



Bankruptcy's Fresh Start Versus Family Law's Marital Obligations—Part II

by Kathy A. Higby

Editors' Note:

This is the second part of a two-part article. Part I, which was published in the April issue,¹ discussed the bankruptcy court's framework and legislative policy to provide relief for a client whose ex-spouse attempts to discharge marital debts earlier ordered by a divorce court to be paid by that ex-spouse. The author introduced the concepts of debts "in the nature of support" and a balancing test, both designed to avoid dischargeability of marital debts. This Part II examines the applicable case law regarding both the U.S.C. § 523(a)(5) and § 523(a)(15) objections to discharge, and the effect of nondischargeability of debts.

Applicable Case Law

U.S.C. § 523(a)(5) Objection To Discharge

A review of applicable federal law indicates that the exemption to discharge of debts "in the nature of support" has broad application. Debts may indeed be exempt that, at first glance, appear to be dischargeable. An understanding of applicable case law and a careful analysis are required to maintain the benefits obtained in the underlying dissolution action.

A determination as to whether a debt is a nondischargeable support obligation or a dischargeable division of property is accomplished under the "factors and intent" test.² The court must conduct a two-part

inquiry to determine whether a payment is in the nature of support. First, the court must divine the spouses' shared intent as to the nature of the settlement agreement, even if it is unambiguous. The court is required to look beyond the words and labels of the agreement to resolve this issue. Second, if the court decides that the payment was intended as support, it must then determine that the substance of the payment was in the nature of support at the time of the divorce by determining whether the surrounding facts and circumstances, especially financial, lend support to such a finding.³ A party's obvious need for support at the time of the divorce is enough to raise the presumption that the obligation was intended as support, even when it is otherwise identified in the parties' agreement as property division.⁴

The intent of the parties can best be found by examining three principal indicators:

- 1) the language and substance of the agreement in the context of the surrounding circumstances, using extrinsic evidence if necessary;
- 2) the parties' financial circumstances at the time of the settlement, including whether a spouse had custody, was unemployed, or was employed in a less remunerative position than the other spouse; and
- 3) the function served by the obligation at the time of the divorce, recognizing that an obligation that serves to maintain daily necessities is indicative of debt "in the nature of support."⁵

A written agreement between the parties is persuasive evidence of intent. However, if the agreement is ambiguous or silent as to the parties' intent, the court must determine the parties' intention by looking to extrinsic evidence.⁶ When the agreement is ambiguous, evidence that payment of the debt is necessary in order for

the ex-spouse to maintain daily necessities, such as food, housing, and transportation, indicates that the parties intended the debt to be in the nature of support.⁷

Although intent of the parties is important in classifying debts as dischargeable or nondischargeable, for bankruptcy purposes, it is not the dispositive factor.⁸ The distinction between divorce debt that is dischargeable and debt that is nondischargeable is not the clarity of the language of the settlement agreement, but rather, the function of the property in question.

The following pertinent factors should be considered in making a determination as to whether the obligation is support:

- 1) if the agreement fails to provide explicitly for spousal support, the court may presume that the property settlement is intended for support if it appears under the circumstances that the spouse needs support;
- 2) when there are minor children and an imbalance of income, the payments are likely to be in the nature of support;
- 3) support or maintenance is indicated when the payments are made directly to the recipient and are paid in installments over a substantial period of time; and
- 4) an obligation that terminates on remarriage or death is indicative of an agreement for support.⁹

The court is not required to accept the labels attached to monetary matters in a prior divorce case when applying bankruptcy law. If the court believes that the

Column Eds.: Bonnie M. Schriener, a sole practitioner in Denver—(303) 458-5100; Leigh Wiggs Monahan of Polidori, Gerome, Franklin & Jacobson, LLC, Lakewood—(303) 936-3300

This newsletter is prepared by the CBA Family Law Section. This month's article was written by Kathy A. Higby, Lakewood, an attorney with Jeffrey S. English & Associates, (303) 235-0735.

property settlement was really in the nature of child support, spousal support, alimony, or maintenance, it can so find and relabel those items when applying bankruptcy law on issues of dischargeability.¹⁰ The court is likewise not required to look at a spouse's present need for support or changed circumstances in order to ascertain whether a debt is dischargeable pursuant to 11 U.S.C. § 523(a)(5).¹¹

Examples of debts found to be in the nature of support and, therefore, exempt from discharge, vary widely. A few debts found to be in the nature of support include:

- 1) an obligation to make mortgage payments to a third party;¹²
- 2) education and medical expenses;¹³
- 3) court-ordered attorney fees incurred during a post-dissolution custody dispute;¹⁴
- 4) an order to pay the ex-spouse's attorney fees in a dissolution action;¹⁵
- 5) obligations in consideration of the ex-spouse relinquishing support;¹⁶
- 6) a psychologist bill awarded in connection with a custody dispute;¹⁷
- 7) annual payments representing an ex-spouse's one-half interest in real estate;¹⁸
- 8) guardian *ad litem* fees;¹⁹ and
- 9) hold-harmless agreements.²⁰

If the debts in dispute had the actual effect of providing support, enabling the nondebtor to maintain a home and have a monthly income, the debtor's obligations therefor may be nondischargeable. If, however, the debts are not found to be in the nature of support and, therefore, are not exempt under § 523(a), they may yet be determined nondischargeable under § 523(a)(15).

U.S.C. § 523(a)(15) Objection To Discharge

To prevail under a § 523(a)(15) claim, the non-debtor ex-spouse must show that the debt is not exempt under § 523(a)(5) (as discussed above) and that the debt was incurred in the course of a divorce or separation. This first element will be satisfied by a court's denial of an alternative request for a determination of nondischargeability pursuant to § 523(a)(5). The second element is easily established by referring to the agreement or orders in the dissolution action.

Two defenses to nondischargeability are set forth in § 523(a)(15), regarding (1) the debtor's inability to pay the obligation, and (2) a balancing test of the benefit to the debtor and the resulting detriment to the ex-spouse.

The first defense is that the debtor does not have the ability to pay the debt from income or property not reasonably necessary to be expended for the maintenance and support of the debtor or his or her dependents and, if the debtor is engaged in a business, for the payment of expenses necessary for the continuation, preservation, and operation of the business. Establishing the debtor's ability to pay requires an extremely fact-sensitive analysis. However, case law provides guidelines addressing this issue. *In re Smither*²¹ provides a five-step analysis regarding a debtor's ability to pay:

“Congressional policy concerning 11 U.S.C. § 523(a)(5) has always been to ensure that genuine support obligations would not be discharged.”

- 1) determine the amount of debts that the non-debtor ex-spouse is seeking to have exempted from discharge and the repayment terms and conditions of those debts;
- 2) calculate the debtor's current income and the value and nature of any property retained after the bankruptcy filing;
- 3) ascertain the amount of reasonable and necessary expenses that the debtor must incur for the support of himself or herself and any dependents and the continuation, preservation, and operation of his or her business, if any;
- 4) compare the debtor's property and current income with his or her reasonable and necessary expenses to determine ability to pay; and
- 5) determine the debtor's ability to pay by comparing debts at issue with assets available to meet those debts.

This test focuses on whether the debtor's budgeted expenses are reasonably necessary. It is a good practice to compare the bankruptcy budget with the latest financial affidavit filed in the domestic action for inconsistencies.

Even if the debtor has the ability to pay, the debt may yet be discharged if discharging the debt would result in a benefit to the debtor that outweighs the detrimen-

tal consequences to the former spouse. Again, this balancing-of-equities test is extremely fact sensitive. *Smither* sets forth eleven non-exclusive factors that the court should consider in making this determination:

- 1) the amount of debt involved, including all payment terms;
- 2) the current income of the debtor, objecting creditor, and their respective spouses;
- 3) the current expenses of the debtor, objecting creditor, and their respective spouses;
- 4) the current assets, including exempt assets, of the debtor, objecting creditor, and their respective spouses;
- 5) the current liabilities, excluding those discharged by the debtor's bankruptcy, of the debtor, objecting creditor, and their respective spouses;
- 6) the health, job skills, training, age, and education of the debtor, objecting creditor, and their respective spouses;
- 7) the dependents of the debtor, objecting creditor, and their respective spouses, their ages, and any special needs they may have;
- 8) any changes in the financial conditions of the debtor and the objecting creditor that may have occurred since the entry of the divorce decree;
- 9) the amount of debt that has been or will be discharged in the debtor's bankruptcy;
- 10) whether the objecting creditor is eligible for relief under the Bankruptcy Code; and
- 11) whether the parties have acted in good faith in the filing of the bankruptcy and the litigation of the 11 U.S.C. § 523(a)(15) issues.

Section 523(a)(15) protects hold-harmless agreements and property settlement obligations not in the nature of support by expanding the definition of debts that may not be dischargeable in bankruptcy. However, it appears that the analysis required to prevail under this section is more subjective and amorphous than that required under § 523(a)(5). An argument in the alternative under both sections is warranted in many situations. Careful drafting in a settlement agreement or requesting protective findings in final orders in the underlying dissolution action can minimize the potential for dischargeability of marital obligations in a future bankruptcy action.

Effect of Nondischargeability Of Debts

If the debts are found to be in the nature of support pursuant to § 523(a)(5) and, therefore, nondischargeable, an issue may arise as to the modifiability of those debts in the underlying dissolution action. There appears to be no case on point to resolve the question of whether a finding of "in the nature of support" for purposes of determining nondischargeability re-characterizes the prior debt distribution into a modifiable maintenance award and a taxable event. A review of the applicable state and federal law, as well as applicable legislative intent, provides some guidance in this area.

The plain language of 11 U.S.C. § 523(a)(5) indicates that debts are nondischargeable if owed "for alimony to, maintenance for, or support of such spouse." The statute clearly distinguishes nondischargeable alimony and maintenance debts from other nondischargeable debts found to be in "support of such spouse." Case law furthers this distinction between alimony/maintenance and debts "in the nature of

support" and confirms that debts "in the nature of support" can be set out in the parties' separation agreement.

For example, an obligation to pay a spouse's interest in property by providing for monthly payments could be acknowledged by the parties in the agreement as a debt "in the nature of support." If the facts indicate that the monthly payments were necessary to meet the spouse's monthly living expenses, this acknowledgment would be helpful to asserting a § 523(a)(5) claim, as it goes to the intent test.

Section 523 of the bankruptcy code departs from the general policy of absolute, or fresh start, for the debtor in order to enforce an overriding public policy favoring the enforcement of familial obligations.²² Because the issue of nondischargeability is decided based on federal law, a debt could be in the "nature of support" under § 523(a)(5), even though it would not legally qualify as alimony or support under state law.²³ In fact, property division often achieves the same goal as alimony—that is, support.²⁴ Even an obligation designated as a property settlement may be related to support because state courts often will adjust alimony awards

depending on the nature and amount of marital assets available for distribution.²⁵ The inquiry of the bankruptcy court should be limited to the nature of the obligation at the time it was undertaken.

Where appropriate and *authorized* by state law, debtors can resort to state court to seek modifications of divorce settlements on the grounds of changed circumstances.²⁶ Colorado law is well-settled that property and maintenance issues are inextricably interwoven.²⁷ This is so because both property and maintenance provisions serve the dual purpose of providing sufficient means of support for each party in a dissolution of marriage action. Colorado's legislative intent surrounding the maintenance statute was to encourage the court to provide for the financial needs of spouses by property disposition, rather than by an award of maintenance. An award of maintenance may be ordered only if the available property is insufficient for that purpose, and if the spouse who seeks maintenance is unable to secure employment appropriate to his or her skills and interests. Thus, a highly relevant factor to be considered by the court in effecting a just division of marital property is the extent

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to which the division will promote the objective of providing for each party's financial needs without maintenance.²⁸

A property division that has become final is not subject to modification unless the court finds the existence of conditions that justify the reopening of a judgment.²⁹ Maintenance, on the other hand, is subject to modification as to future installments on a showing of changed circumstances so substantial and continuing as to make the terms unjust.³⁰ In equitably adjusting the financial obligations of the parties based on changed circumstances, the property division remains fixed and requisite adjustments to achieve fairness are to be made in the maintenance provisions of a decree.³¹

Congressional policy concerning 11 U.S.C. § 523(a)(5) has always been to ensure that genuine support obligations would not be discharged.³² Section 523 was broadened to ensure the legislative intent that other marital obligations would not be discharged. Accordingly, § 523(a)(15) was added to allow the bankruptcy court a balancing test as yet another exception to the discharge of debts that were not in the nature of support.

A recharacterization of the debt as maintenance ignores the plain language of 11 U.S.C. § 523(a)(5), which provides that a debt is nondischargeable if owed "for alimony to, maintenance for, or support of such spouse." In this author's opinion, once a debt is determined to be in the nature of support pursuant to federal bankruptcy law for purposes of determining dischargeability of marital obligations in a Chapter 7 bankruptcy filing, it is not, *ipso facto*, recharacterized as a maintenance obligation for purposes of state law and, therefore, modifiable in the underlying dissolution of marriage action.

Conclusion

Practitioners should be wary of advising a client on the issue of nondischargeability of a debt in bankruptcy based on the parties' nomenclature that the debt was a property division. The label does not resolve the issue; the intent of the parties does not resolve the issue. The function of the debt is dispositive when determining dischargeability under 11 U.S.C. § 523(a)(5).

If debts arising under a dissolution of marriage or legal separation fail to qualify as a non-exempt debt under 11 U.S.C. § 523(a)(5), they may still be nondischarge-

able under § (a)(15), unless the debtor does not have the ability to pay them or the detriment to the ex-spouse of such a discharge outweighs the benefit of a discharge to the debtor. These sections afford substantial protection to the ex-spouse attempting to retain financial benefits established in a prior divorce decree.

NOTES

1. See Higby, "Bankruptcy's Fresh Start Versus Family Law's Marital Obligations—Part I," 28 *The Colorado Lawyer* 55 (April 1999).

2. *In re Young*, 35 F.3d 499, 500 (10th Cir. 1994).

3. *Id.*; *In re Sampson*, 997 F.2d 717, 723 (10th Cir. 1993).

4. *Sampson*, *supra*, note 3 at 725.

5. *In re Gianakas*, 917 F.2d 759, 762, 763 (3rd Cir. 1990).

6. *In re Yeates*, 807 F.2d 874, 878 (10th Cir. 1986).

7. *Id.* at 879.

8. *Kubera v. Kubera*, 200 B.R. 13, 16 (Bankr. W.D.N.Y. 1966).

9. *In re Goin*, 808 F.2d 1391 (10th Cir. 1987).

10. *Kubera*, *supra*, note 8 at 17; *In re Marriage of Barber*, 811 P.2d 451, 455 (Colo.App. 1991), *citing In re Harrell*, 745 F.2d 801 (11th Cir. 1985).

11. *Sylvester v. Sylvester*, 865 F.2d 1165, 1166 (10th Cir. 1989).

12. *Gianakas*, *supra*, note 5; *Kubera*, *supra*, note 8; *Yeates*, *supra*, note 6.

13. *Gianakas*, *supra*, note 5; *Draper v. Draper*, 790 F.2d 52, 54 (8th Cir. 1986).

14. *In re Jones*, 9 F.3d 828 (10th Cir. 1993).

15. *Allison v. Allison*, 372 P.2d 946 (Colo. 1962).

16. *Sylvester*, *supra*, note 11.

17. *In re Miller*, 55 F.3d 1487 (10th Cir. 1995).

18. *Goin*, *supra*, note 9.

19. *In re Morris*, 14 B.R. 217 (Bankr. Colo. 1981).

20. *Barber*, *supra*, note 10.

21. *In re Smither*, 194 B.R. 102 (Bankr. W.D. Ky. 1996).

22. *Sampson*, *supra*, note 3 at 721.

23. *Gianakas*, *supra*, note 5 at 762; *Yeates*, *supra*, note 6 at 878.

24. *Gianakas*, *supra*, note 5 at 763.

25. *Id.*, *citing Buccino v. Buccino*, 580 A.2d 13, 18-19 (Pa.Super. 1990).

26. *Id.*

27. *In re Marriage of Jones*, 627 P.2d 248 (Colo. 1981).

28. *Id.* at 252.

29. CRS § 14-10-122.

30. *Jones*, *supra*, note 27 at 253; CRS § 14-10-122.

31. *Jones*, *supra*, note 27.

32. *Jones*, *supra*, note 14 at 880, *citing Shine v. Shine*, 802 F.2d. 583, 588 (1st Cir. 1996).

