# When Worlds Collide: Compatibility of Family Law and Bankruptcy Law

**By David R. Hagen**

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Divorce and financial problems are often closely associated. In some dissolutions, bankruptcy looms as a real possibility. For this reason, family law attorneys should carefully consider the crossover issues between bankruptcy and family law to best advise clients.

MARITAL AND FINANCIAL PROBLEMS SEEM TO go hand in hand and financial problems seem to exacerbate martial problems. According to a 2012 survey from the American Institute of CPAs, money is the most common reason couples fight. This is even truer with spouses going through a divorce.

In her book, *The Two-Income Trap: Why Middle Class Mothers and Fathers Are Going Broke*, Harvard Professor (now U.S. Senator) Elizabeth Warren indicates that over 86% of all individual bankruptcy filings were caused by one of three causes: loss of a job, uninsured medical problems, or the breakup of a marriage. Even in situations without acrimony, divorce can cause financial hardship as spouses realize that it is usually more difficult to operate two households with an income stream that was formerly operating one.

With this nexus between marital and financial problems, one would think that the two systems would be compatible, or at least designed and enacted with each other in mind. This is just not so. The family and bankruptcy codes have different agendas. Family law seeks equity in the division of assets and debts within a community, among many other things. The principal purpose of the Bankruptcy Code is to grant a fresh start to the "honest but unfortunate debtor."[1] One party unexpectedly filing bankruptcy can really complicate a pending, or even completed, dissolution. The language and procedures used in the two systems can be very different and a bankruptcy will usually create unintended results.

This divergence between the two fields is nothing new. Congress has redefined the dischargeability of community property equalization payments twice in just the past 21 years. Even the United States Supreme Court found it necessary to delve into these crossover issues in a 1991 decision, *Farrey v. Sanderfoot*[2], which dealt with the issue of avoiding liens on awarded community property.

With the changes to the Bankruptcy Code in 2005, these differences have become even more pronounced. A new category of debt, called a Domestic Support Obligation (DSO) was created, the automatic stay was greatly modified, and even the dischargeability of attorney fees was affected. This has made it even more important than ever for family law and bankruptcy law practitioners alike to understand a little bit about each other's field, at least enough to spot issues and know when to seek help.

While these issues can be problematic, they can also provide solutions. Contemplating the changes that a bankruptcy can make to a dissolution agreement or judgment can prevent potential problems later in time. A corollary to this would be attempting to bankruptcy-proof a dissolution agreement to avoid problems later. Finally, the effective use of bankruptcy can make a dissolution proceeding much easier by removing the debt element from family law negotiations or trial or even make it easier for a former spouse to pay support.

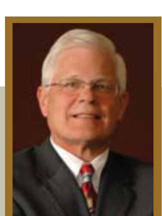
Family law attorneys always look for some type of general guideline as to whether it is better to deal with the family law issues or the bankruptcy issues first. Unfortunately, the answer is that it depends and really needs to be determined on a case-by-case basis. It depends upon the nature of the community and separate assets, the nature of the debts, income, and the cooperation, or lack thereof, between the parties and their counsel.

This article will discuss five different issues for family law counsel to consider in almost every dissolution proceeding, at least as it relates to the potential effect of a bankruptcy filing. Not only will this help protect counsel from potential liability, but it may also allow them to be more effective advocates of their client's position by thoughtfully removing debt from an otherwise contentious dissolution proceeding.

The five big crossover issues in the fields of family and bankruptcy law that should be considered are income, property of the bankruptcy estate, exemptions, non-dischargeable debt, and the automatic stay.

### Income

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was billed as a significant restriction on an individual's ability to file bankruptcy and specifically to discharge consumer debt. It really did not end up turning out this way. In fact, in 2010, an all-time record number of individuals filed bankruptcy in the United States. Rather than making bankruptcy less available, BAPCPA increased the steps necessary to get a discharge, thus increasing the cost (including fees) of going through bankruptcy.



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The centerpiece of BAPCPA, at least as it related to individuals, was something called the means test. The means test was designed to preclude some individuals who had an ability to pay something on their debts from filing a Chapter 7 bankruptcy. It requires that an individual or couple take all income from whatever sources during the six full months immediately preceding the bankruptcy filing and then doubling it, creating an imputed annual income. If this imputed annual income is less than the median income for a household of their size, they pass the means test and they are eligible to file a Chapter 7 bankruptcy.

## MEDIAN INCOMES IN THE GREATER LOS ANGELES AREA

| | |
|---|---|
| 1 Person Household | $49,983 |
| 2 Person Household | $64,779 |
| 3 Person Household | $68,917 |
| 4 Person Household | $79,418 |
| 5+Person Household | $79,418 plus $8,100 for each additional individual in excess of 4[3] |

If the imputed annual income is greater than the median income listed above, the individual or couple must complete the second part of the means test. The second part requires that the six-month income total be divided by six, producing an imputed monthly income. Deductions are then taken from this monthly imputed income. Some deductions are based upon the actual amount of money spent, such as a mortgage payment or court-ordered support payments. However, other deductions, such as food and utilities, are based upon guidelines set forth by the Internal Revenue Service when they seek to collect taxes.

A person needs to be relatively skillful, or have good software, to determine exactly what deductions are allowed or not. If the imputed monthly income, minus the allowed deductions, are about $200 or less, the individual or couple will pass the means test and be allowed to file Chapter 7. If the means test is not passed, a debtor will need to file a repayment type of bankruptcy, usually a Chapter 13 or even Chapter 11.

It needs to be emphasized that the means test only applies to individuals filing consumer bankruptcy cases. A consumer bankruptcy case is defined as one in which 51% or more of the debt is a result of the operation of a household. This includes the total amount of any outstanding mortgage. Bankruptcy filings that are not consumer cases will be subject to much less scrutiny in terms of income, although the U.S. Trustee's Office takes the position that a motion to dismiss can still be filed under 11 USC §707 in non-consumer cases with income over expenses using the simple standard of abuse.[4]

Why does this matter to the family law practitioner? First, if the opposing party is threatening bankruptcy, the attorney may be able to discern whether the threat of bankruptcy is a bluff if he or she has an idea of the opposing party's income and expenses. Certainly, if the debt is 51% consumer and an individual's income is much higher than the median income without significant allowable deductions, a threat of Chapter 7 bankruptcy may be just a threat.

Second, if the parties are cooperative and their income is such that they do not currently pass the means test, they may qualify later after the dissolution is complete or at least until after they are separated. This creates two separate incomes and they may qualify at that time for two separate bankruptcy filings.

**Property of the Bankruptcy Estate**

11 U.S.C. §541 provides that if one spouse files bankruptcy, all of the community property and the filing spouse's separate property become assets of the bankruptcy estate subject to administration by the trustee for the benefit of creditors. Obviously, this means that the non-filing spouse's separate property does not become property of the bankruptcy estate. The bankruptcy courts will usually use applicable non-bankruptcy law, meaning the state community property statutes, to determine what is community and what is separate.

There are several problems and also planning opportunities for the family law practitioner. First, if the non-filing spouse does indeed have separate property, it is possible that it might have a community property component. A bankruptcy trustee will use applicable state law, including the Moore Marsden calculation, to determine what this community property component might entail. If this is an issue, an expert should be retained to determine the community property component before a bankruptcy filing to determine what the risk of the trustee making such a claim might be.

Second, there is nothing that can stop one spouse from filing bankruptcy. Thus, if they don't like the way the family law proceeding is going and are willing to give up all assets except those that are exempt, they could file a bankruptcy. This would also mean that, with a few restrictions, the filing spouse would be able to choose which assets to exempt, or protect, from administration by the trustee.

On the other hand, if the parties are not entirely hostile, there may be some planning opportunities in the dissolution proceeding. For example, if it appears that only one spouse may need to file a bankruptcy, it may be that that party chooses to take assets that are exempt, or otherwise less likely to be administered by a trustee, as part of an otherwise equal and non-collusive division of assets. For example, family law courts tend to value a small business by including a healthy sum for goodwill. In a bankruptcy context, a trustee usually will not put as much value on this because they really cannot compel a debtor to continue to operate a business. A trustee usually looks only to the value of the various assets of a business. Thus, the spouse that needs to file may choose to take the business as part of an otherwise equal division of assets.

The same would be true if the spouse that needed to file decided to take exempt assets as part of an otherwise equal and non-collusive division of community assets. Transfers such as this could certainly be evaluated in light of fraudulent conveyance statutes so any planning such as this needs to be done very carefully and in consultation with bankruptcy counsel. If debt could be a problem in a dissolution and there are assets that might not be exempt, at the very least, any marital settlement agreement and resulting judgment should clearly demonstrate what assets are separate property and that any division of assets is found by the family law court to be equal.

**Exemptions**

Exemptions protect assets from being administered by the bankruptcy trustee. This means that the individual or couple get to keep these assets at the end of the bankruptcy proceeding. Exemption laws had their beginning in English common law which did not allow creditors to take a debtor's clothing so as to avoid breaches of the peace caused by naked people wandering the streets.[5] In fact, the California State Constitution requires the legislature to establish an exemption scheme to protect individuals from the "consequences of… economic misfortune."[6]

In California, individuals, or a couple, get to choose between two different sets of exemptions. One set is contained in CCP §703, the other in CCP §704. Joint debtors, generally husband and wife, are not entitled to two sets of exemptions. They must elect one set of exemptions as a couple.[7]

To be eligible to claim a particular state's exemptions, a debtor must reside in that state for two years preceding the bankruptcy filing. If they did not reside in any one state for that period, then the laws of the state in which they resided during the 180-day period before the two-year period applies (or during a longer portion of the 180-day period than in any other place). If this sounds confusing, it is. Courts and attorneys around the country struggle with the interpretation of these code provisions which were brought about by BAPCPA.

The most important exemption in the CCP §703 set of exemptions is the wild card. It protects $26,925 in any asset a person owns, even cash in the bank. This section then goes on to protect certain amounts of furniture, clothing, jewelry and other assets.

The most important exemption in the CCP §704 set of exemptions is the homestead. The homestead exemption protects equity in a person's primary residence. It protects $75,000 for a single person, $100,000 for a married couple or head of household and $175,000 for a person 65 years of age or older, disabled, or over the age of 55 making less than $25,000 (or $35,000 if a married couple). The Bankruptcy Code now also requires that a person is only entitled to a maximum homestead of $125,000 until such time as they have lived in that state for approximately 3.4 years. (This will obviously only relate to those claiming the larger $175,000 homestead amount and recently moved.)

The exemption is for equity in the property. For exemption purposes, equity is determined by taking the fair market value of the property and subtracting the value of any consensual liens (mortgages and deeds of trust). This section then goes on to protect certain amounts of furniture, clothing, jewelry and other assets. This set of exemptions is similar to the first series but has important differences. Thus, both sets must be analyzed to decide which one is more advantageous to the debtor. However, there is no wild card available in the CCP §704 set of exemptions.

It should be noted that within the past several weeks, the California Senate approved legislation that would increase the homestead exemption to $300,000 for all homeowners. If this legislation is passed by the California Assembly and ultimately signed by the Governor, it would substantially enhance a homeowner's rights in California. This change in the homestead exemption amount has been proposed in prior years but never made it out of either legislative body. The fact that it has now been passed by the Senate could be telling.

In addition to the CCP §703 and §704 sets of exemption described above, the U.S. Supreme Court has held that any retirement plan which is ERISA-qualified or contains a "spendthrift" provision can be kept by a person filing bankruptcy, regardless of the amount in the plan. Further, BAPCPA protects IRA related type accounts up to a current maximum of $1,245,475.

State and federal governments have put a premium on protecting homesteads and retirement accounts. What this means to the family law practitioner when negotiating a division of assets in a dissolution is that homestead property and retirement accounts should be seen as premium assets. At the very least, in any dissolution with any appreciable debt, an analysis of what assets are exempt and not exempt needs to be addressed. Further, if there are too many assets to exempt, or multiple homes, and the parties are cooperative, they might consider dividing the community assets and complete the dissolution. Thus, when the two single people later file two separate bankruptcy proceedings, they would be entitled to two sets of exemptions, including potential homesteads.

**Non-Dischargeable Debt**

Historically, child and spousal support were non-dischargeable under 11 U.S.C. §523(a)(8). This is still true. Other obligations, including community property equalization payments, were dischargeable. This dischargeability of community property equalization was changed in 1994 so that non-support obligations would discharge unless the creditor filed a timely non-dischargeability action in bankruptcy court. The court was then required to use a balancing test considering the benefit to the debtor against the detriment to the creditor. Obviously, decisions using this balancing test varied widely. This is no longer the law.

Interestingly, there appears to be an exception to the non-dischargeability of equalization payments if a person chooses to file Chapter 13, makes all the payments required, and ultimately receives a discharge.

BAPCPA now provides an exception to discharge under 11 U.S.C. §523(a)(15) for all obligations to a spouse or child arising out of a dissolution, whether it be by separation agreement or divorce decree. These are now called Domestic Support Obligations (DSO).

What does this mean to the dissolution practitioner? First, there is no longer any protection in bankruptcy for dissolutions that go awry with respect to community property equalization payments, with the exception of a discharge obtained in a Chapter 13 proceeding.[8] Second, provisions between spouses to indemnify the other from certain debt may very well be determined to be a DSO and thus non-dischargeable. This needs to be taken into account when crafting a division of community property and debts as most marital settlement agreements typically include indemnity provisions.

Third, this has some implication with respect to an award of attorneys' fees. Fees between a debtor and his or her attorney will still be a dischargeable debt. However, fees paid to the other spouse's attorney might be made non-dischargeable if the payment is made directly to the other spouse, thus becoming a DSO. Further, an indemnity provision by the filing spouse to the non-filing spouse would also make this debt, at least as to the non-filing spouse, non-dischargeable. It is also possible in some cases to get a consensual security interest in some asset that would be retained after a bankruptcy proceeding.

If these provisions are not acceptable or deemed too problematic, the only way to make the fees non-dischargeable would be to make it clear in the marital agreement and resulting judgment that the fees are based upon need and are actually akin to traditional support. This provides a good argument that those fees would then be dischargeable under 11 U.S.C. §523(a)(8) as support. While this may be persuasive, it is not binding upon the bankruptcy court. Further, it is also necessary to file a timely adversary proceeding in bankruptcy court to obtain this determination.

**Automatic Stay**

11 U.S.C. §362(a) traditionally held that almost all actions against a debtor were stayed by virtue of the bankruptcy filing. The stay is typically quite broad and even includes actions by the state and federal taxing authorities to collect funds.

BAPCPA created a number of exceptions to the stay, especially with respect to family law matters. These exceptions now include actions to establish paternity, to establish or modify support, to collect domestic support obligations from property that is not property of the estate, child custody and visitation issues, or domestic violence issues.[9] Obtaining a property division continues to require modification of the stay.

The stay continues until property is no longer property of the estate, until the case is closed or dismissed, or debtor is discharged.[10] In a Chapter 7 proceeding, a stay is typically in effect for three to four months. In Chapters 12 and 13, it is in effect until the plan is completed, typically three to five years. In a Chapter 11 proceeding, the stay is in effect until the plan is confirmed. After the stay expires or is terminated, the discharge injunction under 11 USC §524(a) applies.

Relief from a stay can be obtained for cause, including allowing a state court to adjudicate rights of the spouses in property disputes, even though distribution of property of the estate is under the jurisdiction of the bankruptcy court. If a family law practitioner has any doubt as to whether the automatic stay applies, it is always best to file a motion in bankruptcy court asking for relief from the stay. It is always easier to get an order from the court as a precautionary matter as opposed to having to explain yourself to a bankruptcy judge at a later point in time.

For the family law practitioner, cooling down a dissolution proceeding by filing bankruptcy and getting an automatic stay is not usually a good strategy. The stay is, in most cases (in Chapter 7, at least), short lived. Further, the property issues in the dissolution now involve a third party–the Chapter 7 trustee–thus making matters much more complicated.

Bankruptcy law and family law simply do not fit well together. A bankruptcy filing, either during or after a dissolution, can generate unintended results for the parties and their counsel. In any dissolution with debt, or even contingent liabilities, the consequences of a potential bankruptcy should be considered. Further, in situations where the parties are at least somewhat cooperative, some planning opportunities exist to make it a bit easier for two households to financially survive.

At the end of the day, parties going through a divorce or a bankruptcy are both, in a manner, seeking a fresh start. The two systems just have a different definition of that term and how to go about achieving that objective. It is hoped that this article provides the family law practitioner with some ability to spot some of these issues and potential opportunities and provide increased value to the representation of their clients.

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1 *Grogan v. Garner*, 498 U. S. 279, 286, 287 (1991).
2 500 U.S. 291 (1991).
3 U.S. Department of Justice, Census Bureau Median Family Income By Family Size, available at http://www.justice.gov/ust/eo/bapcpa/20150515/bci_data/median_income_table.htm (last accessed June 11, 2015).
4 See *Zolg v. Kelly (In re Kelly)*, 841 F.2d 908, 913 (9th Cir. 1988).
5 *See* Koger & Reynolds, Is Pre-Filing Engineering Prudent Planning or §727 Fraud? (Or When Does a Pig Become a Hog?), 93 Commercial LJ 465, 467 (1988).
6 *See* Cal. Const. Art. 20, §15.
7 *In Re Baldwin*, 70 BR 612; 9th Cir. BAP 1987.
8 *See* 11 USC §1328.
9 *See* 11 U.S.C. §362(b)(2).
10 11 U.S.C. §362(c).

# Test No. 81

This self-study activity has been approved for Minimum Continuing Legal Education (MCLE) credit by the San Fernando Valley Bar Association (SFVBA) in the amount of 1 hour. SFVBA certifies that this activity conforms to the standards for approved education activities prescribed by the rules and regulations of the State Bar of California governing minimum continuing legal education.

1. According to U.S. Senator Elizabeth Warren, the top three causes of bankruptcy are loss of job, uninsured medical problems, and the breakup of a marriage.
❑ True ❑ False

2. The principal purpose of the Bankruptcy Code is to give the "honest but unfortunate debtor" a fresh start.
❑ True ❑ False

3. The Bankruptcy Abuse and Prevention and Consumer Protection Act (BAPCPA) of 2005 significantly restricted an individual's ability to file bankruptcy and specifically to discharge consumer debt.
❑ True ❑ False

4. The means test included in the BAPCPA only applies to cases with consumer debt.
❑ True ❑ False

5. 11 USC §541 provides that if one spouse files bankruptcy, all of the community property and the filing spouse's separate property become assets of the bankruptcy estate subject to administration by the trustee for the benefit of creditors.
❑ True ❑ False

6. Exemptions protect certain types of assets from administration by the bankruptcy trustee.
❑ True ❑ False

7. In California, each spouse can elect to choose a different set of exemptions.
❑ True ❑ False

8. The current homestead amount in California is $300,000.
❑ True ❑ False

9. Original exemption statutes were created in England to exempt a debtor's clothing so as to prevent breaches of the peace caused by naked people wandering the streets.
❑ True ❑ False

10. ERISA qualified retirement accounts are typically not subject to administration in bankruptcy.
❑ True ❑ False

11. Under Federal statute, IRA accounts are exempt up to approximately $1.2 million.
❑ True ❑ False

12. Spousal and child support are always non-dischargeable in bankruptcy.
❑ True ❑ False

13. Obligations between spouses, including community property equalization payments between spouses, are dischargeable.
❑ True ❑ False

14. In a Chapter 13 proceeding, obligations to spouses can be dischargeable.
❑ True ❑ False

15. Attorneys' fees, payable to one's own attorney, are not dischargeable in a bankruptcy.
❑ True ❑ False

16. Attorneys' fees, payable by the non-client spouse, can potentially be non-dischargeable.
❑ True ❑ False

17. A non-filing spouse's separate property is not included in the filing spouse's bankruptcy proceeding.
❑ True ❑ False

18. Current homestead laws provide for exemptions of $75,000 for a single person, $100,000 for a married couple or head of household, and $175,000 for individuals over the age of 65 or disabled.
❑ True ❑ False

19. When representing a spouse in a marriage with significant debt, it's important to always be the first spouse to file.
❑ True ❑ False

20. So long as the spouses are legally married, one spouse cannot file bankruptcy by themselves.
❑ True ❑ False

## MCLE Answer Sheet No. 81

**INSTRUCTIONS:**

1. Accurately complete this form.
2. Study the MCLE article in this issue.
3. Answer the test questions by marking the appropriate boxes below.
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**ANSWERS:**
Mark your answers by checking the appropriate box. Each question only has one answer.

| | | |
|---|---|---|
| 1. | ❑ True | ❑ False |
| 2. | ❑ True | ❑False |
| 3. | ❑ True | ❑ False |
| 4. | ❑ True | ❑ False |
| 5. | ❑ True | ❑ False |
| 6. | ❑ True | ❑ False |
| 7. | ❑ True | ❑ False |
| 8. | ❑ True | ❑ False |
| 9. | ❑ True | ❑ False |
| 10. | ❑ True | ❑ False |
| 11. | ❑ True | ❑ False |
| 12. | ❑ True | ❑ False |
| 13. | ❑ True | ❑ False |
| 14. | ❑ True | ❑ False |
| 15. | ❑ True | ❑ False |
| 16. | ❑ True | ❑ False |
| 17. | ❑ True | ❑ False |
| 18. | ❑ True | ❑ False |
| 19. | ❑ True | ❑ False |
| 20. | ❑ True | ❑ False |