Practical Bankruptcy Advice for Family Law Attorneys

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Divorce does not necessarily end financial entanglement with a spouse. This can be painfully true if one spouse petitions for bankruptcy relief while the parties are contemplating a divorce or shortly after divorce. This article offers family law attorneys practical tips regarding property settlements, domestic support, and dividing marital debts to ensure an ex-spouse's bankruptcy does not have devastating ramifications for the non-filing ex-spouse.

A hypothetical: Pete and Jane own a home with a mortgage, a boat, and have amassed $40,000 in credit card debt during their marriage. Upon divorce, Pete is awarded the house and the boat, and in lieu of spousal support he is ordered to pay the $40,000 credit card debt and a $70,000 equalizing payment to Jane that is described as a "money judgment" in the decree. Unfortunately for Jane, Pete later files bankruptcy under chapter 13 and discharges the credit card debt and the money judgment. Jane alone remains liable to creditors for the community debt[1] and never receives her $70,000. Pete walks away with the house, the boat, and a fresh start without the credit card debt. Unfair? Yes. Preventable? Also, yes.

I. UNSECURED PROPERTY SETTLEMENTS ARE DISCHARGEABLE IN A BANKRUPTCY FILED UNDER CHAPTER 13.

A divorced party awarded a "money judgment" (i.e., an "unsecured property settlement") as an equalizing payment could end up with no payment if an ex-spouse files for bankruptcy under chapter 13 and discharges the money judgment.[2] Thus, to protect an equalizing payment awarded in a divorce from being discharged in a bankruptcy proceeding, the equalizing payment needs to be *more* than just an unsecured property settlement.

In the hypothetical, Jane's attorney could have protected her equalizing payment from being discharged with one of two types of liens: a consensual lien or an owelty lien.

Practice Tip: Secure equalizing payments with a consensual lien on real property contemporaneously with the entry of the divorce decree.

One way to ensure an equalizing payment is shielded from an ex-spouse's bankruptcy is to secure the payment with a *consensual lien* on real property contemporaneously with the divorce decree. In bankruptcy cases, some liens can be "avoided" by the court on a debtor's motion to eliminate a lien on their home if certain factors are met. One such factor is that the lien must be a "judicial" lien.[3] Judicial liens are defined as a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding."[4]

In a recent case decided by the Bankruptcy Court for the Eastern District of Washington, the debtor ex-husband attempted to avoid a $20,000 equalizing payment awarded to his ex-wife in the divorce decree. However, the ex-wife's equalizing payment was secured by a consensual lien with a deed of trust.[5] The bankruptcy court held that the ex-wife's consensual lien could not be avoided because it was not a "judicial" lien.[6] Thus, consensual liens must be paid, even after a bankruptcy discharge.

In the hypothetical with Pete and Jane, Jane's equalizing payment would have survived Pete's bankruptcy discharge if contemporaneously with the entry of the divorce decree, she secured her payment with a consensual lien on the home. Washington consensual liens against real property are easily created and perfected by having the grantor sign a deed of trust in front of a notary and then recording the deed of trust in the county where the property is located.[7] A consensual lien would have been a simple and effective mechanism to secure Jane's equalizing payment.

Practice Tip: Include specific language in the decree that states the property is awarded *subject to a lien* held by the other party.

An alternative to a consensual lien is an owelty lien, which is a "sum of money paid in the case of partition of unequal proportions for the purpose of equalizing the portions." [8] An owelty lien generally cannot be discharged or avoided by a debtor in bankruptcy as long as it is "granted as compensation for an interest in real property that is transferred, or which the divorce court refers to as a lien against specific property."[9] An owelty lien automatically attaches to all of the debtor's real property in the same county where the judgment is entered.[10] However, if the divorce decree is entered in a county other than where the real property is located, counsel must remember to record the judgment in the county where the property is located.[11]

For a debtor to avoid a property lien, a debtor must have an interest in the property prior to the fixing of the lien.[12] A mere community property interest in real property prior to the fixing of a lien will not meet this requirement. Bankruptcy courts have held that when a divorce decree awards the community property home to one spouse, subject to the lien of the other spouse, the decree awards a fee simple interest to one spouse and *simultaneously* grants the lien to the other spouse.[13] Thus, owelty liens are not avoidable in bankruptcy proceedings.

For an owelty lien to be effective, however, the lien should not be described in a divorce decree or settlement document as merely as a "money judgment." For example, Pete and Jane's problematic divorce decree might have read as follows:

7. Real Property *(summarized in section 2 above)*

The real property is divided as explained below:

Real Property Address	Tax Parcel Number	Given to which spouse as his/her separate property?
[redacted]	[redacted]	Petitioner

Petitioner shall refinance the home mortgage within 4 months of entry of the Final Divorce Order. If the Petitioner fails to refinance the residence as set forth then the home shall be listed for sale immediately with [redacted] Enforcement of this provision shall be via arbitration with [redacted] based upon written submissions per the [redacted] Rules for Domestic Motions. Arbitrator shall have authority to grant any relief deemed appropriate including award of attorney fees.

The following debts will be paid from the refinance of the home:

1. [redacted] Credit Card
2. [redacted] Credit Card
3. [redacted] Home Equity
4. [redacted] Loan
5. [redacted]

If the home is sold any remaining proceeds shall first apply to the Money Judgment due to the wife and the balance is awarded to the husband.

This decree awards the marital home to Pete. It also requires Pete to refinance and pay a money judgment to Jane. The decree does not, however, *specifically* grant the property to Pete *subject to a lien*. The decree language is not clear whether this is an owelty lien or an unsecured property settlement. The consequences of not having a clearly established owelty lien could mean Jane must file a lawsuit in bankruptcy court and participate in a trial to determine if Pete's bankruptcy discharges his obligation to pay the money judgment to Jane. Clear language such as "The Real Property is awarded to Pete, subject to a lien held by Jane in the amount of $70,000" could help the bankruptcy court determine, without a trial, that Jane has a nondischargeable lien on the property.

II. DOMESTIC SUPPORT OBLIGATIONS ARE NONDISCHAREGABLE FOR DEBTORS FILING UNDER ANY CHAPTER OF THE BANKRUPTCY CODE.

It is imperative that domestic support obligations ("DSOs") are structured properly so as not to be mistaken for unsecured property settlements dischargeable in a chapter 13 bankruptcy.[14]

Practice tip: If a spouse is awarded financial support, the support should be structured in incremental payments over time that terminate upon the recipient's death or remarriage.

DSOs consist of debts "owed to a debtor's child or former spouse in the nature of alimony, maintenance, or support, arising out of a court order."[15] While that definition appears straightforward, whether an obligation is a DSO is a fact-driven analysis. In the Ninth Circuit, "[i]n determining whether an obligation is intended for support [and thus is not dischargeable], the [bankruptcy] court must look beyond the language of the decree to the intent of the parties and to the substance of the obligation."[16] The bankruptcy court's analysis focuses on the *intent* of the parties and whether the spouse arguing for a DSO actually "*needs support*."[17] In determining if a spouse "needs support," the court examines several factors including: the existence of minor children, an imbalance of incomes between the ex-spouses, the nature and duration of the proposed obligation, and the terms related to the termination on remarriage or death.[18]

Bankruptcy courts have held that lump sum payments that do not terminate upon the death or remarriage of the recipient are not need-based, and thus are dischargeable because such payments are more akin to property settlements rather than support.[19] However, support paid in incremental payments over time and that terminates upon the death or remarriage of the recipient is less likely to be discharged as an unsecured property settlement. It may be advisable to secure

the obligation by a deed of trust against the obligor's real property to eliminate the risk of a court finding the obligation is not a DSO.

Because Pete owes $70,000 to Jane regardless of need, and the obligation does not terminate upon her remarriage or death, she faces an expensive and uphill legal battle in the bankruptcy court to determine if the money owed to her is a nondischargeable DSO, or merely a dischargeable unsecured property settlement.

III. MARITAL DEBTS ASSIGNED TO ONE SPOUSE IN A DIVORCE GENERALLY ARE DISCHARGEABLE IN A BANKRUPTCY FILED UNDER CHAPTER 13.

Understanding how bankruptcy courts treat the division of marital debts in a divorce is crucial for family law attorneys. Debts assigned to one spouse in a divorce are nondischargeable under chapter 7 because chapter 7 exempts from discharge debts incurred as "part of a dissolution judgment."[20] This exception does not apply to chapter 13, which provides those debts may be discharged.[21]

Practice Tip: Expressly state in the decree/settlement that the parties intend the assignment of the marital debts to function as a Domestic Support Obligation.

One strategy to prevent an ex-spouse from discharging the marital debt is to include specific language in the divorce decree or settlement that indicates the assignment of that debt is intended to function as a nondischargeable DSO. Although not technically "owing to a former spouse," marital debts assigned to one spouse can, in limited circumstances, be treated as a DSO by the bankruptcy court.[22] However, the bankruptcy court still examines the intent of the parties and the recipient's "need" for support in deciding if an assigned debt should be treated as a DSO.[23]

Problems arise when divorce decrees state that "no support is awarded" (typically because the parties have not arranged for traditional support payments), but the parties intended the assignment of community debt to one spouse to function as support. Contradictory language in the decree can create ambiguity about the parties' intent and this ambiguity becomes a hurdle for the party insisting on payment.[24] To avoid ambiguity, the decree should include consistent, express language about the parties' intent. Additionally, hold harmless language should be included to further evidence the parties' intent to treat the assignment of the debt as a DSO. Hold harmless language can show that the parties intended to create an obligation "owing to the spouse" rather than the creditor.[25]

For Pete and Jane, rather than stating "no support is awarded," the decree should have included a provision that stated: "Support is awarded and will be paid in the following form: Pete will pay debts [list of debts.]"

Practice Tip: Negotiate settlement terms with the risk of discharge in mind.

Decree language indicating the divorcing parties' intent is not a fail-safe. Despite careful drafting, a bankruptcy court could find that the assignment of marital debts in a divorce is not a DSO, particularly if the facts suggest the recipient was not in "need." Thus, the risk remains that the bankruptcy filing ex-spouse could discharge the marital debts, rendering the obligations in the decree nothing more than hollow promises.

In our example, Jane agreed to allow Pete to keep the boat in exchange for Pete assuming the credit card debt. Pete was able to discharge the debt and keep the boat, leaving Jane saddled with the debt, and up the river without even a paddle!

The Bottom Line

Family law attorneys must carefully draft divorce decrees to protect a client's equalizing payment and support payments from bankruptcy discharge. Equalizing payments should be secured with a consensual lien on real property contemporaneously with the entry of the divorce decree. Additionally, the decree should contain specific language stating that the property is awarded subject to a lien held by the other party. Domestic support should be paid in incremental payments over time that terminate upon the recipient's death or remarriage. Further, if the parties intend the assignment of a debt to function as support, the decree should clearly articulate that intent. Family law attorneys should also be mindful that a bankruptcy filing by a client's ex-spouse could force their own client to consider bankruptcy. Consequently, family law attorneys should have some understanding of bankruptcy law or should consider associating with an attorney who regularly practices bankruptcy law. These practical tips could prevent some of the devastation that results when an ex-spouse files for bankruptcy.

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[1] An ex-spouse in Washington is liable for community debt. Chapter 26.16 RCW.
[2] 11 U.S.C. § 1328(a).
[3] 11 U.S.C. § 522(f)(1)(A).
[4] 11 U.S.C. § 101(36).
[5] *In re Huff*, No. 18-01665-FPC13, 2019 WL 856257, at *2 (Bankr. E.D. Wash. Jan. 29, 2019).
[6] *Id.*
[7] RCW 61.04.01 and 65.08.070.
[8] *Hartley v. Liberty Park Assocs.*, 54 Wash. App. 434, 438, 774 P.2d 40, 42 (1989).
[9] *In re Emery*, No. 15-41333-BDL, 2016 WL 7383720, at *2 (Bankr. W.D. Wash. Dec. 20, 2016) (citing RCW 4.56.190).
[10] "[I]t is settled that a debtor cannot use § 522(f)(1) to avoid a lien on an interest acquired after the lien attached." *Farrey v. Sanderfoot*, 500 U.S. 291, 299 (1991).
[11] RCW 6.13.090.
[12] 11 U.S.C. § 522(f)(1).
[13] *Huff*, 2019 WL 856257, at *2, (citing *In re Catli*, 999 F.2d 1405, 1408 (9th Cir. 1993)).
[14] 11 U.S.C. § 324; 11 U.S.C. § 1328(a).
[15] 11 U.S.C. §101(14)(C).
[16] *Shaver v. Shaver*, 736 F.2d 1314, 1316 (9th Cir. 1984).
[17] *Id.*
[18] *Id.*
[19] *In re Gaetaniello*, 496 B.R. 238, 242 (Bankr. M.D. Fla. 2013) (holding that a lump payment of $53,274 owing to spouse pursuant to a divorce decree was not intended to be a DSO, as the spouse had no need for support, but was

instead a property settlement, and therefore was not excepted from discharge under 11U.S.C. §§ 523(a)(5) and 1328(a)(2).

[20] 11 U.S.C. § 523(a)(15); *See In re Short,*, 232 F.3d 1018, 1020 (9th Cir.2000) (holding that "the [debt assigned to chapter 7 debtor in a divorce] is non-dischargeable because it was incurred by the debtor as part of the division of property in the course of a judgment of dissolution"); *See also In re Francis,* 505 B.R. 914, 919 (B.A.P. 9th Cir. 2014) (Holding that "[one spouse's] obligation to pay and hold [the other spouse] harmless from the Credit Card Debts arises directly from his covenants in … the marital dissolution Judgment. There is no requirement in § 523(a)(15) that a debt obligation incurred as part of a dissolution judgment be payable directly to the ex-spouse in order to be excepted from a debtor's discharge.").

[21] 11 U.S.C. § 1328(a).

[22] *See Edwards v. Edwards,* 83 Wash. App. 715, 720, 924 P.2d 44, 46 (1996), *as amended* (Feb. 14, 1997), *amended,* 932 P.2d 171 (Wash. Ct. App. 1997); *See also In re Nelson,* 451 B.R. 918, 923-925 (Bankr. D. Or. 2011).

[23] *Nelson,* 451 B.R. 918, at 923.

[24] When a chapter 13 debtor is ordered to hold ex-spouse harmless on joint debt in one provision of a divorce decree, but another provision states that no support is awarded, the court will consider numerous factors to ascertain if the hold-harmless obligation truly is support. *See e.g., Nelson,* 451 B.R. 918, at 923-925.

[25] *See Francis,* 505 B.R. 914, at 919. Note, however, that while the "non-debtor ex-spouse may look to the debtor for reimbursement pursuant to any nondischargeable 'hold harmless' obligations but the non-debtor ex-spouse is not immune from pursuit by the primary joint creditors." *In re Arias Nussa,* 565 B.R. 209, 219 (Bankr. D.P.R. 2017) (citing *In re Clark,* 207 B.R. 651, 657 (Bankr. E.D. Mo. 1997)).