



Considerations at the Intersection of Bankruptcy & Divorce

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Overview:

- o Bankruptcy basics
- o When bankruptcy should/could come first
- o When divorce should/could come first
- o Filing together vs. filing separately
- o When one spouse or ex-spouse files on their own – before, during, or after divorce
- o Considerations in drafting the marital property settlement agreement & support
- o Attorney fees
- o Protecting your client's best interests
- o Seeking expertise

Bankruptcy Basics

- o A married person can file jointly with spouse, or individually
- o Upon filing, an “automatic stay” goes into place against most creditors, with exceptions for certain issues re: divorce/domestic support obligations
- o Each Debtor gets property exemptions, some double for married couples, some not:
 - o Homestead: One only. Up to \$250k
 - o Vehicles: \$2500 per debtor, one vehicle per debtor, but can't stack in one car.
 - o Personal property: \$4500 per debtor, \$600 limit per item.

Basics Cont'd

- Chapter 7 = liquidation of any non-exempt property; discharge in 3-4 months.
- Chapter 13 = payment plan over 3-5 years; must have disposable income; best option to address arrearages on secured property like house or car; must pay all secured debt & priority unsecured debt; discharge of some or all unsecured debts at end.

Debt Hierarchy

- Secured: secured by collateral such as home or car; e.g., mortgage or car loan.
- Unsecured Priority: no collateral, but given special treatment:
 - Taxes less than 3 years old
 - **Domestic support obligation**
- Unsecured: bottom of the barrel: medical bills, credit cards, personal loans.

The Easy Way:

Filing bankruptcy together before divorce

- o Reasons for filing joint bankruptcy before divorce:
 - o Both parties think they will ultimately have to file bankruptcy
 - o Parties can cooperate in filing bankruptcy
 - o Most or all marital /individual assets are exempt – i.e., Chapter 7 = 4-month delay in filing for dissolution

Benefits of Bankruptcy before Divorce

- o One fee (\$1500 - \$1700 legal fee, \$306 filing whether joint or individual)
- o Simplifies marital settlement agreement by clearing most or all debts that would have needed to be divided
- o Prevents common post-divorce problem of one spouse being ordered to pay a joint debt and then not paying it

Reasons to File Divorce First

- o Only one spouse would benefit from bankruptcy
- o Combined income too high to file a Chapter 7 and divorce could help one or both parties avoid Chapter 13.
- o Too much non-exempt property; each spouse needs own separate exemptions
- o One spouse needs immediate marital settlement & payment of support for self or children; bankruptcy will likely delay

When One Spouse is Uncooperative

- o What if one spouse won't agree to a joint bankruptcy before divorce?
 - o Other spouse can file on own; will be discharged from individual AND joint debts
 - o Non-filing spouse will remain liable for entirety of joint debts; creditors can continue collection efforts
 - o Court in subsequent divorce case cannot order filing party to pay the debt, and cannot keep creditors from pursuing the non-filing party for the debt – no jurisdiction over federal bankruptcy law.
 - o Non-filing spouse may wish to join after all.

Uncooperative Spouses Cont'd

- o What if one spouse files bankruptcy in the middle of the divorce?
 - o Financial matters of the marital property settlement will be stayed under “automatic stay” provision of bankruptcy code, unless / until lifted by bankruptcy court.
 - o Non-financial matters such as parenting plan would not be stayed.

Applicable Automatic Stay Exceptions – 11 USC 362(b)

(b) The filing of a petition ... does not operate as a stay—

- o (2) under subsection (a)—
 - o (A) of the commencement or continuation of a civil action or proceeding—
 - o (i) for the establishment of paternity;
 - o (ii) for the establishment or modification of an order for domestic support obligations;
 - o (iii) concerning child custody or visitation;
 - o (iv) for the dissolution of a marriage, except to the extent that such proceeding seeks to determine the division of property that is property of the estate; or
 - o (v) regarding domestic violence.

Bankruptcy after Divorce

- o What if an ex-spouse files for bankruptcy *after* a divorce?
 - o Filing spouse may discharge joint debts assigned to him or her in marital settlement, wipes out liability to **creditors**.
 - o Non-filing spouse will remain liable for joint debts to **creditor** (judge can only assign liability between the two spouses; doesn't change contract with creditor).
 - o Does **not** wipe out filing spouse's obligation to the **non-filing spouse**, cannot discharge obligations between spouses set forth in marital settlement.
 - o Non-filing spouse can seek relief from court of dissolution to enforce filing spouse's obligations under divorce decree, or may wish to file own bankruptcy.
 - o Bankruptcy court will not revisit issues of marital property division; lacks jurisdiction. *In re Cini* (court wouldn't revisit marital property division disputed by ex-husband); *In re Zrubek* (court won't rewrite prior award of percentage of military pension to ex-wife)

Domestic Support Obligations

- o Bankruptcy code prohibits discharge of:
 - o “domestic support obligations.” 11 USC 523(a)(5); and
 - o “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.” 11 USC 523(a)(15).
- o Clearly covered: court-ordered child support and alimony payments labeled as such.
- o Non-filing ex-spouse generally will not need to take any action in bankruptcy case to enforce this.
- o Bankruptcy’s “automatic stay” does not apply to collection of ongoing child support/alimony.
- o Stay will stop garnishment for arrearages though, at least temporarily.

Trickier Domestic Support Obligations

- o What if it is not clearly called support? I.e., award of property/assumption of debts.
 - o In determining whether obligation is intended for support of former spouse, and therefore not dischargeable in bankruptcy, court must look beyond language of decree to **intent of parties** and **substance of obligation**. 11 U.S.C. § 523(a)(5)(B).
 - o E.g., *In re Lightner* - “Debtor's assumption of marital obligations was in nature of maintenance and support and not property settlement, and therefore, was not dischargeable, where former spouse had waived maintenance on understanding that debtor would honor and assume all debts of marriage.”
 - o *In re Smith* - “Moneys due former spouse under marital and property settlement agreement and stock transfer agreement were not in nature of support or maintenance,” therefore nondischargeable. Court “not bound by label[s]” but will give them some weight. Other provision in agreement dealt with child support & alimony; money/stock was for wife’s joint ownership of business; payment obligation continued beyond wife’s death.

- o If debtor ex-spouse tries to discharge marital settlement obligation in bankruptcy, even if obviously non-dischargeable, best practice for non-filing ex-spouse still to object in bankruptcy court and argue that obligation was meant to be for support.
- o Do so by filing adversary complaint against ex-spouse within bankruptcy case.

Can Divorce Attorney Fees Be Included in Bankruptcy?

- o If your client is the one filing bankruptcy:
 - o May be dischargeable if no lien taken on proceeds of property settlement award.
 - o May be nondischargeable if 1) lien taken/promissory note signed, and 2) timely proof of claim filed by attorney as creditor. *In re Danelson.*

Can Divorce Attorney Fees Be Included in Bankruptcy?

- o If your client's ex-spouse is supposed to pay your client's attorney fees to your client or you:
 - o Award of fees incurred in divorce or custody matter may be considered in the nature of support - i.e., not dischargeable.
 - o You should receive notice if correctly listed as a creditor
 - o If filing ex-spouse listed attorney fee as a "priority unsecured debt," you are okay - not trying to discharge.
 - o If listed as general unsecured debt - Your client should object in bankruptcy court (file adversarial action) and argue that the fee award was a domestic support obligation.

Planning Considerations to Avoid Complications

- o In drafting marital property settlement agreements, clearly label property awards as “support” to avoid room for argument down the road
- o Include clause that property settlement agreement may be revisited/modified
- o Encourage clients to consider working together to file bankruptcy, in both spouses’ financial best interests
- o If non-client spouse is talking about bankruptcy, take into consideration when negotiating division of any joint debts

Sample Marital Property Settlement Language

In the event of the declaration of bankruptcy by the Wife or Husband, the party filing bankruptcy shall continue to remain personally liable to the non-filing party for any obligations the filing party was ordered to pay as part of this Agreement. It is the intention of the parties that any bankruptcy filed shall be effective as against the creditor only, but shall not be intended to act to the financial detriment of the other spouse. The parties further agree that in the event a bankruptcy filing by either spouse causes financial detriment to the non-filing spouse, any provisions in this Agreement regarding equitable distribution and/or alimony shall be modified to compensate the non-filing party for the financial loss.

When to Seek Expertise

- o Always in client's best interest.
- o Two-Way Street – most family law attorneys aren't fluent in bankruptcy and vice versa, with huge pitfalls
- o Find a go-to attorney to swap consulting if not doing already.

Questions

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