# BANKRUPTCY LAW NEWSLETTER

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## DIVORCE AND BANKRUPTCY

## NEW LIFE--NEW START

*By Brett N. Rodgers**

### Introduction

The purpose of this article is to examine the relationship between divorce proceedings and bankruptcy filings. We will explore strategies and practice tips which will illustrate the use of bankruptcy as a solution instead of a problem in divorce matters.

### I. The Impossible Settlement

The reason many bankruptcies are filed soon after finalization of a divorce proceeding is because the financial arrangement decreed is not a feasible solution. Rarely do the parties negotiate their financial split in an objective, realistic or cooperative manner. It is not uncommon for one or the other spouse to become so emotionally drained that they agree to an impossible financial arrangement just to avoid a grueling court battle. As a result, they often agree to pay too much, or agree to receive too little in the divorce settlement. Likewise, we see the "War of the Roses" divorce where the lust for spite drags the parties down to financial and emotional ruin. Unfortunate are the judges who must decide the feasibility of two households based on emotional testimony rather than facts supported by objective financial experts.

Many times the divorcing litigants had experienced financial problems in trying to maintain one family budget. Now, under the strain of a divorce proceeding they must negotiate, or litigate, the impossible arrangement to maintain two households with little or no positive change in their collective income.

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The typical impossible settlement requires the wage earning spouse to pay the family debts, and to hold harmless the other spouse. In addition, the wage earning spouse is usually responsible for child support and other major family expenses, e.g., a house payment. When reality hits and expenses soon exceed income, the wage earner spouse files a bankruptcy petition. Then, notwithstanding the hold-harmless agreement between the parties, the joint creditors come after the other spouse, which often precipitates a second bankruptcy filing.

## II. Divorce and Prepackaged Bankruptcy

In situations where the parties to the divorce have substantial debt, limited equity and income, the filing of a Chapter 7 or Chapter 13 Bankruptcy petition can create workable family budgets for each of the filing spouses. Chapter 7 can relieve the parties of most of or all of their debt. Chapter 13 may relieve the parties of a substantial portion of their unsecured debt and allow the parties to pay only the fair market value of any secured property they own and desire to keep. Further, if the marital home mortgage is in arrears (prior to a foreclosure sale having been held) a Chapter 13 filing can reinstate the mortgage by paying the pre-petition arrears over a reasonable time through the Chapter 13 plan. Under the recent Supreme Court Case of Johnson v Home State Bank ___ U.S. ___, (case 90-693, decided June 10, 1991), debtors can file a joint Chapter 7 Bankruptcy discharging their unsecured debt and their personal liability on a home mortgage, then they can file a Chapter 13 Bankruptcy to cure a default on their home mortgage.

The above brief and cursory summary of Chapter 7 and 13 Bankruptcy advantages is used only to illustrate that the "impossible settlement" outside of bankruptcy can be made possible by filing a Chapter 7, 11, or 13 Bankruptcy case prior to the judgment of divorce.

### A. Can debtors (spouses) file a Joint Consumer Bankruptcy Petition after a divorce proceeding is commenced and before the final divorce decree is entered?

Section 302(a) of the Bankruptcy Code in relevant part states:

> "A joint petition under a Chapter of this title is commenced by the filing with the Bankruptcy Court of a single petition under such chapter by an individual that may be a debtor under such chapter and such individual's spouse." (Underline emphasis added.)

If the debtors qualify as debtors under Section 109 of the Bankruptcy Code (as most consumer debtors do) then the reading of Section 302 would allow such a joint filing. Caution should be exercised to determine in each state the effective date the divorce is deemed final so that the parties are legally married at the time the bankruptcy is filed.

### B. Using the Consumer Bankruptcy as a Tool.

In determining the advantages of a pre-packaged consumer bankruptcy the divorce attorney must work with opposing counsel to evaluate the feasibility of supporting two households with and without debt relief. In making this determination both counsel should obtain their own bankruptcy expert (an experienced bankruptcy attorney or other financial expert), or agree to share the results of one expert.

If the bankruptcy expert determines a joint bankruptcy filing would benefit the parties, then these benefits must be carefully explained to the spouses. Income and family budget figures must be specifically laid out for the client so the bottom line figures are clearly understood.

The ultimate result of filing the divorce, then filing, for example, a pre-packed Chapter 13 case, is that the two households may end up retaining more necessary property, such as automobiles, and may save the family residence from foreclosure while actually paying less in the process. Failure to agree to such a pre-packaged Chapter 13 plan could cause continued financial chaos, repossession of vehicles, and foreclosure on the family residence.

Without a necessary bankruptcy reorganization the alternative "impossible settlement" will eventually clog the State Court with numerous collection hearings (child support, alimony, creditors), and could eventually lead to separate individual bankruptcy filings by the parties.

A divorce settlement which incorporates a pre-packaged Chapter 13 reorganization can also authorize the parties to amend their Chapter 13 plan and settlement agreement should the financial picture change over the next five years. For example, if the major wage earning spouse receives a substantial pay increase the Chapter 13 plan could be amended to increase child support payments and/or give additional dividends to the creditors. Likewise, if the financial picture weakens, the parties could amend the Chapter 13 plan to reject or sell certain property thereby adjusting their financial burden.

Such an arrangement gives the parties and the court a flexible mechanism to react to the changes the divorced parties will undoubtedly experience with their new lives.

## III. Recent Case Law re: Divorce and Bankruptcy

Prior to giving some examples, strategies and "what-if" situations, a summary of some recent cases should be noted.

On May 23, 1991 the Supreme Court of the United States decided Farley v Sanderfoot. III U.S. 181S. In Sanderfoot the debtor husband got real property in the divorce settlement and the wife was given a judicial lien interest in the real property by the State Divorce Court. The husband attempted to avoid the wife's judicial lien pursuant to Section 522(f). The Supreme Court held that because the judicial lien and the debtor's interest in the property were created simultaneously the lien could not be avoided.

In In re Zeits, 79 B.R. 222, (E.D. PA 1987) a Chapter 11 debtor filed while a State Court divorce proceeding was pending. The non-debtor wife filed a motion for lift of stay so she could proceed in State Court for a division of the property. The debtor argued that if relief of stay was granted the non-debtor wife would be allowed to carve out her rights in the property of the estate apart from participation by, and consideration of the rights of, other creditors of the debtor. The court denied the request for lift of stay, thereby retaining jurisdiction over any division of property.

A decision contrary to Zeits supra is In re White, 851 F2d 170, (6th Cir. 1988), where the Appeals Court upheld a Bankruptcy Court's grant of stay relief allowing a divorce action filed by a non-debtor wife to continue in State Court. In allowing this relief the court recognized that the State Court would make a division of the marital estate including the husband debtor's Chapter 11 Bankruptcy estate. Notwithstanding this ruling, the Appeals Court also recognized that the Bankruptcy Court had the discretion to retain jurisdiction over the division of the estate property if it so desired.

## IV. Uncharted Ground - What If?

The previous discussion regarding the divorce and pre-packaged consumer

bankruptcy was fairly simple because there was agreement between the parties to file a joint consumer bankruptcy as part of their divorce settlement. The issues become more difficult in situations as in White, Zeits, and Sanderfoot, supra, where a divorce is pending and then one spouse files for bankruptcy.

What if joint Chapter 13 debtors, with a confirmed plan, file for divorce during the pendency of their bankruptcy and then one spouse wants to have the plan modified? If the debtors can't agree on a modified plan, does the State Court or the Bankruptcy Court decide the controversy? While the Bankruptcy Court has the power to retain jurisdiction, it traditionally allows the State Court to decide matters regarding child support, alimony and division of property.

However, the Divorce Court might decree a settlement that could upset some of the Mandatory Plan provisions of Section 1325 of the Bankruptcy Code. For example, the State Court could order the sale and division of property, which would upset the liquidation test or readjust or remove dedicated income which is necessary for the plan payments to the trustee. In these situations, should the Chapter 13 trustee (who is authorized under Section 1329) move for modification of a suitable plan? If the State Court is granted jurisdiction to hear the matter, should the Chapter 13 trustee or allowed unsecured creditors be parties in interest in the divorce proceeding?

What if the non-wage earning spouse pushes for an impossible divorce settlement which the wage earning spouse feels is not feasible unless debt relief is obtained through bankruptcy? Could the wage earner spouse present evidence to the State Court showing how a proposed pre-packaged joint Chapter 13 Plan would make payment of the necessary family obligations more feasible? Assuming the benefits of the pre-packaged joint Chapter 13 plan were convincing, could the State Court order the other spouse to file the proposed joint Chapter 13 petition a part of the divorce settlement? Assuming the non-wage earning spouse was reluctant to file a joint Chapter 13 petition, could the State Court give the non-wage earning spouse an option of filing the joint Chapter 13 petition or taking less in the divorce settlement (alimony, child support, payment of certain expenses)?

This list of "what-if's" is clearly uncharted ground intended only to stimulate thought on how bankruptcy and divorce law can interact to benefit both spouses. Hopefully, the use of bankruptcy can be perceived as a shield and a savior, rather than the sword which slices assets from the ex-spouse.

## RECENT BANKRUPTCY DECISIONS:

The following are summaries of recent Court decisions that address important issues of bankruptcy law and procedure. These summaries were prepared by Jahel H. Nolan with the assistance of Larry A. Ver Merris.

In re H & S Transportation Co., Inc., Case No. 90-5393 (6th Cir. July 18, 1991).

This opinion authored by Judge Richard F. Suhrheinrich involves a preference claim asserted by a trustee against United Liberty Life Insurance Co. ("United"). United owned a towboat which was chartered by Inland Transportation Co. which in turn hired H&S Transportation Co., Inc. ("H&S") to operate it. As H&S operated the towboat it purchased fuel on credit from five separate fuel suppliers. Under 46 USC Section 971, the fuel vendors acquired a lien against the boat which would automatically be extinguished when H&S paid the outstanding fuel debts.

H&S filed Chapter 11 on September 4, 1981. The trustee initiated an adversary proceeding against each of the fuel suppliers and United to recover $149,586.98 made to the fuel vendors during the preference period. In response to this suit, two of the suppliers filed a motion for summary judgment asserting the new value defense. The motion was granted. Subsequently, these same two suppliers brought an in rem action in admiralty against United's boat. In order to dismiss the suit and free the boat, United paid the suppliers. The trustee settled the preference claims against the other two suppliers.

The remaining preference claim against United was tried and the trustee prevailed. The district court reversed stating that United was not a creditor of H&S under the Bankruptcy Code. The court of appeals reversed and remanded the case to the district court for consideration of the remaining issues raised by United. The district court again reversed. The trustee appealed.

The Sixth Circuit affirmed the district court and stated that United was a creditor as defined under the Code with regard to each fuel purchase since each transaction gave rise to a contingent indemnity claim against the debtor. If the debtor failed to pay its fuel bill, the supplier had a right to execute its statutory lien on United's boat. Consequently, if any fuel supplier had executed on the lien, United would have had a right of indemnity from the debtor. Therefore, the requirements of a preferential transfer under 547(b) were present. However, by virtue of the statutory lien and payment thereon, United was subrogated to the rights of the fuel suppliers. Therefore, it could assert the successful new value defense.

Using these conclusions and the single transfer theory recognized in In re C-L Cartage Co., Inc., 899 F2d 1490 (6th Cir. 1990), which states that avoidability is an attribute of the transfer rather than of the creditor, the court determined that Section 550(a) never came into play.

In addition, because United also stood in the shoes of the suppliers that settled with the trustee, res judicata barred the trustee from seeking further relief as to those suppliers.

In the alternative the court agreed with the district court's finding that United was entitled to assert the new value defense in its own right because H&S paid some of its fuel bills in order to purchase new fuel during the preference period thus creating new liens on United's boat. Consequently, the new credit enabled H&S to continue to purchase fuel on credit. Therefore new liens were new value.

Lawrence v. Kuntz, Case No. 1:90-CV-749 (W.D. Mich. July 2, 1991).

This opinion authored by Judge Richard A. Enslen involves the imposition of sanctions on a debtor. On October 30, 1989, Elizabeth Kuntz received a divorce judgment from Walter Lawrence. The judgment awarded Kuntz two separate monetary awards, one of which was contingent upon Lawrence returning certain property within 21 days of the divorce. Four days later, Lawrence filed Chapter 13.

On January 2, 1990, Kuntz filed a secured proof of claim but later she amended the claim to reflect an unsecured debt. On May 1, 1990, a hearing was held on Lawrence's objection to Kuntz's claim and motion to strike. The Bankruptcy Court found it to be meritless and awarded Kuntz non-dischargeable fees and costs.

On May 31, 1990, Lawrence filed a second objection to Kuntz's claim and a motion to strike. On June 5, 1990 the court issued an order declaring Kuntz's claim to be unsecured. Lawrence then filed a motion for reconsideration of the June 5, 1990 order. A hearing was held on Lawrence's second motion to strike and was again found to be meritless. Costs and

fees were assessed against him for $500. Lawrence appealed.

The District Court stated that Mr. Lawrence had continuously harassed the Bankruptcy Court and had begun to harass the District Court by filing motion after motion after motion. Judge Enslen stated that the finding that Kuntz's claim was valid was not clearly erroneous or a miscarriage of justice and the imposition of sanctions, while unusual, was not improper.

In response to Lawrence's claim that the court erred in ordering the fees and costs to be nondischargeable, the court stated that while Section 1305 does allow some post-petition claims to be treated as pre-petition claims, sanctions are not included in the exceptions. If a debtor were allowed to have sanctions discharged, one of the primary functions of Rule 11 would be thwarted.

In re Pratincole Co., Inc., Case No. 90-93567 (W.D. Mich. May 23, 1991).

This opinion authored by Judge Robert Holmes Bell involves a motion to withdraw the reference. In August of 1990, Pratincole had become delinquent on payments due under two promissory notes and several franchise agreements made with TCBY. In response, TCBY filed suit in the United States District Court for the Eastern District of Arkansas against Pratincole and the guarantors of the notes and agreements. Shortly thereafter, Pratincole filed bankruptcy.

Pratincole later filed a complaint against TCBY in bankruptcy court alleging breach of contract and warranty, negligence and violations of the Michigan Franchise Law and the Consumer Protection Act. It also requested a jury trial. TCBY moved the court to withdraw the reference.

In response to Pratincole's assertion that the district court had no authority to determine whether the claims were core or non-core, the Court stated that it was not precluded from making those determinations based on the Bankruptcy Amendment and the Federal Judgeship Act which places original jurisdiction of all matters arising under title 11 with the district court. In addition, the Court noted that Bankruptcy Rule 5011 points to this conclusion by stating that a motion to withdraw the reference can only be heard by a district judge. Consequently, the Court found that Pratincole's claims were non-core because they did not fit into any of the enumerated core categories.

The Court decided to withdraw the reference stating that the bankruptcy court could not conduct jury trials on non-core matters without the parties' consent. In addition, Judge Bell determined that exercising de novo review of a jury's verdict was directly contrary to the Seventh Amendment. Judicial economy would also best be served since the bankruptcy court could not enter a final judgment and a second jury trial would have to be conducted.

The Court also decided that transferring the venue would serve both parties' interests because the claims raised by Pratincole in the bankruptcy suit were identical to the counterclaims in the Arkansas action. The Arkansas Court had also refused to transfer venue. In order to avoid potential conflicting verdicts, the waste of judicial resources and additional expense to the parties, the Court transferred venue.

In re JRT, Inc., Case No. 90-83557 (W.D. Mich. May 23, 1991).

This opinion, also authored by Judge Robert Holmes Bell, involves substantially the same facts as the Pratincole case summarized above. In this case, however, the plaintiff admitted that the proceedings were non-core but argued that withdrawal of the reference was not required because it had moved to withdraw its jury demand.

The Court was not persuaded by this argument because the record indicated that TCBY opposed JRT's motion and, alternatively, TCBY had

motion to waive fees and costs of appeal. The debtor filed a lien against Judge Edward C. Farmer prepared under the color of the United States Bankruptcy Court. However, the documents were "homemade", frivolous and unsupported by fact or law. The court granted Judge Farmer's motion to strike and, on July 30, 1991, entered an order determining the "lien" to be null and void. The debtor filed an objection.

Likewise, on July 31, 1991, the Court entered an order striking and denying certain papers because it considered them to be incomprehensible, frivolous, not in adherence with applicable Bankruptcy Rules and filed for improper purposes. To the extent they constituted an appeal, the papers had been filed before the July 30, 1991 hearing on Judge Farmer's motion to strike.

On August 5, 1991 the debtor filed an objection to the July 30, 1991 order; an objection to the July 31, 1991 order; a notice of appeal; and a motion to waive fees and costs.

The Court found the two objections to be frivolous as a matter of law. When frivolous papers are filed, the court may prevent a pro se litigant from filing an in forma pauperis complaint or objection. In addition, the Court stated that denying the relief sought in the two objections would not be prejudicial.

As for the appeal, the Bankruptcy Court Clerk had docketed it thereby allowing the debtor to proceed subject to applicable bankruptcy rules including the payment of $105 in fees. The debtor requested that she be allowed to proceed with the appeal without paying costs and fees involved due to her poverty. The Court found that the debtor had failed to file an affidavit stating that she was unable to pay the fees thereby making her motion procedurally improper. In addition, after reviewing the debtor's schedules, the Court found that she was not impoverished. Judge Gregg noted that every person who files bankruptcy is not by definition in poverty. The Court stated that the 1991 poverty level for person in Michigan is $6620 per year. The debtor's income far surpassed that level.

Last, the Court noted that a court may determine that an appeal may not be taken in forma pauperis when it finds, in writing, that the appeal is not in good faith. Based on his review of the entire case, Judge Gregg found that the debtor lacked good faith.

**STEERING COMMITTEE MEETING MINUTES:**

No meeting was held in August. The next Steering Committee meeting will be held at noon at the Peninsular Club on Friday, September 20, 1991.

## LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan during the period from January 1, 1991 through July 31, 1991. These filings are compared to those made during the same period one year ago, and two years ago.

| | 1/1/91 - 7/31/91 | 1/1/90-7/31/90 | 1/1/89-7/31/89 |
|---|---|---|---|
| Chapter 7 | 3,039 | 2,292 | 1,940 |
| Chapter 11 | 99 | 92 | 61 |
| Chapter 12 | 12 | 12 | 7 |
| Chapter 13 | 1,028 | 981 | 711 |
| Totals | 4,178 | 3,377 | 2,719 |

## EDITOR'S NOTEBOOK:

The Michigan Supreme Court recently decided an interesting case involving the priority of a purchase money security interest versus an after-acquired property clause. The case is entitled NBD - Sandusky Bank v Ritter, 471 NW2d 340 (Mich S Ct 1991). This case also discusses attachment and perfection of security interests.

The Institute of Continuing Legal Education will be sponsoring a basic bankruptcy seminar here in Grand Rapids on Friday, December 6, 1991 at the Eberhard Center. Please contact ICLE for more details.

*Larry A. Ver Merris*