# Intersection Between Bankruptcy and Nonbankruptcy Law

**Randy Nussbaum, Moderator**
*Nussbaum Gillis & Dinner, P.C.; Scottsdale, Ariz.*

**Hon. Eddward P. Ballinger, Jr.**
*U.S. Bankruptcy Court (D. Ariz.); Phoenix*

**John G. Loughnane**
*Nutter McClennen & Fish LLP; Boston*

**Brian D. Shapiro**
*Law Office of Brian D. Shapiro; Las Vegas*

**Intersection Between**

**Bankruptcy and Non Bankruptcy Law**

# INTELLECTUAL PROPERTY ISSUES

American Bankruptcy Institute

23rd Annual Southwest

Bankruptcy Conference

September 10, 2015

John G. Loughnane, Esq.
Nutter, McClennen & Fish, LLP
Seaport West
155 Seaport Boulevard
Boston, MA  02210-2604
617-439-2000
jloughnane@nutter.com

This article aims to provide insolvency practitioners an overview of intellectual property issues relevant to distressed situations. Part I contains a summary of the four traditional categories of IP assets and some basics of the IP laws protecting such assets. Part II discusses the law governing the creation and perfection of security interests in IP assets. Part III discusses the treatment of licensed IP assets in bankruptcy. Part IV discusses some recent cases of interest involving IP/insolvency issues and Part V discusses some recommendations for reform related to IP issues proposed by the ABI's Commission to study the Reform of Chapter 11.

## I. INTELLECTUAL PROPERTY OVERVIEW

The four primary areas of IP law (copyright, patent, trademark and trade secrets) share one unifying trait: the protection of human ingenuity. Beyond that, the differences in the protections are substantial. For each category of IP asset, set forth below is a brief overview of the source of law, how rights are obtained under applicable law, the duration of such rights and how such rights are transferred.

### A. Copyright

Authors of original works fixed in a tangible medium are entitled, under federal law, to certain exclusive rights in their works for limited periods of time. Copyright law protects subject matter such as music, books, photographs and computer programs.

#### 1. Source of Law

Congress has constitutional authority to "promote the progress of science and useful arts, by securing for limited times to authors and inventors exclusive rights to their respective writings and discoveries." U.S. Constitution, Art. 1, § 8, cl. 8. Pursuant to that authority, Congress passed the nation's current copyright law -- the 1976 Copyright Act (17 U.S.C. §§ 101-810) which completely preempts state law. Regulations implementing the provisions of the statute appear at 37 C.P.R. Parts 201-204.

#### 2. Obtaining Copyright Rights

Copyright protection exists immediately and automatically upon the creation of an original work of authorship fixed in any tangible medium of expression. Works of authorship include without limitation:

(a) Literary works;

(b) Musical works, including any accompanying words;

(c) Dramatic works, including any accompanying music;

(d) Pantomimes and choreographic works;

(e) Pictorial, graphic and sculptural works;

(f) Motion pictures and other audiovisual works;

(g) Sound recordings; and

(h) Architectural works.

17 U.S.C. § 102. Though not specifically listed in Section 102, computer programs are recognized to be entitled to copyright protection. 17 U.S.C. §§ 101, 117. Copyright protection does not extend to any "idea, procedure, process, system, method of operation, concept, principal or discovery." 17 U.S.C. § 102(b). The rule of thumb is that copyright protects the expression of an idea, not the idea itself.

The owner of a copyright is entitled to the following exclusive rights:

(a) To reproduce the copyrighted work in copies or phono records;

(b) To prepare derivative works based upon the copyrighted work;

(c) To distribute the copies or phono records of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease or lending;

(d) In the case of literary, musical, dramatic and choreographic works, pantomimes and motion pictures and other audiovisual works, to perform the copyrighted work publicly;

(e) In the case of a literary, musical, dramatic and choreographic works, pantomimes and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audio visual work, to display the copyrighted work publicly; and

(f) In the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.

17 U.S.C. § 106 (emphasis added).

Registration with the United States Copyright Office is not a prerequisite to the creation of a copyright. However, registration is a prerequisite to the filing of an infringement action. 17 U.S.C. § 411. Registration is also necessary to record assignments (discussed below) and to obtain other benefits of the Copyright Act. For example, registration prior to the occurrence of infringing activity provides the right to statutory damages and attorneys' fees. 17 U.S.C. § 412.

3. Duration of Rights

For works created on or after January 1, 1978, copyright protection exists from the time of the work's creation and endures for a term consisting of the life of the author plus 70 years. 17 U.S.C. § 302(a). With respect to works made for hire, copyright endures for a term of 95 years from the year of its first publication or 120 years from the year of its creation, whichever expires first. 17 U.S.C. § 302(c).

4. Transfer of Rights/Assignment

Copyright vests initially in the author or authors of the work. 17 U.S.C. § 201. "Works made for hire" are exceptions to that general rule. In the case of a work authored by an employee within the scope of his employment, the employer owns copyright in the work as a work made for hire. A work may qualify as a work made for hire on a second basis, namely, where the work was authored by a non-employee pursuant to an agreement that specifically designates the contemplated work as a "work made for hire". In order to qualify as a work made for hire under this second basis, however, the work must fall within one of nine categories of works enumerated under the Copyright Act.

Copyright owners may assign their rights, but before doing so must ensure that the copyright is registered. Section 205(c) of the Copyright Act provides:

> Recordation of a document in the Copyright Office gives all persons constructive notice of the facts stated in the recorded document, but only if:
>
> (1) the document, or material attached to it, specifically identifies the work to which it pertains so that, after the document is indexed by the Register of Copyrights, it would be revealed by a reasonable search under the title or registration number of the work; and
>
> (2) registration has been made for the work.

17 U.S.C. § 205(c) (emphasis added).

As between two conflicting transfers, the one executed first prevails if it is recorded in compliance with the Copyright Act within one month after its execution within the United States or within two months after its execution outside the United States, or at any time before recordation in such manner of the later transfer. 17 U.S.C. § 205. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, or valuable consideration or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer. As discussed below in Part II.A.1, judicial interpretations of Section 205 have unduly complicated the process of perfecting a security interest in copyrights.

B. Patent

Inventors and discoverers of new products and processes are afforded, under federal law and after application and approval, the right to exclude others from making, using or selling the patented invention described in the approved application. Patents can be issued for new, useful and unobvious inventions of statutorily approved subject matters.

1. Source of Law

The Congressional authority to enact patent legislation is based on the Constitutional clause noted above. The current Patent Act, enacted in 1952 and subsequently amended, is contained at 35 U.S.C. §§ 1-376. Regulations of the United Stated Patent and Trademark Office ("PTO") appear at 37 CPR Parts 2-6.

The Patent Act provides that "whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefore." 35 U.S.C. § 101. Thus, to be eligible for patent protection, an invention must, first, fit within one of the following statutory subject matters listed in Section 101:

(a) process (a term itself defined by the Patent Act to mean "process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material");

(b) machine;

(c) manufacturer;

(d) composition of matter; or

(e) any new and useful improvement on any of the above.

In addition, the invention must be novel, useful and unobvious.

Patent law also allows "design" patents to be granted for new, original and ornamental designs for articles of manufacture and for "plant patents" to be granted for certain distinct and new varieties of plants.

2. Obtaining Patent Rights

Unlike copyright protection, which protects the expression of ideas upon their fixation in a tangible medium of expression, patent rights can only be obtained after approval of an application filed with the PTO. Once an application is filed, the PTO conducts an examination in which prior art is reviewed and a determination is made as to whether a patent should be issued. If the examiner rejects the application, the applicant may make a timely resubmission for re-examination. Disputes about the PTO's action on a patent are subject to administrative proceedings in the PTO and then federal judicial proceedings.

3. Duration of Rights

Utility patents have a term of 20 years from filing. 35 U.S.C. § 154(a)(2). In certain instances, a one time extension of 5 years may be granted § 154(b). Design patents have a term of 14 years. 35 U.S.C. § 173.

4. Transfer of Rights/Assignments

The Patent Act makes clear that ownership of a patent always initially vests in the inventor or inventors and that patents have the attributes of personal property. Section 261 states:

> Applications for patent, patents or any interest therein shall be assignable in law by an instrument in writing. The applicant, patentee, or his assigns or legal representatives, may, in like manner, grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part in the United States.
>
> A certificate of acknowledgment [subject to notarization in the United States or abroad] shall be prima facie evidence of the execution of an assignment, grant or conveyance of a patent or application for a patent.
>
> An assignment, grant or a conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage.

As discussed below in Part IIA, the courts that have addressed the issue have concluded that the above statutory language is materially different from Section 205 of the Copyright Act. As a result, perfection of a security interest in a patent is considered easier for a secured lender to achieve than perfection in copyrights.

C. Trademark

A trademark is a word, phrase, design, sound or symbol used on or in association with a good or service that serves to identify the source of the good or service and to embody a standard of quality. Sellers of goods and services who use brand names to identify and distinguish their products are entitled, under both state and federal law, to various rights to exclude others from using a similar mark in a way likely to be confusing to a consumer. Additionally, owners of famous marks can confront third-parties that use their famous marks in a way that dilutes the distinctive nature of the famous marks (even where confusion is not likely). Trademark law protects such trademarks as Xerox, Ford, and Coca-Cola.

1. Sources of Law

There is no specific Constitutional source for Congress' authority to legislate on the subject of trademarks. As a result, Congress has relied on the Interstate Commerce Clause as a source of authority. The current federal trademark law is the Lanham Act, passed originally in 1946 (and comprehensively revised in 1988), which is codified at 15 U.S.C. §§ 1051-1128. The PTO has issued regulations located at 37 CPR Parts 1-7.

The Lanham Act, unlike the Patent Act and Copyright Act, does not preempt state law. Indeed, trademark rights arise under state common law. The Lanham Act simply provides a mechanism for the enforcement of rights in trademarks used in interstate commerce. Similarly, various states have enacted state registration statutes that provide certain benefits in the event of alleged infringement.

2. Obtaining Trademark Rights

Trademark rights are most fundamentally established by using a mark in commerce. As noted above, once used in commerce, trademark owners may seek registration under state trademark registration laws in jurisdictions in which the mark is used and under the Lanham Act provided the mark is used in interstate commerce. (The Lanham Act also provides for the filing of an "intent to use" application, but such an application will mature to registration only after its owner has demonstrated use of the mark in the ordinary course of business.)

The benefit of federal registration is the grant of additional rights to the trademark owner throughout the United States, federal jurisdiction and a means of providing constructive notice. Specifically, the Lanham Act provides that a certificate of registration of a mark upon the Principal Register "shall be prima facie evidence of the validity of the registered mark and of the registration of the mark, of the registrant's ownership of the mark, and of the registrant's exclusive right to use the registered mark in commerce on or in connection with the goods and services specified in the certificate." 15 U.S.C. § 1057(b). Moreover, the registration exists as "conclusive evidence of the validity of the mark, of the registrant's ownership of the mark, and of the registrant's exclusive right to use the mark in commerce" subject only to certain enumerated defenses. 15 U.S.C. § 1115(b).

Trademark rights exist only in connection with the goodwill of the owner's business. Thus, a transfer of a trademark must also be accompanied by the transfer of the goodwill of the business in order to be valid. If a court concludes that the transfer of a mark was made without the mark's associated goodwill, then the transfer will be considered void as an "assignment in gross."

3. Duration of Rights

Unlike copyright and patent rights which are granted only for limited periods of time, a trademark has a potentially unlimited life. However, an owner that fails to use and protect the mark risks the loss of ownership. Registrations are renewable indefinitely.

4. Transfer of Rights/Assignment

Section 1060 of the Lanham Act voids any assignment of rights in a federally registered mark against a subsequent purchaser for value without notice unless certain prescribed information reporting the assignment is recorded with the PTO within three months after the effective date of the assignment or prior to such purchase.

D. Trade Secrets

State law provides protections to owners of formulas, patterns, devices of compilation of information used in business, kept secret and that provide an advantage over competitors.

1. Source of Law

Trade secret protection arises from state law and contractual obligations. The Restatement of Torts § 757 states that a trade secret may consist of any “formula, patent, device or compilation of information which is used in one’s business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it.” The Uniform Trade Secrets Act has been adopted in many states and the District of Columbia. The Uniform Act defines a trade secret as information that has “independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use.”

2. Obtaining Trade Secret Rights

Trade secret rights are acquired by the person or entity responsible for developing the secret or acquiring it lawfully. Whether information in fact qualifies as a trade secret requires an analysis of the definitions provided above, or in the applicable jurisdiction.

3. Duration of Rights

Like trademarks, trade secrets can have an unlimited life. However, once a secret becomes known to the public or available to it, the information is no longer protectable as a trade secret.

4. Transfer of Rights/Assignment

Trade secret information may be transferred as long as reasonable precautions are taken by both the transferee and the transferor to maintain the secrecy.

## II. SECURITY INTERESTS IN IP ASSETS

Valuable IP assets may be used by a company as collateral in exchange for financing. This Section discusses issues that arise when IP assets are used as security in a financial transaction.

Lenders who seek to obtain a consensual security interest in most types of personal property collateral must comply with the procedures of UCC Article 9, enacted as state law in every state. IP assets are generally considered to be “general intangibles” under the UCC. See Official Comment No. 5(d) to Section 9-102 of the UCC. A security interest in general intangibles must be perfected by the filing of a financing statement in the appropriate state UCC filing office. Article 9 also provides that certain filings under a federal statute may satisfy the filing requirements of Article 9. See Section 9-311(a).

Uncertainty has arisen over the years on the proper method to perfect a security interest due to the existence of federal legislation covering copyright, patents and trademarks discussed in Part I. Although Article 9 was amended in 1999, the preemption question has arisen in both the pre and post amendment versions. See Section 9-109(c)(1) ("This article does not apply to the extent that … a statute, regulation or treaty of the United States preempts this article.").

A. Copyright

As noted in Part I, copyright law is governed by the 1976 Copyright Act. To what extent does the federal statute pre-empt Article 9? That question has been at the heart of several controversial court decisions.

In the leading case, In re Peregrine Entertainment. Inc., 116 B.R. 194 (Bankr. C.D. Calif. 1990), the borrower's principal assets were a library of copyrights, distribution rights and licenses to approximately 145 films and related rights to accounts receivable from its licensing arrangements. The lender sought to secure its $6 million loan through the filing of UCC-1 financing statements with various state filing offices. After the borrower filed for chapter 11 protection, it sought to avoid the lender's security interest on the grounds that the lender was required to file a notice of its security interest in the U.S. Copyright Office.

The Court held that "the comprehensive scope of the federal Copyright Act's recording provision, along with the unique federal interests they implicate, support the view that federal law preempts state methods of perfecting security interests in copyrights and related accounts receivable." The lender, then, was unsecured. Although the Peregrine facts presumably involved only registered copyrights, its holding was not so limited.

Peregrine was followed by In re AEG Acquisition Corp., 127 B.R. 34 (Bankr. C.D. Cal. 1991), aff'd, 161 B.R. 50 (BAP 9th Cir. 1993). In that case, a secured lender that duly filed relevant UCC financing statements with appropriate state offices and a copyright mortgage with the U.S. Copyright Office was nonetheless deemed unperfected because the underlying copyrights were not registered. The Court noted that the lender's recording of a security interest in the Copyright Office was ineffective absent a prior registration of the relevant copyright with the Copyright Office. A similar rule was acknowledged in In re Avalon Software, Inc., 209 B.R. 517 (D. Ariz. 1997), where the copyrights (relating to computer software) were not registered and the lender failed to file in the Copyright Office.

The AEG decision was rejected in Aerocon Engineering Inc. v. Silicon Valley Bank, (In re World Auxiliary Power Company. et al), 244 B.R. 149 (Bankr. N.D. Cal. 1999). After discussion of Peregrine, AEG and Avalon, the Court concluded that "[w]hen a copyright is unregistered, a secured creditor may perfect its security interest by filing a UCC-1 financing statement with the UCC Office." The holding raises the interesting question of whether a secured lender with a duly filed UCC financing statement on unregistered copyrights will lose its perfected status upon its borrower's registration of the copyrights with the Copyright Office.

Even if a lender can obtain comfort that it has filed in all relevant filing offices, it must confront other difficulties that exist with perfecting a security interest in copyrights. Chief among these is the requirement that a document recorded with the Copyright Office "specifically identify the work to which it pertains." Thus, separate filings for each individual copyrighted item appears necessary. In addition, after-acquired property clauses, recognized and enforceable under Article 9, appear to be of no force and effect under the Copyright Act.

B. Patents

As noted above, patent law is governed by the federal patent statute. A leading case considering the intersection of Article 9 and the patent statute is In re Transportation Design & Technology, 48 B.R. 635 (Bankr. S.D. Cal. 1985). In that case, the lender claimed a security interest in all "general intangibles" and filed a UCC-1 financing statement with the appropriate state filing office. In the bankruptcy case of borrower, the trustee contended that the lender was unperfected with respect to a patent because it had failed to record the security interest with the PTO. The trustee argued that federal recordation was necessary pursuant to Section 261 of the patent statute.

The Bankruptcy Court concluded that the plain language of the federal patent statute governed the rights only of the "bona fide purchasers" or "mortgagees", not trustees in bankruptcy. 35 U.S.C. § 261. The same result was reached in Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp., 143 B.R. 360 (D. Md. 1992), aff'd, 8 F.3d 817 (4th Cir. 1993). See also In re Cybernetic Services, 239 B.R. 917 (9th Cir. BAP 1999).

Parties seeking to obtain a perfected security interest in a patent and protection against bona fide purchasers, should file both under the UCC and with the PTO. Note, however, that filing of a collateral assignment will result in the lender being considered a patent owner and thus a necessary party to any litigation over the patent. See Agin, Bankruptcy and Secured Lending in Cyberspace at 408 (3d ed. 2013-2014).

C. Trademark

Part I above noted that trademark rights arise under state common law and are registerable under either state or federal registration systems. Naturally enough, a trademark created under state common law or a state registered trademark is perfected by the filing of a financing statement under the UCC. Because a trademark cannot be sold or assigned apart from the goodwill it represents, the security agreement and financing statement should specifically include both the debtor's trademark and the associated goodwill of the business associated with such trademark. Some state registration offices will accept a copy of the financing statement, although the UCC does not require any filing other than in the specified UCC filing office.

There are several leading cases concluding that the Lanham Act does not preempt the UCC with respect to the perfection of security interests in trademarks. Thus, based on the reported decisions, perfection of a security interest in a federally registered trademark is accomplished by the filing of a UCC financing statement under Article 9 of the UCC against general intangibles.

For example, in In re TR-3 Industries, 41 B.R. 128 (Bankr. C.D. Calif. 1984), the lender had filed a financing statement covering general intangibles of the debtor but had made no security assignment filing in the PTO. The Bankruptcy Court rejected the creditors committee's arguments that the lender was unperfected. Similarly, in In re Roman Cleanser Co., 43 B.R. 940

(Bankr. E.D. Mich. 1984), aff'd, 802 F.2d 207 (6th Cir. 1986) the Court concluded that the Lanham Act contemplates the registration only of outright assignments, not collateral assignments for security. The Sixth Circuit affirmed the lower court's decision and held that the failure of the security interest to cover machinery and equipment needed to produce the trademarked goods did not transform the grant of a security interest in the trademark to an impermissible assignment in gross. See also In re 199Z Inc., 137 B.R. 778 (C.D. Calif. 1992) (holding that the Lanham Act does not contemplate the recording of security interests at the federal level and that the term "assignment" in Section 1060 of the Lanham Act does not include pledges, mortgages or other hypothecations of trademarks).

The Bankruptcy Court in the District of Massachusetts reached a similar result in In re Together Development Corporation, 227 B.R. 439 (Bankr. D. Mass. 1998). In that decision, the Bankruptcy Court concluded that the term "assignment" was not broad enough to include the granting of a consensual lien. The Court held that the creditor's failure to file a financing statement with the appropriate UCC filing office was fatal. Filing with the PTO is necessary to cut-off the rights of bona fide purchasers.

### D. Trade Secrets

Trade secrets arise under state law and are treated as general intangibles for purposes of Article 9. Accordingly, a security interest in trade secrets is perfected by filing a UCC-1 financing statement in the appropriate state filing offices.

## III. LICENSE ISSUES

### A. Section 365 Basics

In a chapter 11 proceeding, the debtor company will seek to use the time afforded by the automatic stay against creditor action during a case to reorganize around key assets. Frequently, when a stand-alone reorganization is not possible, the company's efforts will focus on selling assets to the highest bidder. A debtor (or chapter 11 trustee in the rare case where one is appointed to displace the debtor's management) has the ability to assume and assign "executory contracts" unless prohibited by applicable non bankruptcy law. The key factor in evaluating whether a license agreement is "executory" is whether performance remains due on each side so that failure to complete performance by either party would be a material breach. In addition to the power to assume and assign, the debtor or trustee also has the power to reject burdensome executory contracts.

Thus, as part of a restructuring or a sale in chapter 11, the company will make a determination on each contract (including each license) as to whether it deems such contract "executory" and if so whether it desires to assume, assume and assign, or reject such contract. In a chapter 7 liquidation case, the chapter 7 trustee will make a similar determination on each contract. Once the debtor or trustee makes the assumption or rejection decision, the decision will be presented to the court for its review and approval in accordance with Section 365 of the Bankruptcy Code.

The nondebtor party to each such contract will be affected significantly by the decision and must therefor (i) pay close attention to the proceedings, (ii) exercise its rights to try to reach its desired business result and (iii) be prepared to respond aggressively to any action by a debtor or trustee that might be beneficial to the debtor or creditors but disastrous for the affected nondebtor IP counterparty.

One initial issue that the nondebtor licensor or licensee should analyze is whether the license is in fact executory and therefor subject to an assumption or rejection in the first place. The Bankruptcy Code does not contain a definition of the term "executory contract." Two recent cases help demonstrate that the decision about "executoriness" is not simple. Specifically, in *In re Exide Technologies, 607 F.* 3d 957 (3d Cir. 2010) the Third Circuit determined that a perpetual, royalty-free trademark license was not an executor contract and thus not subject to assumption or rejection by the licensor debtor. In contrast, *In re Interstate Bakeries Corporation*, 690 F.3d 1069 (8th Cir. 2012) the Eighth Circuit determined that a similar license was executory and thus could be assumed or rejected by the licensor debtor. However, the Eighth Circuit has subsequently vacated that panel decision and reheard the matter en banc in September of 2013. In 2014, the Eight Circuit ruled that the license at issue was not executory and thus could not be rejected by the debtor/licensee, *In re Interstate Bakeries Corp.,* 751 F.3d 955 ($8^{th}$ Cir 2014).

If executory, the debtor (or trustee) must comply with various requirements of Section 365 in order to assume including curing any existing defaults, other than defaults relating to the insolvency or financial condition of the debtor, the commencement of a bankruptcy case, the appointment of a trustee, or the satisfaction of a penalty provision relating to non-monetary obligations.

B. Section 365's Prohibition on Assignment when Prohibited by Applicable Law

One critical exception to the general rule of Section 365 regarding assumption, assignment and rejection of executory contracts is that assignment is not permitted when applicable non-bankruptcy law excuses a non-debtor party from accepting or rendering performance from a third party. Thus, once the issue of "executoriness" is determined, a separate analysis is needed as to whether relevant applicable law operates to preclude a party from accepting performance from a third party over its objection -- an issue that will depend in part on the particular jurisdiction where the case is pending.

Specifically, Section 365(c) of the Bankruptcy Code provides in part that an executory contract may not be assigned when "applicable law excuses a party, other than the debtor, to such contract ... from accepting performance from or rendering performance to an entity" other than the debtor. The classic example of such a contract is a personal services contract: state laws prevent a party from forcing a counterparty to accept personal services from a third party not selected by the counterparty.

Courts have determined that patent, copyright and trademark law also constitute "applicable law" which preclude a debtor from attempting to force its counterparty licensor from accepting performance from a third party licensee. Cases reaching this conclusion include:

1. Patent cases such as *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986 ("[i]t is well settled that a nonexclusive licensee of a patent has only a personal and

not a property interest in the patent and that this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment."); See also In re Catapult Entertainment, 165 F.3d 747, 750 (9th Cir. 1999) (nonexclusive patent licenses cannot be assigned by a debtor licensee).

2. Trademark cases such as *In re N.C.P. Mktg. Group Inc.*, 337 B.R. 230, 237 (D. Nev. 2005), aff'd, 279 Fed. Appx. 561 (9th Cir. 2008); In re XMH Corp., 647 F.3d 690, 695 (7th Cir. 2011) (holding that trademarks are personal and thus not assignable under trademark law without the consent of the trademark owner/licensor).

3. Copyright cases such as *In re Patient Educ. Media*, 210 B.R. 237, 240-43 (Bankr. S.D.N.Y. 1997); *In re Golden Books Family Ent. Inc.*, 269 B.R. 311, 314 (Bankr. D. Del. 2001); *ITOFCA Inc. v. MegaTrans Logistics Inc.*, 322 F.3d 928, 941 (7th Cir. 2003) (determining that nonexclusive copyright licenses are personal to transferees who cannot assign it to a third party absent the copyright owner's consent).

Courts have also analyzed the issue of whether an exclusive IP license similarly restricts an assignment by a debtor licensee without the nondebtor licensor's consent. On this issue, the courts have reached differing results. Some courts have ruled that exclusive patent licenses (like non exclusive patent licenses) are nonassignable without the patent owner's consent. See, e.g., *In re Hernandez*, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002) (to hold otherwise would render an exclusive license the equivalent of an outright assignment which would contravene well established federal law); see also *Proteo Tech Inc. v. Unicity Intern. Inc.*, 542 F. Supp. 2d 1216, 1219 (W.D. Wash. 2008). With respect to assignments of exclusive copyright licenses, some courts have determined to allow assignment reasoning that under applicable copyright law, an exclusive copyright license conveys an "ownership" interest. See, e.g., *In re Golden Books Family Ent. Inc.*, 269 B.R. at 319. Other courts such as *Gardner v. Nike Inc.*, 110 F. Supp. 2d 1282, 1287 (C.D. Cal. 2000) have concluded that exclusive copyright licensees do not have the right to assign absent the copyright owner's consent.

C. Current Circuit Split Regarding Assumption

The specific language of Section 365 contains a drafting ambiguity that has injected an additional level of complexity into the analysis of assumption and assignment issues – and the rights of nondebtor licensors facing a counterparty's licensee's bankruptcy case. Specifically, Section 365(c) provides that a debtor or trustee cannot "assume or assign" an executory contract when applicable law would prevent assignment.

Some courts have opted to read the three words "assume or assign" literally. That is, such courts have refused to allow a debtor licensee to merely assume a nonexclusive intellectual property license on the grounds that such a license is non assignable under applicable nonbankruptcy law. Four Circuit Courts of Appeal (the Third, Fourth, Ninth and Eleventh) have adopted the hypothetical test and ruled that if a contract cannot be assigned under applicable non-bankruptcy law, then it cannot be assumed or assigned by the debtor-licensee. See *In re West Elecs., Inc.*, 852 F.2d 79, (3d Cir. 1988); *RCI Tech. Corp. v. Sunterra Corp.* (*In re Sunterra Corp.*), 361 F.3d 257 (4th Cir. 2004); *Perlman v. Catapult Entm't, Inc.* 165 F.3d 747 (9th Cir.

1999); *City of Jamestown v. James Cable Partners*, L.P. (*In re James Cable Partners, L.P.*) 27 F.3d 534 (11th Cir. 1994).

Two other Circuit Courts of Appeal(the First and Fifth) have rejected that view. See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997); *Bonneville Power Admin. v. Mirant Corp.* (*In re Mirant Corp.*), 440 F.3d 238 (5th Cir. 2006). Instead, these two Circuits have adopted an alternative test knows as the actual test. Under the actual test, a debtor licensee is prevented from assuming a license only if it intends to assign it without the consent of the licensor. If the debtor merely plans to assume the license without attempting to assign, then the debtor is authorized to do so.

The implication of this Circuit split is monumental. In "hypothetical test" jurisdictions, debtor licensees confront the reality of not only being precluded from assigning their IP licenses, they are also precluded from merely attempting to assume such licenses. In contrast, in "actual test" jurisdictions, debtor licensees who do not intend to assign are free to at least assume their IP licenses. The Circuit split is likely to be resolved by the Supreme Court at some point. In 2009, Justice Kennedy was joined by Justice Breyer in issuing a statement on the denial of a petition for writ of certiorari in the case of *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc.*, 556 U.S. 1145 (2009). In the statement, Justice Kennedy described the division in the courts as "an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization" and that in a different case "the Court should consider granting certiorari on this significant question."

D. Lubrizol, the 1988 IP Amendments and Sunbeam

The power granted to a debtor to assume, assume and assign or reject is fundamental to the bankruptcy process. The impact of the power on the rights of intellectual property licensees was highlighted in the 1985 Fourth Circuit decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). In that case, pre bankruptcy, Richmond granted Lubrizol a nonexclusive license of certain patents. After filing for bankruptcy, Richmond rejected the license agreement. The Fourth Circuit held that under the Bankruptcy Code as it then existed, when Richmond rejected the license, Lubrizol, as the patent licensee, lost its rights under the license.

In response to this decision, in 1988 Congress enacted Section 365(n) to the Bankruptcy Code expressly granting licensees of "intellectual property" an option to elect to either (i) treat a rejected IP agreement as terminated or (ii) retain all rights, including rights to enforce any exclusivity provisions in the license and related or ancillary agreements, for the duration of the license and any extensions. At the same time, Congress amended the Bankruptcy Code to define the term "intellectual property" — a definition that included patents and copyrights but specifically did not include trademarks.

Thus, as a result of Section 365(n), now when a debtor is a licensor and seeks to reject a license of "intellectual property" as defined by the Bankruptcy Code, the nondebtor licensee has the statutory right to continue to retain its rights if it so elects. Specifically, Section 365(n) provides the nondebtor licensee with the right to continued usage as long as the licensee continues to pay royalties that are due and waives any right to setoff. However, the licensee making the election will not obtain any future updates, support or protection from infringement from the licensor. Upon the rejection, in other words, the debtor licensor is relieved of its obligations to perform. Nondebtor licensees of rejected contracts should pay careful attention to the language of any proposed sale order to ensure that the Section 363(n) rights are preserved and not subject to any argument that such rights are waived by the typical "free and clear" language in a typical sale order.

As noted above, the defined term "intellectual property" in the Bankruptcy Code does not include trademarks. Accordingly, the 1988 IP Amendments enacted in response to Lubrizol did not specifically grant a nondebtor trademark licensee the right to elect to retain its rights in the event of an executory license rejection by a debtor trademark licensor.

Recently, courts have begun to analyze further the rights of nondebtor trademark licensees when a debtor licensor rejects despite the lack of explicit protection in Section 365(n). For example, in *Sunbeam Products v. American Manufacturing*, 686 F.3d 372 (7th Cir. 2012) the Seventh Circuit held that the rejection of a trademark license does not constitute a termination of the nondebtor licensee's rights under the rejected contract., This result, of course, contrasts with the analysis of Lubrizol and has given trademark licensees of debtor licensors newfound support for retention of their licensee rights in the event of a rejection by a licensor – despite the omission of trademarks from the definition of "intellectual property" added to the Bankruptcy Code by the 1988 IP Amendments. As helpful as the Sunbeam opinion is to nondebtor trademark licensees, the decision leaves open several points about the scope of the licensee's rights which will be resolved only through further litigation or legislation.

## IV. RECENT CASES OF INTEREST

### A. *In re: Trump Entertainment Resorts, Inc.*, 526 B.R. 116 (Bankr. D. Del. 2015)

As noted above, the *Sunbeam Products* decision supports a nondebtor trademark licensee's ability to retain its rights after the debtor licensor rejects its trademark licensing contract. *Sunbeam* did not address the implications of a bankruptcy filing by a licensee on the nondebtor licensor. That issue was examined in *In re: Trump Entertainment Resorts, Inc.*, which concerned the ability of a debtor to assume a trademark licensing agreement it had entered before declaring bankruptcy.

Trump Entertainment Resorts, Inc. ran three hotel casinos in Atlantic City, New Jersey. In a 2010 Trademark License Agreement, Trump AC Casino Marks, LLC, granted Trump Entertainment Resorts the exclusive right to use the Trump name, likeness and other "Trump Marks" in connection with the operation of the hotel casinos. The license was perpetual, but subject to termination if the licensees failed to use the Trump Marks in a manner consistent with the quality a consumer has come to expect from the Trump name.

Finding such deficiency in quality, Trump AC initiated a state court action to terminate the Agreement in August, 2014. In September, 2014, that action was stayed after Trump Entertainment Resorts filed for chapter 11 bankruptcy. Under the Debtors' proposed reorganization plan, the debtors proposed to assume the Trademark License Agreement, and continue to use the Trump Marks in the operation of its hotel casino, the Taj Mahal. Trump AC promptly filed for relief from the automatic stay, in order to proceed with the state court action.

In granting Trump AC's motion, the Court was guided by the Third Circuit's *West Electronics* decision. *In re West Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988). With respect to Bankruptcy Code Section 365(c)(1), the Third Circuit follows the "hypothetical test" as discussed above in Part III. Whether a debtor licensee may assume an executory contract depends on the debtor licensee's hypothetical ability to assign the contract. If the debtor could hypothetically assign the contract, regardless of actual intention, the Third Circuit interprets §365(c)(1) as precluding assumption if "applicable law" excuses the nondebtor party from accepting or rendering performance. In *West Electronics*, since applicable law excused the nondebtor party, the Court held the nondebtor party was entitled to relief from the automatic stay in order to continue proceedings to terminate the non assumable contract.

Following *West Electronics*, the Bankruptcy Court of Delaware examined the applicable law governing trademarks, federal trademark law. The Court found that "under federal trademark law, trademark licenses are not assignable in the absence of some express authorization from the licensor." Furthermore, the Court found that assignment of trademark licenses is prohibited "under circumstances where it is clear that the identity of the licensee is crucial to the agreement." Finding both criteria met, the Court granted Trump AC's motion and lifted the automatic stay, despite the fact that the Debtors had no intention of actually assigning the license.

B. *In re CTLI, LLC*, No. 528 B.R. 359 (Bankr. S.D. Tex. 2015)

A strong presence on social media is important, if not imperative for most businesses. Many businesses invest heavily in cultivating their social media accounts, and view them as assets with real value. However, upon insolvency, individual owners of a business debtor may try to prevent these accounts from becoming property of the bankrupt estate. The U.S. Bankruptcy Court for the Southern District of Texas recently held that business social media accounts are correctly classified as property of a company's bankrupt estate.

*In re CTLI, LLC*, No. 528 B.R. 359 (Bankr. S.D. Tex. 2015), concerned social media accounts created by Jeremy Alcede, the former owner of Tactical Firearms. After declaring chapter 11 bankruptcy, Tactical Firearms reorganized as Debtor CTLI, LLC. Once 100 percent ownership was transferred to a new owner, the Court ordered Mr. Alcede to turn over all passwords for the Debtor's social media accounts. Mr. Alcede refused to comply, arguing the Tactical Firearms Facebook Page and the Twitter account "@tacticafirearm" were his personal accounts, not property of the business. The Court rejected this claim, analogizing Facebook users' "likes" of the page to traditional subscriber or customer lists. Just as a subscriber list contains valuable information that can be used to contact customers, a Facebook page allows a business to communicate directly with customers who have "liked" the page.

In its opinion, the Court acknowledged the potential difficulty of distinguishing between personal and business social media accounts where small business owners' personal identities are closely intertwined with the identity of the business. In holding the accounts property of the Debtor, not Mr. Alcede, the Court considered a variety of factors. The facts that the Facebook page linked directly to Tactical Firearms' webpage, the page was used to post status updates relating to, and promoting the business, and that Mr. Alcede granted other employees access to the page for the purpose of posting business related status updates, convinced the Court the page was property belonging to the reorganized Debtor.

The court weighed similar factors to decide that the Twitter account "@tacticalfirearm", was also property of the reorganized Debtor, not personal property of Mr. Alcede. The account was named after the business had a reorganized description of the business, and was linked to the business's web page. These facts, the Court said, raised the presumption that the Twitter account was property belonging to the Debtor.

Finally, the Court stated it need not concern itself with calculating the portion of goodwill resulting from the social media accounts that was attributable to Mr. Alcede in his professional capacity, from the portion attributable to the business. The Court recognized that some of the accounts' "fans" and "followers" were likely a result of Mr. Alcede's professional goodwill, but dismissed the issue, stating that any truly professional goodwill will follow the professional.

C. *In re Crumbs Bake Shop, Inc.* 522 B.R. 766 (Bankr. D.N.J. 2014)

Crumbs Bake Shop, Inc. was a manufacturer, supplier and retailer of cupcakes and other baked goods. To capitalize on its success, Crumbs entered into a representation agreement with Brand Squared Licensing ("BSL"). Under the Representation Agreement, BSL was to procure and manage license agreements with third parties. Under these agreements the third parties were granted permission to use the Crumbs' trademark and trade secrets in exchange for royalties. Collectively, BSL procured and managed six licensing agreements on behalf of Crumbs.

On July 11th, 2014, Crumbs filed for chapter 11 bankruptcy. On the same date, the Debtors entered into an Asset Purchase Agreement with Lemonis Fischer Acquisition Company, LLC ("LFAC"), under which LFAC would buy substantially all of the Debtors' assets. The licensing agreements were specifically excluded from the assets to be sold to LFAC and a provision in the Proposed Sale Order stated "…title and interest in and to the Purchased Assets shall pass to the Purchaser at Closing free and clear of all liens, claims, interests, and encumbrances, including, but not limited to…any leasehold interest, license or other right, in favor of a third party". On August 27th, 2014, the Court approved the sale free and clear of liens, claims, encumbrances and interest.

After the Court approved the sale, BSL filed a motion asserting that under §365(n) of the Bankruptcy Code licensees can elect to retain the rights granted to them by their respective contracts. BSL additionally sought any royalties that would be due under the contracts, if the licensees elected to retain their rights. LFAC then entered a motion for an order in aid of the Court's prior Sale Order, approving the sale of assets, free and clear of liens, claims, encumbrances, and interests. The Court was asked to determine the parties' respective rights under the Sale Order.

The Court's analysis focused on Bankruptcy Code Section §365(n), which provides for licensees of intellectual property of a debtor-licensor to elect to retain their rights under a licensing agreement, regardless of the debtor's rejection. The Court declined to adhere to a narrow construction of §365(n). Instead, it found that trademark licensing agreements do not fall outside the scope of §365(n) simply because trademarks are not specifically included in the definition of "intellectual property" found in §101(35A) of the Code. Based on the legislative history surrounding the adoption of §365(n), the Court found trademark licensees' rights were to be determined on a case by case basis. Examining the facts of this case, the Court found that stripping the licensees of their contractual rights would result in an inequitable outcome.

The Court additionally held that §363(f) does not trump §365(n) where the consent of the licensee is absent. The Court disagreed with LFAC's argument that the licensees gave implied consent when they did not object to the Sale Motion. The Court found that the ten words of the Proposed Sale Order, which extinguished the licensees' rights, were so vague and so deeply buried within the twenty-ninie page document that it would be inequitable to presume the licensees had adequate notice. Thus, lacking adequate notice, the licensees' failure to object did not constitute implied consent. Since consent was not granted, §363(f) did not override §365(n). Therefore, the licensees could retain their rights under their respective licensing agreements if they chose to do so. Finally, the Court held that because the license agreements were specifically excluded from the sale to LFAC, any royalties due under the license belonged to the Debtor, not to LFAC.

LFAC appealed to the Bankruptcy Appeals Court. However, LFAC and the Debtors reached a settlement before briefs were filed and the Court dismissed the appeal.

D. *In re RadioShack Corp.*, No 15-10197 (Bankr. D. Del. May 20, 2015)

As part of RadioShack's bankruptcy proceedings, the Debtor sought Court approval of the sale of certain intellectual property and related assets. The related assets of the proposed sale included 67 million customers' personally identifiable information (PII). The PII consisted of the customer's full name, physical address, phone number, email address (if on file), and twenty-one other categories of transaction data. Seventeen State Attorney Generals raised objections to the proposed sale due to the nature of the related assets. On May 14, 2015, the Debtors, the Attorney Generals, and the proposed purchaser, General Wireless Operations Inc., commenced mediation.

As a result of the mediation, an agreement was reached that may have implications for any future sale of personally identifiable information. The most salient point of the agreement is that the purchaser agreed to only purchase email addresses that have been active within two years prior to the sale. In addition, the purchaser agreed to notify by email all customers whose email addresses were purchased within 60 days of the sale. The agreement requires that the notification clearly explains how General Wireless came to be in possession of the customer's email address and information and provides an opportunity for the customer to opt out of receiving further communications. Any customer who opts out within 7 days, or any customer whose email bounces back, will not have their personally identifiable information transferred to General Wireless.

Additionally, of the twenty-one original categories up for sale, General Wireless agreed to purchase only seven: the store number, the ticked date and time, the SKU number, the SKU description, the SKU selling price, the tender type, and the tender amount. The Debtor specifically agreed not to sell customer phone numbers and credit or debit card numbers.

## V. ABI Commission

The ABI Commission to Study the Reform of Chapter 11 published its Final Report and Recommendations on Dec. 8, 2014. The Commission's recommendations included certain provisions addressing intellectual property issues.

Part V.A.4 of the Report focuses on "intellectual property licenses," while Part V.A.5 of the Report concentrates on trademark licenses.

In Part V.A.4, the Commission set forth the following "Recommended Principles":

- A trustee should be able to assume an intellectual property license in accordance with section 365(a) of the Bankruptcy Code notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement.

- The trustee should be able to assign an intellectual property license to a single assignee in accordance with section 365(f) notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement. If the trustee seeks to assign an intellectual property license under which the debtor is a licensee to a competitor of the nondebtor licensor or an affiliate of such competitor, the court may deny the assignment if the court determines, after notice and a hearing, that the harm to the nondebtor licensor resulting from the proposed assignment significantly outweighs the benefit to the estate derived from the assignment. The nondebtor licensor should bear the burden of proof in any such hearing.

- Foreign patents and copyrights should be included within the definition of "intellectual property" set forth in section 101(35A) and subject to section 365,including section 365(n). In addition, foreign trademarks should also be included in this definition, subject to the limitations and conditions imposed on domestic trademarks under the recommended principles in Section V.A.5, Trademark Licenses.

In Part V.A.5. the Commission set forth the following "Recommended Principles":

- "Trademarks," "service marks," and "trade names," as defined in section 1127 of title 15 of the U.S. Code, should be included in the definition of "intellectual property" under the Bankruptcy Code. Section 101(35A) of the Bankruptcy Code should be amended accordingly.

- If a debtor is a licensor under a trademark, service mark, or trade name license and the trustee elects to reject that license under section 365, section 365(n) should apply to the license, with certain modifications. The nondebtor licensee should be required to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed trademark, service mark, or trade name; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed trademark, service mark, or trade name. The trustee should maintain the right to oversee and enforce quality control for such products or services and should not be under any continuing obligation to provide products or services to the rejected licensee. In addition, the concept of "royalty payments" under section 365(n) should be expanded to include "other payments" contemplated by the trademark, service mark, or trade name license.

## CONCLUSION

The worlds of insolvency and intellectual property will continue to collide. Added to the mix will be international issues as companies with valuable IP across the world become subject to insolvency proceedings. One example of an international insolvency contest over IP was the well publicized Fourth Circuit opinion in the Qimonda case, Jaffe v. Samsung Electronics Co., Ltd, 737 F.3d 14 ($4^{th}$ Cir 2013), cert. denied, No. 13-1304 (Oct. 6, 2014). Look for similar disputes to continue to arise as parties seek to extract value from a distressed company's IP assets and the courts struggle to apply insolvency and intellectual property laws to new and novel fact patterns.

2811058.3

# AMERICAN BANKRUPTCY INSTITUTE

## 23rd Annual Southwest Bankruptcy Conference

**September 10 – 12, 2015**

*TOPIC:*

**Interplay Between Asset Protection, Estate Planning And Bankruptcy**

**September 11, 2015**

By:

**RANDY NUSSBAUM**
**Attorney at Law**

of

**Nussbaum Gillis & Dinner, P.C.**
*rnussbaum@ngdlaw.com*

14850 N. Scottsdale Road, Suite 450
Scottsdale, AZ 85254
(480) 609-0011

# INTERPLAY BETWEEN ASSET PROTECTION, ESTATE PLANNING AND BANKRUPTCY

When bankruptcy filings skyrocketed a few years ago, publications were inundated with articles about how bankruptcy law impacted on a variety of other areas of law and vice versa. As non-bankruptcy lawyers found even their most stable and long-term clients seeking bankruptcy protection, this education became crucial so practitioners could continue to properly represent individuals and businesses facing bankruptcy issues.

Despite the overwhelming amount of data that was available for non-bankruptcy lawyers to better understand how bankruptcy would impact on their practices, almost nothing has apparently been written on the topic of this presentation. This dearth of material was surprising, though it may be the result of too many bankruptcy experts not considering potential estate planning ramifications when their clients filed for bankruptcy and estate planning attorneys not being kept current by their clients when bankruptcy issues arose.

As I began preparing for this discussion, I realized that notwithstanding the paucity of formal materials, the number of issues which can arise when these areas of the law intersect are staggering. Therefore, this writing will focus on simply identifying those issues so the practitioner can be on the alert when they arise and proceed accordingly.

I will begin by over-viewing asset protection and estate planning concerns an individual should have when trying to prepare for potential financial difficulties.

## I. WHAT IS EFFECTIVE ESTATE PLANNING THAT PROVIDES ASSET PROTECTION?

Oftentimes, the public is confused with the difference between estate planning and pre-bankruptcy planning. Many individuals who have engaged in extensive estate planning assume that that same estate planning will shield their assets from creditors, either in or out of bankruptcy. Presumably those individuals are aware that proper estate planning could minimize their tax exposure and assume that the same is true as to exposure to non-tax creditors.

Nothing could be further from the truth as to the impact that traditional estate planning would have on creditor protection. Traditional estate planning provides little, if any, such protection. However, some estate planning can provide asset protection benefits.

Before touching upon the ways that estate planning could be used for asset protection purposes, I will provide verbiage that I incorporate into my initial letter with every client that my firm and I represent who is seeking individual bankruptcy protection. This verbiage discusses issues and concerns a client should have when considering bankruptcy and the client wants to understand what prepetition conduct may be acceptable and which may lead to further complications.

## ***PROPERTY OF YOUR ESTATE AND EXEMPTIONS***

*When you file for bankruptcy, all property that you have an interest in becomes property of your bankruptcy estate. This includes both tangible and intangible property and your interest in corporations, L.L.C.s, partnerships, or any business entity. Property of your estate is an all-encompassing concept and includes rights of action, personal and real property, claims and money owed to you as of the time of bankruptcy filing though not payable at that time, such as a tax refund. Any inheritance that you become entitled to within 180 days after your bankruptcy filing also becomes property of your bankruptcy estate.*

*Under Bankruptcy and Arizona law, you are allowed to exempt certain of your property. Exemptions exist so that debtors do not become wards of the state because of bankruptcy. The exemptions in Arizona are relatively liberal and include $150,000 worth of equity in your house (unless you have owned the house for less than 40 months, in which case your exemption cap is just less than $150,000) and most household goods and possessions. You may also claim as exempt property $6,000 equity per car in two different cars (if filing a joint petition), although only $300 per spouse can be claimed in a single bank or credit union deposit account. You must include checks that have not cleared in calculating that balance. You must also anticipate that such accounts may be frozen by the financial institution upon its notification of your bankruptcy filing, and you must be prepared to terminate any automatic payments and deposits or provide a new account created after your bankruptcy filing to accommodate those transactions. Seventy-Five Percent (75%) of any wages owed at the time of your bankruptcy filing are exempt. If an asset contains equity above and beyond the exemption amount, then your trustee can seize and liquidate it and distribute the proceeds to your creditors.*

*Though monies put away in a qualified retirement plan are normally exempt, any contributions you may make to that plan within 120 days of bankruptcy are not.*

*Additionally, assets that are held in a living trust are not exempt except for your homestead.*

*Changes made in 2005 in the bankruptcy law will impact on certain of these exemptions. However, as a general rule, the Arizona exemptions will still be allowed as long as you have resided in Arizona for at least two years prior to filing for bankruptcy protection.*

*State law also provides that you can protect six months worth of "food, fuel and provisions," which historically has allowed a Chapter 7 debtor to purchase six months worth of groceries and pre-pay necessary utilities for six months prior to filing for bankruptcy. What is uncertain at this juncture is the definition of what constitutes fuel since the statute was written many years ago at* *a time in which fuel probably consisted of firewood, heating oil, and the like, but trustees have normally permitted the prepaying of electricity, gas, and water with little objection. It is not clear as to whether telephone and cell phone service and cable are included; since the amounts involved are normally not that great, it is not commonly challenged. But in 2010 one Judge ruled against a debtor on this issue. On the other hand, it is not recommended that you try to claim this exemption by purchasing a gift card from a grocery store or pre-pay on a gas credit card because doing so does not actually constitute the purchase of fuel and provisions, but rather the right to buy such provisions or anything sold by that merchant in the future.*

## ***VALUING YOUR ASSETS***

*We are relying upon the information you have provided us concerning the value of your assets and the current balances and enforceability of any liens or claims secured by those assets. As already explained to you, the personal property valuation should be based upon its liquidation or "garage sale" value, whereas real estate should be valued at what a ready, willing, and able buyer would pay under normal market conditions.*

*Nevertheless, if you have any concern or questions about the value of any asset you are listing of substantial worth, we strongly recommend that either you or we retain an expert to value that asset. We strongly recommend this because if you overvalue your asset and this results in equity in excess of your exemption or the current lien balance, your bankruptcy trustee will have an absolute right to seize and liquidate that asset for the benefit of your creditors.*

*Similarly, if you are unsure or cannot provide us with confirmation of the lien balances and evidence of perfection of those liens (vehicle titles, recording information, etc.), we will need to investigate those matters as well. As just explained above, if a miscalculation of the enforceability or balance of a lien creates vulnerable equity for your trustee, that asset may be lost.*

*Additional cost will be incurred if we need to help you in this regard, but it is money well spent if you can avoid potentially unexpected and unpleasant consequences.*

## ***PRE-BANKRUPTCY PLANNING***

*Pre-bankruptcy planning is the converting of non-exempt assets into exempt assets. This practice is not illegal or improper; Bankruptcy Code legislative notes specifically permit this type of activity. This is not to say that this procedure is without risk.*

*In July of 1996, In re Elia became the first Arizona published opinion on pre-bankruptcy planning. The judge found nothing inappropriate with buying a* *house right before bankruptcy and other similar strategies. However, that case is persuasive but not binding on the other judges. In other courts throughout the country, this issue has been addressed and in certain instances, the pre-bankruptcy planning vilified by the bankruptcy judges. Though no single test has been universally accepted by the courts in determining whether or not to tolerate pre-bankruptcy planning, a number of criteria continuously surface in case after case:*

1. *What is the amount of the transfer to exempt property?*

2. *What is the proximity to the bankruptcy filing?*

3. *Did the conversion to exempt property involve newly acquired funds or previously secured property?*

4. *Did the conversion benefit insiders of the debtor?*

5. *Did the debtor mislead creditors during the conversion?*

*Other courts have considered additional circumstances in determining whether or not the pre-bankruptcy planning is reproachable, but the best way to summarize whether or not pre-bankruptcy planning will succeed is to consider the old maxim, "pigs get fat, and hogs get slaughtered."*

*Your attorney would also be incurring some risk if the planning progresses to a stage where it could be interpreted as a fraud upon creditors. Though normally the bankruptcy courts do not condemn the attorneys for the planning, but rather punish the debtors, in past non-bankruptcy settings, the Arizona courts have sanctioned attorneys for overly zealous asset protection tactics.*

*Debtors whose pre-bankruptcy planning has been successfully challenged face a number and variety of repercussions. Oftentimes, the courts order that transfers be set aside and/or reversed. For example, if a debtor has utilized cash to increase his homestead by $50,000 in advance of bankruptcy, an intolerant court can either require that the debtor find the means to replace the $50,000, or, in extreme circumstances, compel the debtor to sell the exempt property and remit $50,000 to the estate. In certain instances, reversing what has occurred is simple while at other times creates a new set of problems for the debtor.*

*In some situations, courts have found the pre-bankruptcy planning to be so egregious as to justify the denial of a discharge. Though this result is rare, being deprived of a discharge defeats the entire reason behind bankruptcy and is disastrous for the debtor.* ***This risk is now even more pertinent because of the following change in the law.***

*One of the changes in the bankruptcy law which went into effect on April 20, 2005, specifically provides that the Court has the power to reduce a state law homestead exemption by any transfers of nonexempt property made to increase that exemption for an extended period of time (10 years) prior to bankruptcy filing if such transfers were done in fraud of creditors. Though this has always been the case law, this change now incorporates the case law into the Bankruptcy Code itself and no one knows how strictly this new section will be interpreted by the courts. Unfortunately for you, it may increase the chances that your pre-bankruptcy planning could be successfully challenged, though you may still need to engage in the planning nevertheless.*

***The BAPCPA was specifically designed to discourage debtors from engaging in pre-bankruptcy planning and in particular to stop the practice of Chapter 7 debtors paying down their mortgages in advance of bankruptcy. Some experts have even gone so far as to recommend that pre-bankruptcy planning is no longer a viable option.***

In simplest terms, most pre-bankruptcy planning will be tolerated subject to two other conditions. As the following section, which is also incorporated into my initial letters, explains, an individual cannot utilize fraudulent or preferential transfers so as to accomplish that plan.

## *FRAUDULENT TRANSFERS AND PREFERENCES*

*Certain transfers and payments are prohibited under the Bankruptcy Code. These prohibitions were designed to ensure that individuals contemplating bankruptcy do not dispose of their property to place outside the reach of creditors or pick and choose certain creditors to pay unless certain rules are followed.*

*A fraudulent transfer is any transfer of property for which inadequate consideration is received at a time in which the transferor is insolvent or rendered insolvent by the transfer. Insolvency is generally defined as having debts that exceed your assets. If such a transfer occurs within two years of filing bankruptcy, and in certain instances, even longer, the bankruptcy trustee has the right to recover the property or an amount equivalent in cash from the transferee.*

*A preference is a payment made within 90 days of bankruptcy on account of an old debt and in the case of insiders, within one (1) year of bankruptcy. There are exceptions to this rule, but if a preferential payment is made, the trustee may recover the payment from the recipient. A preferential payment does not have to be in the form of cash; any transfer received from a third party within the statutory guidelines on account of an old debt can create a preference.*

*Starting in 2003, the U.S. Trustee's Office has demanded that debtors disclose whether they have renounced any interest in any estates within four years of bankruptcy. This question is being asked because if an individual has* *renounced such an interest, the U.S. Trustee's Office believes that such action may be a fraudulent transfer. It may be a fraudulent transfer because in certain instances, if the debtor has exercised control over that estate interest, renouncing it in advance of bankruptcy may be a designed effort to deprive creditors of that same interest upon the filing of a bankruptcy. This is not to suggest you do not have a right to renounce an interest in a will or a trust within four years of bankruptcy, but there may be a situation in which such activity can be challenged.*

*Because there are many intricate rules and a number of exceptions, you need to consult with me about any transaction that may be fraudulent or preferential. Sometimes there are ways to reverse or rectify the transaction in advance of bankruptcy and by doing so, eliminate the problem.*

None of the above discussion provides any guidance to an individual trying to incorporate estate planning into an asset protection strategy.

So what are the options available to an individual who would like his estate planning to also provide creditor protection as well?

1. The cash value of annuities and life insurance can be protected – Arizona law provides that if your client owns an annuity or has cash value in life insurance in which the beneficiary has been the same for at least two years prior to a bankruptcy filing or creditor action, the cash value is protected as long as the beneficiary is a dependent or family member.[*] At one point, because of an unexpected opinion from the Ninth Circuit Bankruptcy Panel called *Hummel*, policies were only protected if the beneficiary was a dependent family member, but the Ninth Circuit Court of Appeals ultimately reversed the lower court and ruled that such policies are protected as long as the beneficiary was either a family member ***or*** a dependent. This protection is conditioned upon a party not engaging in a fraudulent transfer to fund the annuity or the life insurance, but in almost all instances, the protection is absolute. Furthermore, presumably because of a legislative oversight, no cap is currently in place under Arizona law.

Therefore, a high likelihood exists that if you have a client with a substantial amount of assets who wants to plan for the future, one way of doing so is using this alternative, though of course your client would not want to do so for fraudulent purposes and would need to have such planning in place for at least two years to ensure that it could be successful.

Two recent cases demonstrate the value of life insurance planning. *ML Servicing Co., Inc. v. Coles*, 235 Ariz. 562 (2014) holds that even a life insurance policy purchased with money "misappropriated" by one breaching a fiduciary duty, is protected because the creditor's remedies were limited to recovery of the premium paid and the creditor had no claim to the death benefit. ("As discussed above, § 20-1131 provides a proper remedy at law when creditors have been defrauded in order to pay life insurance premiums--the creditor may recover the amount of premiums paid in fraud of the creditor, plus interest. A.R.S. § 20-1131.B. This is an adequate remedy at law because it makes Appellants whole by placing them in the same position they would have been in but for Cole's alleged misuse of those funds to pay the Policies'

[*] Other Southwestern States have similar statutes.

premiums."). There is a brief but unresolved petition for review pending, however, in ML Servicing. In a similar vein, the Court of Appeals recently held, in an unpublished decision, that a post-judgment transfer of a term life insurance policy to an ILIT for the expressed purpose of making sure that the insured's family would enjoy the policy proceeds to the exclusion of his and his family's creditors, was not a fraudulent transfer relying on *In re Estate of King*, 228 Ariz. 565 (App.2012). *MidFirst Bank v. Barness*, 2014 W.L. 6456046.

2. Spendthrift trust – Under bankruptcy law, an interested party can look back for as many as 10 years to investigate and potentially challenge spendthrift trusts and the like, but as a general proposition, if your client follows state law in the creation of a spendthrift trust and has the luxury of waiting at least four years before encountering financial difficulties or bankruptcy, a high likelihood exists that the planning would be effective. Of course, this presupposes that your client can wait the four years and is willing to relinquish control of the corpus, but in many instances, if your client has the foresight to engage in such planning, the protection is very effective.

3. Other forms of trust and business entities – Other options exist, including the ability to transfer assets into an LLC controlled by beneficiaries and, in particular, children, in return for a membership interest in that LLC. Because this type of planning is very fact intensive, this topic will not be discussed further except to note that surviving a rigorous challenge will depend upon, a) whether the planning otherwise made business sense; b) the consideration that was provided to the conveying party; and c) the passage of time between the planning and the financial problems.

There are a few other quick considerations that the practitioner always needs to consider if his client is looking for protection from creditors.

1. The law is unclear as to whether personal property in the name of a living trust is protected under Arizona exemptions laws. The Arizona legislature has specifically extended protection to a homestead that is conveyed into a living trust, but not personal property. Though in most cases the amount of assets that may be exposed by a couple would be capped at $10,000 to $20,000, it is exposure that can be avoided if consideration is paid to this issue. You need to be familiar with your respective state's laws in this area.

2. Make sure that if your debtor client dies, that his creditors cannot otherwise get to his estate. If your client dies within 180 days of filing for bankruptcy* and has named his own living trust as the beneficiary under his life insurance policy, those proceeds may not be protected. Almost all courts consider a living trust to simply be an extension of that individual, which is why an individual seeking bankruptcy protection needs to understand that placing assets in a living trust will not shield them from creditors. The author has not ever faced the issue of a client dying within 180 days of a bankruptcy filing who had named his living trust as the beneficiary of his life insurance policies, but this practice seems very risky.

---

* Under the Bankruptcy Code, a bankruptcy trustee is entitled to any rights in an inheritance a debtor is entitled to within 180 days of a bankruptcy filing.

Now let's consider concerns your client may have if your client is the beneficiary of an inheritance and contemplating bankruptcy.

## II. PROTECTING YOUR BANKRUPT CLIENT'S RIGHTS TO AN INHERITANCE

As a preliminary matter, if your client is a beneficiary under a will or trust, the courts have been very generous in tolerating the disclaimer of any such future interest by the beneficiary. Of course, a beneficiary is always risking that once he relinquishes such right, that later on the trustor/grantor will not reinstitute it, but normally the beneficiary is willing to take that chance.

I will now discuss options to consider if your client is seeking bankruptcy and does not want to risk his inheritance.

1. Disclaim the inheritance once financial difficulties arise – This is the easiest and most straightforward option. Obviously, if the client later on realizes disclaimer was not necessary, the client may not be able to reverse what has occurred, especially if the grantor/trustor does not cooperate.

2. Once the grantor/trustor dies, disclaim any interest in the estate – The case law provides that a client can do so even in the face of financial difficulties. Despite challenges to the contrary, the courts have consistently held that such a disclaimer does not constitute improper action or a fraudulent transfer because the requisite elements of a fraudulent transfer are not met by such tactics.

3. Have the grantor/trustor remove you as a beneficiary – This is the most absolute option, but if later on you want that party to reinstate your client as a beneficiary, that party may not be willing to do so. This option is especially flexible because the grantor/trustor can remove the beneficiary's name even after the beneficiary files for bankruptcy protection. This can be a valuable strategy in circumstances in which an individual files for bankruptcy and then unexpectedly discovers an interest may become available when someone who has named your client in a will or trust becomes terminally ill within 180 days of your client's bankruptcy filing.

4. Have the grantor/trustor leave the interest in a spendthrift trust – Though this option can be a little more expensive than the others, by having the grantor/trustor leave any interest to the beneficiary in the form of a spendthrift trust, the exposure of the beneficiary's interest is normally limited to the amounts that may be paid within 180 days of the beneficiary's bankruptcy filing. This leaves the question of whether a beneficiary can disclaim any payment that may be paid within 180 days of that party's bankruptcy filing. Of course, a party contemplating this strategy needs to make sure that such a disclaimer is proper and can be limited to just the 180 day period.

Finally, a recent U.S. Supreme Court decision could have a major impact on planning of this type.

In the *Clark v. Rameker* decision, the Supreme Court ruled unanimously that an inherited IRA is not exempt and therefore is subject to trustee seizure when a bankruptcy is filed. Prior to this very recent and to some extent surprising Supreme Court decision, individuals holding inherited IRAs could exempt those IRAs upon filing for bankruptcy as though they were their own IRAs and if an individual inherited such an IRA within 180 days of bankruptcy, the IRA would be protected as well notwithstanding the 180 day inheritance rule. Now, clients possessing such inheritances are no longer able to exempt them upon filing for bankruptcy protection. This may require them to engage in planning regarding those inheritances or to ask the grantor/trustor to modify his estate planning in certain instances.

Whether the inherited IRA is protected may depend upon whether your state has a statute which specifically exempts inherited IRAs. If it does, most experts believe state law will control. This was not an issue in the *Clark v. Rameker* decision because the subject state did not have such a statute.

## III. CONCLUSION

Over the years I have had a number of clients engage in planning to minimize the impact of a potential inheritance on that filing. Clients have been willing to pay for such planning even when after the fact it is proven to have been unnecessary. On the other hand, when a few years ago a client with a very ill father elected not to have the parent consider any alternative planning, the client effectively lost her entire inheritance when her dad died within 180 days of her bankruptcy filing. This was very unfortunate. Since the client had been warned and knowingly and willingly elected her course of conduct, she accepted the consequences. The outcome would have been far different, though, if that same client had not been educated and then discovered one day that she had lost her entire inheritance because she was unaware of other options that may have been available for her and her dad.

# AMERICAN BANKRUPTCY INSTITUTE

## 23rd Annual Southwest Bankruptcy Conference

**September 10 – 12, 2015**

*TOPIC:*

**Interplay Between Bankruptcy and Personal Injury Law**

**September 11, 2015**

By:

**RANDY NUSSBAUM**
**Attorney at Law**

of

**Nussbaum Gillis & Dinner, P.C.**
*rnussbaum@ngdlaw.com*

14850 N. Scottsdale Road, Suite 450
Scottsdale, AZ 85254
(480) 609-0011

1245272/999-71

# <u>INTERPLAY BETWEEN BANKRUPTCY AND PERSONAL INJURY LAW</u>

## I. <u>INTRODUCTION</u>

The interplay between bankruptcy and personal injury law is an intriguing one because confusion is rampant as to how bankruptcy impacts on other areas of the law. Over the course of my over 35 years of legal experience, I have probably experienced more confusion and ambiguity when these two areas of the law collide than any others. This outline is intended to alert the practitioner to material concerns which arise which, if not considered, can lead to dire ramifications for the party either pursuing the claim or defending it.

So when do these two areas of the law intersect?

Oftentimes, individuals pursuing personal injury claims find themselves seeking bankruptcy protection. Not surprisingly, in many instances the personal injury claim is based upon some type of catastrophic loss which compels the damaged party to seek Bankruptcy Court protection. The first section of this outline discusses the risks of such individuals pursuing bankruptcy protection and certain strategies to consider to help mitigate the ultimate consequence of filing for bankruptcy.

In other instances, the bankruptcy debtor is not the aggrieved party, but rather the tort feasor. In those cases, it is incumbent upon both the plaintiffs and defendant's counsel to understand the effect that bankruptcy has on such a pending claim. From the defendant's perspective, understanding the protections of the automatic stay is crucial, whereas the plaintiff needs to appreciate not just how the automatic stay impacts on the claim, but also needs to consider whether the automatic stay in any way impacts on sources of other recoveries, such as insurance, while also taking into account whether a claim may exist to challenge the dischargeability of the debt under 11 U.S.C. § 523. As importantly, the plaintiff should understand how his strategy may be altered by the bankruptcy filed by the debtor and, finally, due consideration needs to be given to the impact of the bankruptcy on the applicable statute of limitations.

As you can well imagine, an in depth analysis of the innumerable issues that arise when a bankruptcy is filed while a personal injury claim is pending could easily justify an all day presentation, but this outline will simply identify crucial issues so that the practitioner is at least aware when further analysis and investigation is appropriate.

## II. <u>IMPACT OF PERSONAL INJURY CLAIMANT FILING FOR BANKRUPTCY</u>

### A. <u>Claim is Property of the Estate</u>

Without question, the claim is property of the bankruptcy estate. It does not matter whether a formal action has been brought; if even a potential claim exists at the time of the bankruptcy filing, the claim belongs to the trustee. Sometimes a technical argument can be made as to exactly when the claim arose, but in most instances, determining that date is not that difficult. For example, if an individual was involved in a car accident on February 1, 2013, filed bankruptcy on February 3, 2013, and then did not even seek medical treatment until March 1, 2013, the claim is still property of the bankruptcy estate even if the debtor did not realize he was hurt until after the bankruptcy filing date.

This leads to the next issue of whether the claim could be exempt.

### B. Is Claim Exempt?

In most cases, exemptions are a creature of state law. In Arizona, no exemption is available to assert an exemption claim for a personal injury claim. See *In re Hoffpauir*, 125 B.R. 269 (1990). In other parts of the country, part of the claim up to a certain amount may be exempt.

What about the ability to exempt lost wages?

Courts have not allowed debtors to exempt damages above and beyond lost wages. The reasoning behind this ruling revolves around the presumption that a damage claim for ancillary damages is different than the actual lost wage claim itself. See *In re Mulvihill*, 326 B.R. 459 (2005).

This brings up the issue of how the form of bankruptcy leads to different treatment of personal injury claims.

### C. How does Form of Bankruptcy Impact on Claim?

In a Chapter 7, in most instances, the claim, as least in part, belongs to the bankruptcy trustee to pursue it. The debtor has little, if any, influence on the trustee's pursuit of the claim since the trustee's principal duty is to creditors, not the debtor.

In a Chapter 13, the trustee will normally let the debtor pursue the claim independently with the proceeds to be turned over to the Chapter 13 trustee for the benefit of creditors. Of course, as in the case of a Chapter 7, this leads to the question of why would the debtor have any incentive to pursue the claim if the monies will go to creditors, not the debtor. This will be discussed in the next section.

In a Chapter 11, the debtor in possession would normally pursue the claim as well. However, even though the proceeds should be available for distribution to creditors, the debtor may be permitted to potentially retain some of the proceeds free and clear of creditor's claims.

### D. How Debtors can Benefit

Obviously, debtors benefit when creditors are paid, especially priority or non-dischargeable claims. But, bankruptcy debtors prefer the option of using part of the personal injury recovery for their own benefit.

Two common strategies are available to allow debtors to retain a percentage of the recovery free and clear of creditor claims.

First of all, especially in the case of a Chapter 7, notwithstanding the debtor's obligation to fully cooperate, it oftentimes is advantageous for the bankruptcy trustee to allow the debtors to retain "some skin in the game" in return for aggressively and zealously assisting in the pursuit of the claim. Especially in cases in which the debtor may have a major time commitment or even advance costs, it only makes business sense to permit the debtor to negotiate some type of percentage interest in any recovery. As long as creditors are not hurt, they really should not care, though of course a debtor does not want to be too greedy.

The same basic principle exists in a Chapter 13, though in both Chapter 7 and Chapter 13, it is crucial that if the debtor will be able to keep any recovery free and clear of creditor claims, that such an agreement is approved by the Court prior to the claim being pursued. Or, if the claim is already being pursued, Court permission is sought as quickly as possible.

In a Chapter 11, if the debtor values the claim for liquidation analysis purposes at a certain amount as part of the Plan confirmation process, and interested parties agree on the valuation of the claim, I do not see why a court would not approve a settlement in which the debtor would be entitled to keep some of the proceeds free and clear of creditors' claims. Once again, without the debtor's commitment to pursue the claim, creditors may receive nothing at all and if creditors are comfortable with the debtor's valuation of the claim for purposes of creditor distributions, creditors should not complain if a debtor reaps a windfall because he recovers more than was projected in the Plan.

Counterarguments exist as to why the debtors should never be able to directly benefit, either in 7, 11, or 13, but as a practical matter, providing ample incentive for debtors to diligently pursue claims makes business sense if everyone benefits.

### E. Get Appointed Counsel

In representing a personal injury claimant in bankruptcy, it is crucial that the attorney gets appointed as counsel. Since being compensated is the ultimate goal in such representation, and getting paid is close to impossible if you are not appointed counsel, do so right away. Also, remember that in most instances, getting your fees approved will require Court approval as well. Fortunately for the practitioner, if the compensation understanding is included in the original retention paperwork, it is extremely rare for a Bankruptcy Court to then interfere with the ultimate payment of the fees and costs.

### F. Other Issues to Consider

In some instances, an individual may be better off settling the case before filing for bankruptcy, especially if the debtor could engage in proper pre-bankruptcy planning with the proceeds.

As bankruptcy counsel, even if you discover that your client has a personal injury claim pending after you file the case, make sure you list it, even if belatedly. Failure to do so could result in the debtor's discharge being denied in certain instances.

If the claim is potentially large enough and the amount of debt relatively small, consider dismissing the bankruptcy case if the case is filed because bankruptcy counsel did not know or was unaware of the pending personal injury claim. Doing so is relatively easy in a Chapter 13 because of the right to dismiss, but can also be pursued in either a Chapter 7 or 11. If creditors can be reassured that they will be paid in full by the case being dismissed, then they may cooperate. Or, if a Chapter 7 is pending, but it is determined that the personal injury claim is of a magnitude that it would be more than sufficient to pay creditors in full, consider converting the case to a Chapter 11. At least in a Chapter 11, the debtor will have much more say as to the ultimate settlement of the claim.

Even in a Chapter 7, if the debtor possesses a claim in which the ultimate recovery will exceed the amount of the debt, consider negotiating a settlement or an understanding with the trustee so that the debtor retains control of the litigation once creditors are paid in full. As a practical matter, creditors should not care if the claim revests in the debtor after they are paid, and it is inherently unfair for the debtor to suffer and not receive an ultimate recovery because the Chapter 7 trustee's only concern is full payment to creditors.

Finally, understand that if a bankruptcy case is filed prior to a statute of limitations running and then the statute runs during the pendency of a bankruptcy case, certain statutory periods are extended to allow the trustee to pursue the claim for up to two (2) years from the date the case was filed. See 11 U.S.C. § 108. The extension only benefits the trustee, but in certain instances this can be extremely valuable for the debtor, especially if the debtor is facing priority or non-dischargeable debt.

## III. IMPACT OF PERSONAL INJURY DEFENDANT FILING FOR BANKRUPTCY

### A. Proceeding is Stayed Against the Debtor

As a general rule, all proceedings are immediately stayed against the debtor. This is the case whether the claim is in litigation, is pre-litigation or is on appeal. The scope of the automatic stay is broad. If a claimant violates the stay, the violator is subject to sanctions.

## B. Pursuing Claim when the Debtor is Insured

In most instances, a claim against the debtor's insurance company does not impact directly on the debtor, but you normally still need stay relief. Normally, procuring stay relief is relatively straightforward and easy if the claimant is limiting his claim to the amount of insurance coverage available. You also will be able to procure stay relief if the claim being pursued is in excess of the amount of the insurance coverage as long as the claimant is only trying to quantify the amount of the claim so as to quantify a bankruptcy estate claim. On the other hand, the claimant will not be granted stay relief if the intention is to simply pursue the debtor for the excess amount unless a dischargeability claim has been brought.

## C. Dischargeability Litigation

If the claimant believes that the cause of action is non-dischargeable, either because of willful and malicious conduct or based upon another statutory basis under 11 U.S.C. § 523, the claimant can file a dischargeability complaint in Bankruptcy Court. The filing of the dischargeability complaint, though, does not mean that the matter will then automatically be heard by the Bankruptcy Court. The claimant could ask for stay relief and request that the underlying claim be heard in State Court, but he would still have to pursue a separate proceeding in Bankruptcy Court to determine whether the claim is dischargeable. Or, the Bankruptcy Court may prefer the matter be heard in its Court, depending upon the nature of the claim.

Confusion has arisen surrounding the issue of where personal injury claims should be heard. Bankruptcy Courts do not have jurisdiction to consider a pure personal injury claim except to the extent of whether the claim is dischargeable. Sometimes, the parties litigate the amount of the claim in State Court and then the Bankruptcy Court considers whether the claim is dischargeable. In that scenario, the claimant would be well served to seek specific findings of fact in State Court which parallel the requisite elements of a non-dischargeable finding. From the claimant's perspective, the goal is to minimize what has to be duplicated in Bankruptcy Court.

Just because a party procures stay relief to pursue a claim in State Court does not preserve that party's right to pursue the debtor for the non-dischargeable portion of the claim. The claimant has to timely file a Complaint in most instances, or the claim will be discharged.

## D. Impact on Statute of Limitations

Under Arizona law, a tort claimant normally has two years from the date the cause of action arose to file a Complaint. An intervening bankruptcy case will extend the statute of limitations for up to 30 days from the date the stay is lifted. See U.S.C. § 108(c). Be careful, though, because even though certain deadlines will be extended, purely ministerial steps will not be extended.

Do not ever leave yourself in a situation in which you do not have time to procure stay relief so you can timely take action in State Court. Be proactive and proceed as quickly as possible to procure stay relief when needed.

### E. Impact of Discharge or Case Closing

Once the discharge is granted, you do not need stay relief to proceed against the debtor in cases in which you are only proceeding against insurance coverage. Nevertheless, many practitioners still procure stay relief just to be safe. Make sure that everyone is clear that the claimant only intends to proceed against the insurance coverage or to reduce the claim to a monetary amount against the bankruptcy estate. Under no circumstances should you do anything which could be interpreted as a violation of the debtor's discharge.

If this all sounds complicated, it is, and is one of the reasons why in such situations, it is a sound idea for defense counsel to consult with bankruptcy counsel when not clear as to what can or cannot be done. The same is true as to the attorney representing the claimant against an individual who has filed for bankruptcy protection.

# AMERICAN BANKRUPTCY INSTITUTE

## 23rd Annual Southwest Bankruptcy Conference

**September 10 – 12, 2015**

*TOPIC:*

**Interplay Between Divorce and Bankruptcy**

**September 11, 2015**

By:

**RANDY NUSSBAUM**
**Attorney at Law**

of

Nussbaum Gillis & Dinner, P.C.
*rnussbaum@ngdlaw.com*

14850 N. Scottsdale Road, Suite 450
Scottsdale, AZ 85254
(480) 609-0011

# 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.

## I. IMPACT OF AUTOMATIC STAY OF 11 U.S.C. § 362

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 brethrens' 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 unpleasantry 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.

# AMERICAN BANKRUPTCY INSTITUTE

## 23rd Annual Southwest Bankruptcy Conference

**September 10 – 12, 2015**

*TOPIC:*

**Interplay Between Property of the Estate, Exemptions and Divorce**

**September 11, 2015**

By:


**RANDY NUSSBAUM**
**Attorney at Law**

of

Nussbaum Gillis & Dinner, P.C.
*rnussbaum@ngdlaw.com*

14850 N. Scottsdale Road, Suite 450
Scottsdale, AZ 85254
(480) 609-0011

# 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. <u>CLAIMING EXEMPTIONS</u>

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.+

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.

---

* His and himself are interchangeable with her and herself.

\+ 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 (Bkrtcy. 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 Grassmueck*, 127 B.R. 869 (Bkrtcy. 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.

## Community Property and Bankruptcy

Anna Nicole and J. Howard are husband and wife and live in Arizona, a community property state. Both are employed. Before they were married, Anna Nicole owned a Harley Davidson motorcycle and a Ferrari (which was subject to a 100,000 lien). She also owned stock in Guess. J. Howard owned (free and clear from any liens) an oil well. He also owed $10,000 to Oil Tycoon Bank.

During their marriage, the couple borrowed $100,000 to purchase a small convenience store and $10,000 to purchase a pick-up truck to use at the couple's ranch. J. Marshall also borrowed $5,000 to purchase a car for his son, Pierce, from a prior marriage. The lender agreed the debt would be J. Marshall's sole and separate liability. Anna Nicole was not a signatory to the loan. While married, J. Howard became indebted to medical clinic for $50,000 for a birthday present cosmetic surgery procedure for Ann Nicole.

### Hypothetical One

**Anna Nicole and J. Howard file bankruptcy jointly.**
**What property comes into the estate and what debts are subject to discharge?**

In a typical bankruptcy, "all legal or equitable interests of debtor in property as of the commencement of the case" become property of the estate. 11 U.S.C. §541(a)(1). In community property states, this includes all interest of the debtor and the debtor's spouse in community property. 11 U.S.C. 541(a)(2). The trustee in a chapter 7 marshalls all these assets to pay the couple's debts, subject to any exemptions. Both the husband and wife will generally receive a personal discharge (putting aside any issues as to nondischargeability or denial of discharge). 11 U.S.C. § 524(a). The discharge prohibits creditors from pursuing either spouse's after acquired property for any remaining prepetition debts.

### Hypothetical Two

**Anna Nicole alone files for bankruptcy while the couple is married. J. Marshall does not join in the bankruptcy filing.**

A. <u>What happens to the couple's property?</u>

Anna Nicole's estate consists of all her sole and separate property (Harley Davidson, Ferrari and Guess stock). In addition, all of the couple's community property also becomes property of the estate (convenience store, the pick-up truck).[1] *In re Peterson*, 437 B.R. 858, 866 (D. Ariz. 2010). J. Howard's oil well would not be property of the estate.

Subject to any exemptions, the trustee would be able to sell Anna Nicole's sole and separate property and any community property to pay the estate's debts. Anna Nicole would receive a personal discharge, discharging her from her separate and community debts. She would not be liable for any of J.

[1] Even if the one spouse files for bankruptcy while their divorce is pending, all community property comes into the estate. Until the divorce decree is entered and property divided, the property remains community property. *In re Petersen*, 437 B.R. 858 (D. Ariz. 2010).

Marshall's separate debt, those incurred before they were married and after they were married. Those are expressly J. Howard's sole and separate obligations. They are not discharged by Anna Nicole's bankruptcy.

Because the trustee will use the community property to pay the estate's debts, J. Howard loses his (½) community property interest in the convenience store and the pick-up truck even though he did not file bankruptcy. However, as sort of a consolation for losing his community property, the nonfiling spouse in a community property state gets what is colloquially referred to as a community discharge. 11 U.S.C. § 523(a)(3). The community discharge is not technically a discharge, but really an injunction prohibiting creditors from collecting against any after acquired community property of the nonfiling spouse for any of the discharged debts. J. Howard as the nonfiling spouse is still responsible for his separate *and* community debts, but the community discharge limits the property against which a creditor may proceed.

In this case, J. Marshall would receive a community discharge barring the creditors on the convenience store debt and the pick-up truck from pursuing the couple's community property. These creditors would only be able to pursue J. Marshall's sole and separate property for repayment of these debts. And even with respect to the hospital debt, J. Marshall only receives a community discharge. So while Anna Nicole is free to enjoy the benefits of her makeover free of charge, J. Howard's sole and separate liability because he, not her, contracted for the hospital debt. A.R.S. § 2§ 25-215(D).

B. Does the community discharge apply to any of J. Howard's sole and separate debt?

Yes. A.R.S. § 25-215(B) provides that "community property is liable for the premarital separate debts or other liabilities of a spouse . . . but only to the extent of the value of that spouse's contribution to the community property which would have been such spouse's separate property if single." Therefore, absent bankruptcy, the 10,000 bank loan can be collected from J. Howard's separate property *and* any contributions J. Marshall made to the community that would have been his separate property if he had been single, which includes his wages. Because a portion of the community property would normally be available to satisfy this debt under Arizona law, it is a community claim under the 11 U.S.C. § 101(7)[2] and the community discharge will enjoin the lender from collecting against after acquired community property.

This would not appear to apply to the separate debt incurred by J. Marshall to purchase the car for his son. A.R.S. 25-215(B) speaks to premarital separate debts. *See also Schlaefer v. Financial Management Service, Inc.,* 196 Ariz. 336, 996 P.2d 745 (App. 2000)(holding medical expenses incurred during marriage by wife and set forth as wife's sole and separate debt per the couple's prenuptial agreement could not be collected from marital community property by creditor). Both lenders will be able to pursue J. Howard's sole and separate property, however.

C. What if the parties subsequently divorce?

A divorce after a community discharge effectively undoes the community discharge. J. Howard would lose the benefit of the community discharge. Once the marriage is dissolved and the community

[2] A community claim is a "claim that arose before the commencement of the case concerning the debtor for which property of the kind specified in section 541(a)(2) of this title is liable, whether or not there is any such property at the time of the commencement of the case."

divided between the spouses, the community property loses its community property status and becomes the individual's sole and separate property. That sole and separate property is available for a creditor to collect against, as the community discharge only applies to prevent collection against community property.

Anna Nicole would still have her personal discharge, meaning her prepetition creditors could not pursue her for the debts for which she received a discharge.

**Hypothetical Three**

**During their marriage, a judgment is entered against J.Howard in state court based on fraud. Subsequently, Anna Nicole files bankruptcy. The judgment creditor is provided notice of the bankruptcy, and Anna Nicole lists the debt as a community debt. The creditor ignores the proceeding however, and the debt is discharged. Years later, J. Howard files for bankruptcy. The creditor objects to discharge and J. Howard argues the debt was discharged in Anna Nicole's earlier bankruptcy.**

<u>A. Is the judgment debt discharged as to J. Howard?</u>

No. J. Howard's liability remains, but the "sources against which the debt may be enforced have been reduced." *In re Costanza*, 151 B.R. 588, 911-12 (Bankr. D.N.M. 1993); *see also In re Strickland*, 153 B.R. 909 (Bankr. D.N.M. 1993). Anna Nicole is clearly not liable for the debt, as she received a personal discharge in her earlier bankruptcy of this debt. J. Howard did not receive a personal discharge. However, Anna Nicole's bankruptcy resulted in a community discharge, enjoining the judgment creditor from pursuing any of the couple's community property. Therefore, J. Howard remains liable to the creditor, but only from his sole and separate property. If the nonfiling spouse has little to no separate property, the creditor is left with no remedy (unless the couple subsequently divorces).

<u>B. What if the judgment creditor objects to discharge under 11 U.S.C. § 523(a)(2) in Anna Nicole's original bankruptcy?</u>

The answer to this question depends first on whether the debt is a community debt or the separate debt of the J. Howard, the "guilty" spouse. In our hypothetical, Anna Nicole already listed the debt as a community debt. But, let's assume now that Anna Nicole filed bankruptcy and either did not list this debt or listed it as her husband's separate debt. The Court will have to determine whether this debt is a community or separate obligation by looking to state law. While generally debts incurred during marriage are considered community obligations, this presumption can be overcome by clear and convincing evidence. Anna Nicole may argue that she had no knowledge of this debt, did not consent to or participate in J. Howard's actions to establish that the debt is his sole and separate obligation. However, where a debt is incurred for the benefit of the community, the debt is generally considered a community obligation, regardless of the innocence or lack of knowledge by the spouse not incurring the debt. *In re Rollinson*, 322 B.R. 879, 882 (Bankr. D. Ariz. 2005). The innocent spouse defense only applies when seeking to determine the *liability* of the innocent spouse's sole and separate property for that debt. *Id*. at 881-82.

Assuming the judgment is community debt, and the court concludes it is nondischargeable under 523(a)(2), future community property will be liable for this debt, despite Anna Nicole's personal discharge and the community discharge. 11 U.S.C. 524(a)(3). "This happens automatically by operation of §§ 524(a)(3) and (b), without the necessity for any determination as to the knowledge or participation of the 'innocent' spouse, so long as the debt is community debt. This is true regardless of whether the spouse filing for bankruptcy is 'an innocent spouse.'" *Rollinson*, 322 B.R. at 883. There is no community discharge available for a community claim where either spouse engaged in wrongful conduct. 4 Collier on Bankruptcy, ¶ 524.02[3][a], at 524-28 (15th ed. Rev. 2005). The guilty spouse cannot hide behind the discharge of the innocent spouse. *In re Le Sueur,* 53 B.R. 414, 417 (Bankr. D. Ariz. 1986); *In re Bush*, 2005 WL 6960185 * 4 (9th Cir. BAP). Therefore, under the facts of this hypothetical, Anna Nicole's and J. Howard's after acquired community property will be liable for this debt.

The next question, however, is the scope of the discharge (or more appropriately the scope of nondischargeability) beyond the community discharge. Is Anna Nicole entitled to discharge this debt as to her sole and separate property? This question focuses on whether she is in fact an "innocent spouse." To attribute liability to Anna Nicole personally for this debt, a creditor would have to establish some kind of agency relationship between Anna Nicole and J. Howard other than simply the fact that they are spouses, knowledge by Anna Nicole of the alleged misconduct of J. Howard or some kind of culpable conduct by Anna Nicole. *See In re Tsurukawa*, 258 B.R. 192, 198 (9th Cir. BAP 2001); *In re Oliphant*, 221 B.r. 506, 511 (Bankr. D. Ariz. 1998)(holding that "'in order for the debt to be nondischargeable in the 'innocent' spouse's [separate] bankruptcy,' the plaintiff seeking a nondischargeability order 'must show culpable conduct or fraudulent intent on the part of the 'innocent' spouse.'"). Without such evidence, the debt will be discharged as to the innocent spouse's sole and separate property. *In re Rollinson*, 322 B.R. 879, 880 (Bankr. D. Ariz. 2005).

2. Sole and Separate Debt of Guilty Spouse

If the debt were not incurred for the benefit of the community and no other facts established that this judgment was a community debt, Anna Nicole would receive a personal discharge for this debt and her sole and separate and community property would not be liable for the debt. *Rollinson*, 322 B.R. at 883 (citing *In re Clark*, 179 B.R. 898 (Bankr. D. Ariz. 1995).

**This hypothetical illustrates the importance for a creditor with a potential community claim to pay attention when only one spouse files for bankruptcy. Note, 523(a)(3) protects a creditor who is not listed or scheduled in the bankruptcy.

**Hypothetical Four**

> **Assume J. Howard has a $25,000 nondischargeable state court judgment against him individually and against the marital community from a claim that he embezzled from his employer. The creditor did not name Anna Nicole in the state court lawsuit and no judgment was entered as to her personally. J. Marshall and Anna Nicole admit the embezzlement is a community debt, as it benefitted the community. Anna Nicole files for bankruptcy protection. Subsequently the parties divorce.**

A. What does the creditor have to prove to have this judgment debt nondischargeable as to the Anna Nicole, the "innocent spouse"?

This debt was clearly a debt of the community, since the embezzlement benefitted the community. Upon divorce, both parties remained liable to the creditor for the community debt. Therefore, the obligation could be collected from Anna Nicole's and J. Howard's post dissolution separate property and any community property provided to them by way of the dissolution decree, which would now have the status of separate property. With bankruptcy being filed, however, the question becomes whether this debt is nondischargeable. Under In re Oliphant, the creditor would have to establish that Anna Nicole engaged in culpable conduct or intent. 221 B.R. 506, 511 (Bankr. D. Ariz. 1998). "Fraudulent intent will not be presumed. *In re Bursh,* 14 B.R. at 705–06. As stated earlier, however, it may be proven inferentially. The "innocent" spouse's knowledge of the other spouse's fraudulent conduct may be relevant to an inference of fraudulent intent, depending on the nature and extent of such knowledge and on whether there are other relevant facts that bolster the inferential value of the knowledge. In certain cases, knowledge itself may be inferred where the facts and circumstances are so egregious that denial of knowledge is simply not credible. Fraudulent intent also may be inferred from other facts. For example, the nature and extent of the benefit conferred to the "innocent" spouse may be so great or unusual that it is reasonable to conclude that the "innocent" spouse engaged in fraudulent activity him or herself." *Id*.

B. From what property of the debtor may the creditor collect?

If the creditor can establish culpability on Anna Nicole's part and thus personal liability, then her separate property is liable for this debt. There is no community property to satisfy this community obligation any longer as the parties are divorced.

**Bonus Hypothetical**

Husband and Wife own three residential rental properties (which Husband manages) and the marital residence. In addition, they are expecting a $20K federal tax refund for the previous tax year. They also don't like each other much so Husband moves out. On Sept. 1st Wife files and serves a petition for marital dissolution (Wife later finds out that while they have been separated, Husband obtained two new credit cards and has used them pay his living expenses). Two days later Husband files a Chapter 7 bankruptcy proceeding. A few weeks later the family court holds an expedited hearing in response to Wife's plea that see need funds while the dissolution is pending. The Court orders that upon receipt Husband deliver half of the tax refund to Wife and begin forwarding half the net residential rental proceeds. Soon thereafter Husband obtains his discharge, but fails to comply with the family court order. In fact, he helps his BK trustee sell the rentals.
After an evidentiary hearing, the Family Court enters a final decree in which it:

1. Confirms its order-directing turnover of half the tax refund proceeds;

2. Directs that Husband shall be liable for the debt incurred on the credit card accounts he opened after the parties split; and
3. Awards Wife half the equity from the sale of the rental units.

Husband rushes to the Bankruptcy Court, asking for an order declaring the decree null and void.

What would you do if you were the BK judge or the BK lawyer?

What should the family lawyer for judge have done?