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When Family Law and Bankruptcy Collide



Hon. Catherine Gallagher (Ret.)
Courtesy Photo



Hon. Robert Yonts (Ret.)
Courtesy Photo

A family law attorney's greatest nightmare is covering uncharted areas of law, which always seem to loom on the horizon and threaten the accuracy of the advice provided to clients. Family law crossover issues have become increasingly intricate and routinely cover real property, estate planning, pension/deferred compensation, insurance, tax and now more than ever, bankruptcy matters.

Bankruptcy has become even more of an issue during the recent economic downturn. Spouses involved in divorce may often threaten to file for bankruptcy as a means of exerting leverage, and a weak economy only increases this leverage. Some family law lawyers suggest when one party threatens bankruptcy it may really mean "I will file for bankruptcy relief to throw a monkey wrench in these proceedings if we don't arrive at the support payments I think are reasonable." As a result, many family law attorneys tend to refer out cases with significant bankruptcy-related issues. Before seeking the advice of a bankruptcy expert, however, it is helpful to understand

Judge Catherine Gallagher (Ret.) joined JAMS in 2009. Previously, she served as the presiding judge of Santa Clara County Superior Court. She has experience in all aspects of dispute resolution. Judge Robert Yonts (Ret.) joined JAMS following his retirement from Santa Cruz County Superior Court after 13 years on the bench. Previously, he practiced civil, real estate and business law in the Santa Cruz and San Francisco Bay Area counties for 25 years.

some of these issues and pitfalls.

FAMILY SUPPORT ORDERS

Generally speaking, once a bankruptcy petition is filed, an automatic stay from the federal bankruptcy action freezes any state court proceedings, with a few exceptions carved out particularly for family law matters (11 U.S.C. §362). For instance, determination of child custody is never stayed and other marital proceedings, such as domestic violence orders and the dissolution itself, are also exempt from the automatic stay. Moreover, the state court's jurisdiction to establish or modify domestic support obligations (child and spousal) is unaffected by any bankruptcy filing (11 U.S.C. §362(b)(2)(A)).

A "domestic support obligation" is defined in 11 U.S.C. §101(14A) as a debt owed to or recoverable by "a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative," and further as being "in the nature of alimony, maintenance, or support ... 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*" (emphasis added). The statute further refines the definition by limiting the debt to those "established or subject to establishment before, on, or after the date of the order for relief ... by reason of applicable provisions of a separation agreement, divorce decree, or property settlement agreement..."

Notably, child and spousal support, including accruing interest, are non-dischargeable in any bankruptcy proceedings. In fact, these obligations are exempt from the automatic stay and are placed in first position for payment before the obligor's other creditors. (11 U.S.C. §507(a)(1)(A)). Moreover, these obligations have first priority and are non-dischargeable under Chapters 7, 11 or 13. As such, care should be given so that all of the components of the do-

mestic support obligations are clearly labeled in any support order. This should include not only the monthly monetary amount, but also the miscellaneous extras (e.g., medical insurance payments, child care, tuition, etc.), which are often added to the monthly figure, in order to avoid any problems stemming from the automatic stay.

Of course, the bankruptcy court will examine the "add-ons" to independently evaluate dischargeability. For example, in a dissolution proceeding in one state, the court ordered a spouse to pay a \$50 per day penalty for each day spousal support was late, which the bankruptcy court found was not "in the nature of support" and the penalty was discharged. *In re Smith*, 586 F.3d 69 (1st Cir. 2009).

DEFERENCE TO STATE COURT

The issue of dischargeability of debts is one of federal law, not a question for state court determination. Usually, the bankruptcy court is very deferential to the careful dance which must sometimes play out when the family support issues are intermixed with debtor payoffs under Chapter 11 and 13 proceedings. Accordingly, the bankruptcy judge will try to respect the family support order, while at the same time allowing creditors to have a fair share of the family property pie.

MARITAL PROPERTY DIVISION

While certain proceedings in a marital dissolution action are exempt from the automatic stay, one notable exclusion is the division of marital property, where the property is also part of the bankruptcy estate. The bankruptcy estate includes the interest of both husband and wife in all community property not yet divided by the family court at the time of the bankruptcy filing, even though the bankruptcy petition might have been filed by only one spouse. (11 U.S.C. §541(a)(2)) In order to move forward

with the division of property in the dissolution, the nonbankrupt spouse must file a motion with the bankruptcy court to lift the stay “for cause,” otherwise the property remains community property and under the protection of the bankruptcy estate. If the motion is denied, once the bankruptcy case is closed and/or the debtor spouse is discharged in bankruptcy, the state court’s jurisdiction over the property is fully restored and the community property can be divided. *See Marriage of Seligman*, 14 Cal.App.4th 300 (1993).

Debts arising out of a division of property not contained in the domestic support obligation order are non-dischargeable in Chapters 7 or 11, but are dischargeable under Chapter 13. If the parties are cooperative and willing to plan the division of assets before the filing for bankruptcy (and the related “preference period”), many of these issue can be avoided.

JOINT OR INDIVIDUAL FILING

In light of the above, the decision to file for bankruptcy either jointly or by only one spouse requires careful planning and timing considerations. If both spouses do not file, the debts may not be fully discharged and the non-filing spouse could be legally responsible for all debts. Additionally, the bankruptcy court can independently examine any marital settlement agreement to determine if it injures creditors’ interests. For instance, the court will void any property transfers between spouses intended to defraud creditors. *See* 11 U.S.C. §548 and *In re Beverly*, 374 B.R. 221 (9th Cir. BAP 2007). In *Beverly*, the court not only voided the transfer of property, but fur-

thermore denied the entire Chapter 7 discharge based on the debtor-spouse’s “intent to become judgment proof” by utilizing the marital settlement agreement to shield or hide assets.

Furthermore, assigning the mortgage debt as part of a support order contained in a marital settlement agreement is not binding in the bankruptcy court, which will independently determine if the debt is dischargeable. In one case, a bankruptcy judge voided pre-bankruptcy “non-dischargeability” agreements between individuals as unenforceable on public policy grounds. *In re Cole*, 226 B.R. 647 (9th Cir. BAP 1998).

IMPACT ON NON-FILING SPOUSE

In community property states such as California, the bankruptcy of one spouse makes all of the couple’s property subject to the bankruptcy court’s jurisdiction. Creditors who have a claim against the community, even one based on the contract of the non-filing spouse, can participate in the bankruptcy estate. Upon the discharge of the filing spouse, all property later acquired by the couple is free from the claims of the community creditors included in the bankruptcy. (11 U.S.C. §524(a)(1)(3)).

DISCHARGEABILITY OF ATTORNEY FEES

Parties sometimes agree attorneys fees should also be part of a support award for tax purposes (in hopes spousal support will be deductible) and to help insure the bankruptcy court does not discharge those fees. In general, an attorneys fee award is not dischargeable if incurred to obtain child or spousal support. A recent case also held an attorneys fee award to a child representative

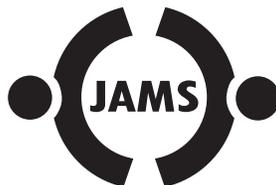
was not dischargeable, as a public policy exception; otherwise attorneys would be reluctant to represent children in the future. (*Levin v. Greco*, 415 B.R. 663 (N.D.Ill. 2009)). Thus, the child’s attorney qualified for the §523(a)(5) domestic support exception to discharge under the bankruptcy code.

When attorneys fees are incurred in equalizing marital property (by making an award to one spouse to offset assets given to another), they are generally not considered related to support and maintenance and thus are dischargeable, as are all other attorneys fees not related to support issues. Some attorneys argue that attorneys fees awards in connection with the division of property should not be discharged in Chapter 7 or 11 proceedings, but can be in Chapter 13 proceeding. In the end, dischargeability of an attorneys fee award depends on how closely it is related to obtaining support and which bankruptcy chapter is involved.

CONCLUSION

Given the complexity of the crossover issues, attorneys representing family law clients should have a fundamental understanding of the bankruptcy court, in order to give their clients the most effective legal advice. The stress of living through dissolution and a bankruptcy at the same time is daunting for clients. Having a knowledgeable attorney can make all the difference in the world for them.

In Practice articles inform readers on developments in substantive law, practice issues or law firm management. Contact Vitaly Gashpar with submissions or questions at vgashpar@alm.com.



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