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For Better or for Worse

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TOPIC:

Interplay Between Bankruptcy and Divorce

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AUTOMATIC STAY ISSUES

For this year’s presentation, I will be focusing on stay lift issues in divorce cases, while also touching upon other issues that have arisen over the years for domestic relations attorneys when one or both the parties decide to file for bankruptcy protection. As in the past, the purpose of this presentation is not to prepare you to formally respond to any issue that may arise. Instead, the goal is to alert you as to when you need to be concerned to avoid potential complications and in some instances, avoid malpractice claims.

STAY LIFT ISSUES THAT ARISE IN DOMESTIC RELATIONS CASE

I. WHEN THE STAY DOES NOT APPLY

A. The automatic stay does not prevent parties from dissolving a marriage. It also does not prevent a party from filing a Petition to dissolve a marriage.

B. The stay does not prevent a party from pursuing child support from property which is not property of the estate.

C. The stay does not prevent a party from pursuing spousal maintenance against property which is not property of the estate.

D. The stay does not prevent a party from determining paternity.

E. The stay does not prevent a party from requesting that the Court determine the amount of child support.

F. The stay does not prevent a party from having a Court determine the amount of spousal maintenance.

G. The stay does not impact on issues regarding child custody, etc.

H. The stay does not prevent proceedings regarding domestic violence.

I. The stay does not impact on withholding of income from the debtor or the estate under a judicial or administrative Order.

II. WHEN THE STAY DOES APPLY

A. The stay prevents a party from collecting any monies arising out of a domestic relations matter from the bankruptcy estate.

B. The stay prevents a party from dividing the debtor’s property as part of the domestic relations matter.

C. The stay prevents the parties from dividing up debt.
D. The stay requires a party to take affirmative action in most cases to stop all ongoing proceedings that are in violation of the stay.

E. In many instances, the stay requires a party to return to the status quo if certain action in violation of the stay was taken shortly before the bankruptcy filing.

III. LIFTING OF THE AUTOMATIC STAY

A. In certain instances, the Court will issue a comfort Order if the moving party is unsure as to whether future action would violate the stay.

B. The Court will consider the equity involved and whether the stay needs to be lifted.

C. The Court will oftentimes consider lifting the stay if doing so will not disrupt the debtor's efforts to obtain a discharge or reorganize.

D. The Court will consider lifting the stay for cause.

The following scenarios oftentimes create confusion for domestic relations attorneys:

IV. CONFUSING SCENARIOS

A. The stay only applies to action being taken against the debtor, not actually by the debtor.

B. A party owing support in a reorganization will normally be provided with a chance to cure that default through the Plan, whereas in a Chapter 7 liquidation, the Court will normally allow the aggrieved party to proceed directly against the debtor without delay.

C. If the stay applies, you cannot rely upon the Superior Court to provide you guidance as to what action on your end may violate the stay.

D. The Court will consider the equities involved in determining the amount of any sanction for violating the stay.

E. You will normally be sanctioned even if you violate the stay accidentally.

F. You will be subject to punitive damages if you intentionally violate the stay.

G. If you reach a settlement with a debtor in a domestic relations dispute, make sure as part of the settlement, the stay is lifted.
Be very cautious of proceeding when you believe the automatic stay may have been invoked. Certain serial debtors have become very sophisticated in triggering stay violations to their own benefit and some lawyers have created a small cottage industry in pursuing stay violations in domestic relations matters.
HOW TO COMMIT MALPRACTICE

Over the years, my different outlines have touched upon especially precarious situations for domestic relations lawyers. I therefore have decided to delineate all of those concerns in one outline for easy reference.

I. VIOLATING THE AUTOMATIC STAY

You do not want to violate the automatic stay. You and your clients could very well be liable for sanctions and in certain situations, even punitive damages. When in doubt, obtain what bankruptcy practitioners refer to as a “Comfort Order.” There is something to be said by having a bankruptcy judge say to you in open court, “It is not necessary for you to obtain this Order, but I will give it to you if you really want one.”

II. EXPOSING YOUR CLIENT’S POTENTIAL LIABILITY BY FILING THE DIVORCE BEFORE THE OTHER SPOUSE FILES FOR BANKRUPTCY

Once the divorce is entered, both parties are jointly liable for all the community debt. The same is not true if one party files for bankruptcy and obtains a discharge of the community debt through the bankruptcy.

III. NOT SECURING A PROPERTY SETTLEMENT AGREEMENT WHEN THE OTHER PARTY IS THREATENING BANKRUPTCY

When a high likelihood exists that the other spouse will be filing for bankruptcy, you need to ensure that your client’s entitlements are secure. If you do not, then the property settlement obligations can be discharged in a Chapter 13.

IV. HAVING YOUR CLIENT INDEMNIFY THE OTHER SPOUSE WHEN YOUR CLIENT IS PLANNING ON FILING A CHAPTER 7

The indemnification obligation is non-dischargeable, which will leave your client subject to claims brought by the other spouse even if a Chapter 7 bankruptcy is filed and a discharge obtained.

V. NOT ENGAGING IN RUDIMENTARY PRE-BANKRUPTCY PLANNING

As long as your client does not engage in improper machinations, a divorce is a means of engaging in planning to minimize the impact on your client when your client files for bankruptcy protection.
VI. **LABEL AS MANY OF THE ENTITLEMENTS AS POSSIBLE YOUR CLIENT IS RECEIVING AS SUPPORT IF YOUR CLIENT IS FILING FOR BANKRUPTCY**

Spousal maintenance and child support are 100% exempt from creditors even after received. This is in contrast to any property settlement your client may be entitled to, which is property of the estate and can be seized by a Chapter 7 bankruptcy Trustee.

VII. **IF BOTH SPOUSES WANT TO CLAIM INDIVIDUAL HOMESTEAD EXEMPTIONS, MAKE SURE THEY GET DIVORCED FIRST**

Under Arizona law, a married couple can only claim one homestead exemption of $150,000. Once divorced, each can claim a homestead exemption of $150,000.

VIII. **NOT PROTECTING YOUR RETAINER WHEN YOUR CLIENT FILES FOR BANKRUPTCY**

Even earned upon receipt retainers can be vulnerable under current case law, but at the very least, make sure you have billed and relieved all of your time if your client is filing for bankruptcy protection.
DISCRETE ISSUES IN DIVORCE/BANKRUPTCY

INTRODUCTION

My goal in this presentation is to provide divorce lawyers with a blunt and pragmatic discussion of pertinent issues facing them when divorcing clients are considering bankruptcy or a spouse is threatening or already is in bankruptcy. Today’s article will not be addressing hypothetical or esoteric issues which may surface one day. Instead, my presentation will cover pertinent issues currently before the Bankruptcy Court.

I will begin with a discussion on the current controversy surrounding “earned upon receipt” retainers.

PROTECTING EARNED UPON RECEIPT RETAINERS

The Boates decision, in which a Chapter 7 trustee challenged a rather large earned upon receipt retainer being held by counsel for Mr. Boates*, proves the maxim that “bad facts make bad law.” I strongly recommend you read that decision, though my independent analysis of it provides some guidance as to how our bankruptcy judges will probably react to earned upon receipt retainers being held by divorce lawyers for clients filing for bankruptcy protection.

Mr. Boates’ bankruptcy attorneys knew they were facing a very awkward situation for their client, who was a local lawyer anticipating a non-dischargeability challenge by one of his largest creditors. Mr. Boates had available approximately $70,000 in cash at the time of his filing and wanted to earmark that money as a war chest to ward off the inevitable challenge. He therefore paid that money to his law firm and though the Fee Agreement was not perfectly drafted, it clearly was one that was intended to be an earned upon receipt one.

The trustee’s attorney challenged the earned upon receipt retainer and presented a number of arguments, including the alleged failure to comply with State Bar ethical rules regarding earned upon receipt retainers and the innovative contention that once the bankruptcy was filed, the Chapter 7 trustee stood in the shoes of the bankrupt client. Since under the ethical rules, a client always reserves the right to demand a refund of the unused portion of even an earned upon receipt retainer, the Chapter 7 trustee should have the exact same right to do so.

The bankruptcy judge, Judge Nielsen, recognized that the trustee’s argument would effectively render it almost impossible for a bankruptcy attorney to retain any type of sizeable retainer in advance of a filing in Chapter 7 and ruled against the trustee. The trustee timely appealed and the Bankruptcy Appellate Panel, in a decision which was probably technically correct, but ignored the realities of the legal marketplace, reversed the trial court and found that the Chapter 7 trustee had the right to reject the contract and demand a refund of the fees being held which had not been earned.

* Mr. Boates was recently disbarred.
So, what should a divorce lawyer do who has a client seeking bankruptcy, but wants to have money on account since many bankrupt clients are not the best candidates for future prompt pay?

That lawyer still needs to consider accepting an earned upon receipt retainer and needs to make sure that the wording in the fee agreement is in exact compliance with State law. Furthermore, the lawyer needs to balance the desire to have an adequate retainer with the reality that the larger the amount involved, the greater chance that the trustee’s attorney will try to recover the money.

Next, the more work that can be completed prior to the bankruptcy filing, thereby reducing the retainer, the better off the lawyer will be for obvious reasons.

Incorporate strong language as to why the earned upon receipt retainer is appropriate and is not being utilized purely to try to circumvent a trustee’s seizure powers.

Finally, make sure the client knows of the potential challenge so that the client recognizes the risks that at least part of the payment may be seized.

Oftentimes, a divorce client doesn’t pay the retainer directly, but rather has a third party do so. This approach is an excellent way of circumventing this concern with one caveat. Under no circumstances should the earned upon receipt retainer flow through the debtor’s hands or should the fee agreement provide that any refund should go to the debtor for whatever reason. Even though the attorney needs to address the ethical proprieties of having a third party pay the fee, it’s much better to have the third party pay the fee directly in such a case because as long as the debtor has no direct legal interest in it, it’s basically impossible for the trustee to then try to seize those funds.

The divorce lawyer has different concerns if the client is seeking relief under Chapter 11 or 13. In those cases, the pre-Petition retainer need not be earned upon receipt, and the divorce lawyer should be able to retain it under most circumstances without challenge. Instead, in those situations, the divorce attorney needs to procure approval from the Bankruptcy Court to be retained and to ultimately be paid, which is a discussion for a different presentation.

**DIVORCE AND DISCHARGEABILITY ISSUES**

When a divorce lawyer is representing an individual who is contemplating bankruptcy, that lawyer should be understandably concerned about the timing of any bankruptcy relative to the divorce. At one time, the common practice was to complete the divorce before either side filed for bankruptcy, but the *Community Guardian Bank v. Hamlin* decision put an abrupt halt to that strategy in many situations.

That case altered the common approach of completing the divorce first because prior to that decision, many divorce and bankruptcy lawyers assumed that a debt which one spouse signed on behalf of the community would remain that spouse’s continuing obligation and not be the responsibility of the non-signing spouse once the divorce was entered. This belief arose from
the misconception that the obligation of the non-signing spouse as a member of the community would terminate once the community ended.

Though the *Hamlin* decision was disconcerting because it could leave a non-signing spouse vulnerable for a large amount of debt, it simultaneously encouraged a strategy which has now become commonplace. Instead of waiting for the divorce to be entered before either spouse files for bankruptcy, now as part of the negotiation process, the spouse who incurred the majority of the debt on behalf of the community could agree to file for bankruptcy prior to the divorce being entered, obtain a discharge which would also discharge the community, which would allow the non-signing spouse to be free and clear of the debt. This option had been available before the *Hamlin* decision, but had oftentimes been ignored because bankruptcy and divorce lawyers didn’t understand the true impact of allowing the divorce to be completed first.

The *Hamlin* decision did leave unresolved until recently the issue of what to do when one spouse engaged in what is known as non-dischargeable conduct which could eventually lead to a judgment under 11 U.S.C. § 523.

In certain instances, the Bankruptcy Codes does not allow a debtor to discharge debt because of public policy reasons. In those situations, with very few exceptions which are so rare as to not be worth noting at this time, when a judgment is rendered against the wrongdoing spouse, assuming only one spouse engaged in that conduct, the judgment would not just be entered against that spouse, but against the community as well. This left the “innocent” spouse in a rather precarious position. That individual was in a precarious position because even though he/she may have done nothing wrong, since bankruptcy case law provided that the judgment would be entered against the community and the *Hamlin* decision unequivocally stated that upon divorce the debt would become the responsibility of both spouses in their sole and separate capacity. Consequently, the “innocent” spouse would find himself/herself burdened by a non-dischargeable obligation the rest of that individual’s life even though that person had done absolutely nothing wrong.

For years, this lawyer has been waiting for a case to litigate and convince either a trial court or an appellate court to permit an innocent spouse to obtain a discharge of the indebtedness on the basis that the public policy considerations of *Hamlin* should not be extended to non-dischargeable judgments. This lawyer has been successful in negotiating very fair settlements for innocent spouses in cases in which the other spouse had committed rather egregious securities violations and that spouse and the community were facing multi-million dollar non-dischargeable judgments. Every time this attorney filed a Complaint on behalf of the innocent spouse, requesting that he/she be allowed to discharge the indebtedness notwithstanding the existing case law, the Arizona Corporation Commission had done the right thing and, as both a practical and equitable matter, consented to releases for the innocent spouse at rather substantial discounts. However, relying upon the governmental agency’s willingness to grant relief in such circumstances was of little benefit in other cases in which the aggrieved creditor would not have the same incentive to release the innocent spouse.

The *Mangold* decision, a copy of which is attached, may now provide relief for the innocent spouse. Judge Collins, who historically had represented creditors during his legal
career and had no inherent reason to be necessarily sympathetic to debtors in this situation, found it inappropriate that an innocent spouse should have her husband’s sins visited upon her upon that innocent spouse seeking bankruptcy relief. Though the Mangold decision was not published, but rather posted, and cannot be cited as precedence for the law, the Mangold decision can be cited to provide guidance to any Court addressing this issue. Without question, it recognizes the miscarriage of justice if an innocent spouse’s financial future is totally destroyed because of no misconduct on that individual’s end.

So why is this important to a divorce lawyer? It is important so that a divorce lawyer recognizes the importance of creating a record as part of the divorce proceedings that an innocent spouse is truly innocent and ensure that the divorcing spouses’ lawyers have the spouses file a bankruptcy while they are still married. Upon the bankruptcy being filed, the innocent spouse needs to force the issue by then having the spouses divorce and then immediately seek a determination from the Court that the innocent spouse should not be burdened by a non-dischargeable judgment. No guarantee exists that this strategy will work, but based on the Mangold decision, the current trend is definitely pointing in the right direction.

Attachment (In re Mangold)
UNITED STATES BANKRUPTCY COURT
DISTRICT OF ARIZONA

In re

ROBERT W. MANGOLD and
MICHELE M. MANGOLD,
Debtors.

v.

MICHELE MANGOLD,
Movant,

THOMAS M. PICCOLO, JOSHUA T. GREER, and MOYES, SELLERS AND HENDRICKS,
Respondents.

Chapter 7 Proceedings
Case No: 2:12-bk-16858-DPC

UNDER ADVISEMENT RULING REGARDING POST-NUPITAL AGREEMENT AND MICHELE MANGOLD'S LIABILITY TO THOMAS J. PICCOLO

[NOT FOR PUBLICATION]

Thomas M. Piccolo ("Piccolo") holds a nondischargeable judgment against Robert M. Mangold ("Mr. Mangold") and the marital community of Mr. Mangold and Michele Mangold ("Ms. Mangold"). Ms. Mangold contends her Post Nuptial Agreement ("Post Nuptial Agreement") with Mr. Mangold prevents Piccolo from collecting on his judgment by garnishing wages earned by her after her bankruptcy discharge and after execution of the Post Nuptial Agreement. Piccolo contends the Post Nuptial Agreement is unenforceable as it is a sham contract and a fraudulent agreement. Piccolo also contends that, where a creditor obtains a nondischargeable judgment against a marital community, under Arizona law both spouses remain liable on that obligation even if the marital community is properly dissolved by agreement or by a valid court decree.
dissolving the marriage.

This Court now finds that, under the facts of this case, the Post Nuptial Agreement is unenforceable and avoidable. The Court also finds that sole and separate property acquired by an “innocent” spouse is not forever liable for nondischargeable debts incurred by the “guilty” spouse during the existence of their marital community.¹

I. BACKGROUND

1. On June 25, 2010, a judgment was entered by the Arizona Superior Court, Maricopa County (“State Court”) in favor of Piccolo and against Mr. Mangold in the amount of $1,625,787.26 plus interest at the rate of 10% per annum in case number CV2009-013428 (“State Court Action”). See Exhibit A attached to the Notice of Errata filed at docket number 9 in adversary case number 2:12-ap-01863-DPC (“Adversary Proceeding”).

2. Mr. and Ms. Mangold filed their joint chapter 7 bankruptcy on July 27, 2012 (“Petition Date”) at case number 2:12-bk-16858-DPC (DE² 1).

3. On November 1, 2012, Guaranty Solutions, LLC (assignee of Piccolo) filed an adversary proceeding against Mr. and Ms. Mangold seeking to hold certain obligations nondischargeable under 11 U.S.C. §§ 523(a)(2), (4), (6) and (19).³ See docket entry number 1 in the Adversary Proceeding. On November 8, 2013, the Court signed the parties’ stipulated order substituting in Piccolo as the party plaintiff. See docket entry 35 in the Adversary Proceeding. On December 3, 2014, this Court entered judgment (“Community Judgment”) in favor of Piccolo and against Mr. Mangold’s sole and

¹ This Order sets forth the Court’s findings of fact and conclusions of law under Rule 7032 of the Rules of Bankruptcy Procedure.
² “DE” refers to docket entries in the administrative file concerning this chapter 7 case.
separate property and against the property belonging to the marital community of Mr.
and Ms. Mangold. See Adversary Proceeding docket number 69.

4. On February 18, 2015, this Court entered a Stipulated Judgment against
Ms. Mangold in the amount of $10,000 ("Ms. Mangold Judgment"). See Adversary
Proceeding docket number 84. The Ms. Mangold Judgment has been fully satisfied. See
the Satisfaction of Judgment at Adversary Proceeding docket number 227.

5. Ms. Mangold received her bankruptcy discharge on November 13, 2012.

DE 23. At that time, Mr. Mangold was also discharged of all pre-petition debt except the
Community Judgment.

6. On October 1, 2015, Mr. and Ms. Mangold entered into the Post Nuptial
Agreement. See Ex 1 and Ex 4.4

7. As a part of his continuing efforts to gain satisfaction of the Community
Judgment, Piccolo garnished Ms. Mangold’s wages from Expert Realty5 and has sought
to conduct post-judgment discovery from Ms. Mangold so as to locate assets of
Ms. Mangold from which the Community Judgment could be paid.

8. Claiming Piccolo violated her discharge injunction, Ms. Mangold filed a
Motion for Sanctions for Violation of 11 U.S.C. § 524 ("Sanctions Motion") against
Piccolo and his attorney, Joshua T. Greer ("Greer") and Greer’s law firm, Moyes, Sellers
and Hendricks (the "Law Firm"). Ms. Mangold’s November 21, 2017 Sanctions Motion
(DE 67) contends her wages from Expert Realty are her sole and separate property and,
therefore, not available to Piccolo for collection on his Community Judgment. Piccolo
responded to the Sanctions Motion on November 27, 2017 (DE 68). Ms. Mangold replied
on December 21, 2017 (DE 71).

4 All exhibits admitted at the March 27, 2018 trial of this matter shall be hereinafter referred to as “Ex ___________.

5 Expert Realty is an entity created by the Mangolds but allegedly owned by just Ms. Mangold as her sole and
separate property.
9. Piccolo filed his December 12, 2017 Motion for Sanctions Pursuant to Rule 9011 ("9011 Motion") (DE 69). Ms. Mangold responded on December 21, 2017 (DE 72) and Piccolo replied the day after Christmas (DE 74).

10. On January 11, 2018, this Court held its initial hearing on the Sanctions Motion and the 9011 Motion (DE 76). At that hearing, the Court established a schedule for additional briefing and set an evidentiary hearing for March 27, 2018.


12. An evidentiary hearing was conducted by the Court on March 27, 2018. Ms. Mangold, Mr. Mangold and Donna Navarro testified at trial. When the trial concluded, the Court took this matter under advisement.

13. On April 5, 2018, the parties filed a Stipulation for Entry of Order Regarding Asset (DE 92) and the Court entered an order that day approving the Stipulation (DE 94). In essence, the Stipulation notes the parties agree that all assets owned by the Mangolds as of October 1, 2015 (the date the Post Nuptial Agreement was executed), remain subject to collection by Piccolo in connection with his Community Judgment.

II. JURISDICTION

This Court has jurisdiction over these matters pursuant to 28 U.S.C. §§ 157(b) and 1334.
III. ISSUES

A. Whether the Post Nuptial Agreement is enforceable.

B. Whether the Community Judgment is enforceable against Ms. Mangold’s sole and separate property.

IV. ANALYSIS

Mr. Piccolo’s Community Judgment exceeds $1.6 million. That Community judgment is nondischargeable and is subject to Piccolo’s collection efforts against the marital community assets of Mr. and Ms. Mangold as well as the sole and separate assets of Mr. Mangold. Post-petition community property acquired by the Mangolds is liable for Piccolo’s Community Judgment. See Valley Nat’l Bank v. LeSuer (In re LeSuer), 53 B.R. 414 (Bankr. D. Ariz. 1985) and In re Rawlinson, 322 B.R. 879, 844-885 (Bankr. D. Ariz. 2005). The Community Judgment is not the sole and separate obligation of Ms. Mangold. See Tsurukawa v. Nikon Precision, Inc. (In re Tsurukawa), 258 B.R. 192 (9th Cir. B.A.P. 2001). None of these facts or legal issues are in dispute.

The controversy between these parties lies with Ms. Mangold’s contention that the Post Nuptial Agreement dissolved the Mangolds’ marital community and, since that date, all property acquired by her constitutes her sole and separate property. Ms. Mangold does acknowledge, however, that property which was transferred to her or was acknowledged in the Post Nuptial Agreement as belonging to her remains available to collection efforts by Piccolo. See DB 94. Piccolo claims the Post Nuptial Agreement is unenforceable and avoidable as a fraudulent transfer and, therefore, did not dissolve the Mangolds’ marital community. For the reasons stated below, the Court agrees with Mr. Piccolo. Piccolo further suggests that any property acquired hereafter by Ms. Mangold is also available for Piccolo’s Community Judgment collection efforts. For the reasons stated below, the Court disagrees.
A. The Post-Nuptial Agreement.

The Post Nuptial Agreement is invalid for two reasons. First, this Court finds the Mangolds’ intention in executing the Post Nuptial Agreement was improper as they were principally attempting to avoid payment to Piccolo. Under Arizona’s version of the Uniform Fraudulent Transfer Act (“UFTA”) (A.R.S. §§ 44-1001, et seq.), transfers by a debtor are invalid and avoidable if they were made with the intent to hinder, delay or defraud creditors. The Court finds this was exactly the Mangolds’ intent in executing the Post Nuptial Agreement.

Second, this Court finds the Mangolds entered into the Post Nuptial Agreement with no intention of adhering to the terms of the Post Nuptial Agreement. The Court in Arizona Cotton Ginning Co. v. Nichols, 454 P.2d 163, 166 (Ariz. 1969) explains the consequences where parties to a contract have no intention of being bound by the terms of that contract:

Where neither party intends that a contract shall result by what is done, no valid contract results; and where both parties actually intend that there shall be no contract and that intent is known and admitted, there is no occasion to consider the existence or nonexistence of any objective manifestation to the contrary . . . . Where parties executed what on its face purported to be a written contract, at execution neither party intended it to be a contract, and therefore the whole transaction was a sham.

Id.

1. The Mangolds’ Agreement Was Entered Into With the Intent to Hinder, Delay or Defraud Piccolo.

Ms. Mangold admitted in her pleadings and at trial that her primary motive for executing the Post Nuptial Agreement was to avoid her liability on garnishment on Piccolo’s Community Judgment. See DEs 87 and 91, Trial Audio Recording at 9:29 a.m. She also pointed to a more theoretical reason, namely her desire to protect herself from possible future community judgments that could result from her husband’s future
The Court finds Ms. Mangold signed the Post Nuptial Agreement intending to avoid the consequences of the Community Judgment. Parties seeking to avoid exposing their future community property to existing community judgments by entering into post-marriage agreements to declare such property sole and separate property of each spouse have run afoul of fraudulent transfer laws. See In re Beverley, 374 B.R. 221, 234 (B.A.P. 9th Cir. 2007), aff’d in part, dismissed in part, 551 F.3d 1092 (9th Cir. 2008). As one court noted, to consider transmutation of property interests not subject to the UFTA would give short shrift to the UFTA. State ex rel. Indus. Comm’n of Arizona v. Wright, 43 P.3d 203, 207 (Ariz. Ct. App. 2002).

In determining whether the Post Nuptial Agreement was entered into by the Mangolds for an improper purpose, i.e. fraud, fraudulent intent, a fraudulent objective, or even resulting in a fraudulent transfer or conveyance in this case, the Court looks to the UFTA for guidance. In Arizona, the UFTA is codified in Arizona’s Revised Statutes §§ 44-1001, et seq. It is not necessarily the transaction itself, but rather the purpose behind the transaction, that brings it within the inquiry of A.R.S. § 44–1004. State ex rel. Indus. Comm’n of Arizona v. Wright, 43 P.3d 203, 207 (Ariz. Ct. App. 2002). Sections

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*Ms. Mangold testified she was informed by counsel that divorcing Mr. Mangold would not protect her future earnings from Piccolo. The Court does not presume this advice was correct, nor was the rationale for this advice adequately explained in the pleadings or at trial. However, the Court does not mean to encourage Ms. Mangold to divorce Mr. Mangold in an effort to free her from Piccolo’s financial grip. Encouraging or suggesting one divorce their mate is not the job of the courts. See Spector v. Spector, 531 P.2d 176, 181 (Ariz. 1975) (Agreements between spouses that provide for or tend to induce divorce or separation, are contrary to public policy).
44-1004\textsuperscript{7} and 1005\textsuperscript{8} aid courts in ascertaining fraudulent intent. The badges of fraud outlined in § 44-1004(B) are factors courts should consider when looking at whether the purpose of contracting parties reflect their fraudulent intent. Badges of fraud are merely signs or marks of fraud from which intent may be inferred. \textit{Gerow v. Covill}, 960 P.2d 55, 63 (Ariz. Ct. App. 1998), \textit{as amended} (Aug. 26, 1998) (citing \textit{Torosian v. Paulos}, 313 P.2d 382, 388 (Ariz. 1957)); A.R.S. § 44-1004.

[They are facts having a tendency to show the existence of fraud, although their value as evidence is relative and not absolute .... Often a single one of them may establish and stamp a transaction as fraudulent. When, however, several are found in the same transaction, strong, clear evidence will be required to repel the conclusion of fraudulent intent.]

\textit{Torosian}, 313 P.2d at 388.

The Mangolds' Post Nuptial Agreement sought to put collectible assets out of the reach of Piccolo in a manner that hindered, delayed or defrauded him. The Mangolds'

\textsuperscript{7} A.R.S. Section 44-1004, Transfers fraudulent as to present and future creditors

A. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation under any of the following:

1. With actual intent to hinder, delay or defraud any creditor of the debtor.

2. Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either:

(a) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction.

(b) Intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.

B. In determining actual intent under subsection A, paragraph 1, consideration may be given, among other factors, to whether:

1. The transfer or obligation was to an insider.

2. The debtor retained possession or control of the property transferred after the transfer.

3. The transfer or obligation was disclosed or concealed.

4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit.

5. The transfer was of substantially all of the debtor's assets.

6. The debtor absconded.

7. The debtor removed or concealed assets.

8. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.

9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.

10. The transfer occurred shortly before or shortly after a substantial debt was incurred.

11. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

\textsuperscript{8} A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.
intent was to remove community wages earned by Ms. Mangold and other future interests acquired by her out of Piccolo's reach by converting their future community assets to her sole and separate ownership. This transfer to Ms. Mangold was without consideration to Mr. Mangold. Several of the § 44-1004(b) badges of fraud are implicated by the Mangolds' actions:

1. This was an insider transaction;
2. At the conclusion of the transaction, both parties maintained complete control over all current and future assets;
3. The existence of the Community Judgment precipitated the Mangolds' execution of the Post Nuptial Agreement;
4. The transfer to Ms. Mangold alone of important wage rights together with the creation of the Expert Realty entity through which she was to earn revenue;
5. The Mangolds were insolvent at the time of the transaction; and
6. This transaction occurred shortly after satisfaction of the Ms. Mangold Judgment.

But for the Mangolds' desire to evade Piccolo's Community Judgment, the Mangolds would not have entered into the Post Nuptial Agreement. This Court finds the Post Nuptial Agreement is avoidable as both an intentional and constructive fraudulent transfer under §§ 44-1004 and 1005 of Arizona's UFTA.

2. The Mangolds Did Not Intend to Be Bound by Their Agreement.

Ms. Mangold testified that the written terms of the Post Nuptial Agreement did not match her understanding of what the Post Nuptial Agreement was to achieve relative to the Mangolds' community property existing at the time of execution and as it pertained to the married couples' property interests in the future. DE 91, Trial Audio Recording at
9:47-9:53 am. Specifically, Ms. Mangold said that the Post Nuptial Agreement should not alter community property interests or any interests that were affected by a judgment. *Id.* However, Ms. Mangold conceded that the Post Nuptial Agreement did not actually read consistent with her understanding in this regard. Moreover, there are two versions of the Post Nuptial Agreement, both reflecting the same date and signatures. *See* Exs. 1 and 4. It was not clear to the Court which Post Nuptial Agreement was the controlling version. Ms. Mangold conceded she also did not know which version controlled. *See id.* and DE 91, Trial Audio Recording at 9:47-9:53 a.m.

The evidence before this Court demonstrates that, after execution of their agreement, the Debtors' continued to conduct their financial affairs in the same manner as before the Post Nuptial Agreement was executed. All purchases made and expenses and costs incurred by the Mangolds continued to be paid by Mr. Mangold. Mr. Mangold was not reimbursed by Ms. Mangold for covering her share of these payments nor did the Post Nuptial Agreement require he be reimbursed by Ms. Mangold for his expenditures on her behalf. Mr. and Ms. Mangold also continued to treat their income as jointly owned. The Mangolds never intended to dissolve their marital community. Not only did Mr. and Ms. Mangold's actions and course of conduct show that they did not actually intend to carry out the terms of the Post Nuptial Agreement, but the property acquired by Ms. Mangold and Mr. Mangold after execution of the Post Nuptial Agreement was so fully commingled that any separate identity it could have had was lost. *See Potthoff v. Potthoff*, 627 P.2d 708, 713 (Ariz. Ct. App. 1981) (A transmutation of separate property occurs where commingling of property is such that the identity of the property as separate or community is lost and it therefore becomes community).

The Court finds the Mangolds did not abide by, or ever intend to abide by the terms of the Post Nuptial Agreement, regardless of which version of the Post Nuptial Agreement the parties held up as a shield to Piccolo's collection efforts. The Mangolds'
primary intent in executing the Post Nuptial Agreement was to seek to shelter assets acquired by them after execution of that agreement and to place Ms. Mangold’s future income out of the reach of Piccolo’s Community Judgment.

3. **Summary As To The Post Nuptial Agreement**

The Post Nuptial Agreement is invalid and unenforceable because this Court finds the Post Nuptial Agreement was entered into with fraudulent intent at a time when the Mangolds were insolvent and where Mr. Mangold received no consideration for the transfer of these future community property rights. The Post Nuptial Agreement is hereby avoided as both an intentional fraudulent transfer and a constructive fraudulent transfer under §§ 44-1004 and 1005 of the Arizona Revised Statutes. Moreover, Mr. and Ms. Mangold did not have the intent to be bound by the Post Nuptial Agreement, either at the time it was executed or thereafter. The Court finds the Post Nuptial Agreement is void as a sham transaction. Because the Post Nuptial Agreement is unenforceable, the Mangolds’ community was never dissolved. Their marital community remains intact to this day. Ms. Mangold’s wages in question remain property of the Mangolds’ community and are available for garnishment by Piccolo as he seeks to enforce the Community Judgment.

B. **Sole and Separate Property of Ms. Mangold.**

Ms. Mangold cites Bankruptcy Judge Case’s decision in the Arizona bankruptcy matter of *Taylor Freezer Sales of Arizona, Inc. (In re Oliphant)*, 221 B.R. 506 (Bankr. D. Ariz. 1998) for the notion that, if a creditor is successful in a nondischargeability case against a divorced debtor, that creditor/plaintiff “could only then recover from debtor’s post-divorce separate property.” DE 71 at page 4 of 33. The Court does not read *Oliphant* to support Ms. Mangold’s position. In *Oliphant*, the court denied the “innocent
spouse’s motion to dismiss a nondischargeability adversary proceeding in her bankruptcy
holding there were adequate material allegations supporting the creditor’s claim that the
debtor was not “innocent” so that the debtor’s § 523 liability needed to be tried to the
court.

For his part, Piccolo contends that neither a valid post nuptial agreement between
the Mangolds nor a non-collusive divorce could free Ms. Mangold of her community’s
debt to Piccolo. Piccolo points to Community Guardian Bank v. Hamlin, 182 Ariz. 627,
631-32 (App. 1995) corrected (7-10-1995) for the proposition that, upon the dissolution
of a marital community, both spouses become liable for the debts of the community as
successors to the marital community. The Hamlin court specifically held “...both
spouses remain jointly liable for the community obligations after divorce.” Id at 631.9

Hamlin, of course, was not a bankruptcy case nor did either spouse in Hamlin obtain a
bankruptcy discharge. Here, however, Ms. Mangold’s sole and separate debts were
discharged. She has no sole and separate liability to Piccolo. After satisfaction of the
Ms. Mangold Judgment, Piccolo has not been entitled to collect from the sole and
separate property of Ms. Mangold. To date, this point has been moot as Ms. Mangold
has not owned any sole and separate property. Hereafter, if and when she acquires sole
and separate property, a community debt incurred by Mr. Mangold alone may not be
satisfied from the post discharge separate property acquired by Ms. Mangold. The
language of the Community Judgment itself acknowledges this fact by indicating that

9This Court questions whether Hamlin overstated its holding relative to the spouse who did not incur the community
debt at issue in that case. As to that spouse, this Court contends her liability on that community debt does not make
her sole and separate property liable for the community debt but, rather, extends post-divorce only to the extent of
the community property (or the value of that property) which she received from her divorce. After all, the
community’s creditors were never entitled to collect from her sole and separate property and such creditors would
be disadvantaged by the divorce disposition only to the extent she left the community with community property
which should be available to pay the community’s creditors. Moreover, she benefited from the inacquittal of the
community debt to the extent she walked away from the community with community assets that should have been
delivered to the community’s creditors. Furthermore, if the creditors wanted her sole and separate property to be
available to satisfy their claims, they could and should have had her personally (i.e. solely and separately) sign for
the debt. If the community debt was a tort incurred by the debtor’s spouse, the tort victim would have no claim
against the innocent spouse’s sole and separate property, so why should the post divorce sole and separate property
of the debtor stand good for the tortfeasor’s liability?
judgment is against Mr. Mangold’s sole and separate property and the community
property of the Mangolds.

Piccolo also points to the case of In re Kimmel, 378 B.R. 630 (9th Cir. B.A.P.
2007), not because it is factually similar to the case at bar but because of dicta in that case
suggesting that, upon the filing of a bankruptcy by an innocent spouse, a creditor could
have filed a nondischargeable claim to demonstrate the non-filing spouse incurred a
nondischargeable debt to that creditor and, once proven, “then 524(a)(3) would not
protect after acquired community property.” Id. at 181. Significantly, Kimmel involved
a post-nuptial agreement entered into by the spouses many, many years prior to the
creditor’s efforts to reopen one spouse’s discharge. Also, Kimmel did not involve a filed
§§ 523 or 727 adversary proceeding but, rather, addressed the effect of a community
discharge under § 524. Kimmel is neither binding on the Court nor persuasive on issues
before the Court.

If and when Ms. Mangold’s marital community is legally and unavoidably
dissolved, thereafter her earnings and legitimately acquired post-marital dissolution
property will become her sole and separate property. Ms. Mangold is not solely and
separately liable to Piccolo on his Community Judgment and Ms. Mangold has received
a discharge of her sole and separate debts. That sole and separate property acquired after
her bankruptcy discharge will not be available to Piccolo in collection of his Community
Judgment nor would that Community Judgment become her sole and separate liability.
In short, should Ms. Mangold ever acquire sole and separate property hereafter, that
property would not be available for involuntary collection remedies on Piccolo’s
Community Judgment. See In re Rawlinson at 883-885.10

10 This Court is aware of the irony of its criticism of dicta contained in the Kimmel case when Section IV (B) of this
Order is also dicta. However, the parties asked for direction on this topic and the Court’s thoughts in this regard
might be of value in the parties’ efforts to resolve this long and hard fought battle.
V. CONCLUSION

The Mangolds’ Post Nuptial Agreement is a sham agreement, is unenforceable and is hereby avoided as an actual and constructively fraudulent transfer. However, should Ms. Mangold’s community ever be lawfully and unavoidably dissolved by an enforceable post nuptial agreement or separation agreement or by a noncollusive, lawful dissolution of her marriage to Mr. Mangold or if the marital community is dissolved by the passing of her spouse, Ms. Mangold may then acquire sole and separate property which would not be susceptible to collection remedies available to the holder of the Community Judgment.\(^\text{11}\)

Based on the foregoing, the Sanctions Motion against Piccolo, Greer and the Law Firm is hereby denied. The 9011 Motion is also denied for the reason that, based on the novelty and complexity of the legal issues presented to the Court and the contested nature of the facts surrounding the Post Nuptial Agreement, Ms. Mangold’s counsel’s pursuit of the Sanctions Motion and his defense of the 9011 Motion were (1) not presented for any improper purpose; (2) warranted under existing law; (3) his factual contentions had evidentiary support; and (4) his denial of factual contentions were warranted on the evidence.

DATED AND SIGNED ABOVE.

To be Noticed through the BNC to:
Interested Parties

Harold Campbell
Campbell & Coombs, PC
1811 S. Alma School Rd., Suite 225
Mesa, AZ 85210

\(^{11}\text{Under Arizona’s community property laws, property acquired by Ms. Mangold through “gift, devise or descent” would also become her sole and separate property. See ARS § 25-213 (A).}\)
INTERPLAY BETWEEN PROPERTY OF THE ESTATE,
EXEMPTIONS AND DIVORCE

During my 35 years of practicing law, I have determined that if you want to terrorize a
divorce lawyer, mention to that lawyer that his client is contemplating bankruptcy. Invariably,
the attorney will start to shake and go pale. Similarly, if a bankruptcy lawyer is advised that his
clients are considering a divorce, that lawyer will oftentimes lose all interest in the ongoing
representation. This reaction is not just related to the variety of conflict issues that may arise
when the topics of bankruptcy and divorce surface in the same proceeding, but because most
practitioners understand that a variety of procedural and substantive obstacles will need to be
addressed in such circumstances.

This article will primarily focus on substantive issues which need to be considered by
bankruptcy lawyers in cases in which they are representing one, or in certain instances, both
spouses seeking a divorce.*

The first issue addressed is how property of the bankruptcy estate is impacted by the
initiation of divorce proceedings.

I. DOES THE DIVORCE PROCEEDING IMPACT ON PROPERTY OF THE
BANKRUPTCY ESTATE?

As a preliminary matter, this letter is being written by an Arizona practitioner based
upon Arizona community property law and Arizona having opted out of federal exemptions. This
is a crucial determination because a number of different issues arise when federal exemptions
apply. However, many of the principles are applicable to other community property states as
well.

However, determining what falls within the purview of property of the bankruptcy estate
is normally controlled by 11 U.S.C. § 541 and/or 11 U.S.C. § 1306. In certain instances, state
law may control as to what property is excluded from the bankruptcy estate, but as a general
proposition, there is a fair amount of uniformity throughout the southwest in the definition of
what constitutes property of the bankruptcy estate.

If only one spouse files for bankruptcy protection (keeping in mind that the bankruptcy
estate includes all community property), community property that would be property of the
bankruptcy estate if the couple was happily married is still community property for purposes of
the Bankruptcy Code. This is the case even if upon initiating divorce proceedings, the spouses
have informally divided up the property. This is a crucial understanding for two distinct reasons:

1. The spouse filing for bankruptcy would normally have had time to engage in some
   basic planning to try to protect as much of the property being retained as possible; and

* Needless to say, I do not recommend normally representing both spouses in such situations without a
   comprehensive conflict waiver and separate determination that it is both spouses’ best interest to retain one
   bankruptcy lawyer.
2. If the non-filing spouse is not advised in advance of the bankruptcy filing and does not take any steps to protect his share of the assets, the non-filing spouse could find himself caught totally off guard and subject to a turnover order which could have been avoided if that spouse had been given notice.

Please note that the situation just described occurs prior to a formal order from the domestic relations court dividing up the family’s assets. Unfortunately, many times little attention is paid to this concern when one spouse is filing for bankruptcy, which oftentimes leads to rather tragic unintended consequences as to a non-filing party. See, In re McCoy, 11 B.R. 276 (9th Cir. BAP 1990) (where community assets had not been divided prior to the debtor spouse’s petition being filed and it was found that the non-debtor spouse’s community interest was subject to claims from the debtor spouse’s post-separation creditors).

II. CLAIMING EXEMPTIONS

In Arizona, when only one spouse files for bankruptcy protection, it is customary to file a “dummy exemption schedule” for the non-filing spouse to eliminate any confusion as to how exemptions are being claimed. This is especially necessary in Arizona, which allows a married couple to stack their individual exemptions with the exception of the homestead exemption. In friendly situations, the two spouses can decide how to assert the joint exemption in a way most advantageous for both spouses, but when a divorce is pending, it is not unusual for the parties to quarrel as to claiming exemptions.

From practical experience, I have learned that one debtor cannot stack the exemption rights of the non-filing spouse without that spouse’s consent. This can lead to rather unfortunate outcomes in two different ways. First of all, a non-filing spouse can refuse to allow the other spouse the right to stack exemptions even though the non-filing spouse may not have any need to claim that exemption. This strategy is malicious and counterproductive, but does occur.

More commonly, a non-filing spouse may refuse to consent to a stacking of the exemptions even if the non-filing spouse may be trying to protect an asset of inconsequential value. For example, if the filing spouse has a vehicle worth $12,000, whereas the non-filing spouse is driving an old junker worth no more than $1,200, common sense dictates that the spouses would agree to stack their exemptions into one $12,000 vehicle and then negotiate a settlement with the bankruptcy trustee to retain ownership of the $1,200 older car. But, if the non-filing spouse refuses to allow the other spouse to stack the exemptions, the filing spouse would consequently leave $6,000 of equity exposed in his car.²

Already, the first two sections of this outline delineate when spouses cooperating can create a “win/win” result for both spouses, but if the spouses do not want to work together, a number of outcomes exist which can create havoc for either of the spouses.

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¹ His and himself are interchangeable with her and herself.
² Please note that under Arizona, with the exception of handicapped vehicles, each spouse can claim a $6,000 exemption in one vehicle.
Arizona law provides absolute protection to alimony being paid (or already paid) and child support, as well. At one time the statute governing domestic support obligations was not so broad, but in recent years, the exemption has been expanded to even include past due support and support which has already been deposited by the recipient.

This provides cooperative spouses with an amazing variety of options regarding asset protection. Unprotected money in the hands of one spouse will now be entitled to exemption protection upon receipt by the other as long as the payment is in the form of some type of support since it is absolutely protected under Arizona law. Presumably, the same is true in other states and to some extent under the federal exemptions.

As a simple example, if a man on the verge of bankruptcy has $5,000 in his bank account, but owes his ex-wife for either child support or spousal maintenance, by paying his ex-wife past due support, that money is transformed into an exempt asset in the hands of his spouse. Even more importantly, if the payment is past due and the payment is being made pursuant to a court order, the Bankruptcy Code provides that the payment is not a preference. See, 11 U.S.C. § 547(c)(7).

The exact same strategy can be used in instances where the recipient of the support is on the verge of bankruptcy. By ensuring that the payment being received is in the form of support, a party seeking bankruptcy protection can shield monies which otherwise may be vulnerable. This allows that individual to potentially create a nest egg similar to what some clients do with social security.

Few bankruptcy trustees or judges would question the strategy just outlined, especially because normally the amount at stake is simply not worth fighting over and invariably the spouse receiving the support needs it or would not have been awarded it in the first place. But what about situations in which one party owns a sizeable amount of non-exempt assets, is subject to potential collection efforts and needs to file for bankruptcy? In that case, what options are available to that individual if he is legitimately liable to an ex-spouse for either spousal maintenance and/or child support?

In that situation, since many individuals owing support want to make sure the support is paid, why couldn’t the spouse filing for bankruptcy pledge his assets to the other spouse as security for future support? Doing so is not unusual in the context of a domestic relations settlement and it is actually a prudent practice for the party owed the support to try to secure as much of a future payment as possible. If the arrangement is negotiated at arm’s length and is for fair consideration, what is the fundamental problem with this type of understanding? See, In re Ottaviano, 63 B.R. 338 (Bkrcty. D. Conn. 1986) (holding that a pre-petition division of non-exempt community property in lieu of periodic alimony payments by debtor spouse was for a reasonably equivalent exchange of value and therefore not subject to a fraudulent transfer claim initiated by the debtor’s bankruptcy trustee).

My office has researched this issue and was surprised to discover that no definitive case law exists in the Ninth Circuit that we could find. If the transaction was a sham or entered into for the specific purpose of avoiding or defrauding creditors, presumably a challenge could be
mounted under 11 U.S.C. § 548. In re Holloway, 955 F.2d 1008 (5th Cir. 1992) (transfer of security interest to non-debtor spouse was fraudulent); In re Kaczorowski, 87 B.R. 1 (Bkrtcy. D. Conn. 1988) (reasonably equivalent value was not received by debtor for pre-petition transfer of debtor’s one-half interest in family residence to non-debtor spouse). However, when the transaction really has been negotiated to ensure that the recipient party is protected, this strategy appears to be viable in most instances.

So what happens if one party goes overboard in the planning? The best example of what occurs in that situation can be found in the In re Beverly decision. In re Beverly, 374 B.R. 221 (9th Cir. BAP 2007) affirmed 551 F.3d 1092 (9th Cir. 2008). In re Beverly involved a lawyer who exchanged a number of communications with his wife in which he painstakingly spelled out his efforts to avoid paying his creditors by conveying non-exempt assets to his non-filing spouse and retaining otherwise exempt assets in his name. The court ruled that the division of property was not equitable and denied the debtor’s discharge along with granting other relief. What remains unknown is what the court would have done if a factual determination had determined that the division was fair and equitable. One suspects that in light of the husband’s clear intent to avoid paying his creditors, the trier of fact could still have found that the transfer was an improper one and set the transfer aside. Under those circumstances, the Court may not have denied the debtor his discharge.

III. DEALING WITH DEBT

When one spouse files for bankruptcy protection, the ultimate discharge includes not just that spouse’s sole and separate property, but community obligations as well. As a matter of law, in such instances the non-filing spouse is still only liable in a sole and separate capacity. This is fair and makes sense since invariably the other spouse did not sign on the obligation or engage in the activity resulting in the claim.

Comprehending this aspect of the law is important because when primarily one spouse has incurred the debt, having that spouse file for bankruptcy while the couple is still married could very well allow the other spouse to avoid having to file for bankruptcy. This leads to the following question: If as part of a property settlement agreement issued prior to the divorce being finalized the non-filing spouse receives community property, will that property be immune from claims of the bankruptcy trustee? Once again, there is a dearth of case law on this issue, but if a division of assets is at arm’s length, one would ask why wouldn’t this strategy work? For example, if the husband had incurred $100,000 of credit card debt (which under Arizona law would be community debt) and prior to bankruptcy had exchanged $100,000 of non-exempt assets in return for keeping $100,000 of exempt assets as part of a property settlement agreement, if the assets conveyed to the wife are no longer part of the community property estate, this strategy may work. Of course, a lot depends upon whether the parties can engage in an absolute divestment of the community’s assets prior to the divorce being entered and whether there is a finding by the Court that there was an actual intent to hinder, delay or defraud creditors and that fair consideration was provided. See, In re Roosevelt, 87 F.3d 311 (9th Cir. 1996) (overruled on other grounds) (where a creditor commenced an adversary proceeding seeking denial of discharge under 11 U.S.C. § 727 and the court found that the debtor spouse’s pre-petition transmutation of the debtor’s community property interest in his homestead through a
marital separation agreement with his non-debtor wife was not done with the intent to hinder, defraud or delay); compare with In re Roosevelt, 220 F.3d 1032 (9th Cir. 2000) (finding on appeal of the Chapter 7 trustee’s §§ 544, 547 and 548 claims that the non-debtor spouse’s “for value” defense was meritless because she did not have an interest in the assets transferred to her debtor husband as part of a marriage settlement agreement).

In many instances, even if the law is not clear, it may make sense to consider such tactics as long as the clients understand that in certain instances, the spouse filing for bankruptcy could be facing potential denial of discharge as in the In re Beverly case.

IV. OTHER MISCELLANEOUS ISSUES

You need to be aware of the bankruptcy trustee’s ability to access even exempt assets to pay a support claim. One reason why the spouses would normally want to cooperate prior to bankruptcy is to avoid this result.

Spouses have to be careful not to engage in preferential transfers. This would commonly occur in a case in which one spouse may have legitimately owed the other spouse money and then repays that debt within one year of bankruptcy. With the exception of certain payments made pursuant to a domestic relations order, the payment would be preferential.

Be careful not to confuse a property settlement with spousal maintenance award. A property settlement is not exempt and such a transfer can result in the receiving spouse having to turn that property over to a bankruptcy trustee if that spouse decides to file for bankruptcy. Or, in other instances, if the payment from one spouse to the other is not identified as either spousal maintenance or property settlement, and if the conveying spouse then files for bankruptcy, the transfer is subject to being set aside as a preference as well. In re Grassmuck, 127 B.R. 869 (Bkrcty. D. Or. 1991).

V. CONCLUSION

The purpose of this outline was not to be a definitive treatise on this subject. Instead, it was simply to highlight a variety of issues that arise when individuals are undergoing the dual trauma of bankruptcy and divorce.
INTERPLAY BETWEEN DIVORCE AND BANKRUPTCY

Not surprisingly, and often tragically, individuals seeking bankruptcy relief also end up divorcing or the reverse is true, i.e., a divorcing couple encounters the need to file for bankruptcy. This occurs because a divorce oftentimes creates or exacerbates the financial troubles of the individuals, or the monetary pressures leading to bankruptcy drives couples apart. This is especially true in today’s economic climate in which so many citizens are unemployed or underemployed and real estate can no longer be relied upon as a lifeline and the lending industry has cut off the availability of cheap credit.

This outline is designed to highlight issues which arise in cases in which a bankruptcy is filed during the pendency of a divorce or parties decide to divorce after filing for bankruptcy. It was drafted for bankruptcy lawyers, but divorce lawyers should find it valuable.


Much confusion has arisen regarding the scope of the automatic stay in divorce proceedings. This confusion probably results from lawyers having been taught all these years that the filing of a bankruptcy prevents action being taken against a debtor unless stay relief is procured from the Bankruptcy Court. Although it is true that the automatic stay normally prevents such action from going forward, the Bankruptcy Code does include a number of exceptions directly relating to divorce proceedings. Those exceptions include the commencement or continuation of a civil action proceeding – (1) for the establishment of paternity, (2) for the establishment or modification of an order for domestic support obligations, (3) concerning child custody or visitation, (4) for the dissolution of a marriage, except to the extent that such proceedings seek to determine the division of property of the estate or, (5) regarding domestic violence.

The automatic stay also does not apply to the collection of a domestic support obligation from property that is not property of the estate or the withholding of income that is property of the estate or property of the debtor for payment of domestic support obligation under judicial or administrative order or statute.

The exceptions to the automatic stay are broad and have been expanded over recent years. The legislature has determined, probably correctly, that bankruptcy has been used inappropriately in many instances to frustrate the non-filing debtor from enforcing his or her rights in divorce court. Because of a strong public policy of allowing the completion of divorce proceedings and of insuring that such individual’s rights are not impaired or impeded by bankruptcy, the automatic stay does not prevent one spouse from pursuing or enforcing most monetary entitlements.

Notwithstanding the clear wording of the Bankruptcy Code, many Superior Court judges are very hesitant to permit a divorce proceeding to continue once one party files for bankruptcy protection. That is why in instances in which a non-bankruptcy judge
expresses concern, it is normally more expedient to simply seek stay relief in Bankruptcy Court so that you can then return to State Court with a Federal Court Order specifically ratifying your client’s right to proceed against his or her spouse notwithstanding a bankruptcy filing. Even though the debtor may oppose such stay relief, I have found over the years that bankruptcy judges will summarily grant a stay motion because those judges understand their fellow brethren’s hesitation to proceed without clear guidance from them and bankruptcy judges have no interest in interfering with efforts to enforce and protect rights under divorce law.

Confusion has arisen as to what occurs when, in the midst of a divorce proceeding, a spouse attempting to enforce his or her rights files for bankruptcy. Interestingly enough, when a party files for bankruptcy who is not the one actually commencing or continuing a civil proceeding against the other spouse, the automatic stay does not apply. However, as a practical matter, since State Court judges are extremely uncomfortable when a bankruptcy is filed in a divorce proceeding and oftentimes the commencement or continuation of a proceeding by one spouse leads to counterclaims being filed by the other, stay relief is sought as well.

II. **SCOPE OF PROPERTY OF THE ESTATE AND IMPACT ON LIABILITIES WHEN A BANKRUPTCY IS FILED DURING A DIVORCE**

Divorce lawyers may have heard horror stories or actually had clients experience the ramifications of one spouse filing for bankruptcy during a divorce proceeding. Unlike some horror stories that are primarily fictional, these oftentimes are real for the following reasons.

Under 11 U.S.C. § 341, property of the bankruptcy estate of one spouse includes not only that spouse’s sole and separate property, but community property as well in almost all instances. In most cases, because of the strong community property presumption under Arizona law and other community property states, almost all of that couple’s property will fall within the jurisdiction of the Bankruptcy Court. Consequently, when one spouse files for bankruptcy without warning or preparing the other, even though the filing spouse may have engaged in some basic pre-bankruptcy planning, the other spouse would not have the benefit of this strategy. A bankruptcy filing by one spouse could therefore result in the non-filing spouse getting caught with a substantial amount of money in a bank account in excess of the exemption or even worse, other non-exemption assets which could have easily been converted to exempt ones if the non-filing spouse had known of the inevitable bankruptcy filing. In situations in which the divorce is especially acrimonious, the non-filing spouse may find himself or herself having to turn over to the bankruptcy trustee monies in a checking account which would have been spent if that spouse would have been given the opportunity to allow outstanding checks to clear.

One may ask why one spouse would file for bankruptcy without telling his or her spouse in advance so that the non-filing spouse could engage in some prophylactic steps. Sadly, it is not uncommon for one spouse to deliberately time the bankruptcy filing in
hopes of catching the other spouse off guard and inflicting as much pain as possible on the other spouse, purely out of anger or acrimony.

On the other hand, a bankruptcy filing initiated by one spouse during a divorce proceeding can be of great benefit to the non-filing spouse. That is because not only are the filing spouse’s sole and separate debts discharged in a bankruptcy filing, but community obligations are discharged as well. This leads to a strategy which can allow a non-filing spouse to directly benefit from a bankruptcy filing by the other spouse. Arizona law provides that one spouse can bind the community in many instances but cannot bind the other spouse in a sole and separate capacity unless the other spouse has signed for the indebtedness or has specifically agreed to be responsible for it. Therefore, in such instances, which are very common in cases of credit cards or similar debts, if the non-filing spouse is not liable in a sole and separate capacity, a bankruptcy proceeding commenced during the divorce case could effectively wipe out the non-filing spouse’s exposure on such debts, thereby allowing that spouse to avoid bankruptcy.

This leads to a very serious malpractice pitfall for divorce lawyers. Arizona law specifically provides that in most instances, once a divorce is completed, community obligations become sole and separate obligation of each of the spouses. See Community Guardian Bank v. Janice Hamlin, 182 Ariz. 627, 898 P.2d 1005. This makes sense to some extent because once the divorce is completed, the community ceases to exist. However, a spouse who may not have signed or taken on any other community obligations now will find himself or herself liable in a sole and separate capacity once the divorce is completed. Each of the spouses would then have to file for bankruptcy protection since a filing by one will not shield the other. Contrast this to what occurs if the spouse who is primarily responsible for the debts files for bankruptcy while the divorce is proceeding. By cooperating and working together, one spouse may not have to file at all since that spouse would receive the benefits of the other spouse’s community discharge.

III. DISCHARGEABILITY OF CERTAIN DIVORCE BASED DEBTS

This is one area where recent changes of the bankruptcy law should eliminate any confusion. In a Chapter 7 proceeding, a spouse cannot discharge any support obligations under 11 U.S.C. § 523(a)(5) and also cannot discharge any indemnification obligations under 11 U.S.C. § 523(a)(15). This bar to discharge is automatic and does not require a spouse to file a complaint under U.S.C. § 523 to preserve such rights. If a spouse agrees to assume certain indebtedness of the marriage and then files for bankruptcy protection upon the completion of the divorce, that individual would be liable to his or her former spouse under 11 U.S.C. § 523(a)(15). For this reason, it is crucial for divorce lawyers to fully understand the ramifications of the statutes because if their clients are contemplating bankruptcy after divorcing, their ability to reap the benefits of the bankruptcy proceeding could be severely impaired if attention is not paid to the division of the debt. In such cases, it is better for the spouses to be totally candid with each other regarding their future intentions. Future aggravation can be avoided if the possibility of bankruptcy is
discussed from the onset so that appropriate verbiage can be incorporated into the operative divorce documentation.

IV. **SCOPE OF DISCHARGE: DANGERS OF CHAPTER 13**

The scope of the discharge in a Chapter 13 is probably misunderstood more than any other aspect of Chapter 13 by divorce lawyers. When the Bankruptcy Code was dramatically modified in 2005, and the Code increased the power of a spouse to enforce domestic support obligations, the legislature did not address an individual’s ability to discharge non-support obligations in a Chapter 13. I am convinced this was purely an oversight because the legislative intent was very clear that it did not want individuals to be able to modify domestic relations obligations in a bankruptcy proceeding. Nevertheless, notwithstanding massive changes in the Bankruptcy Code, the legislature left intact the power of a Chapter 13 debtor to treat non-support obligations as general unsecured debt. That is because, whereas in a Chapter 7 property equalization payments and indemnity obligations are not dischargeable under 11 U.S.C. § 523(a)(15), they are clearly dischargeable in a Chapter 13.

Why is this so precarious for both the divorcing client and the attorney involved? Time and time again, I have clients come to me who are relying upon either the property equalization payment or indemnification rights to ensure that they are receiving their fair share of the community estate. Once the filing spouse is able to discharge that indebtedness, the result is normally a dramatic imbalance in distribution of assets and liabilities. For example, in the case of a husband who is allowed to keep his business in return for agreeing to pay the business debt and then compensating his wife for the value of the business, that husband’s Chapter 13 filing could permit that individual to discharge the obligation to indemnify his wife and pay the equalization payments. This could be extremely unfair, especially in situations in which the husband retains exempt assets, be it the equity in the house or a disproportionate amount of retirement funds in return for indemnifying his wife or by paying a disproportionately large equalization payment. I have handled cases in which the opposing spouse has shrewdly reaped the upside of the divorce and none of the downside by careful planning and by lulling the other spouse into a property settlement agreement in which the spouse contemplating bankruptcy accepts a large amount of the debt in return for retaining certain of the exempt assets.

So what can be done to prevent this from happening? There are basically three ways to keep this from happening. They are:

1. Try to ensure that any indemnification of property equalization payment is fully secured. If you are securing the obligation, perfect the security agreement since the last thing in the world you want to do is agree to a secured arrangement just to have the bankruptcy debtor avoid the transaction.

2. Try to label as much of the obligation as domestic support (alimony, maintenance, or other support), since domestic support is not dischargeable even in a Chapter 13. In certain cases, this may not be possible or practical, but in other situations,
by treating and labeling the obligation as domestic support, you increase your client’s protection. Although labels do not control, and bankruptcy courts look to the substance of the underlying agreement rather than the label alone, if you are able to appropriately label the obligation as domestic support, this should help your client.

3. Do not let your client enter into a property settlement agreement which is dependent upon the other spouse not filing for bankruptcy unless you have conducted an independent analysis and can opine that that spouse is really not eligible for bankruptcy relief. This would normally require the intervention of bankruptcy counsel, because an individual may look to be solvent but can quickly become insolvent with proper planning.

V. IMPORTANCE OF PAYING DOMESTIC SUPPORT OBLIGATIONS

A Chapter 13 debtor’s failure to pay domestic support obligations that become due after filing affects the debtor’s ability to get a plan confirmed and can lead to dismissal of the debtor’s case.

A Chapter 13 plan cannot be confirmed unless the debtor has paid domestic support obligations that become due after the filing. One of the requirements of confirmation is that the debtor has paid all domestic support amounts that are required to be paid after the date of the filing.

The 2005 Amendments included protection of future support obligations in Chapter 13 cases. Prior to the Amendments, failure to pay maintenance obligations was already a ground for dismissal of a Chapter 7 case. The 2005 Amendments added § 1307(c)(11), which provides a ground to dismiss a Chapter 13 case for the debtor’s failure to pay domestic support obligations that first come due after the filing of a bankruptcy case.

VI. ATTORNEYS’ FEES AND DISCHARGEABILITY

Divorce attorneys must be aware of certain attorneys’ fees issues that may arise if a client or client’s spouse or former spouse files bankruptcy. A frequently litigated issue under 523(a)(5) and 523(a)(15) is the dischargeability of attorneys’ fees. Support obligations must be owed directly to the former spouse or children to be nondischargeable.

However, there is an exception for attorneys’ fees for the representation of the former spouse or child where the spouse or child was awarded support that is nondischargeable in a bankruptcy. The determination rests on the nature of the fees and whether or not they are considered “support.” Most courts have concluded that attorneys’ fees and costs incurred in divorce actions between ex-spouses or matters involving child support or custody are in the nature of support under 523(a)(5).
Some courts have allowed the discharge of attorney’s fees in certain situations.

The Ninth Circuit held in one case that an attorney-creditor lacked standing to bring an action under section 523(a)(15) because the attorney-creditor was not a spouse, former spouse, or child of the debtor. The attorney-creditor had represented the debtor in divorce proceedings. The non-debtor spouse and children did not have liability on the attorney-creditor’s claim. The Ninth Circuit noted that the attorney-creditor would have standing under 523(a)(5) where the non-debtor spouse or children had liability on the creditor’s claim — in other words, if the attorney-creditor had represented the non-debtor spouse or children.

VII. WHICH SUPPORT OBLIGATIONS ARE EXEMPT

Arizona law has been amended over the years to provide that support obligations are 100% exempt, be it child support or spousal maintenance. The exemption applies to amounts past due and even amounts once collected. The scope of this exemption is very broad and provides a vehicle for pre-bankruptcy planning in that if a party contemplating bankruptcy avoids comingling support with non-exempt monies, the support money is protected even upon the filing of a bankruptcy petition. The scope of this statute also provides an avenue for potential planning between the spouses, but that discussion is beyond the scope of this outline.

VIII. POST-DISSOLUTION STATE COURT RELIEF

Because of the possibility of one spouse’s rights being severely impaired by the bankruptcy filing by the other spouse, Arizona case law specifically permits a damaged spouse to return to State Court to attempt to modify the divorce decree because of the bankruptcy filing by the other spouse. Seeking such relief in many instances may not be of much benefit if the bankrupt spouse is otherwise not collectable, but it is an option you need to be aware of because there are situations in which it could benefit your client. The seminal case which specifically authorizes a spouse to seek post decree modification in Arizona is Judith A. Birt v. John Mark Birt, 208 Ariz. 546, 96 P.3d 544.

IX. CONCLUSION

It is almost impossible for a divorce lawyer to be sufficiently familiar with bankruptcy law to properly and accurately advise his client of the impact of bankruptcy. Therefore, if a divorce lawyer has any concern that a bankruptcy may be filed by the other side, which today is not unusual, then it is strongly recommended that independent bankruptcy counsel is retained to avoid the unpleasantries of an unexpected bankruptcy filing. As importantly, if the spouses are willing to work together notwithstanding the emotional turmoil of the divorce, in many instances a properly timed and prepared bankruptcy filing could actually help facilitate the divorce proceeding by reducing exposure and potential costs for both sides.
Divorce lawyers also need to understand how a Chapter 13 filing can impact on his client's rights, as well, in regards to non-support obligations of the filing spouse.