Continuation of the Divorce Fight in a Chapter 13 Bankruptcy

DIANE BRAZEN GORDON

The emotional and financial fight in a divorce may not be over when the divorce decree is entered. One of the parties may file a Chapter 13 bankruptcy and seek to discharge a debt assigned to him or her in the divorce case. That party may classify a marital debt as property settlement debt, rather than a debt for alimony, maintenance, or support, resulting in a dispute regarding whether a marital debt is for alimony, maintenance, or support under federal bankruptcy law. If the answer is "yes," that debt is not dischargeable under any bankruptcy chapter. If the answer is "no," the debt may be dischargeable in a Chapter 13 bankruptcy and only a percentage paid in the Chapter 13 bankruptcy plan. Because of this distinction, family law and bankruptcy attorneys should be aware of the treatment of marital debts in Chapter 13.[1]

CHAPTER 13 BASICS

A person filing a bankruptcy case is required to complete schedules listing all of his or her debts, in addition to much other financial information. The bankruptcy schedules designate debts as secured (schedule D), unsecured priority (schedule E), or general unsecured (schedule F). In a Chapter 13, the debtor also files a Chapter 13 plan, which is a contract setting forth the order of payment and the amount to be paid to the creditors by the Chapter 13 trustee.

The particular classification of a debt in a Chapter 13 case as a priority or general unsecured claim can be very important. Whereas unsecured priority claims are paid in full, allowed general unsecured claims receive a percentage of the debt, according to the terms of the Chapter 13 plan. A Chapter 13 plan typically lasts three to five years and at the end of the plan, a debtor receives a Chapter 13 discharge.[2] There are many reasons a debtor may file a Chapter 13, rather than a Chapter 7 bankruptcy. The difference in treatment of marital debts in Chapter 13 as opposed to Chapter 7 may be one of those reasons.

Section 523 of the Bankruptcy Code[3] provides that certain debts are within exceptions to the bankruptcy discharge. There are two main exceptions to discharge involving marital debts. These two discharge exceptions are found in Sections 523(a)(5) and 523(a)(15). Debts under section 523(a)(5) are for alimony, maintenance, or support. Debts under section 523(a)(15) are other marital debts such as property settlements or debts divided by a divorce court

Diane Brazen Gordon practices law in Lincolnshire, Illinois, and is licensed to practice law in Texas and Illinois. She was a law clerk for the Honorable Gerald D. Fines, US Bankruptcy Judge, Central District of Illinois, and has been practicing primarily in the area of bankruptcy law since 1990. Her law practice concentrates on bankruptcy law, unfair collection law, and student loan law on behalf of consumers. She is a member of The American Bankruptcy Institute, the Federal Trial Bar of the Northern District of Illinois, The National Association of Consumer Bankruptcy Attorneys, The National Association of Consumer Advocates, The Women's Bar Association of Illinois, and the Illinois State Bar Association. Ms. Gordon serves as Vice Chair of the Bankruptcy Committee, ABA Section of Family Law, and is Vice President of North Shore Law. Ms. Gordon has spoken at several conferences for the American Bar Association Section of Family Law on the topic of Bankruptcy and Marital Debts. She also wrote "Dischargeability of Divorce Debts in Bankruptcy," published in the American Journal of Family Law, *Volume 24 Number 3 Fall, 2010.*

as part of an equitable distribution. Much litigation involves disputes regarding whether a particular debt is a 523(a)(5) debt or a 523(a)(15) debt.

SECTION 523(a)(5): DOMESTIC SUPPORT OBLIGATIONS

Section 523(a)(5) states that "[a] discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual from any debt—(5) for a domestic support obligation." In turn, domestic support obligation (DSO) is defined in Section 101(14A) as follows;

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

1. owed to or recoverable by—
   (a) a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative; or
   (b) a governmental unit;
2. 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 so designated;
3. 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—
   (a) a separation agreement, divorce decree, or property settlement agreement;
   (b) an order of a court of record; or
   (c) a determination made in accordance with applicable nonbankruptcy law by a governmental unit; and
4. 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. 11 U.S.C. § 101(14A).

Section 101(14A) was added as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BACPA), but courts deciding the issue of whether a debt is in the nature of alimony or support rely on pre-BACPA cases interpreting paragraph (B) in the definition of a DSO.[4]

Much litigation focuses on whether a debt falls under Section 523(a)(5) or Section 523(a)(15).

DSO creditors receive special treatment in bankruptcy.[5] If the debt meets the definition of a DSO, the debtor will be unable to discharge that debt by filing any type of bankruptcy. The party seeking to have a debt determined to be a DSO has the burden of proving by a preponderance of the evidence that the obligation is in the nature of support.[6] Exceptions to discharge of a debt are construed strictly against a creditor and liberally in favor of a debtor.[7] However, the underlying policy of Section 523(a)(5) favors enforcement of familial support obligations over a debtor's "fresh start."[8]

SECTION 523(a)(15): PROPERTY SETTLEMENT DEBTS

Section 523(a)(15) provides that a debt is excepted from discharge if it meets these three statutory elements:

1. The debt must be to a spouse, former spouse, or child of the debtor;
2. The debt must not be a DSO; and
3. The debt must have been incurred in the course of a divorce or separation or in connection with a separation agreement, divorce decree, or other order of a court.

The reason debts under section 523(a)(15) arising from a property settlements or equitable distribution awards may be discharged in Chapter 13 is because of the language in section 1328(a).[9] Section 1328 provides for a discharge in Chapter 13 casesas well as a "super discharge" of some debts, including certain marital obligations that would otherwise be nondischargeable in Chapter 7.[10] Section 1328(a) contains a list of the types of debts that are

exceptions to a Chapter 13 discharge. The super discharge provided in section 1328(a) includes Section 523(a)(15) debts because Section 523(a)(15) is not enumerated in the exclusive list of exceptions from discharge found in section 1328(a).[11] Section 523(a)(15) debts are not listed as excepted from a Chapter 13 discharge in Section 1328(a) and, therefore, they are included in the debts that are discharged.

Because of the language in Section 523(a), a Chapter 7 debtor cannot discharge DSO debts under Section 523(a)(5) or property settlement debts under Section 523(a)(15). A Chapter 13 bankruptcy case is often a forum for disputes regarding the classification of a marital debt because property settlement debts are dischargeable in Chapter 13.

Courts often rely on pre-BACPA cases.

If a creditor can prove that its claim is a DSO in a Chapter 13, that creditor has a much greater ability to collect those debts than creditors owed general unsecured claims. Debts that are DSOs are first priority debts in a Chapter 13 case and must be paid in full.[12] Additionally, a debtor cannot receive a Chapter 13 discharge at the end of the case unless all DSOs have been paid in full.[13] The automatic stay does not operate as a stay of the commencement or continuation of an action to establish or modify an order for a DSO.[14] Likewise, the automatic stay does not operate as a stay of the collection of DSOs from property that is not property of the bankruptcy estate.[15] For all these reasons, the classification of a debt as a DSO, rather than a general unsecured claim, is very important and gives the DSO creditor significantly greater ability to collect the debt.

DSO or Property Settlement?

A bankruptcy court may be a forum for the hotly contested issue of whether a certain debt is a DSO or a property settlement debt. A Chapter 13 creditor owed a marital debt could sustain a large financial loss if the debt is a property settlement debt rather than a DSO. A Chapter 13 plan may pay a small percentage of the amount of general unsecured claims. The amount of the percentage to be paid to the general unsecured creditors depends on provisions in the Bankruptcy Code and local practice. If the debtor has a high monthly disposable income or a large amount of nonexempt assets, the percentage paid to general unsecured creditors may be high.

If a debtor proposes to treat a marital debt as a general unsecured claim rather than a DSO in a Chapter 13 plan, the former spouse/creditor may object to that treatment by filing a proof of claim and asserting that the claim is a DSO. The former spouse/creditor may also file an objection to confirmation of the Chapter 13 plan and argue that that the plan cannot be confirmed because it does not provide for full payment of the DSO obligation. In response, the debtor may file an objection to the DSO claim of the former spouse, and argue that the claim is a general unsecured claim subject to discharge, rather than a DSO. In this context, there is a contested case requiring a bankruptcy judge to decide whether the marital debt is a DSO or a property settlement debt. Indeed, parties are fighting in bankruptcy courts all over the country about whether a variety of debts are DSOs or for property settlements, including debts for mortgage payments, attorney's fees, car loans, credit cards, medical expenses, college expenses, and student loans. Accordingly, a large body of case law has developed on whether a marital debt is in the nature of alimony, maintenance, or support under the second part of the DSO definition. The results depend on the facts of the case, and all the federal circuit courts of appeals have reviewed bankruptcy decisions on this issue.[16]

Bankruptcy courts look to federal law to determine whether a particular claim is in the nature of support.[17] A state court's designation or language in a marital settlement agreement stating that a debt is support or a property settlement is not binding on the bankruptcy court, which can look behind such language to determine the real nature of the debt.[18] The majority of courts find that payment of support, maintenance, or alimony need not be payable directly to the spouse or one of the payees listed in the first element of the definition in order to be nondischargeable.[19]

Determining Intent of the Parties

To determine whether the debt is in the nature of alimony, maintenance, or support, the bankruptcy court must determine the intent of the parties or the divorce court at the time of the obligation. A bankruptcy court does not rely solely on the labels used by the parties and must look beyond the labels to

examine whether the debt is in the nature of support or alimony.[20] If the parties entered a marital settlement agreement, the bankruptcy court will determine whether the parties intended that the obligation be in the nature of alimony, maintenance, or support.[21] If the divorce was concluded with a trial and decided by a judge, the bankruptcy court will determine whether the divorce court judge intended that a particular award be for support, and the intended purpose the obligation was meant to serve.[22] In fact, a marital debt may be a DSO, even though it cannot be a support debt under state law.[23]

To determine the intent of the parties or the divorce court judge, bankruptcy courts look at many factors. Some courts developed multifactor tests to discern intent and other courts conclude that all facts are relevant to the totality of circumstances in a particular case.[24] The list of factors is not necessarily exclusive, and the bankruptcy court will look at all evidence that may assist the court in determining the parties' intent at the time of the agreement.[25] Most courts will not consider the present ability to pay or economic circumstances of the parties at the time of the bankruptcy proceeding.[26]

Policy favors enforcement of support obligations over a "fresh start."

Courts agree that no matter what list of factors a court uses, the list is not exclusive and that all evidence, direct or circumstantial, will be considered if it assists the court in determining intent.[27] To determine intent of the parties in a marital settlement agreement, the courts focus on (1) the language and substance of the agreement; (2) the financial situation of the parties at the time of the agreement, including prospects for future income; and (3) the function served by the obligation at the time of the agreement.[28]

In *In re Dudding*, the bankruptcy court listed eight factors it considered to be most important to the analysis of whether the parties intended the assumption of joint marital debt to be in the nature of alimony, maintenance, or support.[29] The court in *Dudding* stated that no one factor controls and that "[a[ll evidence, direct or circumstantial, which tends to illuminate the parties' subjective intent is relevant."[30]

CASES IN POINT

Recently the US Court of Appeals for the Ninth Circuit Court affirmed a bankruptcy court's determination that a marital obligation was in the nature of support, and therefore entitled to priority treatment in the debtor's Chapter 13 case.[31] In *In re Ashworth*, the ex-wife filed a proof of claim and asserted that the claim was a DSO entitled to priority treatment; the debtor (the ex-husband) objected, asserting that the marital obligation was a general unsecured claim.[32] The claim was based on the settlement of a personal injury action the ex-wife had filed against the ex-husband.[33] The bankruptcy court held that the ex-wife's claim was a DSO because the parties intended that the obligation be for support, and the Ninth Circuit affirmed.[34]

Ashworth followed the authority established in its prior opinion in *Friedkin v. Sternberg*,[35] which looked to several factors in order to determine the intent of the parties at the time of the settlement agreement.[36] The court explained these factors as follows:

Foremost, the trial court should consider whether the recipient spouse actually needed spousal support at the time of the divorce. In determining whether spousal support was necessary, the trial court should examine if there was an "imbalance in the relative income of the parties" at the time of the divorce decree. The trial court should also consider whether the obligation terminates upon the death or remarriage of the recipient spouse and whether the payments are "made directly to the recipient spouse and paid in installments over a substantial period of time." Finally, the labels given to the payments by the parties may be looked at as evidence of the parties' intent."[37]

Ashworth also considered the fact that the divorce judgment allowed the ex-husband to claim the payments as alimony on his tax returns and required the ex-wife to report the payments as taxable income.[38] The Ninth Circuit affirmed the bankruptcy court's decision that the ex-wife met her burden of proof by a preponderance of the evidence that the obligation was in the nature of support.[39]

The US Court of Appeals for the First Circuit in *In re Smith*, affirmed a decision of a bankruptcy appellate panel (BAP), which reversed a bankruptcy court, and found that a late payment penalty in a separation agreement was not a domestic support obligation.[40] *Smith* focused on the intended purpose the obligation was meant to serve, and

noted that the label applied to the obligation by the court or the parties is not necessarily controlling.[41] The court declined to adopt a specific multifactor test to determine intent, and agreed with the BAP that "the critical factors depend on the totality of the circumstances of a particular case."[42] It concluded that the late-fee provision was intended to encourage payment of alimony and was not itself alimony.[43]

A state court's designation is not binding on a bankruptcy court.

A bankruptcy court in *In re Daulton* set forth a list of 20 factors to test whether a property settlement agreement is in the nature of alimony, maintenance, or support, but stated that the list "include[s]" these factors and the last factor is a catch-all of "[o]ther special or unique circumstances of the parties."[44] Bankruptcy courts have looked at additional factors, such as whether one spouse has custody of minor children, the circumstances surrounding the dissolution, and whether the award served to provide basic necessities such as shelter.[45] Other factors include (1) whether the obligation terminates on the death or remarriage of either spouse, (2) the characterization of the payment in the decree and the context in which the disputed provisions appear, (3) whether the payment appears to balance disparate income, (4) whether the payment is due in a lump sum or over time, (5) whether the payments are to be made directly to the former spouse or to a third party, (6) whether the parties intended to create an obligation of support, (7) whether an assumption of a debt has the effect of providing daily needs to a former spouse or children, and (8) whether the obligation has the effect of providing the support necessary to ensure a home for the former spouse and any minor children.[46] The outcome depends in the particular facts of the case and the evidence available to the bankruptcy court.

CONCLUSION

For many years, bankruptcy courts have been resolving disputes regarding whether marital debts allocated to a party in a divorce proceeding are in the nature of alimony, maintenance, or support under federal bankruptcy law. Because of the treatment of marital debts in Chapter 13, an obligation labeled as alimony or support in a divorce decree may be considered a dischargeable property settlement by a bankruptcy judge. Even though a marital debt is not support under state law, the debt may be a DSO under federal bankruptcy law. The results can be devastating to a domestic support creditor, or can be a powerful way for a financially distressed person to obtain relief from property settlement debts.

NOTES

1. This distinction is not usually important in a Chapter 7 bankruptcy because virtually all marital debts are not dischargeable in Chapter 7 cases.

2. In contrast, a typical Chapter 7 bankruptcy proceeding without any nonexempt assets will end after a few months, and the debtor will receive a discharge of personal liability for most unsecured debts.

3. All section references in this article are to the Bankruptcy Code unless otherwise noted.

4. *Ashworth v. Ehrgott*, BAP CC-12-1591-TADPA, 2013 WL 6620863 at *4 (BAP 9th Cir. 2013), citing *Beckx v. Beckx*, 2009 Bankr. Lexis 4584 at *16 (9th Cir. 2009); *In re Dudding*, 10-10557, 2011 WL 1167206 at *5 (Bankr. D.Vt 2011).

5. *In re Smith*, 586 F.3d 69, 72 (1st Cir. 2009).

6. *Id.* at 73. *Cummings v. Cummings*, 244 F.3d 1263, 1266 (11th Cir. 2001).

7. *In re Reines*, 142 F.3d 970, 972 (7th Cir. 1998).

8. *In re Sampson*, 997 F.2d 717, 722 (10th Cir. 1993), citing *Shaver v. Shaver*, 736 F.2d 1314, 1316 n.3 (10th Cir. 1993).

9. *In re Pagels*, 10-71138-SCS, 2011 WL 577337, at *6 (Bankr. E.D. Va. 2011).

10. *In re Earnest*, 11-50665-KKS, 2013 WL 6504359, at *3 (Bankr. N.D.Fla. 2013).

11. *In re Pagels*, 2011 WL 577337, at *6 (Bankr. E.D. Va. 2011).

12. *In re Krueger*, 457 B.R. 465, 473 (Bankr. D. S.C. 2011), *citing* 11 U.S.C. §1322(a)(2) (West 2011); *In re Johnson*, 397 B.R. 289, 295 -296 (M.D. N.C. 2008).

13. In re Johnson, supra, at 296.

14. 11 U.S.C. §362(b)(2)(A)(ii).

15. 11 U.S.C. §362(b)(2)(B).

16. The US Court of Appeals decisions from each circuit include *In re Smith*, 586 F.3d 69 (1st Cir. 2009); *In e Brody*, 3 F.3d 35 (2d Cir. 1993); *In re Gianakas*, 917 F.2d 759 (3rd Cir. 1990); *In re Catron*, 43 F.3d 1465 (4th Cir. 1994); *In re Biggs*, 907 F.2d 503 (5th Cir. 1990); *Long v. Calhoun*, 715 F.2d 1103 (6th Cir. 1983); *In re Sorah*, 163 F.3d 397 (6th Cir. 1998); *In re* WL 6620863 (9th Cir. 2013); *In re Reines*, 142 F.3d 970 (7th Cir. 1998); *Boyle v. Donovan*, 724 F.2d 681 (8th Cir. 1984); *Ashworth v. Ehgrott*, 2013 *Sampson*, 997 F.2d 717 (10th Cir. 1993); *Cummings v. Cummings*, 244 F.3d 1263 (11th Cir. 2001), *Richardson v. Edwards*, 127 F.3d 97 (D.C. Cir. 1997).

17. *In e Brody*, 3 F.3d 35 at 39 (2d Cir. 1993); *In re Gianakas*, 917 F.2d 759, 762 (3rd Cir. 1990); *Long v. Calhoun*, 715 F.2d 1103, 1107 (6th Cir. 1983).

18. *Cummings v. Cummings*, 244 F.3d 1263 (11th Cir. 2001); *In re Dennis* 25 F.3d 274 (5th Cir. 1994).

19. *Long v. Calhoun*, 715 F.2d 1103, 1105-1107 (6th Cir. 1983) and *In re Spong*, 661 F.2d 6 (2d Cir. 1981).

20. *Cummings v. Cummings*, 244 F.3d 1263, 1265 (11th Cir. 2001).

21. *In re Reines*, 142 F.3d 970, 973 (7th Cir. 1998); *In re Brody*, 3 F.3d 35, 38 (2d Cir. 1993); *In re Sampson*, 997 F.2d 717, 723 (10th Cir. 1993).

22. *In re Smith*, 586 F.3d 69, 74 (1st Cir. 2009); *See Cummings v. Cummings*, 244 F.3d 1263, 1266 (11th Cir. 2001) ("the bankruptcy court should have examined the intent of the divorce court before making a determination that no portion of the equitable distribution was in the nature of support").

23. *In re Sampson*, 997 F.2d 717, 722(10th Cir. 1993); *Matter of Briggs*, 907 F.3d 503 (5th Cir. 1990) (court held that Texas divorce decree obligation was nondischargeable alimony even though state law did not allow court-ordered alimony); *In re Harrell*, 754 F.2d. 902 (11th Cir. 1985) (post-majority child support and educational expenses); *Boyle v. Donovan*, 724 F.2d 681, 683 (8th Cir. 1984) (college education found to be nondischargeable support).

24. *In re Smith, supra*, n.22, at 74.

25. *In re Body, supra*, n.17, at 38; *Cummings v. Cummings*, 244 F.3d 1263, 1266 (11th Cir. 2001).

26. *In re Palm*, 972 B.R. 356 at 3 (10th Cir. 1992); *In re Gianakas*, 917 F.2d 759, 763 (3rd Cir. 1990); *In re Sylvester*, 865 B.R. 1164, 1166 (10th Cir. 1989); *Boyle v. Donovan*, 724 F.2d 681, 683 (8th Cir. 1984).

27. *In re Brody*, 3 F.3d 35, 38 (2d Cir. 1993).

28. *In re Catron*, 43 F.3d 1465 at 4 (4th Cir. 1994); *In re Sampson*, 997 F.2d 717, 723–726 (10th Cir. 1993); *In re Gianakas*, 917 F.2d 759, 762–763 (3rd Cir. 1990); *Long v. Calhoun*, 715 F.2d 1103 at n. 7 (6th Cir. 1983); *In re Pagels*, 2011 WL 577337, at *8; *In re Krueger*, 457 B.R 465, 474–475 (Bankr. D.S.C. 2011) (also considered factor of whether there was overbearing by either party); *In re Daulton*, 139 B.R. 708, 710 (20 factors focusing on the language of the agreement, the relative income of the parties, the nature and function of the obligation, needs of any children, length of the marriage, and the age and health of the parties).

29. 2011 WL 1167206 at *6 (Bankr. D. Vt. 2011), citing *In re Kaufman*, 115 B.R. 435,440–441 (Bankr. E.D.N.Y.1990), *In re Phegley*, 443 B.R. 154,158 (8th Cir. BAP 2011) (describing a 6-factor test), *In re Daulton*, 139 B.R. 708, 710 (Bankr. C.D.Ill. 1992) (analyzing 20 factors); *In re Deberry*, 429 B.R. 532, 539 (Bankr. M.D.N.C.2010) (listing four factors, but noting the list is nonexclusive and all relevant evidence should be considered), *In re White*, 408 B.R 677, 681 (Bankr. S.D.Tex.2009) (employing a five-factor test).

30. *In re Dudding, supra*, n.3, at *6, citing *In re Brody*, 3 F.3d 35, 38 (2d. Cir. 1993).

31. *In re Ashworth*, 2013 WL 6620863 (9th Cir. 2013).

32. *Id.*

33. *Id.*

34. *Id.*

35. 85 F.3d 1400 (9th Cir. 1996).

36. Ashworth v. Ehrgott, *supra*, n.4, at *1.

37. *Id.* at *4, citing *Sternberg, supra*, n.35.

38. *Ashworth, supra*, n.4, at *4.

39. *Id.* at *5 and*6.

40. 586 F.3d 69 (1st Cir. 2009).

41. *Id.* at 73–74.

42. *Id.* at 74.

43. *Id.* at 74.

44. 139 B.R. 708, 710 (C.D. Ill. 1992).

45. *In re Earnest*, 2013 WL 6504359 at *3 (Bankr. N.D.Fla 2013).

46. *In re Dudding*, No. 10-10557, 2011 WL 1167206 at *6 (Bankr. D. Va. 2011).