

DIVORCE AND BANKRUPTCY
Discharge of divorce related debts/obligations
in bankruptcy cases filed on or after October 17, 2005
and
How Bankruptcy Stops A Divorce Case.
by
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1. Chapter 7 Liquidation.

A. Child support and spousal maintenance debts/obligations (“Domestic Support Obligations”) are not discharged and a creditor does not need to file any complaint to prevent discharge. Debts/obligations “in the nature of” child support and spousal maintenance are also not discharged and a creditor does not need to file any complaint to prevent discharge. However, litigation may eventually be needed in bankruptcy court or state court to establish that an unclear debt is “in the nature of” child support and spousal maintenance. Litigation is more likely in Chapter 13.

B. Divorce property/debt settlement agreements or divorce decrees regarding property/debt are also not discharged. A creditor does not need to file any complaint to prevent discharge.

For example, in a divorce John agrees or is ordered to pay a joint Mastercard debt and hold Mary harmless from the Mastercard debt. The holdharmless obligation means that if John does not pay Mastercard, and if Mary pays Mastercard, then Mary may sue John for reimbursement. If John files Chapter 7 after the divorce is final and does not pay Mastercard, then John probably can discharge John’s liability to Mastercard which means that Mastercard cannot sue John. However, Mastercard may still collect from or sue Mary because Mary did not file bankruptcy. Despite John’s Chapter 7, Mary may sue John for reimbursement if Mary pays Mastercard. Mary does not need to file an objection to discharge in John’s Chapter 7. John’s holdharmless obligation to Mary is automatically not discharged in John’s Chapter 7 because it was in a divorce decree or property settlement agreement. This 2005 change in the law gives more protection to ex-spouses. (Prior to October 17, 2005 Mary was required to file an adversary complaint objecting to the discharge of the obligation in John’s Chapter 7 and even then the judge could have discharged some or all of the obligation if John proved it was an undue hardship.)

Some courts have ruled that a “holdharmless” order is not required in the divorce decree to prevent the discharge of the obligation. These courts have ruled that if a divorce decree orders one spouse to pay a debt, then that order implies a holdharmless obligation and that there is a the right to sue the spouse who breaches the order.

As another example, in a divorce John agrees or is ordered to pay Mary \$30,000 as a property equalization payment. John cannot discharge this obligation to Mary in Chapter 7. Despite John’s Chapter 7, Mary may sue John for the \$30,000 if John does not pay it when due. Mary does not need to file an objection to discharge in John’s Chapter 7. John’s \$30,000 obligation to Mary is automatically not discharged in John’s Chapter 7 because it was in a divorce decree or property settlement agreement. (Prior to October 17, 2005 Mary was required to file an adversary complaint objecting to the discharge of

the obligation in John's Chapter 7 and even then the judge could have discharged some or all of the obligation if John proved it was an undue hardship.)

The Arizona Court Of Appeals in *Birt v. Birt*, 208 546, 96 P.3d 544 (App. 2004) ruled that a divorce court may re-open a divorce decree when on party files bankruptcy shortly after divorce to avoid the divorce decree's effects on the allocation of community debts. The *Birt* ruling was under the pre-2005 bankruptcy law when it was sometimes possible to use Chapter 7 to discharge divorce property/debt settlement agreements or divorce decrees regarding property/debt. The *Birt* ruling probably is not significant in Chapter 7 cases filed after 2005. However, The *Birt* ruling may be significant in Chapter 13 cases.

2. Chapter 11 Reorganization.

Same rules as Chapter 7.

3. Chapter 13 Reorganization, if the reorganization plan is not fully completed and the court grants the debtor a hardship discharge due to circumstances beyond the debtor's control. This is rare.

Same rules as Chapter 7.

4. Chapter 13 Reorganization with a fully completed plan.

A. Child support and spousal maintenance debts/obligations are not discharged, the same as Chapter 7. A creditor does not need to file any complaint to prevent discharge. Debts/obligations "in the nature of" child support and spousal maintenance are also not discharged, the same as Chapter 7. Litigation may be necessary to establish the "nature of" of a debt/obligation for the reasons in the next paragraph.

B. Divorce property/debt settlement agreements or divorce decrees regarding property/debt are discharged if they are not "in the nature of" child support and spousal maintenance. Two examples are described in paragraph 1B, above, regarding Chapter 7. These obligations will be discharged in Chapter 13 but not in Chapter 7. This Chapter 13 "loophole" was not closed by the 2005 law. However, the Arizona Court Of Appeals in *Birt v. Birt*, 208 546, 96 P.3d 544 (App. 2004) ruled that a divorce court may re-open a divorce decree when on party files bankruptcy shortly after divorce to avoid the divorce decree's effects on the allocation of community debts.

5. Loss Of Exemptions

11 USC § 522.c.1 appears to say that if a person files bankruptcy and that person has a domestic support obligation (child support or spousal maintenance) that "accrues before, on, or after" the day the bankruptcy is filed, then regardless of any nonbankruptcy law, any property owned on the day the bankruptcy is filed is liable for payment of the domestic support obligation during and after the bankruptcy case .

For example, Arizona law gives a \$5,000 exemption to protect one motor vehicle. If a person who owes past due spousal maintenance does not file bankruptcy, then the ex-spouse might not be able to collect any past due spousal maintenance from a motor vehicle that has less than \$5,000 equity. (In 2007 Arizona amended the homestead statute, ARS 33-1103 to allow for liens against a homestead for child support arrearages

or spousal maintenance arrearages, which may make the change in the Bankruptcy laws less important concerning homesteads, since state law has also removed the homestead protection.)

On the other hand, it appears that if a person who owes past due spousal maintenance files bankruptcy, then the ex-spouse may now or in the future be able to collect any past due spousal maintenance out of any property owned by the person on the day the bankruptcy is filed, such as a vehicle with less than \$5,000 equity. So a person who now owes past due child support or past due spousal maintenance may be worse off by filing bankruptcy because the person will lose certain exemptions available under state and federal law.

It is also unclear if this means that during the time a person's Chapter 7 case is open, the bankruptcy trustee may sell the person's otherwise exempt property to pay past due child support or spousal maintenance. Most courts have said that the trustee may not sell exempt property to pay such past due obligations, but that the right belongs to the ex-spouse.

6. To minimize risk of discharge or nonpayment of a divorce obligation/debt:

A. Designate as many obligations as possible as spousal maintenance or child support. Be aware that a court in a rare case may determine that something designated as spousal maintenance or child support is actually a property settlement, in which case it may be discharged in Chapter 13 and may not be collected out of exempt property. (This is the reverse of the situation where a court may determine that something not designated as spousal maintenance or child support is "in the nature of" spousal maintenance or child support and may not be discharged in any Chapter of bankruptcy.) There may be adverse income tax consequences to designating something as spousal maintenance or child support. Consult a tax expert and an expert divorce attorney.

B. Secure obligations/debts with properly filed liens to the extent possible. Properly filed liens generally are valid in bankruptcy.

C. Let the other side know that filing a bankruptcy will mean the loss of otherwise exempt property if there is now or in the future any past due child support or spousal maintenance.

7. Bankruptcy will almost always stop a divorce case.

If the divorce seeks to divide property that is subject to the bankruptcy court, then filing an bankruptcy by either spouse or both spouses will automatically stop the divorce case from being filed or from proceeding if it has been filed, except as explained in the next paragraph. The law requires this because the bankruptcy trustee has the right to investigate to be sure the divorce is not being used to transfer money or property so that the trustee or creditors cannot get to it. In a community property state such as Arizona, when only one spouse files bankruptcy and the married couple has community property debts, all non-exempt community property (if any) becomes part of the filing spouse's bankruptcy estate. In other words, the non-filing spouse may have his or her interest in non-exempt community property (if any) taken by the bankruptcy court to pay claims of community creditors. For more information, refer to the separate document explaining what happens when only one spouse files bankruptcy in a community property state.

There is an exception to when a bankruptcy stops a divorce case. The bankruptcy does not stop the part of the divorce case or other court case that is to establish paternity, establish or modify child support or spousal maintenance, concerning child custody or visitation, or for the dissolution of marriage if it does not seek to divide property that is subject to the bankruptcy.

If you have filed bankruptcy and the bankruptcy case is not closed and you want to file for divorce or complete a pending divorce, then you probably need to hire an attorney to file a motion in the bankruptcy court to lift the automatic stay to allow the divorce to be filed or to proceed. It takes about 30 days to get the order lifting the automatic stay, assuming no opposition is filed.

In those situations where a bankruptcy is filed while a divorce case is pending, there is a difference of opinion among attorneys as to whether, after the automatic stay is lifted or after the discharge of the debtor in bankruptcy, the divorce court may proceed to allocate debt. Some attorneys believe the divorce court is prohibited by bankruptcy law from allocating debt or ordering one spouse to pay the debt and holding the other spouse harmless from the debt. These attorneys believe it there may be an advantage to filing bankruptcy in the middle of a divorce. Other attorneys believe bankruptcy law does not prevent the divorce court from making such orders and that if such orders are made after the bankruptcy is filed, then such orders may not be discharged in bankruptcy.