

# **BANKRUPTCY** **BASICS** for the family law attorney

by Keith L. Rucinski



## When domestic relations cases involve financial woes for one or both parties, even a basic grasp of bankruptcy law can mean the difference between winning and losing.

Bankruptcy is an area of law that intersects with many other areas of the legal practice, with perhaps the greatest impact of that intersection being in the area of family law. Family law is not for the faint of heart, as it requires a combination of legal skills and empathy in helping clients put their emotional lives and financial resources on a path to recovery. Often adding to the complexities of a family law case are the issues that arise when one party (or both parties) to the state domestic case files a bankruptcy case in federal court.

The issues that arise include:

- Does the bankruptcy automatic stay stop the domestic court proceedings?
- Can the domestic court enter orders regarding support payments and paternity?
- Are the assets being divided by the domestic court a part of the bankruptcy estate?
- Can the domestic court order debts discharged in bankruptcy collectible?

Understanding the basics of bankruptcy law can assist the family law attorney in addressing these issues.

In April 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was signed into law. As of Oct. 17, 2005, all provisions of the law became fully effective for all bankruptcy cases filed on or after this date.

Holders of domestic support obligations (DSO), alimony and child support are now given priority (after secured creditors). In addition, bankruptcy trustees are now required to report bankruptcy filings to state enforcement agencies so that these agencies can determine if a claim should be filed in the bankruptcy on behalf of persons owed a domestic support obligation (the support recipient). The law allows a state support agency to file a claim in bankruptcy for funds owed to an individual being serviced by the agency. Support recipients may also file their own claims. It should be noted that it is not necessary to file a claim in the bankruptcy if arrangements have been made by the agency to allow the support payer to pay the agency directly (outside the Chapter 13 bankruptcy plan) and the payer is current on those obligations.

When filing a claim for a domestic support obligation, the claim should only reflect the amount of past-due support

owed at the time of the bankruptcy filing. It is improper for domestic counsel or their client to file a claim for expected future payments or to file a claim based on an amount not reduced to judgment. The penalty for purposely filing a false claim can include a \$500,000 fine or imprisonment for up to five years, or both, pursuant to 18 U.S.C. 152 and 3571.

All creditors of the debtor may attend the bankruptcy trustee's 341 meeting of creditors to question the debtor about their respective claim. The support recipients and representatives of the state support agency may attend the 341 meeting, though the agency representatives are not required to be attorneys. The meeting is held so parties can ask questions on how they are going to be paid under the bankruptcy plan. The meeting is not the place to litigate pending domestic court issues or to appeal domestic court judgments, as the bankruptcy trustee has no jurisdiction or authority regarding these matters.

Bankruptcy law requires those in need of financial relief of their debts to first attempt to put together a repayment program through a credit counseling service. To earn a discharge, debtors must then take a financial management course

through an approved credit counseling service. The U.S. Department of Justice Trustee Program is charged with oversight duties and the approval process for entities who wish to provide credit counseling services and financial management courses. These entities must be of a non-profit nature. Debtors earning a discharge are deterred from filing successive bankruptcies and can be subject to a waiting period of two to eight years depending on the type of bankruptcy filed and the discharge earned.<sup>1</sup>

One fundamental shift in a debtor's ability to file bankruptcy is the requirement of a "means test" in Chapters 7 and 13 cases. The focus of the bankruptcy law is to deter people from filing Chapter 7 (where unsecured creditors often receive nothing)

to Chapter 13 (where debtors must devote best efforts to repay creditors over a three-to-five-year time period). Each has its own version of the means test. In Chapter 7, the means test is used to determine if the debtor is eligible for Chapter 7 based on income and allowed expenses. In Chapter 13, the means test is used to determine if the debtors have to propose a three- or five-year repayment program based on their average income for the previous six months prior to filing bankruptcy. The average income is then projected for a full year. If the debtor's calculated annual income is greater than the average for the debtor's state (based on the last census data), then the debtor must propose a five-year plan. If the income is less than the state average, the debtor is permitted to propose a three-year plan. The three- and

five-year plan durations are known as the "applicable commitment period." Allowed expenses are based on a combination of allowed "real expenses" and limited Internal Revenue Service allowances.

### **Bankruptcy Chapters**

Although this article focuses on consumer Chapter 7 and Chapter 13 bankruptcies, an overview of all bankruptcy chapters is as follows.

#### **Chapter 7**

Debtors can only earn a discharge in Chapter 7 once every eight years. Chapter 7 is subject to a means test to determine eligibility. The trustee can challenge a Chapter 7 filing under 11 §707(b) for abuse and totality of the circumstances. Attorneys are subject to due diligence re-



quirements to ensure that the debtor has made full disclosure of assets, income and liabilities on the bankruptcy petition. Attorneys may not rely on just “what the debtor told me.” Most debtors needing Chapter 7 are still eligible once fulfilling the creditor counseling and financial management courses required under bankruptcy law. Chapter 7 is the liquidation of assets to pay creditors to earn a discharge. The debtor generally retains exempt assets pursuant to 11 §522.

**Practice tip:** When parties to a domestic case have little income, no assets and huge debts, opposing domestic counsel may want to work together to get the parties to file a Chapter 7 either before or at the start of the domestic proceeding. This bankruptcy filing will eliminate most consumer debt. With less debt, there would be less litigation on which party is ordered to pay the debt, and with less debt payments to make, there may even be funds available allowing the domestic court ordered support payments to be timely paid.

### Chapter 9

This is the reorganization of governmental entities, for example, Orange County, Calif.

### Chapter 11

This chapter is best known for reorganizations or liquidation of business entities (K-Mart, United Airlines). Chapter 11 can also be used for individual debtors with secured debt over \$1,081,400 and/or unsecured debt over \$360,475. Domestic Support Obligations can be pursued against debtors in a Chapter 11.

### Chapter 12

This chapter is limited to family farmers and is similar to a Chapter 13 in structure. Domestic Support Obligations can be pursued in a Chapter 12.

### Chapter 13

Chapter 13, as it is known today, came into existence in 1938 (under the Chandler Act). Business entities are not eligible for Chapter 13. To be eligible for Chapter 13, individual debtors must have secured debt totaling less than \$1,081,400 and unsecured debt less than \$360,475. The debt limit is indexed to inflation and adjusted every three years. The next adjustment is scheduled in April 2013.

Debtors not eligible for Chapter 13 due to their debt limit must seek bankruptcy protection under Chapter 11. In Chapter 13, debtors are not required to liquidate

assets, but must propose to repay creditors by making monthly payments to a trustee for a three- to five-year period. The trustee disburses funds to creditors pursuant to a court approved bankruptcy plan.

Chapter 13 requires repayment of debts over a three- to five-year period. The requirements under BAPCPA for a Chapter 13 bankruptcy pursuant to 11 §1325 are as follows.

- The plan has been proposed in good faith and does not violate any law.
- Creditors will receive at least as much they would receive in a Chapter 7 liquidation of the debtor's assets.
- Secured creditors will receive full payment of their debt or return of their property.
- Secured creditors must receive equal monthly payments throughout the duration of the Chapter 13 plan.
- It appears the debtor can make the proposed plan payments.
- The debtor filed the plan in good faith (not to hinder creditors).
- The debtor has made all domestic support obligations payments timely since the date the debtor filed for bankruptcy (“filing date”).
- The debtor has filed all tax returns (federal, state, local) for the last four years prior to filing bankruptcy.
- The debtor has accurately completed the means test and has properly proposed a “three- to five-year commitment period” to repay his debt.

### Bankruptcy claims

In bankruptcy, there are four main types of claims: administrative, secured, priority and unsecured.

#### Administrative claims

These claims must be paid 100 percent, must be approved by the court and provide a benefit to the bankruptcy estate. Examples of these include court costs and fees; attorney fees and expenses; accounting services; appraisal services; and other court-approved professional services fees (pursuant to 11 §330).

#### Secured claims

These claims must be paid 100 percent. Examples of these include mortgages properly recorded under state law prior to

the bankruptcy filing; automobiles with properly recorded lien prior to the bankruptcy filing; judgment liens properly perfected under state law prior to the bankruptcy filing; some income taxes; property taxes; and bonds secured by corporate assets.

#### Priority claims

These claims must be paid at 100 percent and are strictly defined pursuant to 11 §507. Examples of these include some income taxes; child support and alimony; employee benefits and wages (with time and dollar amount restrictions); payroll taxes; and up to \$2,600 for deposits made by customers for goods or services debtor did not provide (generally defective home remodeling and repair jobs).

#### Unsecured claims

These creditors are the last to be paid and generally receive nothing

(in Chapter 7) or a percentage of their claim (in Chapter 13). Examples of these include bond holders not secured by corporate assets; non-perfected mortgages and liens; credit card debt; delinquent rent and utilities; loans from family and friends; and miscellaneous debt.

### BAPCPA and domestic support obligations

For attorneys engaged in family law and child support issues, it is necessary to have a working knowledge of bankruptcy law. The following is a review of major bankruptcy provisions with respect to alimony and child support issues.

#### Definition of domestic support obligation

The definition of a domestic support obligation in 11 U.S.C. §101(14A) follows.

A debt that accrues before, on or after the date of the order for relief in a case under this title, including interest that accrues on that debt as provided under applicable non-bankruptcy law notwithstanding any other provision of this title, that is

- (A) owed to or recoverable by
  - (i) a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative; or
  - (ii) a governmental unit;
- (B) in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) of such spouse, former

spouse, or child of the debtor or such child's parent, without regard to whether such debt is expressly or designated;

- (C) established or subject to establishment before, on, or after the date of the order for relief in a case under this title, by reason of applicable provisions of
- (i) a separation agreement, divorce decree, or property settlement agreement;
  - (ii) an order of a court of record; or
  - (iii) a determination made in accordance with applicable non-bankruptcy law by a governmental unit; and
- (D) not assigned to a nongovernmental entity, unless that obligation is assigned voluntarily by the spouse, former spouse, child of the debtor, or such child's parent, legal

guardian, or responsible relative for the purpose of collecting the debt.

### The automatic stay

An automatic stay in 11 U.S.C. §362 is effective on the filing of the bankruptcy petition. The purpose of the stay is to stop third parties from pursuing assets and income of the debtor until the bankruptcy court makes decisions with respect to creditors' objections to lift (remove) the stay and whether the debtor's plan should be confirmed (approved) as filed. In general, all state civil court actions against the debtor must be held in abeyance until the bankruptcy court grants relief from stay allowing the action to continue. Criminal charges against the debtor are not held in abeyance on the filing of the bankruptcy petition and are not subject to the automatic stay.

An exception to the automatic stay provisions is found in 11 U.S.C. §362 (b)(2) which allows domestic court proceedings

to continue despite the filing of a bankruptcy. The automatic stay does not apply to the following actions.

- Actions to determine paternity.
- Actions to establish or modify an order for domestic support obligations.
- Actions concerning child custody or visitation.
- Actions for the dissolution of a marriage, except to the extent that such proceeding seeks to determine the division of property of the estate. Note: It is best to discuss with the bankruptcy trustee to determine assets of the bankruptcy estate that the trustee may be pursuing on behalf of creditors of the bankruptcy estate.
- Actions against the debtor for domestic violence.
- Collection of a domestic support obligation from property that is not property of the bankruptcy estate. As noted above, it is prudent to discuss property of estate issues with the assigned bankruptcy trustee. One example of an exempt, non-estate asset is retirement and pension accounts.
- Actions to garnish income of the debtor for payment of a domestic support obligation under a state law or statute.
- Actions to suspend driver license or professional license of the debtor pursuant to state law and the Social Security Act, section 466(a)(16).
- Actions to report overdue support payments by a parent to a consumer reporting agency under 466(a)(7) of the Social Security Act.
- Interception of tax refunds as specified under sections 464 and 466(a)(3) of the Social Security Act.
- Enforcement of a medical obligation as specified under title IV of the Social Security Act.

### Priorities

Under BAPCPA, payments of domestic support obligations have been placed in first priority and must be paid after payment of administrative and secured claims.

In 11 U.S.C. §507, expenses and claims have priority in the following order.

- (A) Allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition in a case under this title are



owed to or recoverable by a spouse, former spouse, or child of the debtor, or such child's parent, legal guardian, or responsible relative, without regard to whether the claim is filed by such person or is filed by a governmental unit on behalf of such person, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the petition shall be applied and distributed in accordance with applicable non-bankruptcy law.

- (B) Subject to claims under subparagraph (A), allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition, are assigned by a spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative of the child for the purpose of collecting the debt) or are owed directly to or recoverable by a governmental unit under applicable non-bankruptcy law, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the petition be applied and distributed in accordance with applicable non-bankruptcy law.

### Exemptions

Section 522 of the bankruptcy code states the assets that the debtor may retain and exclude from being used in the repayment of creditors. Pursuant to 11 USC §522(d)(10)(D), the debtor may exempt the right to receive alimony, support or separate maintenance to the extent reasonably necessary for the support of the debtor and any dependent of the debtor. Even though exempt, alimony and child support must still be disclosed on the bankruptcy petition.

### Debts discharged in bankruptcy (and some exceptions)

Generally, a debt discharged in bankruptcy enjoins creditors from attempting to collect the debt pursuant to 11 USC §524. Debt that is not discharged remains enforceable against the debtor.<sup>2</sup> Collection efforts may not be commenced until the bankruptcy case is closed.

State courts are not permitted to modify a discharge order entered by a federal bankruptcy court.<sup>3</sup>

Some domestic counsel draft property settlement agreements stating that a person cannot file bankruptcy to discharge the settlement. The agreements fail to state any legal authority for this assertion and are in contradiction to Title 11 of the U.S. Code (the bankruptcy code). Further, it can be argued that attorneys who ask the domestic court to reinstate discharged debt (or substitute the discharged debt for other obligations) may be violating the discharge injunction of 11 U.S.C. §524. These violations could be grounds for sanctions in both the state domestic court and federal bankruptcy court.

11 U.S.C. §523 of the bankruptcy code lists certain debts that are not discharged on the completion of the bankruptcy case. These non-dischargeable debts remain enforceable against the debtor. 11 U.S.C. §523 (a)(5) states that a domestic support obligation cannot be discharged by the debtor and therefore the debtor remains completely liable on the debt for support payments.

11 U.S.C. §523(a)(15) makes a property settlement non-dischargeable in a Chapter 7. In Chapter 13, a property settlement can be paid and discharged as an unsecured claim at the unsecured dividend rate.

### Preferences

Generally, each class of creditors (administrative, secured, priority and unsecured) must be treated equally. If, prior to filing bankruptcy, the debtor paid ("preferred one creditor") by using remaining funds to pay off the creditor while creditors in the bankruptcy will not be paid in full, the bankruptcy trustee would often commence legal action to recover the funds from the preferred creditor for the bankruptcy estate, so all creditors would be treated equally.

Pursuant to 11 USC §547(c)(7), a payment on a domestic support obligation prior to the bankruptcy filing is not considered a preference and may not be recovered for the benefit of the bankruptcy estate.

### Notices to holders of Domestic Support Obligations

Under BAPCPA, Chapter 7 Trustees, pursuant to 11 U.S.C. §704(c), and Chapter 13 Trustees, pursuant to 11 USC §1302, must supply the following notices to holders of domestic support obligations.

- Notice to holder of DSO that he or she may use the services of the state child

enforcement agency for assistance in collecting the claim through and after the bankruptcy.

- Notify the state child support agency of the debtor's bankruptcy filing.
- Upon discharge of the bankruptcy case, notify the holder of the debtor's last known address and employer. Note: Trustees are permitted to rely on the debtor for name and address of the holder of the domestic support obligation. If the debtor does not know the name or address, a notice is only sent to the state child support agency.

Further general educational information on bankruptcy is available at [www.chapter13info.com](http://www.chapter13info.com). ■

## Author bio



Keith L. Rucinski is the standing Chapter 13 bankruptcy trustee for Akron. Rucinski is an attorney and certified public accountant. He has taught over 30 graduate and undergraduate courses in taxes, financial statement analysis, accounting and business law, and is a frequent speaker at local and national seminars.

## Endnotes

- <sup>1</sup> Many non-bankruptcy attorneys confuse the terms dismissal and discharge. If a case is dismissed, the bankruptcy is void and creditors may collect the entire amount of the debt plus back interest and penalties which were abated due to the bankruptcy filings. If the case is discharged, the debtor has successfully completed the bankruptcy plan and creditors listed in the bankruptcy may not pursue the debtor for further payment of that debt.
- <sup>2</sup> See *In Re Rajotte*, 81 Fed. Appx. 29; (Sixth Circuit Court of Appeals) (2003).
- <sup>3</sup> See *In Re Hamilton*, 540 F.3d 367 (Sixth Circuit Court of Appeals) (2008).