

Bankruptcy Trustee v. Non-Debtor Spouse Is the Battleground State Court or Bankruptcy Court?

by Timothy Duggan

Matrimonial lawyers are occasionally confronted with bankruptcy filings by one or both spouses during or after a matrimonial action. The bankruptcy case can dramatically change the landscape of the matrimonial action by adding new parties and issues to an already acrimonious situation.

Among the more notorious characters is the Chapter 7 bankruptcy trustee. Recently, the United States Bankruptcy Court for the District of New Jersey held that a Chapter 7 trustee's rights as a "hypothetical lien judgment creditor" are superior to the rights of a non-debtor divorcing spouse in the equitable distribution of property of the bankruptcy estate.¹ The bankruptcy court found that the debtor's interest in bankruptcy estate property is encumbered by the Chapter 7 trustee's judgment lien, and any transfer of property, including equitable distribution, is subject to the trustee's lien and jurisdiction of the bankruptcy court.

BANKRUPTCY PRIMER

For family lawyers, the following bankruptcy fundamentals are important to understand in evaluating the impact of *Howell* on your practice.

1. **Bankruptcy Estate:** Upon the filing of a bankruptcy petition, a bankruptcy estate is created. The bankruptcy estate consists of all property in which the debtor has an interest, legal or equitable. 11 U.S.C. § 541.
2. **Earnings:** In a Chapter 7 bankruptcy case, post-petition earnings are not property of the bankruptcy estate. 11 U.S.C. § 541(a)(1). In a Chapter 13 bankruptcy case, post-petition earnings are property of the bankruptcy estate. 11 U.S.C. § 1306(a)(2).
3. **Exempt and Excluded Property:** In both Chapter 7 and Chapter 13 bankruptcy cases, the debtor is entitled to certain exemptions, including \$17,425 in the debtor's residence, \$9,300 in the debtor's household goods, and \$2,775 in a vehicle. 11 U.S.C. § 522 (d). In addition, Employee Retirement Income Security Act (ERISA) qualified plans, IRA accounts and certain other types of retirement plans are not property of the bankruptcy estate. 11 U.S.C. § 541(c); *In re Yubas*, 104 F.3d 612 (3d Cir. 1997).
4. **Control and Sale of Assets:** In a Chapter 7 bankruptcy case, the Chapter 7 trustee stands in the shoes of the debtor and takes control of the debtor's property. 11 U.S.C. § 704. The trustee may sell jointly owned property, including property jointly owned by spouses. 11 U.S.C. § 363 (h). The non-debtor spouse is entitled to notice of the sale, and may object to the sale if the detriment to the non-debtor spouse outweighs the benefit to the bankruptcy estate. 11 U.S.C. § 363 (h)(1)-(4). The non-debtor spouse also has a right of first refusal. 11 U.S.C. § 363 (i).
5. **Bankruptcy Stay:** The bankruptcy stay does not prohibit a non-debtor spouse from either seeking to establish the amount of alimony, support, or maintenance, or deciding issues of custody. 11 U.S.C. § 362 (b)(2). These actions are exempt from the automatic stay. However, any action to seek distribution of bankruptcy estate property (*i.e.* equitable distribution) is subject to the bankruptcy stay, and the non-debtor spouse must have the bankruptcy stay lifted, modified or annulled before proceeding in state court. 11 U.S.C. § 362 (a)(3).
6. **Priority Claims:** The Bankruptcy Code provides priority treatment to certain creditors who must be paid before general unsecured creditors. Relevant to this article is Bankruptcy Code §§ 507(a)(7) and 726(a)(1), which require pre-petition alimony, maintenance and support to be paid before the claims of general unsecured creditors (assuming money exists).

THE HOWELL DECISION

Mrs. Howell filed a complaint for divorce in May 2003, and immediately obtained a *pendente lite* order requiring Mr. Howell to pay \$500 per week, plus roof expenses and healthcare expenses. After Mr. Howell refused to pay spousal support, the state court judge entered two arrest warrants and revoked Mr.

Howell's driver's license. Seeking to stay further enforcement procedures, Mr. Howell filed a Chapter 7 bankruptcy petition. Mr. Howell listed his home on his bankruptcy schedules with a value of \$400,000, encumbered by a mortgage in the amount of \$240,000. He also claimed an exemption of \$17,425 in the equity in the home. Mrs. Howell immediately filed a motion for relief from the bankruptcy stay in order to return to state court to complete her divorce action and seek equitable distribution of their joint property, including the home.

In reviewing the motion, the bankruptcy court noted that relief from the bankruptcy stay is not required to proceed against exempt assets.² However, since the debtor's sole remaining asset was his equity in his residence, which he owned with his wife, Mrs. Howell's only chance for relief was to recoup what she could from the debtor's equity in the form of equitable distribution.

Mrs. Howell argued that the bankruptcy court should abstain from deciding this issue, and permit her to return to state court. The Chapter 7 bankruptcy trustee opposed the motion, arguing that since a judgment of divorce had not been entered, Mrs. Howell did not have a right to equitable distribution. The trustee further argued that since the determination of the respective interests of the bankruptcy estate and Mrs. Howell required careful consideration of both bankruptcy and equitable distribution law, the bankruptcy court should retain jurisdiction. The bankruptcy judge agreed with the Chapter 7 trustee, and denied Mrs. Howell's motion.

The bankruptcy court performed a thorough review of the two leading bankruptcy court decisions that had exhaustively reviewed various case law analyzing the interaction of bankruptcy law and New Jersey equitable distribution law. First, the bankruptcy court reviewed *In re Berlingeri*,³

which held that a right to equitable distribution arises upon the entry of a judgment of divorce.⁴

If the judgment of divorce awarding equitable distribution is entered before a bankruptcy petition is filed, it is a pre-bankruptcy claim. However, if the judgment of divorce and award of equitable distribution is entered post-bankruptcy, the equitable distribution claim is a non-dischargeable post-petition obligation of the debtor.

The bankruptcy court next proceeded to analyze *In re Becker*,⁵ which involved a Chapter 7 debtor who filed for bankruptcy protection before an award of equitable distribution was entered in his state court action. The *Becker* court reaffirmed that a Chapter 7 trustee has the rights of a hypothetical judgment creditor who has levied on a debtor's property as of the date the bankruptcy petition is filed, whether or not a creditor exists.⁶ Citing *Freda v. Commercial Trusts Co.*,⁷ the court also noted that under state law, transfers of property under equitable distribution are subject to existing liens.

The *Becker* court held that the filing of a bankruptcy petition:

is therefore the legal equivalent of a levy by the trustee upon all the debtor's property as of the petition date. It follows equitable distribution and cannot alter a bankruptcy estate's rights in property in which the debtor had an interest on a petition date, allegedly owned or otherwise.⁸

The bankruptcy judge in *Howell* found that a post-petition award of equitable distribution cannot alter the rights of the Chapter 7 trustee as a levying judgment creditor on the debtor's interest in property. The court concluded that Mrs. Howell may seek a monetary award of the "equivalent" value of her rights of equitable distribution, but she may not seek to have the bankruptcy estate property actually distributed to her in kind. The bankruptcy court denied Mrs. Howell's

motion, and retained jurisdiction over the marital residence.

PRACTICAL IMPLICATIONS

What does this decision mean to matrimonial lawyers, and are there any protective measures that can be taken to avoid the harsh results of a Chapter 7 filing?

- Courts following *Howell* will retain jurisdiction over assets subject to the trustee's lien, and deny motions to lift the stay to the extent of the property encumbered by the trustee's lien. If there is sufficient equity in the property, the trustee will seek to sell the property, pay the non-debtor spouse his or her portion of the equity (generally half), and use the balance to pay claims against the bankruptcy estate.
- As the court noted in *Howell*, pre-bankruptcy claims for unpaid alimony, support and maintenance are provided a priority in a Chapter 7 bankruptcy liquidation, and can be collected from exempt assets. Try to obtain a *pendente lite* order as soon as possible.
- Immediately review the debtor's bankruptcy schedules, identify which assets are exempt and not property of the bankruptcy estate, and seek recourse against those assets in your family law action.
- Consider obtaining relief that, under state law, would trump the rights of a levying judgment creditor. For example, bankruptcy courts recognize constructive trusts and certain types of equitable liens. If the debtor-spouse has engaged in fraudulent or unlawful conduct, you may want to seek the imposition of a constructive trust over certain marital assets. Although this remedy is very limited, and does not apply to most matrimonial cases, keep it in mind.
- The filing of a bankruptcy petition and subsequent discharge may be a sufficient *change of cir-*

cumstances permitting a non-debtor spouse to return to state court and adjust the amount of alimony and support to be paid from post-petition earnings. In addition, it is important to note that exempt assets, including pension, IRA and 401(k) accounts, are generally not part of the bankruptcy estate, and will be subject to the control of the state court.

- It is prudent to compare the state court case information statements to the debtor's bankruptcy schedules. Any discrepancy (*i.e.* missing assets) may provide support for dismissal of the bankruptcy case, or denial of the discharge under Bankruptcy Code Section 727.

Before spending time and money filing motions, analyze the debtor's bankruptcy schedules and determine what is encumbered by the trustee's lien. Deduct the debtor's exemptions and costs of sale (most trustees use 10 percent as the standard cost of sale), and you will have an idea of what the trustee will recover from the sale of the asset. Of course, it is very important to

know the true value of the property in question, and it may be prudent to retain an appraiser.

Often it is more cost effective to negotiate a deal with the trustee to buy out his or her interest in the property and pursue the exempt assets in state court. However, before making an offer, fully evaluate your client's claim, including his or her right to a priority claim for pre-bankruptcy arrears in alimony and support, which may be used as a bargaining chip with the trustee. ■

ENDNOTES

1. *In re Howell*, 311 B.R. 173 (Bankr. N.J. 2004).
2. Under 11 U.S.C. § 522 (c)(1), exempt assets are available to satisfy unpaid alimony, support and maintenance.
3. 246 B.R. 196 (Bankr. D.N.J. 2000).
4. Relying upon N.J.S.A. 2A: 34-23 and *Carr v. Carr*, 120 N.J. 336 (1990).
5. 136 B.R. 113 (Bankr. D.N.J. 1992).
6. 11 U.S.C. §544 provides in pertinent part:
 - (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the

debtor or any obligation incurred by the debtor that is voidable by

- (1) a creditor that extends credit to a debtor at the time of the commencement of the case, and that obtains, at such time with respect to such credit, a judicial lien on all property in which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
 - (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists;...
7. 118 N.J. 36 (1990).
 8. *Becker*, 136 B.R. at 115-118.

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