the military retirement benefits. Ziemski v. Ziemski (*In re* Ziemski), 338 B.R. 802 (B.A.P. 8th Cir. 2006); Albert v. Albert (*In re* Albert), 194 B.R. 907 (D. Kan. 1996) (ex-wife's interest in debtor-husband's military retirement pay was her sole and separate property)

EXAMPLE: EDUCATION EXPENSES

- Generally considered a form of support. This is true, even for post-majority education expenses (*"the nature of debtor's promise to pay educational expenses and child support is not determined by the legal age of majority under state law. The bankruptcy court characterized the agreement to pay educational expenses as in the nature of support, and the only ground on which debtor has challenged that characterization on appeal relates to the state law legal duty as determined by the age of majority."* *In re Harrell*, 754 F. 2d 902 (11th Cir. 1985))

EXAMPLE: MEDICAL AND HEALTH INSURANCE

- Courts typically examine the relative financial circumstances of the parties to determine whether an obligation to pay health insurance is a support obligation. *("In addition to the Final Decree's assessment of $400.00 per child as monthly child support, the Interlocutory Orders of the court ordered the Debtor to pay any and all existing debts related to the medical care of the four children. Like the creation of the Debtor's direct support obligation, the assessment of responsibility for these debts formed part and parcel of an unmistakably clear program by the state court to insure the present and future well-being of the children. As such, to the extent that these debts still remain outstanding, the Debtor may not discharge responsibility for them in bankruptcy." Matter of Robinson* 193 B.R. 367 (Bankr. N.D. Ga. 1996)

EXAMPLE: GUARDIAN AD LITEM FEES

- *"It is nearly universally recognized that when a state domestic relations court appoints a guardian ad litem to protect the interests of a child, the services provided by the guardian ad litem have the effect of providing support. The parents or other parties who created the dispute requiring the appointment of the guardian ad litem must bear the cost of that support. Accordingly, equity requires—and the clear weight of caselaw authority holds—that fees incurred by a guardian ad litem be classified as a support obligation that may not be discharged by the parent or other party responsible for the fees. Cf. Reissig v. Gruber (In re Gruber),436 B.R. 39, 43 (Bankr.N.D. Ohio 2010) '[T]he attorney fees were awarded in a proceeding concerning the health and welfare of the Parties' children. As such, it is impractical to sever the award of attorney fees from the needs of the children.')" In re Kassicieh,* 467 B.R. 445 (Bankr. S.D.Ohio, 2012).
- *See also, In re Rackley*, 502 B.R. 615 (Bankr. N.D.Ga. 2013)(discusses Guardian ad Litem fees as well as other discussions under 523(a)(5) and (a)(15).

OTHER EXAMPLES

- Mortgages: *In re* Herbert, 321 B.R. 628 (EDNY 2005)(debtor's obligation to make lump sum payments for shelter was non-dischargeable support even though parties waived support under the separation agreement)
- Birth expenses. Williams v. Kemp (*In re* Kemp), 232 F.3d 652 (8th Cir. 2000).
- College expenses. *In re* Pheegley, 443 B.R. 154 (8th Cir. BAP 2011)(Chapter 13 debtor's obligation to former spouse to continue her education so that she could become a teacher and earn an income sufficient to support herself was a non-dischargeable DSO).
- Day care expenses. Rouse v. Rouse (*In re* Rouse), 212 B.R. 885 (Bankr. E.D. Tenn. 1997).
- Car Payments. *In re* Merrill, 252 B.R. 497 (B.A.P. 10th Cir. 2000) (auto insurance); *In re* Krueger, 457 B.R. 465 (Bankr. D.S.C. 2011) (Car payment and mortgage payments were DSO);
- Credit cards

PROPERTY TRANSFERS
THE PREFERENCE PROBLEM

- The division of assets prior to a bankruptcy may be considered a "preference" in violation of §547 (1 year look back from insiders) or a fraudulent transfer in violation of §548 (2 years under Code, 4 year look back under UFTA).
- Some courts conduct a "surface determination" asking are the transfers contained in the settlement a reasonable reflection of what would have happened at trial? *In re Dunham*, 2000 WL 33679421 (Bankr. D.N.H.); *In re Sorlocco*, 68 B.R. 748, 753 (Bankr. D. N.H. 1986).
- But, the Code uses the term "reasonably equivalent value" which does not contemplate the equities of the parties. *In re Hinsley*, 201 F.3d 638 (5th Cir. 2000) (intangible benefits do not constitute reasonably equivalent value) *See also In re Neal*, 461 B.R. 426 (Bankr. N.D. Ohio 2011) (debtor's agreement to property division that favored former husband in exchange for avoiding litigation was not reasonable equivalent value); *In re Perts*, 384 B.R. 418 (Bankr. E.D. Va. 2008) (transfer to former spouse pursuant to marital settlement agreement fell outside reasonable range). However, in *In re Bledsoe*, 350 B.R. 513 (Bankr. D. Or. 2006), aff'd, 569 F.3d 1106 (9th Cir. 2009) the court held that a state court property division without evidence of fraud or collusion established reasonably equivalent value.
- Cases that are tried are rarely (if ever) reviewed.

CLAIMS ISSUES – FOOD FOR THOUGHT

- In highly contentious divorces a spouse will use a bankruptcy filing as a "pawn" in the chess match being played between the divorcing parties. When the bankruptcy case is filed in the middle of the divorce, issues become very complicated.
- One of the more difficult issues is what happens with the marital property?
- There is much case law about choate interests and inchoate interests and when the non-filing spouse's interest arises under state law *(Butner vs. United States*, 440 U.S. 48 (1979) is often cited in these discussions of property interests).
- Clients are best protected in bankruptcy if property is jointly titled rather than singularly titled (unless title is in your client's name).
- Lis Pendens assist in the case of a mid-stream bankruptcy filing as the bankruptcy trustee has rights as "innocent" purchasers (among other rights).
- An interesting read is a recent case: *In re Ruitenberg*, 2014 WL 959485 (3rd Cir. 2013), wherein the Third Circuit Court of Appeals determined that the soon-to-be-ex'wife had an equitable share in and, therefore, claim in her husband's chapter 7 bankruptcy case for her share of the marital estate based on the pre-petition divorce action that hadn't concluded pre-petition. She later filed a chapter 7 case so this case became a situation of "dueling chapter 7 trustees" over which set of creditors was entitled to the interest in property (which was asserted to be worth approximately a half million dollars).

THE THIRD PARTY PROBLEM

- Joint debt creates the most confusion.
- The Divorce Decree is a contract between the two divorcing parties. It does not impact third party creditors.
- If a bankruptcy is filed, the underlying creditor has every right to collect from any other individual that signed on the debt and to negatively report on that person's credit
- Hold harmless language can be crucial!
  - But – watch out for cases where both parties need to file bankruptcy.
  - In a recent case, Judge Sacca, in the Bankruptcy Court, N.D.Ga. Allowed the discharge of co-signed business debts in a Chapter 7 case because there was no hold-harmless between the divorcing parties with regard to the SBA loan for the business. There is a very thoughtful and thorough discussion of the history and purpose of hold harmless provisions in this case. *Sherman v. Proyect (In re Proyect),* 503 B.R. 765 (Bankr. N.D.Ga. 2013).

IS BANKRUPTCY IN YOUR CLIENT'S FUTURE?

- The parties may be able to handle the debt if non-mortgage debt is at less than half of income. If the non-mortgage debt is more than half of income, and as it approaches and exceeds 100% of income, the bankruptcy may be inevitable.

- If you contemplate a bankruptcy case in one or both of the parties' future – state so, precisely, in the divorce decree in an effort to avoid divorce-related obligations being ones that will then be non-dischargeable under BAPCPA and avoid hold-harmless clauses. Be specific about contemplating a later bankruptcy case.

- It may be appropriate to consider the timing between divorce and bankruptcy. Generally speaking, unless there are no assets of substance to divide and significant debt, it may be prudent to complete the divorce before the bankruptcy filing so as to ascertain all the variables but a bankruptcy lawyer's opinion may be very beneficial in this analysis during the divorce. A bankruptcy mid-stream during a divorce can really complicate things so file bankruptcy deliberately and with bankruptcy counsel input.

SUMMARY

- Bankruptcy law is fairly technical.
- Not all bankruptcy lawyers understand divorce issues
- Proceed with caution!
- Consider a consultation at a minimum to get input.

Shayna M. Steinfeld
Steinfeld & Steinfeld, PC
P.O. Box 49446
Atlanta,GA30359
(404) 636-7786
www.steinfeldlaw.com

Previously presented with Ian M. Falcone
The Falcone Law Firm, PC, 363 Lawrence St.
Marietta, GA 30060
(770) 426-9359
www.falconefirm.com