BRINGING A LAMB TO SLAUGHTER: HOW FAMILY LAW ATTORNEYS UNKNOWINGLY LEAD CLIENTS TO FINANCIAL DISASTER IN THE NEGOTIATION OF A DIVORCE STIPULATION

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INTRODUCTION

Fitzgerald v. Fitzgerald.[1] May this case be branded on the mind of every family law attorney. The husband, Thomas, was the plaintiff, and in conformity with the typical situation,[2] the debtor in bankruptcy.[3] The wife,

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1. Fitzgerald v. Fitzgerald, 144 Vt. 549, 481 A.2d 1044 (1984).

2. Peter C. Alexander, *Building "A Doll's House": A Feminist Analysis of Marital Debt Dischargeability in Bankruptcy*, 48 VILL. L. REV. 381, 382, 387–88 (2003) (noting that women are disproportionately the creditor-spouse).

3. *Fitzgerald*, 144 Vt. at 550, 481 A.2d at 1045.

Sandra, was the defendant in the divorce complaint and creditor-spouse in bankruptcy.[4]

The parties negotiated a property settlement.[5] The court incorporated the stipulation into a divorce decree.[6] The stipulation required the husband to make an equalizing payment to the wife.[7] He did not. Instead, *only one month after the divorce decree*, the husband filed for bankruptcy.[8] Though she entered her appearance as a creditor in bankruptcy court, the wife chose to seek a remedy in Vermont state court.[9] She did not object to the discharge of the husband's debt to her in bankruptcy court.[10] Rather, she filed a Rule 60(b) motion for fraud and misrepresentation with the family court.[11] Prior to the Rule 60(b) hearing, the husband successfully attained a discharge of the equalizing payment to wife in the bankruptcy case.[12] Sandra's slaughter was complete.

The trial court dismissed the wife's 60(b) motion as barred by the husband's discharge in bankruptcy.[13] On appeal, the Vermont Supreme Court held that Title 11 U.S.C. § 523(c) provides that a creditor must pursue an exception from discharge for a debt based on fraud or deceit in the bankruptcy forum.[14] Given that the wife failed to do so, the discharge of the equalizing payment granted by the bankruptcy court was "an injunction against the commencement or continuation of an action, the employment of process, or any act, to collect, recover or offset any such debt as a personal liability of the debtor, or from property of the debtor, whether or not discharge of such debt is waived . . . ."[15] The court stated that an attempt to distinguish the reopening of the underlying judgment, pursuant to Rule 60(b), from enforcement of the discharged debt was "illusory."[16] The Vermont Supreme Court further held that res judicata barred the wife from re-litigating

4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. Braunstein v. E. Airlines Emps. Fed. Credit Union (*In re* Thomas J. Fitzgerald), 49 B.R. 62, 63 (Bankr. D. Mass. 1985).
9. *Fitzgerald*, 144 Vt. at 550, 481 A.2d at 1045.
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.* at 551, 481 A.2d at 1045.
14. *Id.*
15. *Id.* (quoting 11 U.S.C. § 524(a)(2) (1982)).
16. *Id*. at 551, 481 A.2d at 1046.

the claim; "[f]inal orders of a bankruptcy court are res judicata as to all matters that were or could have been litigated before that court."[17]

Though *Fitzgerald* was litigated in 1984, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) continues to enable a similar outcome in Chapter 13 filings. This Article aims to provide family law attorneys with a basic understanding of bankruptcy law so they might successfully negotiate and craft divorce stipulations which are not vulnerable to discharge in bankruptcy. This Article further strives to enumerate specific strategies to achieve that end.

I. THE BANKRUPTCY CODE IN RELATION TO FAMILY LAW

The current Bankruptcy Code became effective law in 1979.[18] Under the Code, a debtor has a number of options when filing a personal bankruptcy. The most common bankruptcy filings are under either Chapter 7 or Chapter 13.

Relief under Chapter 7 requires the debtor to liquidate his assets.[19] Section 522 of the Code affords the debtor limited protection from liquidation.[20] The debtor is able to claim certain enumerated exemptions that cause certain assets to be immune, at least in part, from liquidation.[21] The debtor may choose between the exemptions under the Code, or alternatively the exemptions available under his state's statutes.[22] All assets not protected by an exemption are liquidated, and creditors are paid from the funds produced by the liquidation.[23] Most of the remaining unsatisfied and unsecured debt is discharged.[24]

Relief under Chapter 13 differs substantially from that under Chapter 7. Chapter 13 limits eligibility to individuals with regular income.[25] However, BAPCPA aims to force debtors into Chapter 13 rather than Chapter 7.[26] This goal is achieved by implementing a "means test" that precludes some debtors—those whose incomes are above their home states' medians and

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17. *Id.* at 552, 481 A.2d at 1046 (citing Chicot Cnty. Drainage Dist. v. Baxter State Bank, 308 U.S. 371, 378 (1940)); A. Musto Co. v. Satran, 477 F.Supp. 1172, 1176 (D. Mass. 1979); United States v. Estes, 448 F.Supp. 971, 976 (N.D. Tex. 1978)).

18. JEFFREY T. FERRIELL & EDWARD J. JANGER, UNDERSTANDING BANKRUPTCY 113 (Matthew Bender & Co. eds., 3rd ed. 2013).

19. *Id.* at 165.

20. 11 U.S.C. § 522 (2012).

21. *Id.* § 522(d)(1)–(12).

22. *Id.* § 522(b)(2)–(3)(A).

23. FERRIELL & JANGER, *supra* note 18, at 607.

24. *Id.*

25. *Id.* at 171.

26. H.R. REP. No. 109-31, pt. 1, at 46 (2005).

who have disposable income—from Chapter 7 relief.[27] Under Chapter 13, relief involves a plan to restructure debt, rather than an outright liquidation of assets.[28] The debtor relinquishes a portion of his or her future income for three to five years and in exchange, the court permits the debtor to retain all property.[29] Upon the debtor's completion of the plan, a court discharges most remaining unpaid debts.[30]

Whether under Chapter 7 or Chapter 13, the filing of a bankruptcy petition triggers the creation of the bankruptcy estate and an automatic stay to protect the estate.[31] The estate is comprised of all property in which the debtor has a legal or equitable interest, subject to certain limited exceptions.[32] The estate includes any property in which the debtor has an interest on the petition date as well as property which the debtor subsequently acquires within 180 days of the petition date, if in the form of a property settlement agreement, insurance proceeds, or an interlocutory or final divorce decree.[33] Moreover, the debtor's property interest arising from a property settlement agreement will become part of the estate in spite of any provision in the settlement agreement to restrict or condition the transfer of the debtor's interest.[34] If the debtor files for bankruptcy after the settlement agreement, section 541(c)(1) specifically overrides any settlement provision causing a forfeiture, modification, or termination of the debtor's property interest.[35]

The automatic stay is triggered at the exact moment the bankruptcy petition is filed and either time-stamped by the court or, if an electronic filing, entered on the case docket.[36] The stay serves as an injunction to prohibit creditors from any debt collection efforts without leave of the bankruptcy court.[37] The stay applies to the division of the marital estate.[38] However, the commencement or continuation of civil actions pertaining to paternity, support obligations, child custody, child visitation, domestic violence, or the dissolution of the marriage are not subject to the automatic stay.[39] The stay

27. *Id.* at 15, 46.
28. *Id.* at 10.
29. *Id.* at 79.
30. *Id.* at 295.
31. 11 U.S.C. § 362(a)(1)–(8) (2012); 11 U.S.C. § 541(a).
32. 11 U.S.C. § 362(a)(1)–(8); 11 U.S.C. § 541(a)–(c).
33. 11 U.S.C. § 541(a)(5)(B).
34. *Id.* § 541(c)(1)(A).
35. *Id.* § 541(c)(1)(B).
36. *Id.* § 362(a)(1).
37. *Id.* § 362(a)(1)–(8).
38. *Id.* § 362(b)(2)(A)(iv).
39. *Id.* § 362(b)(2)(A)(i)–(v).

does not preclude pursuit of the debtor's income for domestic support obligations.[40]

Should a divorce proceeding be ongoing at the time of a bankruptcy filing, the property division may only continue if the family law attorney moves the bankruptcy court for a lift of the stay and obtains an order from the bankruptcy court.[41] The bankruptcy court would also need to abstain from the family law matter. *Divorce is a state law issue, and the federal bankruptcy court is not the appropriate forum in which to dissolve the marital estate.*[42] *The bankruptcy court should willingly abstain from the family matter, and stay the bankruptcy case for a sufficient amount of time for the parties to complete the divorce proceeding.*[43]

Unlike earlier bankruptcy law, the modern Bankruptcy Code specifically addresses whether obligations arising from divorce may be discharged:

> Section 523(a)(5). . . . excepts from discharge a debt owed to a spouse, former spouse or child of the debtor, in connection with a separation agreement, divorce decree, or property settlement agreement, for alimony to, maintenance for, or support of such spouse or child but not to the extent that the debt is assigned to another entity. If the debtor has assumed an obligation of the debtor's spouse to a third party in connection with a separation agreement, property settlement agreement, or divorce proceeding, such debt is dischargeable to the extent that payment of the debt by the debtor is not actually in the nature of alimony, maintenance, or support of debtor's spouse, former spouse, or child.[44]

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40. *Id.* § 362(b)(2)(B)–(C).

41. *Id.* § 362(d)(2).

42. *See* Carver v. Carver, 954 F.2d 1573, 1578 (11th Cir. 1992).

> [F]ederal courts generally abstain from deciding diversity "cases involving divorce and alimony, child custody, visitations rights, establishment of paternity, child support, and enforcement of separation or divorce decrees still subject to state court modification." . . . "The reasons for federal abstention in these cases are apparent: the strong state interest in domestic relations matters, the competence of state courts in settling family disputes, the possibility of incompatible federal and state court decrees in cases of continuing judicial supervision by the state, and the problem of congested dockets in federal courts.' . . . [T]he concerns underlying this abstention doctrine are also present in bankruptcy.

Id. (first quoting Ingram v. Hayes, 866 F.2d 368, 369 (11th Cir. 1988); then quoting Crouch v. Crouch, 566 F.2d 486, 487 (5th Cir. 1978)).

43. *Id.*

44. 124 CONG. REC. H11, 32282, 32399 (daily ed. Sept. 28, 1978).

It is critical to characterize the obligation as a domestic support obligation as opposed to a property settlement obligation; Part III.C will discuss this distinction at length.

In 1994, the Bankruptcy Reform Act created an exception to discharge under 11 U.S.C. § 523 for debts arising out of a divorce decree or separation agreement that were not in the nature of alimony, maintenance, or support.[45] Congress recognized that "[i]n some instances, divorcing spouses have agreed to make payments of marital debts, holding the other spouse harmless from those debts, in exchange for a reduction in alimony payments."[46] Congress further noted that in some cases spouses agreed to lower or forego alimony based on a larger property settlement.[47] Before the Bankruptcy Reform Act, a bankruptcy court allowed the discharge of a hold harmless provision or other property settlement obligation that was not in the nature of alimony, maintenance, or support.[48] Congress noted that the creditor-spouse would be "saddled with substantial debt and little or no alimony or support."[49] In an effort to remedy this outcome, Congress made these obligations nondischargeable subject to a balancing test.[50] The obligation was nondischargeable if the debtor had the ability to pay it, and the detriment to the creditor-spouse from nonpayment outweighed the debtor's benefit from discharge.[51] However, Congress set the bar rather high, stating that "[t]he benefits of the debtor's discharge should be sacrificed only if there would be *substantial detriment* to the nondebtor spouse that outweighs the debtor's need for a fresh start."[52]

The balancing test was hugely unpopular and widely criticized by bankruptcy judges. Judge Conrad of Vermont wrote in an opinion, "[i]t has been said that one should never watch laws or sausage being made, and section 523(a)(15) of the Bankruptcy Code is no exception to that caution."[53] Even creditor-spouses, whom Congress had sought to protect with section 523(a)(15), were critical of the balancing test requirement.[54] The test invoked a literal re-litigation of the underlying divorce—a reconsideration of the relative fairness of the spouses' post-divorce standards of living.[55] The test

45. 140 CONG. REC. 142 (Oct. 4, 1994).
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* (emphasis added).
53. Kessler v. Butler (*In re* Butler), 186 B.R. 371, 372 (Bankr. D. Vt. 1995).
54. Brett R. Turner, *The Vampire Rises: Discharge of Property Division Obligations Under Chapter 13 of the Bankruptcy Code in Post-2005 Litigation*, DIVORCE LITIG., Jan. 2007, at 1, 4.
55. *Id.*

was difficult and expensive to apply, often resulting in attorney's fees larger than the award amount.[56] Further, the protection of section 523(a)(15) did not extend to Chapter 13 bankruptcies, which continued to allow the discharge of divorce obligations not in the nature of alimony, maintenance, or child support.[57]

Congress acknowledged that the balancing test was not workable, but did not wish to return to the unlimited discharge of property division obligations of pre-1994 law.[58] Congress responded with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[59] BAPCPA amended section "523(a)(15) to provide that obligations to a spouse, former spouse, or a child of the debtor (not otherwise described in section 523(a)(5)) incurred in connection with a divorce or separation or related action are nondischargeable irrespective of the debtor's inability to pay such debts."[60]

At first blush, it seems that BAPCPA has truly given teeth to the enforceability of a divorce decree in a bankruptcy case. However, section 523(a)(15) applies only to Chapter 7; it is curiously absent from the exceptions to discharge under Chapter 13.[61] Moreover, since BAPCPA aims to force debtors into Chapter 13 rather than Chapter 7,[62] Congress has not only left the door open, but arguably encourages "dishonest former spouses [to use] bankruptcy as a tool for ridding themselves of a property division obligation that they are actually able to pay."[63] As a result, a family law attorney should always anticipate that the opposing spouse may file a Chapter 13 bankruptcy case when drafting a divorce stipulation.

II. THE IMPACT OF A FAMILY LAW ATTORNEY'S KNOWLEDGE OF BANKRUPTCY LAW ON DIVORCE SETTLEMENT

Approximately 95% of all divorces settle.[64] The implication is that 95% of divorce decrees incorporate a separation stipulation that the parties negotiated. However, having a stipulation and enforcing that stipulation are

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56. *Id.*

57. Janet A. Flaccus, *Domestic Relations Lawyers Bankruptcy Reform and the Discharge of Marital-Settlement Promises*, 2005 ARK. L. NOTES 31, 32.

58. Turner, *supra* note 54, at 4.

59. *Id.* at 4, 10.

60. H.R. REP. No. 109-31, pt. 1, at 61 (2005).

61. 11 U.S.C. § 1328(a)(2) (2012).

62. H.R. REP. No. 109-31, pt. 1, at 46 (2005).

63. Turner, *supra* note 54, at 2.

64. Michele N. Struffolino, *Taking Limited Representation to the Limits: The Efficacy of Using Unbundled Legal Services in Domestic-Relations Matters Involving Litigation*, 2 ST. MARY'S J. ON LEGAL MAL. & ETHICS 166, 186 (2012).

very different concepts. Bankruptcy often augments the difference, especially regarding property division obligations in a Chapter 13 case.

Historically,

> bankruptcy [has proven a] powerful tactical weapon for frustrating the enforcement of property division orders . . . . For every case in which a debtor in bankruptcy was legitimately unable to pay a property division obligation, there was *at least* one case in which the debtor had the ability to pay and concealed it from the court, or manufactured an inability to pay for the purpose of obtaining relief in bankruptcy.[65]

As discussed above, Congress curtailed much of this abuse of the Bankruptcy Code by passing BAPCPA. Post-BAPCPA, Chapter 7 debtors are effectively precluded from discharging any divorce award, whether a domestic support obligation or a property division obligation.[66] This does not mean that a creditor-spouse will be paid.[67] It only means the debtor cannot assert that he does not legally owe the ex-spouse the debt. It is very possible, and perhaps probable, that a Chapter 7 liquidation will not produce enough funds to satisfy the entire debt to the ex-spouse.[68] In this case, other unsecured creditors will receive nothing.[69] However, the ex-spouse will maintain the legal right post-discharge to enforce the divorce stipulation and collect the debt.[70]

The situation under Chapter 13 is murkier. Further, given that "[b]ankruptcy is an immensely complex area of the law,"[71] it is not surprising that some family law attorneys misinterpret the 2005 Code amendments to render all divorce-related debts excepted from discharge.[72] However, a filing under Chapter 13 provides a debtor many opportunities to frustrate the enforcement of a divorce stipulation.[73] Understanding how to protect against discharge is difficult for family law attorneys because there are many moving parts and risks that operate simultaneously.

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65. Turner, *supra* note 54, at 2 (emphasis added).
66. *Id.* at 5; Flaccus, *supra* note 57, at 32.
67. FERRIELL & JANGER, *supra* note 18, at 345.
68. *Id.*
69. *Id.*
70. 11 U.S.C. §§ 523(a)(5), (15) (2012).
71. Colin Kreuziger, *Bankruptcy 101 for the Family Law Practitioner,* 18 FAM. L. F. 6, 6 (2009–10).
72. *Divorce and Family Law Obligations Discharged in Bankruptcy*, SCHALLER L. FIRM, http://www.schallerlawfirm.com/divorce-family-law-discharge.html (last visited Apr. 14, 2016).
73. Turner, *supra* note 54, at 5–6.

The objectives of the family law attorney are not simply to move the client further up the "food chain" of creditors, but also to protect against procedural attacks by the trustee or the debtor at that elevated status. Concerns for the family law attorney include: (1) whether the property is part of the bankruptcy estate;[74] (2) whether the client's debt is secured (position on the food chain);[75] (3) how the court will construe the nature of the debt (determination of dischargeability; domestic support obligation or property division obligation);[76] (4) the timing of the transaction creating the security agreement (preferences);[77] (5) which other creditors are also paid first (priority);[78] (6) whether a procedural attack is available to the trustee or the debtor (avoidances);[79] and (7) whether there are any defenses to procedural attacks.[80] Some defenses to these attacks include exceptions to avoidance, establishing that property was not part of the estate,[81] and proving property was held in a constructive trust.[82]

A family law attorney who does not have a basic understanding of these "moving parts," is likely to craft a divorce stipulation that is vulnerable to discharge under Chapter 13. The result is a complete undoing of the equitable division granted by the Family Court, which often leaves the creditor-spouse with nothing.

The subsequent sections of this Article aim to develop a basic understanding of the mechanics of a Chapter 13 case as related to a divorce stipulation. The Article will further provide the family law attorney with specific tools to reduce the risk of a stipulation's discharge.

III. DISCHARGEABILITY UNDER CHAPTER 13, AND STRATEGIES TO OVERCOME IT

A. Best: Property That Is Not Property of the Bankruptcy Estate

1. Award of Asset in Totality

The best way for a creditor-spouse to avoid discharge in bankruptcy is to negotiate an award such that the awarded assets do not become part of the

74. FERRIELL & JANGER, *supra* note 18, at 365.
75. *Id.* at 331.
76. 11 U.S.C. §§ 523(a)(5), (15); 11 U.S.C. § 101(14A).
77. *Id.* § 547(c)(3)(A)(i).
78. *Id.* § 507(a)(1).
79. *Id*. § 547(b).
80. *Id*. § 547(c).
81. *Id.* § 522(b)(1).
82. Davis v. Cox, 356 F.3d 76, 90 (1st Cir. 2004).

debtor-spouse's bankruptcy estate. Examples include the award of a house, pension, or automobile to one party or the other. The party will have legal title to the asset, thus extinguishing any legal or equitable interest of the other spouse in the property.[83] The key is the outright award of title or deed to a party, without an offsetting equalizing payment.

Inclusion of an equalizing payment in a divorce stipulation will likely prove fatal. Courts are likely to interpret an equalizing payment as a property settlement obligation,[84] which Chapter 13 does not except from discharge.[85] Moreover, section 541(c)(1) of the Code precludes the effect of any bankruptcy related forfeiture or modification clause included in the stipulation,[86] thus enabling courts to discharge an equalizing payment under Chapter 13. Here lies the potential for slaughter of a creditor-spouse: in the most frequent circumstance, the divorce stipulation awards the debtor-spouse the marital residence subject to an equalizing payment to the creditor-spouse. The debtor keeps the house and discharges the equalizing payment, leaving the creditor-spouse with nothing.

The family law attorney must also be mindful to perfect the transfer of the awarded asset. If the asset transferred is real property, the family law attorney must make certain that some instrument is properly recorded in the land records to perfect the transfer. Though the parties will have arrived at the property disposition by agreement, it is very possible that the debtor-spouse will refuse to effectuate a deed until the state court issues the divorce decree. Once issued, the debtor-spouse may subsequently refuse to effectuate a deed, with hopes of undoing the award in the bankruptcy forum.

In Vermont, 15 V.S.A. § 754 provides that, with respect to a divorce judgment:

> A certified copy of the judgment, or relevant parts thereof, when recorded in the land records of the town in which real estate of the parties is located, shall be effective to convey or encumber the real estate in accordance with the terms of the judgment, as if the judgment were a deed. A property transfer return shall be filed with the judgment, but the transfer shall be exempt from the taxes imposed by chapters 231 and 236 of Title 32 to the extent of the property interests conveyed to either of the parties.[87]

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83. 11 U.S.C. § 541(a)(2)(A).

84. *See id.* § 523(a)(15) (stating that an expense incurred during a divorce agreement is not dischargeable).

85. *Id.* § 1328(a)(2).

86. *Id.* § 541 (c)(1)(B).

87. VT. STAT. ANN. tit. 15, § 754 (2015).

However, the judgment is not final until the time for appeal has run.[88] The recording of the judgment in the land records will not have legal effect until the end of the appeal period.

Any delay on the part of the creditor-spouse could result in the debtor-spouse filing his bankruptcy petition prior to the recording of the property transfer in the town land records. Unless a divorce decree orders differently, the dissolution of a marriage extinguishes any joint or entireties tenancy, transforming it into a tenancy in common.[89] The debtor-spouse may attempt to include the real property in the bankruptcy estate, claiming the failure to record the transfer created, by default, his interest as a tenant in common.

Should a family law attorney fail to timely record, relief is potentially available. In many jurisdictions, the bankruptcy court would apply the theory of constructive trust and the debtor's attempt would fail.[90] The filing of a divorce complaint creates a marital estate.[91] The estate includes all of the parties' property, regardless of how acquired or titled.[92] The divorce process interrupts the chain of title.[93] Upon entering the divorce decree, the family court extinguishes the marital interest each party had in the marital estate, and redistributes the property, creating new interests in place of the old.[94] Although a divorce decree does not convey title upon entry, it does vest a party's interest in property awarded to him or her effective on the date it is entered.[95] While a debtor holds legal title to property awarded to his ex-spouse in a state court divorce decree, the debtor is deemed to be holding the property in constructive trust for the ex-spouse's benefit.[96] Constructive trusts are imposed where the circumstances are such that the person holding legal title cannot enjoy the property without violating the rules of honesty and fair dealing.[97] "[A]ny property that the debtor holds in constructive trust for another is excluded from the [bankruptcy] estate pursuant to [section] 541(d)."[98]

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88. Labelle v. Labelle, 551 A.2d 1195, 1195 (Vt. 1988) (citing VT. R. APP. P. 4).

89. Sentner v. Evans (*In re* Sentner), No. 04-11466, 2006 WL 1666193, at *2–3 (Bankr. D. Vt. Feb. 9, 2006).

90. Devenger v. Forant (*In re* Forant), 331 B.R. 151, 159–60 (Bankr. D. Vt. 2004).

91. *Id.* at 156.

92. *Id.*

93. *Id.*

94. *Id.*

95. *In re* Hutchins, 306 B.R. 82, 92–93 (Bankr. D. Vt. 2004).

96. *In re Forant*, 331 B.R. at 159–60.

97. *See* Legault v. Legault, 142 Vt. 525, 529, 459 A.2d 980, 983 (Vt. 1983) (citing Lorenz v. Rowley, 122 Vt. 480, 485, 177 A.2d 364, 368 (1962)).

98. Cadle Co., D.A.N. Joint Venture v. Mangan (*In re* Flanagan), 503 F.3d 171, 180–81 (2d Cir. 2007) (citing 11 U.S.C. §§ 541(a)(1), (d) (2006)).

However, a delay in the recording invites a trustee's attack on the transfer as a preference. If the delay results in a perfection of the lien within the 90-day period prior to the debtor's petition filing, the trustee could claim the transfer to the creditor spouse to be preferential as to other creditors.[99] Preference avoidance will be fully explored below.

Outright award of title or deed is frequently not possible; the number and nature of assets may not allow it. However, the family law attorney should try to achieve this end as creatively as possible. For example, all of the pension could be awarded to one party and all of the house to the other party.

In seeking to award an asset in totality however, the family law attorney must be cautious not to fall into the trap of using the *debts* of the marital estate to offset an unequal award of equity to a party. For example, picture a marital estate which contains a house with $50,000 of equity, $40,000 of joint credit card debt, and an I.R.A. worth $10,000. In theory, both husband and wife should leave the marriage with $10,000. ({[$50,000 + $10,000] - $40,000} ÷ 2 = $10,000.) One might be tempted to achieve the outcome of $10,000 to each party by awarding the house and the credit card debt to the husband, and the I.R.A. to the wife. This arrangement would likely not survive a Chapter 13 discharge, should the husband file for bankruptcy. Any clause in the divorce stipulation, which holds the wife harmless and indemnifies the wife from the credit card debt, would not escape discharge unless the wife could prove it was in the nature of alimony, maintenance, or support.[100] The husband's bankruptcy discharge would relieve him of any obligation to repay the credit card debt. However, the joint nature of the debt would mean that the credit card companies are able to collect the debt from the wife. In the end, the wife would possess $30,000 in debt, while the husband would possess $50,000 in equity.

a. Trustee Challenges to Asset Transfer

A divorce stipulation's award of an asset in totality to a party is probably as close to bulletproof to discharge as one can achieve. The stipulation is incorporated into a final divorce judgment issued by the state court. The state court judgment awarding the asset to the non-debtor-spouse extinguishes any

99. 11 U.S.C. § 547(b)(4)(A) (2012).

100. *See In re* Poole, 383 B.R. 308, 308 (Bankr. D.S.C. 2007) (overruling the bankruptcy court's holding that the debtor's obligation to his former wife were in the nature of debt allocation, rather than of "alimony, maintenance or support," and did not meet the statutory definition of "domestic support obligations"). *See supra* Part III.B. for discussion of the characterization of debtor's obligation to a former spouse as a domestic support obligation or property settlement.

legal or equitable interest of the debtor in the property.[101] Thus, the asset is not part of the bankruptcy estate.[102]

The debtor is barred by the *Rooker–Feldman* doctrine from having the Bankruptcy Court reconsider the award of the asset.[103] "The *Rooker–Feldman* doctrine holds that inferior federal courts lack subject matter jurisdiction 'over cases that effectively seek review of judgments of state courts and that federal review, if any, can occur only by way of a certiorari petition to the Supreme Court.'"[104] The doctrine recognizes that the United States Supreme Court has the sole authority to exercise appellate review over a state court's judicial decision.[105]

Though the outright award of an asset to a spouse is a superior award, it is not completely immune to attack. The *Rooker–Feldman* doctrine "applies only to individuals that were parties to the state-court proceeding; nonparties to the state-court proceeding cannot be bound."[106] The bankruptcy trustee—who was not a party to the state court divorce proceeding, nor in privity with any party—can bring an adversarial proceeding to avoid the transfer of the asset.[107] An adversarial proceeding is basically a lawsuit within the bankruptcy case. In such a proceeding, the trustee would be the plaintiff and the creditor-spouse would be the defendant. The trustee has two possible adversarial proceedings he may file to avoid the transfer of an asset: (1) fraudulent conveyance and (2) preference.

b. Fraudulent Conveyance

In theory, the trustee could avoid the transfer of property to the creditor-spouse as a fraudulent conveyance. Any transfer of an interest of the debtor in property, whether voluntary or involuntary, made within two years before the filing of the bankruptcy petition is avoidable if: (1) aimed to hinder, delay, or defraud creditors; or (2) the debtor received less than a reasonably equivalent value in exchange, and the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer.[108]

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101. *See* Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.").

102. 11 U.S.C. § 541(a)(1).

103. Phifer v. City of New York, 289 F.3d 49, 55 (2d Cir. 2002).

104. *Id.* (quoting Moccio v. N.Y. State Office of Court Admin., 95 F.3d 195, 197 (2d Cir. 1996)).

105. Batlan v. Bledsoe (*In re* Bledsoe), 350 B.R. 513, 516 (Bankr. D. Or. 2006).

106. *Id.*

107. Pryor v. Zerbo (*In re* Zerbo), 397 B.R. 642, 651 (Bankr. E.D.N.Y. 2008) (citing Ingalls v. Erlewine (*In re* Erlewine), 349 F.3d, 205, 210–11 (5th Cir. 2003)).

108. 11 U.S.C § 548(a)(1)(A)–(B)(ii)(I) (2012).

A trustee's attempt to avoid a state court divorce judgment's award of an asset to the creditor-spouse as a fraudulent conveyance should fail. Bankruptcy courts have held that "any award of marital property in a non-collusive dissolution proceeding conducted in accordance with state law is conclusively presumed to be in exchange for reasonably equivalent value."[109] Whether the judgment results from adjudication or a consensual settlement agreement is immaterial.[110] Absent extrinsic fraud or collusion among the divorcing parties, reasonably equivalent value is conclusively established when a marital court approves and enters a divorce decree to memorialize a consensual division of marital assets.[111]

The Second Circuit Court of Appeals has enumerated certain "badges of fraud" which can establish actual intent.[112] The nonexclusive list of "badges of fraud" includes:

> (1) [T]he lack or inadequacy of consideration; (2) the family, friendship or close associate relationship between the parties; (3) the retention of possession, benefit or use of the property in question [by the debtor]; (4) the financial condition of the [transferor] both before and after the transaction in question; (5) the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and (6) the general chronology of the events and transactions under inquiry.[113]

To be successful, a trustee's attempt to avoid a divorce decree's award of an asset to the creditor-spouse requires extrinsic evidence of these "badges of fraud."[114]

A few exceptions exist to the above holding. Courts have found that a disproportionate division of assets—coupled either with intent to keep assets from a judgment creditor,[115] or indicators of duress[116]—is sufficient to allow the avoidance of a transfer of an interest of the debtor in property. These exceptions are rare, however. Bankruptcy courts generally acknowledge that

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109. *In re Bledsoe*, 350 B.R. at 518.
110. *In re Zerbo*, 397 B.R. at 654.
111. *Id.*
112. *Salomon v. Kaiser (In re Kaiser),* 722 F.2d 1574, 1582–83 (2d Cir. 1983).
113. *Id.* (citing *In re* May, 12 B.R. 618, 627 (Bankr. N.D. Fla. 1980)).
114. *In re Zerbo*, 397 B.R. at 649, 654.
115. Dobin v. Hill (*In re* Hill), 342 B.R. 183, 188 (Bankr. D.N.J. 2006).
116. Skyles v. Stinson (*In re* Stinson), 364 B.R. 269, 275 (Bankr. W.D. Ky. 2007).

divorcing parties divide assets for many reasons other than achieving economic equivalency.[117]

> Among these are the need to adjust assets based upon ongoing custody and support of children, sentimental attachment to family heirlooms, ending the incurrence of the economic costs of the divorce proceeding itself, and, often, the necessity of bringing closure to what can be a difficult, expensive, emotional and energy-consuming process.[118]

A trustee's attempt to avoid a divorce judgment or stipulation's asset transfer as a fraudulent conveyance is unlikely to succeed. However, the wise family law attorney will consider the "badges of fraud," any substantially disproportionate asset division, and any indicators of duress during the negotiation and drafting of the stipulation.

c. Preference

An overzealous trustee may also try to avoid the transfer as a preference. To understand the rationale behind preferences, one must first understand the role of the trustee. The bankruptcy trustee is just that, a trustee of an estate, specifically the bankruptcy estate. The position is similar to a trustee of an estate in probate. The bankruptcy trustee has fiduciary duties.[119] These duties are owed both to the debtor and the creditors.[120] As a fiduciary of the estate's creditors, he has a fiduciary obligation "to collect and conserve the assets of the estate and to maximize distribution to the creditors . . . ."[121] In this regard, the trustee must further the fundamental bankruptcy policy of equitable distribution among creditors.[122] The Code "allows the trustee to exercise [his] 'strong arm' power and recover . . . assets for the benefit of all creditors . . . ."[123] The trustee's ability to avoid a transfer of an interest of the debtor in property as a preference falls within his strong-arm power.[124] The basis of a preference avoidance is that one creditor should not be favored at the expense of other similarly situated creditors.[125] The reach back period for

117. *In re Zerbo*, 397 B.R. at 654.
118. *Id.*
119. *In re* Kids Creek Partners, 248 B.R. 554, 560 (Bankr. N.D. Ill. 2000).
120. *Id.*; *In re* Moon, 258 B.R. 828, 832–33 (Bankr. N.D. Fl. 2001).
121. *In re Moon*, 258 B.R. at 832.
122. Cumberland Oil v. Thropp, 791 F.2d 1037, 1042 (2d Cir. 1986).
123. *Id.*
124. 11 U.S.C. § 547(b) (2012).
125. *Id.* § 547(b)(1).

preferential payments is 90 days prior to the petition filing, unless the recipient is an "insider," and then the period is one year.[126]

An example may prove helpful. A debtor is about to file for bankruptcy. He is three months delinquent on his Citibank Visa account, his Chase Master Card, and his Green Mountain Power electricity account. The debtor receives his paycheck. In deciding who to pay, the debtor determines that he has nothing to lose if he withholds payment from Citibank and Chase, given that he will soon be filing for bankruptcy. If he fails to pay Green Mountain Power however, his electricity will be turned off. He uses his paycheck to pay Green Mountain Power in full, and pays Citibank and Chase nothing. All three accounts represent unsecured debt; i.e., all three are unsecured creditors. However, the debtor's payment structure prefers Green Mountain Power over his credit card companies. The trustee, using his strong-arm power, can commence an adversarial proceeding against Green Mountain Power to recoup the preferential payment, and then redistribute it equally among all three unsecured creditors.

With a foundational understanding of preferences, one must now re-examine a trustee's ability to avoid a state court divorce judgment's award of an asset, in totality, to a non-debtor-spouse. When a bankruptcy petition is filed, a bankruptcy estate is created.[127] "The trustee succeeds to the property interests of the debtor, and has no more interest in property than the debtor enjoyed prior to filing the bankruptcy petition."[128] A debtor's interest in property is "created and defined by state law," not federal bankruptcy law.[129] Once the dissolution of the debtor's marriage is final under state law, the divorce decree is res judicata as to the debtor and the debtor's former spouse.[130] A "[t]rustee's ability to attack the Dissolution Decree is derivative of the Debtor's right to attack the decree," and if "the Debtor ha[s] no right on the day he file[s] his bankruptcy petition to attack the [state court's] decision regarding" the transfer of the asset, a trustee is "similarly restricted from attacking the [state court's] decision regarding" the transfer.[131] A "[t]rustee's rights with respect to the property of the estate are no more than *derivative* of the rights the Debtor ha[s] on the date he file[s] his petition."[132]

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126. *Id.* § 547(b)(4)(A)–(B).

127. *Id.* § 541(a).

128. Gresk v. Brown (*In re* Brown), 227 B.R. 875, 879 (Bankr. S.D. Ind. 1998).

129. Butner v. United States, 440 U.S. 48, 55 (1979).

130. *In re Brown*, 227 B.R. at 879.

131. *Id.*; *see also* Keller v. Keller (*In re* Keller), 185 B.R. 796, 799–800 (B.A.P. 9th Cir. 1995) ("[T]he trustee may recover a preferential transfer only where the transfer was of an interest of the debtor in property.' . . . Once dissolution has been accomplished . . . the final judgment is *res judicata* as to the division of property and is binding on the bankruptcy trustee.") (quoting 11 U.S.C.§ 547(b) (1994))).

132. *In re Brown*, 227 B.R. at 879 (emphasis in original).

A "[t]rustee must take the facts as he finds them, given that he succeeds to the property rights of the Debtor pursuant to Section 541" of the Code.[133] A trustee cannot attack a division of property allocating property between a debtor and his former spouse.[134]

A word of caution must now be offered. The above analysis hinges upon the finality of the state court's divorce judgment. A procedural morass potentially awaits if the parties' right to appeal the divorce judgment has not expired on the date of the debtor-spouse's filing of the bankruptcy petition. At the very instant that the debtor-spouse files his bankruptcy petition, the automatic stay is triggered.[135] Bankruptcy courts actually time stamp all filings to the second. The automatic stay is an injunction that freezes all assets of the bankruptcy estate, and the ability of any party to reach those assets.[136] The automatic stay specifically prohibits the commencement or continuation of any judicial proceeding against the debtor.[137] Whether the proceeding is deemed "against the debtor" depends on the debtor's status at the inception of the complaint, not the debtor's status on appeal.[138] If the debtor-spouse is the defendant in the divorce complaint, the automatic stay definitely applies. If the debtor-spouse is the plaintiff, it is uncertain. In a non-divorce context, the stay would not apply. However, section 362(b)(2)(A)(iv) of the Code states that the stay is not applicable to the dissolution of a marriage, "*except to the extent that such proceeding seeks to determine the division of property that is property of the estate*."[139] An argument could be made that section 362(b)(2)(A)(iv) trumps, and appellate review of the division of the marital estate unequivocally involves assets in which the debtor has an interest. As such, these assets are part of the bankruptcy estate.

Should this scenario arise, a family law attorney should immediately inform the bankruptcy attorney that the time to appeal the divorce judgment had not expired at the time of the bankruptcy filing. The effect of the automatic stay would likely toll the parties' time to appeal the divorce judgment in state court. Therefore, in order for the divorce judgment to become final, the bankruptcy court would likely need to follow the abstention

133. *Id.*

134. *In re Keller*, 185 B.R. at 800.

135. 11 U.S.C. § 362(a) (2012).

136. *Id.* § 362(a)(1)–(8).

137. *Id.* § 362(a)(1).

138. Assoc. of St. Croix Condo. Owners v. St. Croix Hotel Corp., 682 F.2d 446, 449 (3d Cir. 1982); *see also* Koolik v. Markowitz, 40 F.3d 567, 568 (2d Cir. 1994) ("This Court has recognized that the automatic stay is applicable only to proceedings 'against,' 11 U.S.C. § 362(a)(1), the debtor. . . . Whether an action or proceeding is 'against' the debtor is determined by the posture of the parties at the commencement of the action or proceeding, not by which party has initiated the appeal.") (citations omitted).

139. 11 U.S.C. § 362(b)(2)(A)(iv) (emphasis added).

doctrine and stay proceedings until the divorce is final, and the bankruptcy attorney would need to move the court to do so.

As previously discussed, divorce is a state law issue, and the federal bankruptcy court is not the appropriate forum to dissolve the marital estate.[140] The bankruptcy court should willingly abstain from the family matter and stay the bankruptcy case for a sufficient amount of time for either: (1) the parties to complete appellate review of the divorce judgment, or (2) the time for such appeal to run.[141]

Failure to address the issue that the divorce judgment is not yet final could potentially result in appeals within the bankruptcy forum. The bankruptcy court will have made its determinations based on the assumption that the divorce judgment is final. Either party, if unhappy with the court's rulings, would be able to appeal to the Bankruptcy Appellate Panel, asserting that the court's reasoning was unsound, given that the divorce was still ripe for appeal in state court.

2. Quitclaim Deed in Exchange for Cash

One means of avoiding the risks associated with an equalizing payment is a cash buyout. As most family attorneys are aware, one spouse immediately buying out the other spouse's property interest is rarely feasible. However, should the rare circumstance arise, a payment made in exchange for a quitclaim deed at the time of the execution of the divorce stipulation should withstand a bankruptcy challenge. No property interest due to the creditor-spouse, or debt obligation owed to the creditor-spouse, enters the bankruptcy estate. Avoidance of the payment as a fraudulent conveyance would not succeed for the reasons previously discussed. A preference challenge similarly would fail because the payment would not have been on account of antecedent debt,[142] and would also be a contemporaneous exchange for new value given to the debtor.[143] Lastly, the debtor would have no ability to assert a homestead exemption since that exemption only pertains to *liens* on the homestead.[144] Homestead exemptions are discussed below in Part III.A.3.

140. Carver v. Carver, 954 F.2d 1573, 1578 (11th Cir. 1992).
141. *Id.*
142. 11 U.S.C. § 547(b)(2).
143. *Id.* § 547(c)(1)(A).
144. *Id.* § 522(f).

3. Part In and Part Out: Tenancy in Common Used as Security

A property held as tenants in common would only enter the bankruptcy estate to the extent of the debtor's interest in the property.[145] The portion held by the non-debtor-spouse would not become part of the estate. As previously discussed, a debtor can claim exemptions under the Code or state law, so as to protect his assets from creditors.[146] In theory, a debtor might try to use his homestead exemption to thwart the transfer of a portion of the homestead to the creditor-spouse pursuant to the divorce decree. However, a debtor's right to assert a homestead exemption upon his interest in the property is defined by state law.[147] In Vermont, "the homestead exemption does not apply in the context of divorce."[148]

A divorce stipulation could be worded so that a property shall be owned as tenants in common until such time that the husband pays the wife an equalizing payment. Upon receipt of the payment, the wife's tenancy shall be extinguished. Should payment not be made within one year of the decree, the property shall be sold, with each party receiving a proportionate share of the proceeds in conformity with the party's co-tenant share of the property.[149]

The debtor would not be able to discharge this obligation in a Chapter 13 case. The husband's tenancy would enter the estate, but only to the extent of his legal or equitable interest. That interest is defined by the family court's divorce decree. The husband would be able to exercise his homestead exemption against third-party creditors, but not against his former wife. The husband's pro-rata share of the proceeds from the sale of the property would return to the bankruptcy estate. The estate would therefore not be depleted by the sale.

However, the family law attorney would need to make certain that sufficient equity existed in the property to compensate the wife. For example, assume that an equitable division of property requires a cash payment to the wife of $160,000 in exchange for award of the house and other assets to the husband. The house has not been appraised, but the parties have agreed that it is worth $250,000, subject to a mortgage of $50,000. Based upon the perceived equity of $200,000, the family law attorney secures the $160,000 payment to the wife with an 80% tenancy in common. The husband fails to make the payment to wife, so the wife forces the sale of the house. Soon the parties realize that the market will not substantiate a value of $250,000.

145. *Id.* § 541(a)(2)(A).
146. *Id.* § 522(b)(2)–(3)(A).
147. *In re* Evans, 51 B.R. 47, 49 (Bankr. D. Vt. 1985).
148. Pearson v. Pearson, 169 Vt. 28, 37, 726 A.2d 71, 76 (Vt. 1999).
149. 26 U.S.C. § 1041(c)(1).

Rather, the house sells for $190,000. The wife's 80% share, after the mortgage is paid, is only $112,000, a far cry from the $160,000 contemplated award. One might argue that the difference is mitigated by the fact that the parties should share the depreciation of the house. This is true. However, to the extent that a tenancy in common in the house is used as security for other assets, the wife will be short-changed.

As in the above example, one advantage to a tenancy in common is the flexibility of the ownership percentage. The tenancy could be established with a percentage to the wife that accounts for any equitable amount due to her from the division of the marital estate.

B. Better: Part of the Estate But Secured

The Bankruptcy Code categorizes claims as secured or unsecured.[150] Secured creditors have senior priority over the bankruptcy estate's assets, and are entitled to have their interests in the debtor's property protected during the pendency of the case.[151] To be deemed "secured," a claim must carry some interest in the debtor's property, usually a lien.[152] Section 101(37) of the Code defines lien as a "charge against or interest in property to secure payment of a debt or performance of an obligation."[153] A lien may be consensual (like a mortgage) or involuntary (like a judicial lien).[154] A lien holder not only has a claim for money, but "also has a right to use the specific property to satisfy the . . . claim."[155] However, the "claim is secured only to the extent of the value of the debtor's interest in the property that secures the claim."[156] One must remember that state law defines the debtor's interest in property.[157]

Within the context of divorce, both mortgages and judicial liens may be used to secure support obligations or property division obligations. By securing the obligation with a debtor's interest in property, the family law attorney elevates the creditor-spouse's position on the food chain of creditors. If completed effectively, the creditor-spouse will be almost certain to collect the debt. However, if done ineffectively, the debtor or trustee may avoid the lien, or the court may classify the claim as wholly or partially unsecured.

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150. FERRIELL & JANGER, *supra* note 18, at 331.
151. *Id.* at 331–32.
152. *Id.* at 332.
153. 11 U.S.C. § 101(37) (2012).
154. FERRIELL & JANGER, *supra* note 18, at 332.
155. *Id.*
156. *Id.*
157. Butner v. United States, 440 U.S. 48, 55 (1979).

1. Mortgage

A mortgage is a slightly superior security interest over a judicial lien. Unlike a judicial lien, (1) a debtor is not able to assert his homestead exemption against a mortgage, and (2) a mortgage is generally beyond the trustee's strong-arm power to avoid as a preference or fraudulent conveyance.[158]

Under the Bankruptcy Code, a debtor is able to exempt certain property from the estate.[159] One of the exemptions available to the debtor is a homestead exemption.[160] The exemption under the Code is $22,975.[161] A debtor may however, choose to use state exemptions, rather than federal exemptions.[162] Some states, like Florida and Texas, permit a debtor to exempt millions of dollars of real estate.[163] The Code permits a debtor to "avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled . . . ."[164] However, mortgages are excepted from the debtor's avoidance power.[165] Given that a mortgage is a contractual lien, a strong public policy interest favors making a debtor's exemption rights subordinate to the mortgage holder's rights.[166] If a debtor were permitted to avoid his mortgage, the Code would enable the debtor to purchase a home and, depending on state law, either discharge his mortgage completely, or substantially increase his equity in the property. Lenders would therefore be reluctant to offer mortgages, or alternatively require large down payments.[167] As a result, many people would be precluded from borrowing money for a home.[168] Moreover, in Vermont, a debtor may not exercise his homestead exemption in the context of divorce.[169] State law, not federal law, defines the interest of a debtor in property.[170] The homestead exemption will not shield the debtor's interest, borne of a state divorce decree, from the decree's terms to protect the creditor-spouse.

158. 11 U.S.C. §§ 522(f)(1), 544(a)(3).
159. 11 U.S.C. § 522(b)(1).
160. *Id.* § 522(d)(1).
161. *Id.* (adjusted for inflation pursuant to "Adjustment of Dollar Amounts" in section 522).
162. *Id.* § 522(b)(2)–(3)(A).
163. FERRIELL & JANGER, *supra* note 18, at 403.
164. 11 U.S.C. § 522(f)(1).
165. *Id.* § 522(f)(2)(C).
166. FERRIELL & JANGER, *supra* note 18, at 432.
167. *Id.*
168. *Id.*
169. Pearson v. Pearson, 169 Vt. 28, 37, 726 A.2d 71, 76 (Vt. 1999).
170. Butner v. United States, 440 U.S. 48, 55 (1979).

A mortgage is also shielded from the trustee's ability to avoid as a preference. In order to be considered a preference, a transfer must be for, or on account of, an antecedent debt owed by the debtor before such transfer was made.[171] The creation of a security interest in the property, arising from the divorce stipulation's mortgage, is a transfer on account of a *new* property interest that the debtor acquires. Hence, the requirements for a preference are not met, and the mortgage may not be avoided.

However, a dilatory family law attorney may cause a preference to become a self-fulfilling prophecy. In order to perfect the lien, the family law attorney must make certain to accurately describe the property as collateral in the mortgage and record the mortgage in the town land records within 30 days of the execution of the instrument.[172] If recorded within 30 days, the transfer of the security interest will be deemed to have been made at the time the mortgage was signed.[173] Should the family law attorney fail to perfect the mortgage within 30 days, the transfer of the security interest will be deemed to have been made at the *time of perfection*, rather than the time the mortgage was signed.[174] However, the debt will have been created upon the signing of the mortgage and the settlement agreement, and by the issuance of the divorce decree.[175] Further, the Code presumes the debtor to be insolvent on and during the 90 days immediately preceding the date of the filing of the bankruptcy petition.[176]

Thus, if a mortgage securing an equalizing payment is perfected 30 or more days after the execution of the mortgage, and the perfection occurs within 90 days of the filing of the bankruptcy petition, all of the requirements of preference will be met. The transfer will: (1) benefit the creditor; (2) be on account of an antecedent debt; (3) be made while the debtor was insolvent; and (4) be made on or within 90 days before the filing of the petition.[177] The trustee may avoid the transfer of the security interest.[178] The creditor-spouse

171. 11 U.S.C. § 547(b)(2)(2012).

172. *Id.* § 547(c)(3)(A)(i).

173. Goodman v. S. Horizon Bank (*In re* Norsworthy), 373 B.R. 194, 198 (Bankr. N.D. Ga. 2007).

174. *Id.* (citing Johnson v. Flanders (*In re* Puckett), No. 05-17481, 2006 WL 2089907, at *2 (Bankr. E.D. Tenn. June 26, 2006).

175. The divorce decree's distribution of the real property to debtor is analogous to a bank's distribution of cash to debtor. *Compare id.* at 199 (finding that the "date on which a security deed becomes effective against a bona fide purchaser is the date on which it is filed, not the date on which it was recorded"), *with In re Puckett*, 2006 WL 2089907, at *2 (finding an antecedent debt because "the debt was incurred when the Demand Note was signed . . .").

176. 11 U.S.C. § 547(f).

177. *Id.* § 547(b)(1)–(4).

178. *Id.* § 547(b).

will be left with an unsecured property settlement obligation dischargeable under Chapter 13.[179]

In regard to fraudulent conveyance, any attempt to avoid the transfer of the security interest of the mortgage should fail. As previously discussed, "absent extrinsic fraud or collusion among the divorcing parties, the division of marital assets which is agreed to by the parties, and is contemporaneously or subsequently approved by a matrimonial court, and incorporated into a divorce decree, conclusively establishes reasonably equivalent value."[180] Unlike an award of an asset in totality, the transfer of a security interest will not have the extra layer of protection afforded by a constructive trust. Therefore, it is crucial that the family law attorney perfect the mortgage by recordation in the town land records.

A final warning must be offered in regard to the use of a mortgage to secure an equalizing payment: simply executing and recording a mortgage will not necessarily achieve the sought-after security. The Bankruptcy Court is going to analyze the obligation in relation to the value of the asset securing the mortgage. Should the family law attorney create an under-secured mortgage, trouble awaits. An example might best illustrate this scenario.

Assume that a husband and wife have a house valued at $200,000 with a first mortgage of $150,000. The couple also has unencumbered automobiles and personal property worth $100,000. The total net worth of the marital estate is $150,000 ($200,000 - $150,000 + $100,000 = $150,000). An equitable division requires each party to receive $75,000. The wife wants to "cash out" and leave the husband with all the assets. The husband states that he needs some time to raise the $75,000. A divorce stipulation is drafted wherein the husband agrees to pay the wife $75,000 and executes a second mortgage on the house to the wife to secure this obligation to her. The wife's attorney records the mortgage in the town land records. After the family court issues the decree, the husband files a Chapter 13 petition.

Assume moreover that the trustee determines that the home only provides sufficient equity to secure $50,000 of the wife's $75,000 mortgage. The trustee will sever the wife's secured claim, creating a $50,000 secured claim and a $25,000 unsecured claim.[181] The secured claim will survive discharge. The unsecured claim, given that it will likely be viewed to be a property settlement obligation, will not.

Therefore, it is paramount that the family law attorney makes certain that sufficient equity exists in the asset used for a mortgage's security interest. The family law attorney must also be aware that post-petition interest will

179. *Id.* § 1328(a)(2).

180. Pryor v. Zerbo (*In re* Zerbo), 397 B.R. 642, 654 (Bankr. E.D.N.Y. 2008).

181. FERRIELL & JANGER, *supra* note 18, at 334.

not accrue unless the mortgage is over-secured (i.e., surplus equity).[182] Further, the Court has the power to restructure the mortgage; for example, by elongating the repayment period and lowering the interest rate.[183]

2. Judicial Lien

Every family law attorney should appreciate the United States Supreme Court's ruling in *Farrey v. Sanderfoot*.[184] The Supreme Court effectively accomplished what Congress failed to do in section 1328(a)(2) of the Code. Through *Sanderfoot*, the Court cleared a path to the enforcement of an equalizing payment in the nature of a property obligation under Chapter 13.[185] A family law attorney must take the necessary steps down said path, but this is easily accomplished.

Our discussion must begin with the definition of "judicial lien" under the Code. A judicial lien is a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding."[186] In Vermont, a judicial lien may be created by recording in the town land records a certified copy of a final judgment issued in a civil action.[187]

A *timely* recorded judicial lien,[188] for the same reasons as with a mortgage, would likely withstand an attempt to avoid the lien as a preference or fraudulent conveyance. However, a judicial lien is open to an additional attack pursuant to 11 U.S.C. § 522(f). A "debtor may avoid the fixing of a [judicial] lien to the extent that such lien impairs an exemption to which" he would otherwise be entitled.[189]

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182. *Id.* at 335.

183. *Id.* at 334.

184. Farrey v. Sanderfoot, 500 U.S. 291 (1990).

185. *Id.* at 300–01.

186. 11 U.S.C. § 101(36) (2012).

187. VT. STAT. ANN. tit. 12 § 2901 (2015) ("A final judgment issued in a civil action or a restitution order entered under 13 V.S.A. § 7043 shall constitute a lien on any real property of a judgment debtor if recorded as provided in this chapter."); VT. STAT. ANN. tit. 12 § 2904 (2015).

> A judgment creditor may record a judgment lien at any time within eight years from the date the judgment becomes final in the town clerk's office of any town where real property of the debtor is located. Recording shall consist of filing a copy of the judgment with date when it became final, certified by the clerk of the court issuing the judgment. The certification shall be recorded by the town clerk in the land records.

Id.; *see also* Branton v. Gen. Elec. Credit Auto Lease, Inc. (*In re* Branton), 24 B.R. 44, 45 (Bankr. D. Vt. 1982) (explaining that a lien created by recording a judgment is a "judicial lien" that may be avoided if it impairs an exemption).

188. *See* 11 U.S.C. § 547(e)(2)(A) (stating that a transfer is made if the lien is perfected within 30 days of the transfer).

189. *Id.* § 522 (f)(1).

Historically, debtor-spouses used this avoidance power to rid themselves of liens placed on their homesteads that secured equalizing payments. Recognizing the injustice of the power, the Supreme Court in *Sanderfoot* slammed the door on a debtor-spouse's ability to avoid a lien borne of a divorce judgment.[190] The Court held that a debtor must possess the interest to which a lien attached before it attached, in order to avoid the fixing of the lien on that interest.[191]

Vermont bankruptcy courts have held that "[a] divorce proceeding under 'Vermont law sweeps every asset . . . into a marital estate, and then redistributes the property of that estate to the divorced parties.'"[192] Further, "[a] divorce estate contains all the parties' property, no matter how the parties acquired [it], with the caveat that actual title is immaterial."[193] "'The nature of the process [itself] interrupts the chain of title.'"[194] "Upon entering the divorce decree, the family court 'extinguishe[s] the marital interest each party had in the marital estate, and redistribute[s] the property, creating new interests in place of the old.'"[195]

The mere entry of a divorce decree by a Vermont state court reconfigures the parties' interests in the marital estate and creates new ones.[196] The same divorce decree that awards a fee simple to the debtor-spouse, *simultaneously* grants a lien to the creditor-spouse.[197] In this scenario, the lien does not attach to an interest that the debtor possessed before it attached, but a newly created interest. The debtor may not avoid the lien. The equalizing payment secured by the lien will survive and remain enforceable.

The lesson to be gleaned from *Sanderfoot* is to record a certified copy of the divorce judgment in the town land records. The family law attorney should do this on the day following the appeal period, literally the next day at 8:00 AM. And should the debtor file a bankruptcy petition before the time to appeal has run, the family law attorney should immediately notify the bankruptcy attorney. The bankruptcy attorney must ask for a lift of the stay for the appeal period to run plus one day.[198] The lien may then be perfected. Failure to perfect the lien will result in an unsecured property obligation that

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190. *Farrey*, 500 U.S. at 299.

191. *Id.* at 301.

192. *In re* Hutchins, 306 B.R. 82, 92 (Bankr. D. Vt. 2004) (quoting *In re* Farrar, 219 B.R. 48, 52 (Bankr. D. Vt. 1998)).

193. *Id.*

194. *Id.* (quoting *In re Farrar*, 219 B.R. at 52).

195. *Id. (*quoting *In re Farrar*, 219 B.R. at 54).

196. *Id.*

197. Farrey v. Sanderfoot, 500 U.S. 291 (1990).

198. This Author would suggest moving the court for relief from stay for a specific number of days so as to avert alerting the debtor to the creditor-spouse's intention of filing the lien.

will be discharged under Chapter 13.[199] Should the court grant relief from stay only for the exact period to appeal, the Author would recommend filing the certified copy of the decree at the close of business on the final day of the appeal period, and pray for equitable treatment in the bankruptcy forum. It may actually prove effective. If the recordation occurs after the appellate court is closed, and the family law attorney asks the town clerk to record the time on the recordation of the certified decree, an argument could be made that the debtor's time to appeal had run, the judgment was final, and the lien was therefore perfected.

C. Good: Unsecured but Top Priority

In regard to unsecured obligations, a creditor-spouse dragged into a Chapter 7 case has far less about which to be concerned than if he or she were dragged into a Chapter 13 case. Under Chapter 7, both domestic support obligations and divorce-related property division obligations are excepted from discharge.[200] To the extent that these obligations require cash payment from the debtor-spouse to the creditor-spouse, the claims are unsecured but non-dischargeable. Domestic support obligations receive first priority.[201] The property division obligations will fall into the general unsecured creditor pot.[202] Once the estate is liquidated, funds will pay secured creditors first.[203] Any remaining funds will be distributed to unsecured creditors in the order of their priority.[204] Each priority level must be fully satisfied before distribution may proceed to the next lower priority level.[205] The general unsecured creditor pot is the bottom of the barrel, with creditors hungrily pouncing on any morsel thrown in their direction. The morsels, if any at all, are typically few and far between. Most general unsecured creditors, whether under Chapter 7 or Chapter 13, will be discharged in whole or in part.

The non-dischargeability of support and property obligations does not in any way guarantee payment during the pendency of the Chapter 7 case. It simply means that the creditor-spouse will rise from the dust of the liquidation process with her claim intact, not subject to the Code's post-discharge injunction against recovery.[206] The creditor-spouse may thus return

199. *See generally* 11 U.S.C. § 1328(c) (2012).
200. *Id.* §§ 523(a)(5), (a)(15).
201. *Id.* § 507(a)(1).
202. FERRIELL & JANGER, *supra* note 18, at 310.
203. *Id.* at 331.
204. *Id.* at 310.
205. *Id.*
206. 11 U.S.C. §§ 524(a)(2), (a)(3), (b)(2)(A).

to state court to garnish wages, liquidate the homestead, or pursue other remedies.

The scenario under Chapter 13 is dramatically different. While domestic support obligations are excepted from discharge, property settlement obligations are not.[207] A creditor-spouse holding an unsecured equalizing payment (for example a hold-harmless provision on credit card debt, or a cash offset for equity in the marital home), will likely be thrown into the bottom-feeding, general unsecured creditor pool, praying for some morsel to be cast her way. It is highly possible, even probable, that she will be fully discharged. Any equitable division of the marital estate contemplated by the parties and the family court will be completely undone.

Division of the marital estate is no simple task. Often the nature and limited number of marital assets is such that an equalizing payment or other "property" payment is inescapable. The role of the family law attorney is to characterize these payments as domestic support obligations, rather than property settlement obligations. While difficult, such characterization is not impossible.

The Code defines "domestic support obligation" as a debt "in the nature of alimony, maintenance, or support . . . of [a] spouse, former spouse, or child of the debtor or such child's parent," or a support obligation established by a "separation agreement, divorce decree, or property settlement agreement."[208] Though state property law determines a debtor's interest in property,[209] federal bankruptcy law determines whether a debtor's obligation is a domestic support obligation or a property settlement obligation.[210] The bankruptcy court is not bound by the findings of the state family court.[211] Nor do the labels in the parties' separation agreement bind the bankruptcy court.[212] Section 101(14A)(B) of the Code mandates the bankruptcy court make the determination "without regard to whether such debt is expressly so designated."[213] However, labels do matter. A label of alimony, maintenance, or support creates a presumption that the parties intended the obligation to be just that.[214] The "underlying purpose of the debt assumption" is the critical

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207. *See id*. § 1328(a)(2) (stating that § 523(a)(15) is not part of the enumerated list of exceptions from discharge).

208. *Id.* § 101(14A)(B)–(C)(i).

209. Butner v. United States, 440 U.S. 48, 55 (1979).

210. Brody v. Brody (*In re* Brody), 3 F.3d 35, 39 (2d Cir. 1993).

211. *Id.*

212. Tsanos v. Bell (*In re* Bell), 47 B.R. 284, 287 (Bankr. E.D.N.Y. 1985).

213. 11 U.S.C. § 101(14A)(B).

214. *See* Forsdick v. Turgeon, 812 F.2d 801, 802–03 (2d Cir. 1987) (stating that a state court referee's label of $100,000 as "non-modifiable alimony," while not determinative, is compelling for a bankruptcy court to find that the amount does constitute alimony); *see also* Sorah v. Sorah *(In re* Sorah*)*,

factor; i.e., "whether the debts were assumed in lieu of regular alimony," maintenance, or support payments "or only as a means of dividing property."[215] Therefore, "'the intent of the parties at the time a separation agreement is executed determines whether a payment pursuant to the agreement is alimony, support or maintenance.'"[216] "The key time is the date of the divorce decree because 'federal courts should not be in the position of modifying the matrimonial decrees of state courts, thus interfering with the delicate state systems for dealing with dissolution of marriages and the difficult and complex results that flow therefrom.'"[217] All evidence, direct or circumstantial, which tends to illuminate the parties' subjective intent is relevant.[218] The creditor-spouse has the burden of showing that the parties intended the claim to be in the nature of alimony, maintenance, or support.[219]

Courts look to many factors in attempting to ascertain this mutual intent.[220] These factors include but are not limited to:

> (1) The nature of the obligations assumed; necessities indicating the agreement is more in the nature of alimony; (2) [t]he structure and terms of the contract-*i.e.*, does the agreement evidence an intent or purpose to grant alimony; (3) [w]hether the agreement includes a provision for the support of children; (4) [t]he relative earning power of the spouses; (5) [t]he parties' negotiations and understandings of the provisions; (6) [t]he reasonableness of the assumption given the financial condition of the debtor; (7) [w]hether there was a division of property and a division of the debts relating to that property; (8) [w]hether the former spouse was shown to have suffered in the job market, or was otherwise disadvantaged because of any dependent position held in relation to the debtor during the marriage; and (9) [t]he age and health of the former spouse.[221]

Courts have also considered:

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163 F.3d 397, 401 (6th Cir. 1998) (finding that the bankruptcy court did not give the state court's award, labeled as "alimony," sufficient deference when the bankruptcy court conducted an independent analysis).

215. *In re Bell*, 47 B.R. at 287.

216. Rockstone Capital, LLC v. Metal, 508 B.R. 552, 560 (E.D.N.Y. 2014) (quoting *In re Brody*, 3 F.3d at 38).

217. *In re* Dudding, No. 10-10557, 2011 WL 1167206, at *9 (Bankr. D. Vt. Mar. 29, 2011) (quoting *Forsdick,* 812 F.2d at 802–03).

218. *In re Brody*, 3 F.3d at 38.

219. *Rockstone*, 508 B.R. at 559–60.

220. *Id.* at 560.

221. *In re Bell*, 47 B.R. at 287.

> (1) [W]hether the obligation terminates on the death or remarriage of either spouse; . . . [(2)] whether the payment is due in a lump sum or over time; [(3)] whether the payments are to be made directly to the former spouse or to a third party; . . . [(4)] whether an assumption of a debt or creation of an obligation has the effect of providing the support necessary to ensure that the daily needs of the former spouse and any children of the marriage are met; and [(5)] whether an assumption of debt or creation of an obligation has the effect of providing the support necessary to ensure a home for the former spouse and any minor children.[222]

Some law review articles wrongfully conclude that all hold-harmless provisions and unsecured obligations to a former spouse are outside the scope of domestic support obligations, and thus dischargeable under a Chapter 13.[223] This is not true. Actually, courts have held that a debtor's obligation to pay joint marital debt to a third party combined with a hold-harmless or indemnification clause to the ex-spouse to be a domestic support obligation if certain conditions are met.[224] Courts have also held mortgage payments,[225] divorce related attorney's fees,[226] daycare expenses,[227] and automobile payments[228] to be domestic support obligations.

Case law makes clear that "intent" rules the day in the characterization of a divorce award as a domestic support obligation versus a property settlement obligation.[229] The family law attorney must see herself as an investigator and an advocate when embarking on the task of discerning and expressing the parties' intent.

The family law attorney must clearly state and demonstrate that any unsecured payments or lump sum payments are made "in lieu of alimony, maintenance or support." Detail is imperative. Explain how the payments

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222. *In re Dudding*, 2011 WL 1167206, at *6.

223. Debra L. Leahy, *BANKRUPTCY UPDATE: The Chapter 13 "Super" Discharge and Non-Support Marital Debt*, VT. B.J., Spring 2006, at 48, 48.

224. *See In re Dudding*, 2011 WL 1167206, at *9 (finding "the Debtor's obligation to pay the Wells Fargo debt is a domestic support obligation and is entitled to . . . protections"); *see also* Pauley v. Spong (*In re* Spong), 661 F.2d 6, 9–10 (2d Cir. 1981) (determining that the nature of the debt was more important than the identity of the payee).

225. *See* Kubera v. Kubera, 200 B.R. 13, 17 (W.D.N.Y. 1996) (stating that bankruptcy courts look at the "substance of the liability" when determining that mortgage payments for a family's shelter is a support obligation).

226. *In re* Rogowski, 462 B.R. 435, 446–47 (Bankr. E.D.N.Y. 2011).

227. Rouse v. Rouse (*In re* Rouse), 212 B.R. 885, 889 (Bankr. E.D. Tenn. 1997).

228. *See* Milner v. Milner (*In re* Milner), 347 B.R. 466, 470 (Bankr. W.D.N.Y. 2006) ("Courts have generally treated reasonable transportation expenses as a necessary component of maintenance and support.").

229. *In re Dudding*, 2011 WL 1167206, at *6 (quoting *In re* White, 408 B.R. 677, 681 (Bankr. S.D. Tex. 2009)).

will allow the creditor-spouse to meet her daily necessities; focus on shelter, food, and reasonable transportation expenses. Link the payments to an income disparity should one exist. Include a requirement in the divorce stipulation that the debtor-spouse must maintain a life insurance policy to cover the outstanding debt until satisfied. Recount the parties' negotiations. Explain that the parties contemplated the need for alimony and support but selected the present arrangement to achieve a final separation: a separation that would not require ongoing contact between the parties. The family law attorney must creatively and meticulously illustrate that the parties intended the award in the settlement agreement to be in the nature of alimony, maintenance, or support. Whether the court will find it to be so is uncertain, but it is the task of the attorney to tip the scale in the direction of such a finding.

CONCLUSION

A creditor-spouse whose debt is discharged in bankruptcy can be left destitute. The equitable division of property contemplated by the settlement agreement implodes, and any concept of a post-divorce fresh start is dashed. He or she may have relinquished an interest in the marital residence and now be unable to secure a residence of his or her own. He or she may be unable to satisfy her monthly debts and be forced into bankruptcy. For the discharged creditor-spouse, it is not simply his or her spouse who has failed, but the judicial system as well. Assuredly the discharged creditor-spouse will conclude that the system allows the ex-spouse to legally perpetrate fraud.

A family law attorney can do much to avoid this outcome. While dissolution of the marital estate may prove challenging, many safeguards may be drafted in the divorce stipulation to mitigate or avert the damage associated with bankruptcy discharge. Therefore, a family law attorney must craft a divorce stipulation with an eye towards a potential bankruptcy. For example, had the attorney in *Fitzgerald v. Fitzgerald* secured the equalizing payment with a mortgage, or maintained the property as tenants in common until such time as Sandra received the equalizing payment, Sandra would have been spared from slaughter. A family law attorney must always craft a divorce stipulation with an eye towards a potential bankruptcy, including safeguards to mitigate the damage associated with bankruptcy discharge.