Part 2: Divorce Issues in Bankruptcy Make Handling Divorce Matters Often Advantageous

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Editor's Note: This is the second part of a two-part series. Click here to read Part I.

The Shield and the Sword: DSO Creditors' Collection Improves in Bankruptcy

The first portion of this article reviewed how a domestic support obligation (DSO) creditor need not shudder if he or she discovers that the DSO debtor has filed a bankruptcy. If a bankruptcy is filed, the DSO creditor knows the debt will not be discharged, the nondischargeable portion of the debt does not require a costly adjudication by adversary, and, if the estate administers assets for the creditors, the DSO creditor will be paid as the first priority. This portion of the article focuses on how Congress has fortified the protections and collections for DSO creditors.

Preferences

"Preferences are integrally a part of a collective proceeding (bankruptcy, composition, receivership, and such proceedings that marshall the assets of a debtor)...."[1] "By definition, a preference involves a transfer on account of an antecedent debt, and there is no question as to the reinstatement of the debt if there is a recovery by the trustee or debtor."[2] To this definition numerous exceptions exist, including the immunity to the DSO creditor who receives payment within 90 days of the petition.[3] The exception provided to the DSO creditor is so unambiguously written that a review by this author cannot find one published case in which a trustee and DSO creditor fought over such a DSO payment being preferential.

After all of the above-referenced post-bankruptcy collection abilities remain in place because of the protections afforded under the exception to discharge for DSO creditors in the Bankruptcy Code (topic of Part 1), and due to their immunity to a preferential attack by a trustee, perhaps the

most important aspect of a bankruptcy filing (from a DSO creditor's perspective) is that the bankruptcy may *improve* the collection efforts for the DSO creditor – including rights that would not exist outside of bankruptcy. For example, Florida, unlike most other states, allows the entire homestead to be exempt. The Florida homestead exemption is limited to 162 acres and its residence,[4] or one-half acre[5] and its residence[6] — and only three exceptions are provided by the Florida Constitution.[7] The constitutional protection for the Florida homestead is so vast that even fraudulent transfers into a homestead property[8] cannot defeat the exempt nature of the Florida homestead.[9]

Inside of bankruptcy, this may not be true. DSO creditors may have greater rights — and may even be able to liquidate the Florida homestead.

The 2005 amendments to the Bankruptcy Code added numerous provisions to benefit DSO creditors. Specifically, the Code provides that exempt property will not be liquidated during or after the case to pay creditors *unless* that exempt property is trying to avoid payment for a DSO award.[10] Only the DSO creditor, not the trustee, can assert such claims against the exempt property.[11] On initial review of the issue, a bankruptcy court prohibited a trustee from liquidating the exempt asset to pay the DSO creditor.[12] This particular issue was subsequently brought to the bankruptcy court's attention in the Southern District of Florida in a case called *Quezada*, which also prohibits the panel trustee from liquidating exempt assets for the benefit of the DSO creditor.[13]

Hence, when the debtor files bankruptcy, what must the DSO creditor do, if anything? First, file a proof of claim, as DSO creditors are paid as first priority. Second, a prudent thing is to prohibit there being an adjudication that the otherwise exempt property is exempt. In bankruptcy, absent timely objection to the exemption within 30 days of the date set for the First Meeting of Creditors ("341 Meeting"), the property is deemed exempt.[14] Even though the above-described language of § 522(c) of the Bankruptcy Code appears to assert that the exemption will not permit post-bankruptcy collection against the otherwise-exempt property, it may be advisable to get a comfort order from the bankruptcy court stating that, under 11 U.S.C. § 522(c)(1), the otherwise-exempt property is not deemed to be exempt as to the DSO creditor as provided by the Bankruptcy Code.[15] Thereafter, the creditor could take that bankruptcy court order to the state court when executing against homestead or other exempt properties from which the state court judges or sheriffs will better understand why DSO creditors are executing against properties that would otherwise be deemed *prima facie* exempt from creditor attack.

The better practice would be to have the liquidation or administration in the bankruptcy court. The *Quezada* court hints that it may not deny a DSO creditor's motion that parallels the denied motion filed by the *Quezada* trustee.[16] The denial in *Quezada* arose because the movant was not the DSO creditor or lacked standing. Had a DSO creditor come to the *Quezada* bankruptcy court requesting liquidation of the debtor's homestead, the *Quezada* motion may have been granted by the court. And if that motion had been granted, a more immediate liquidation and payment would possibly arise. Bankruptcy courts, unlike state courts, allow for the rapid liquidation and transfer of cash to the DSO creditor that is often not often provided by state court remedies. For this reason, DSO creditors owed pre-petition debt should contact bankruptcy professionals to review such an issue.

Conclusion

A DSO creditor has many protections and priorities. Sometimes those protections permit DSO creditors to seek remedies that may not be provided to other creditors. First, there is concurrent jurisdiction — so many actions to handle the divorce may be pursued without stay relief. Second, the discharge of a DSO debt will be excepted *without the necessity of filing* a bankruptcy adversary — thereby saving significant costs. Third, because of exception to discharge provided for DSO creditors is strong — together with the priority status and exemption-busting provision of 11 U.S.C. § 522(c) — it may be ill advised to file a denial of discharge action under 11 U.S.C. § 727 on behalf of the DSO creditor. Fourth, the priority for the pre-petition nonpayment of DSO debt alerts the attorney to file a proof of claim for the client, as any recovery will likely benefit the DSO creditor, which holds first-priority status. Fifth, concerns about being subjected to preferential attack are addressed by the Bankruptcy Code, which provides immunity for the DSO creditor. Lastly, a DSO creditor in a debtor-friendly state (like Florida), to the extent such remedies are available, may want to file motions in the bankruptcy court to liquidate the debtor's valuable exempt assets (residence, pension plans, life insurance policies or other assets that could amount to large payments) to provide for quick liquidation and delivery of cash to the DSO creditor's benefit without the necessity of going through the procedural difficulties often experienced in state collection matters. In any event, a DSO creditor's representative should be aware of such opportunities and may want to alert a bankruptcy attorney so as to obtain an expert analysis of whether or not the bankruptcy will deliver expedient and permissible remedies that otherwise might not be afforded to that same creditor outside of bankruptcy.[17]

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[1] *Perkins v. Petro Supply Co. (In re Rexplore Drilling)*, 971 F.2d 1219, 1226 (6th Cir. 1992).

[2] *Tronox Inc. v. Kerr McGee Corp. (In re Tronox Inc.)*, 503 B.R. 239, 330 (Bankr. S.D.N.Y. 2013).

[3] 11 U.S.C. § 547(c)(7).

[4] Interestingly, if not in a municipality, the exemption includes the residence "and improvements thereon."

[5] In incorporated areas of Florida or in a "municipality."

[6] In incorporated areas of Florida or in a "municipality."

[7] Article X, § 4 of the Florida Constitution states, in pertinent part:

> There shall be exempt from for sale under process of any court, and no judgment, decree, or execution shall be a lien thereon, except for the payment of taxes and assessments thereon, obligations contracted for the purchase, improvement or repair thereof, or obligations contracted for house, field, or other labor performed on the realty, the following property owned by a natural person: (1) a homestead....

[8] In 1999, this was an issue delivered to the Eleventh Circuit. "Federal courts attempting to interpret Florida law regarding this issue have reached contrary conclusions. Compare *In re Mesa*, 232 B.R. 508 (Bankr. S.D. Fla. 1999) (imposing an equitable lien on homestead); *In re Kravitz*, 225 B.R. 515 (Bankr. D. Mass. 1998) (denying the homestead exemption when debtor acted with actual fraudulent intent); *In re Bandkau*, 187 B.R. 373 (Bankr. M.D. Fla. 1995) (denying homestead exemption to extent that it was purchased with nonexempt money); *In re Thomas*, 172 B.R. 673, 674 (Bankr. M.D. Fla. 1994) (granting objection to claimed homestead exemption under Fla. Stat. § 220.30); *In re Coplan*, 156 B.R. at 92 (limiting homestead exemption when homestead was acquired in fraud of creditors); *In re Grocki*, 147 B.R. 274, 278 (Bankr. S.D. Fla. 1992) (imposing equitable lien on homestead); and *In re Gherman*, 101 B.R. 369, 370 (Bankr. S.D. Fla. 1989) (sustaining objection to homestead exemption where debtor used fraudulently converted funds to purchase homestead), with *Bank Leumi*, 898 F. Supp. at 887 (refusing to create nontextual exception to homestead exemption based on the fraudulent intent of the debtor); *In re Hendricks*, 237 B.R. at 825 (allowing homestead exemption); *In re Young*, 235 B.R. 666 (Bankr. M.D. Fla. 1999) (holding that homestead exemption could not be disallowed because nonexempt assets were used to acquire homestead even if debtor fraudulently converted nonexempt assets with intent to defeat creditor's claims); *In re Lazin*, 221 B.R. 982, 988 (Bankr. M.D. Fla. 1998) (finding that conversion of nonexempt assets into homestead with intent to hinder, delay or defraud creditors is not exception to homestead exemption); *In re Lee*, 223 B.R. 594 (Bankr. M.D. Fla. 1998) (finding debtor's intent to defraud creditors did not constitute a basis for disallowing Florida homestead exemption); *In re Statner*, 212 B.R. 164 (Bankr. S.D. Fla. 1997) (allowing homestead exemption); *In re Clements*, 194 B.R. 923 (Bankr. M.D. Fla. 1996) (holding that debtor is entitled to keep homestead as exempt even if it was acquired in fraud of creditors); *In re Miller*, 188 B.R. 302 (Bankr. M.D. Fla. 1995) (upholding homestead exemption even though its purchase was fraudulent transfer as to creditors); *In re Popek*, 188 B.R. 701 (Bankr. S.D. Fla. 1995) (allowing homestead exemption); and *In re Lane*, 190 B.R. 125 (Bankr. S.D. Fla. 1995) (allowing homestead exemption)." *Havoco of Am. Ltd. v. Hill (In re Hill)*, 197 F.3d 1135, 1141-1142 (11th Cir. Fla. 1999). The Eleventh Circuit sent the following issue to the Florida Supreme Court: "Does Article X, Section 4 of the Florida Constitution exempt a Florida homestead, where the debtor acquired the homestead using nonexempt funds with the specific intent of hindering, delaying, or defrauding creditors in violation of Fla. Stat. § 726.105 or Fla. Stat. §§ 222.29 and 222.30?" *Havoco of Am. v. Hill*, 790 So. 2d 1018, 1019 (Fla. 2001). The Florida Supreme Court concluded, "Accordingly, we answer the certified question in the affirmative, holding that a homestead acquired by a debtor with the specific intent to hinder, delay, or defraud creditors is not excepted from the protection of article X, section 4. Having answered the certified question, we return this case to the United States Court of Appeals for the Eleventh Circuit for further proceedings." *Havoco of Am. v. Hill*, 790 So. 2d 1018, 1030 (Fla. 2001).

[9] This is without any reference to 11 U.S.C. § 522(o).

[10] 11 U.S.C. § 522(c)(1), which states, "[A] debt of a kind specified in paragraph (1) [tax] or (5) [DSO debt] of section 523(a) ... shall be liable for a debt of a kind specified in such paragraph...."

[11] *In re Covington*, 2006 Bankr. LEXIS 2485, 56 Collier Bankr. Case 2d 1110, 2006 WL 2734253 (Bankr. E.D. Cal. 2006).

[12] *In re Ruppell*, 368 B.R. 42 (Bankr. D. Or. 2007).

[13] *In re Quezada*, 513 B.R. 621, (Bankr. S.D. Fla. 2007).

[14] 11 U.S.C. § 522(l) and Fed. R. Bankr. P. 4003(b)).

[15] Judge Mark hints as such in *Quezada* when he wrote, "New § 522(c) (1) creates a federal right entitling DSO creditors to execute against exempt assets even if those assets would be protected from execution under state law. Although, in theory, a state court judge is perfectly capable of applying federal law, in practical terms, it appears awkward for a DSO creditor to seek relief in state court to pursue assets which are exempt from execution under state law." *In re Quezada*, 368 B.R. 44, 49 (Bankr. S.D. Fla. 2007).

[16] "Without question, BAPCPA enhances the protections to and rights of DSO creditors. These rights include the right under § 522(c) (1) to pursue assets claimed as exempt in a bankruptcy case to satisfy a DSO debt, even if the asset would be protected from execution under state law." *In re Quezada*, 368 B.R. 44, 50 (Bankr. S.D. Fla. 2007).

[17] For instance, liquidating the homestead of the former spouse is not permitted. While in bankruptcy, as provided under 11 U.S.C. § 522(c)(1), the opposite is provided.