

The Intersection of Bankruptcy and Family Law

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Overview

What is (Consumer) Bankruptcy?

- Bankruptcy is the process in which consumers can eliminate or repay some or all of their debts under the protection of the federal bankruptcy court.
- There are two basic types of consumer bankruptcy:
 1. Chapter 7 (“Liquidation”)
 2. Chapter 13 (“Wage Earner”)

Filing bankruptcy generally enables a “fresh start” for debtors.

When Should Someone File?

- **There's no clear answer to this question. Generally, when debts become so insurmountable that they cannot be reasonably paid back, it may be time to consider filing.**
- **But it should be closer to a last resort instead of a first.**

- **Why should it be closer to a last resort?**

1. **It's damaging to your credit. It can be reported for up to 10 years.**

- **Of course, if you're far behind in payments, then your credit may already be shot.**

2. **You may be able to negotiate the debt down without filing.**

- **Once credit card companies know a debtor will file, they're often more likely to negotiate the debt down, sparing the debtor from having to file.**

3. **The debt, although onerous, may not be insurmountable.**

- **Some people may feel that their debt is harder to tackle over time, when a payment plan may suffice.**

4. **The timing may not be right.**

- **If the debtor is likely to incur more debt, filing now won't really save him.**

When Should Someone File (cont.)?

- **Does the client need to file NOW?**
 - **Maybe not. If he is going to incur more debt (say, impending medical expenses or continued unemployment), then why not wait to wrap all the debts into one package?**
 - **Here are some “red flags” for filing sooner rather than later:**
 - **Impending foreclosure**
 - **Impending repossession**
 - **Impending garnishment**
 - **Client can't stand continued creditor harassment**

Some basics first:

- Before we get into talking about bankruptcy types (and features), let's talk about really fundamental things:
 1. Assets
 2. Debts

Assets

- **Assets include virtually anything, in almost any form, that a debtor has an ownership interest in.**
- **Common examples:** home (even with a mortgage), car, clothing, bank accounts, retirement accounts, social security disability claims, potential personal injury claims, tax returns not yet received.

What is an “exempt” asset?

- **Exemptions are those assets that are protected from creditors.**
 - They are defined by state and/or federal law.
 - Under 11 USC § 522(m), exemptions may be claimed by each debtor individually (so the exemption amount may be “doubled”).
 - BUT, in Washington, you cannot double the homestead exemption.

Debts

- **A debt is any liability on a claim (i.e., any liability or obligation that a creditor can file a claim on).**

Types of Debts

- **There are three basic categories of debts:**
 1. **Secured debt**
 2. **Priority (unsecured) debt**
 3. **Unsecured debt**

Secured Debts

- **Secured debts are those debts that are “secured” by some kind of collateral (by way of lien).**
 - **Examples – mortgage, car loan, your soul (if you’re Dr. Faustus, kind of).**
 - **Secured debts have two components:**
 - A. **The debt**
 - B. **The lien**

Unsecured Debts

- Those debts that are not secured by collateral.
- Examples include: credit card debt, medical bills, personal loan from Uncle Joe.
 - They can also include debts that were once secured but are no longer (i.e., “lien-stripped”).

Priority (Unsecured) Debts

- **Priority debts are those debts that by function of law survive the bankruptcy.**
- **Examples:** domestic support obligations, taxes, unreturned rental deposits, those debts deemed improper (fraud, intentional and malicious, personal injury claims stemming from drunk driving), etc.

Wait, what is a domestic support obligation?

- A “domestic support obligation” is any debt incurred before or after a bankruptcy filing that is owed to or recoverable by a spouse, former spouse, child or governmental unit; in the nature of alimony, maintenance or support; and established pursuant to the terms of a divorce decree, separation agreement, property settlement agreement, court order or administrative determination.

What counts as a domestic support obligation?

- The usual suspects: child support, maintenance, etc.
- But some other things too: opposing attorney's fees incurred during a family law proceeding; professional fees related to children (like GAL fees); educational expenses of a minor child; medical insurance coverage for a minor child; and life insurance, with the minor children as beneficiaries.

Types of Consumer Bankruptcy

- There are generally two basic types of consumer bankruptcy when it comes to pro bono/low income clients: chapter 7 and chapter 13.

1. Chapter 7 -

- Those assets that aren't protected by law (i.e., "exemptions"), can be sold to pay down debts.
- But those debts that can be discharged (i.e., erased), will be.

Types of Bankruptcy (cont.)

2. Chapter 13 –

- If the debtor earns an income (and income is broadly defined), the debtor pays back a portion or all of his debts, including unsecured debts.

- The amount paid back depends on the “disposable income” of the debtor.

(No, the debtor doesn't get to really decide what's “disposable”).

What types of debt can be discharged in a chapter 7?

- **Unsecured debts (those debts not attached to collateral):**
 - Credit card debts, medical bills, personal (and other unsecured) loans.
 - Sometimes secured debts (those debts attached to collateral, like a mortgage or car payment). If the debtor lets the property go, any lingering debt becomes unsecured and is dischargeable.

What types of debt (generally) can't be discharged in a chapter 7?

- “Priority (Unsecured) Debts” (those debts defined by law as nondischargeable):
 - Domestic Support Obligations (Child Support and Maintenance)
 - Dissolution Property Distributions
 - Taxes
 - Student Loans
- Secured Debts (those debts attached to collateral) if Debtor intends to retain the property.*

Exceptions to Nondischargeability of Priority Debts (exceptions to the exceptions)

- **Student Loans: Can seek a “hardship discharge”**
 - Very difficult to get. Must show “substantial hardship” (i.e., the debtor will never be able to work sufficiently to pay back your loans and still maintain a minimal standard of living for self and dependents; that this circumstance will continue for a very long time; and that the debtor has made good faith efforts in repaying the debts).

Exceptions to Nondischargeability of Priority Debts (exceptions to the exceptions)(cont.)

- **Taxes:** Income tax liability older than three years may be dischargeable under some circumstances.

Exceptions to Nondischargeability of Priority Debts (exceptions to the exceptions)(cont.)

- **What about domestic support obligations?**
 - **Child support or maintenance? Ha ha ha ha!! No, pretty much never.**
- **What about marital property distributions?**
 - **Actually, maybe. More on this later.**

Why file for chapter 13 instead of 7?

- A debtor may not qualify for filing a chapter 7 (if they earn too much money).
- A debtor feels an obligation to tackle her debts as best she can.
- It's better for your credit.
- Particular tools in a chapter 13, not available in a 7:
 - You can hold on to whatever property you want to hold on to that you can afford to hold on to (even if it's not exempt).
 - You can “cram down” or “lien strip” certain secured debts (i.e., you may be able to rewrite a car loan based on the value of a car; or you may be able to get rid of the lien on a second mortgage, if that mortgage is basically “unsecured”).
 - Some family law debts may be discharged. (More on this later).

What Happens When Someone Files for (chapter 7) Bankruptcy?

1. In filing, a debtor must list all assets and debts, as well as financial information regarding recent transfers, business history, etc. (all to form a financial picture). This is sworn information submitted under penalty of perjury, and is accessible to the public (via “PACER”).
2. Almost all debt collection efforts must cease because of the “automatic stay”. There are exceptions to the automatic stay that are relevant to family law, discussed below.
3. Assets become part of the “bankruptcy estate”, to be administered by the bankruptcy trustee. It generally cannot be transferred, sold or encumbered without the permission of the Court, or if the trustee “abandons” it. There are exceptions, of course. If an asset is not “exempt” (by law), it can be sold by the trustee to pay creditors.
4. A hearing is set about a month out, known as a “Meeting of Creditors” or “341 Meeting”, where creditors can go and ask questions of the debtor on the record. The debtor’s responses are sworn testimony. Some creditors use this meeting as a sort of free mini-deposition. Generally, no creditors appear.

What Happens When Someone Files for Bankruptcy (cont.)?

5. If there are assets to sell, the trustee can sell them to pay creditors. If not, the trustee will issue a “no distribution report”, and the court will soon grant the discharge.
6. If there are assets to sell or if a creditor feels that a debt should not be discharged, the case may remain open.
7. If a creditor is contesting the discharge of a certain debt, that creditor must file an “adversary action” (i.e., a lawsuit within the bankruptcy case, with its own case number) to determine if the debt is dischargeable. Some debts are automatically nondischargeable (especially related to family law).
8. Once these issues are resolved, the case will then be closed (with or without a discharge).

I Thought This Was a CLE About Family Law and Bankruptcy

- Relax, we're getting there. Here are some bankruptcy issues that are pretty unique to family law:
 - The automatic stay may not apply to creditor/spouses in several circumstances.
 - What happens to a family law case if a party files for bankruptcy?
 - Several family law debts are nondischargeable (but a few may be).
 - Community property issues make bankruptcy a little more complicated (or maybe not).
 - Do both spouses need to file?

But First, Little Things to Remember

(Yes, I know you passed the bar)

- Title is not determinative of ownership.
- Property and debts acquired during the marriage are presumed to be community
- Assets do not change their character (community vs. separate) upon marriage, unless untraceably commingled.
- All property, separate and community, is before the court in a dissolution.
- Orders and agreements between two divorcing parties do not affect third-party creditors.

Family Law and the Automatic Stay

- Remember when I said that all collection efforts must cease once a debtor files for bankruptcy (under the “automatic stay”, per Sec. 362)? Well, that’s only partly true.
 - Collections (including garnishment) for domestic support obligations (child support and maintenance) are generally not affected by the automatic stay in a chapter 7. Go right on ahead and collect. In a chapter 13, it is stayed until a plan is court-approved (i.e., “confirmed”).
 - BUT only collect from post-petition earnings (in a ch. 7). DO NOT collect from property that is part of the estate (like garnishing a bank account). That may still be protected by the automatic stay pending administration of the assets (post-petition earnings are not). Seriously, don’t screw this one up, or you and your client face sanctions for contempt of (federal) court.
 - The dissolution itself isn’t stayed (except where it deals with dividing property that’s part of the estate).

Family Law and the Automatic Stay (cont.)

What else isn't "stayed"?

- Establishment of paternity;
- The dissolution itself isn't stayed (except where it deals with dividing property that's part of the estate);
- Modifying/establishing a support order;
- Determining custody/visitation;
- Pursuing DV orders.

What if only one party files for bankruptcy?

- In a chapter 7, the filing debtor discharges his debts and the debts of the community. But he does not discharge the debts of his spouse/domestic partner.
 - That means that the other spouse can still be on the hook.

- Also, creditors can't pursue non-filing co-debtors if the filing debtor files a chapter 13, and the plan envisions repayment of 100% of that debt.
 - I have no idea what that last sentence means.
 - OK, let's say that a husband and wife are co-debtors to a credit card debt. The husband files for chapter 13 bankruptcy. The wife does not file. In his repayment plan, the husband expects to pay that credit card debt off in full. If that's the case, the credit card company can't go after the wife, even though she didn't file for bankruptcy protection.

How Does the Discharge Work for Family Law Debts?

- Domestic support obligations are automatically nondischargeable under 11 USC Sec. 523(a)(5).
 - That means you don't have to go into the bankruptcy court and file an "adversary" case to determine dischargeability.
 - What's a domestic support obligation? Good question.
 - Child support, or that which is support in nature
 - Maintenance or support that is maintenance in nature.
 - Attorney's (and professional) fees incurred as a result of an action related to the welfare of children (custody dispute, child support actions, relocation cases, etc.).
- Property distributions are automatically nondischargeable in a chapter 7 under 11 USC Sec. 523(a)(15).
- In a chapter 13, however, a property distribution debt can be discharged if the debtor completes her payment plan (which is either 3 or 5 years).
 - That means that if a debtor wife leaves her ex-husband with joint debt she was supposed to take care of (like a credit card obligation), she can get that obligation to her ex discharged in a chapter 13.

OK, so both domestic support obligations and property distributions aren't affected by filing for chapter 7. How does this work in a 13?

- For a Chapter 13 Plan to be confirmed by the Bankruptcy Court, it must: pay in full to the former spouse all domestic support obligations owed by debtor at the time of the bankruptcy filing, and the debtor must be current on all domestic support obligations incurred after the bankruptcy filing.
- A Chapter 13 Plan, even if confirmed by the bankruptcy court, is subject to dismissal if the debtor fails to pay any post-petition or post-confirmation domestic support obligations, and a Chapter 13 discharge will not be entered by the bankruptcy court unless and until a debtor certifies that all domestic support obligations have been paid and that the debtor is current on such obligations.

How to Protect My Client from a Property Distribution Discharge

- Only about 10-23% of all chapter 13 filers complete their plan.
 - Remember, to discharge a property distribution debt, a debtor must complete his plan. So statistically, the odds are already good that your client – the spouse creditor – will be safe.
- Maintenance awards are nondischargeable.
 - So when drafting final orders, try to characterize the transfer as maintenance or maintenance-like (a property award in lieu of maintenance, e.g.), including assumption of debt, etc.
 - Bankruptcy Courts will look to the substance of the debt/award, so don't rely on just including cursory language in paragraph 3.7 of the form Decree. Make it stick.
- When it comes to debts related to marriages and kids, courts tend to err on nondischargeable.
 - Don't think you've got a slam dunk here. But the party trying to escape from a domestic relations debt has the uphill battle.

Do Both Spouses Need to File?

- **The short (and technical) answer is no.**
 - But practically, it's often a good idea and I generally recommend it.
 - First, in a chapter 7, if only one party files, the other spouse may be vulnerable to creditors.
 - Second, if both parties are thinking about filing, it's much easier and cheaper to file the case as one case, rather than two separate cases.
 - It may be hard to get the divorcing couple to file together, but if they can do one more thing together (aside from fight), this is a good one.
 - **What about gay couples legally married? Can they file together?**
 - There's no clear-cut answer to this, but I'd say yes. Section 302 authorizes "spouses" to file for bankruptcy. But the section doesn't define "spouse".
 - Spouse is defined under DoMA as between a man and a woman for purposes of federal law. And it's still on the books (although President Obama's administration will not enforce it).
 - A California bankruptcy court ruled legally married gay couples can.

Conclusion (and things to keep in mind)

- **Remember, children and ex-spouses are generally viewed as having a priority claim, and so are often viewed as favorable creditors.**
- **As a priority claim, family law creditors get pretty close to the front of the line if any money is to be paid out from the bankruptcy estate.**
- **Third party creditors are not bound by the agreements and orders of two divorcing parties.**
- **Domestic support obligations and property distributions are automatically nondischargeable in a chapter 7.**
- **Finally, email/call me if you have any questions. There's a ton more information out there that I didn't discuss.**

Thank You

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