Feature ARTICLE

The Collision of Bankruptcy and Divorce

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Bankruptcy and divorce can intersect in predictable and unpredictable ways. Marital strain often accompanies excessive debt, causing many unfortunate families to seek relief in both domestic relations and bankruptcy courts. Absent careful planning, a collision may occur, resulting in litigation of overlapping issues in two different courts. The collision potentially leads to a loss of assets. This article provides a summary of divorce-related matters often encountered in bankruptcy, and suggestions to prevent unnecessary contested matters.

Three areas of conflict generally arise when bankruptcy and divorce cases collide: (A) the application of the automatic stay in bankruptcy; (B) the nondischargeability of divorce-related obligations; and (C) the division of property.

A. The automatic stay in bankruptcy does not apply to many (if not most) divorce-related proceedings.

The following divorce-related proceedings are among the significant exceptions found in 11 U.S.C. § 362(b) which are not stayed upon the filing of a bankruptcy case:

- for the establishment of paternity;
- for the establishment or modification of an order for domestic support obligations;
- concerning child custody or visitation;
- for the dissolution of a marriage, except to the extent such a proceeding involves the division of property which is property of the bankruptcy estate;
- regarding domestic violence;
- the collection of a domestic support obligation from property that is not property of the bankruptcy estate; and
- the withholding of income for payment of a domestic support obligation under a judicial order or statute.

See 11 U.S.C. §§ 362(b)(2)(A), (B) and (C).

One matter that may still be barred by the automatic stay is the commencement or continuation of collection proceedings against property of the bankruptcy estate. For example, a creditor/former spouse may be stayed from filing a collection action, such as a bank attachment, to collect an unpaid property settlement, if the chapter 7 trustee (for the estate of the bankrupt spouse) is attempting to recover the same bank account balance for the bankruptcy estate. If there is any doubt as to whether the automatic stay applies, relief from stay should be sought from the bankruptcy court to avoid possible contempt or sanctions.

Conflicts arise when there is a dispute over division of property, or when a chapter 7 trustee attempts to recover property that is also subject to a property division dispute in a pending divorce. In such situations, it is appropriate for the non-debtor spouse to file a motion in the bankruptcy case for relief from the automatic stay, or to modify the stay, to allow the domestic relations court to determine the appropriate division. Generally, bankruptcy courts will not hesitate to lift the stay under such circumstances, to avoid jurisdictional conflicts.

The leading Sixth Circuit authority is *White v. White*, 851 F.2d 170 (6th Cir. 1988), wherein the court held that it was appropriate for the bankruptcy court to lift the automatic stay to allow the domestic relations court to determine an appropriate property division. If a bankruptcy trustee wishes to be involved in the property division, the court in *White* suggested that the trustee's remedy is to intervene in the divorce.

B. Almost all divorce-related obligations are nondischargeable in bankruptcy.

A debtor who files a bankruptcy case in an attempt to discharge divorce-related obligations is wasting his time. Alimony, child support, or other forms of domestic support obligations are not dischargeable under 11 U.S.C. § 523(a)(5). Even if the payee is not a spouse, former spouse or child, bankruptcy courts have focused less on who the payee is, and more on whether the payment has been ordered in recognition and fulfillment of the duty to provide for the well-being of the child or spouse. *See, e.g., in re Tremblay,* 162 B.R. 60 (Bankr. D. Me. 1993).

Additionally, under 11 U.S.C. § 523(a)(15) (which was substantially amended in 2005), property settlements in divorce cases are nondischargeable in bankruptcy. This includes obligations arising from indemnification and hold harmless agreements. *See, e.g., In re Calhoun*, 715 F.2d 1103 (6th Cir. 1983). In most instances, it is not necessary for the creditor spouse to file an adversary proceeding to determine the dischargeability of a debt covered under §§ 523(a)(5) or (15) – the nondischargeability is automatic.

When reading the findings in a divorce judgment to determine whether obligations are dischargeable, one must be cognizant that the doctrine of collateral estoppel, or issue preclusion, applies. *See Grogan v. Garner,* 498 U.S. 279, 284 (1991); *In re Moffitt*, 254 B.R. 389 (Bankr. N.D. Ohio 2000). If there is a prior state court judgment determining that the nature of a debt is for support or a property settlement, then those findings will likely have preclusive effect in a subsequent bankruptcy case.

C. Property division arising from divorce may cause problems for a former spouse in bankruptcy, and a potential loss of assets.

As noted in *White*, *supra,* when divorce and bankruptcy cases are simultaneously pending, the domestic relations court has jurisdiction over property division. However, after property is awarded to a debtor spouse, and upon the filing of a bankruptcy case, that property becomes property of the debtor-spouse's bankruptcy estate and may be administered by the bankruptcy trustee.

Keep in mind, however, the difference between property awarded to a debtor, and support obligations awarded to a debtor. Most support obligations (including alimony and child support) are exempt from attachment by creditors or a trustee pursuant to Ohio Revised Code § 2329.66(A)(11). Property settlement awards may not be exempt, including the division of real estate and sale proceeds.

The following questions often arise when a former spouse files a bankruptcy case after a division of assets is ordered in a divorce.

1. Can a bankruptcy trustee avoid a division of property, or support award, as a preferential or fraudulent transfer?

Generally, no. Although a bankruptcy trustee has substantial "strong arm" powers allowing her to avoid certain pre-bankruptcy transfers, under 11 U.S.C. § 547(c)(7), a trustee may not avoid or recover a transfer "to the extent such transfer was a bona fide payment of a debt for a domestic support obligation." A bankruptcy court is usually bound by orders of a domestic relations court.

However, with respect to a property division, if a trustee can prove that the parties to the divorce negotiated the terms of a separation agreement with the intent to defraud creditors, or the entire purpose of the divorce was to evade creditors, then a transfer of property may be avoided under the fraudulent transfer provisions of 11 U.S.C. § 548 and the Ohio Revised Code. *See Suhar v. Bruno* (*In re Neal*), 541 Fed. Appx. 609 (6th Cir. 2013) (a property settlement pursuant to a marital dissolution decree was fraudulent, where the debtor did not receive a reasonably equivalent value for the division of assets and liabilities). An agreed dissolution shortly before a bankruptcy will invite scrutiny from a trustee, especially where substantial assets are divided. See *In re Fordu,* 209 B.R. 854 (BAP 6th Cir. 1997) (allowing a trustee to look behind a dissolution judgment to determine whether a fraudulent transfer occurred).

2. Can a bankruptcy trustee recover a property settlement obligation owed to the debtor?

Yes. Any property (not otherwise exempt, such as support) awarded to the debtor becomes property of the bankruptcy estate. Thus, if a debtor is awarded property, or a share of proceeds of the marital property once sold, then the Trustee may "step into the shoes" of the

debtor and recover such property or funds for the benefit of the bankruptcy estate.

Most retirement accounts which were exempt pre-divorce maintain their exempt status post-divorce, as long as the funds remain in exempt form (for example, a standard IRA or 401k remains in the same form post-divorce, or is rolled over into a new IRA). *However,* divorce counsel must be certain to finalize all qualified domestic support orders ("QDROs") addressing a division of retirement funds, and ensure all orders are entered *before* filing the bankruptcy. Otherwise, the funds may not be exempt and subject to claims of creditors and the bankruptcy trustee. See, e.g., *In re Brackett,* 259 B.R. 768, 773 (Bankr. M.D. Fla. 2001).

It should further be noted that a Trustee cannot recover alimony or child support awarded to a debtor spouse, as such funds are exempt from creditors. See Ohio Revised Code § 2329.66(A)(11).

3. If the trustee recovers assets in the bankruptcy case, can the non-debtor spouse file a proof of claim and share in the recovery?

Yes. A non-debtor spouse (or former spouse) may file a proof of claim in the debtor's bankruptcy case for debts arising from a divorce case, as long as the debts arose prior to the commencement of the bankruptcy case. In fact, 11 U.S.C. § 507(a)(1) now grants domestic support obligations the highest priority in any distribution.

All other obligations unrelated to support, including property settlement obligations owed to the creditor spouse, are not entitled to priority status and should be filed as general unsecured claims.

4. Can a bankrupt debtor avoid a judgment lien emanating from a divorce obligation?

No. Under 11 U.S.C. § 522(f)(1)(A), a debtor may avoid certain judgment liens, but there is a specific exclusion for a judgment lien securing a domestic support obligation.

D. Bankruptcy and Divorce Planning

Whether to first file a bankruptcy or divorce depends on the facts. As a general rule, it is best to avoid any conflict between a future divorce and bankruptcy by having both spouses cooperate and file a joint bankruptcy case, or file separate bankruptcy cases at the same time *before* filing the divorce. If both spouses first receive a discharge, then there will be no need to determine which spouse is responsible for certain debts, and to negotiate hold harmless provisions.

Another example of sound pre-bankruptcy planning: a spouse who might be entitled to a property settlement that would be lost in subsequent bankruptcy (it would become property of the bankruptcy estate) instead agrees to waive the property settlement in exchange for not paying alimony or support for a period of years. It is crucial that this be a *fair* exchange.

E. Conclusion

Careful planning is key to avoiding the collision of bankruptcy and divorce. Spouses contemplating both bankruptcy and divorce should consult counsel specializing in both areas (separate attorneys for the bankruptcy and divorce, preferably) to ensure a smooth intersection.

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