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ATTACKING PRE-BANKRUPTCY TRANSFERS OF NON-EXEMPT PROPERTY PURSUANT TO PROPERTY DISTRIBUTION ORDERS

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A CLE Presentation

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Issue: What tools does the trustee or creditor have to attack pre-bankruptcy transfers of non-exempt property that were transferred pursuant to a property distribution order related to the debtor's pre-bankruptcy dissolution?

Typical Scenario: Prior to filing for bankruptcy relief, the debtor and his or her spouse obtain a divorce. The non-debtor spouse, through the decree of dissolution, receives all or most of the unsecured marital assets, while the debtor assumes the liabilities that only he was liable for. The debtor then files for bankruptcy, having little or no non-exempt property for the estate.

Introduction

Section 541 of the Bankruptcy Code governs what is included in the estate of a debtor. Both §541(a)(1) and (d) are relevant in determining what property, that was formerly marital property, would be property of the debtor's bankruptcy estate. Section 541(a)(1) provides that "all legal or equitable interests of the debtor in property as of the commencement of the case" become part of the bankruptcy estate. Section 541(d), however, limits (a)(1); "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest. . . becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."

The interest held by the debtor at the commencement of the bankruptcy case determines what title and rights the estate receives. *In re DeLauro*, 207 B.R. 412, 415 (Bankr. D. N.J. 1997), (citing *N.S. Garrott & Sons. V. Union Planters National Bank,* 772 F.2d 462, 467 (8th Cir. 1985) and *Butner v. United States*, 440 U.S. 48, 55 (1979)). Thus, to determine the extent of the bankruptcy estate's interest in what was formally marital property, it must first be determined what rights the debtor had in the property at the time his or her bankruptcy petition was filed.

State law, not federal law, determines the status of property interests. *DeLauro*, at 415. Indiana law provides that a decree of dissolution constitutes a final disposition of the marital assets, absent fraud. "Indiana has long-recognized that marriage dissolution contemplates a final separation of the parties and a final division of their property, with "all questions regarding the adjudication of marital property rights [] put to rest by the divorce decree." *Brown v. Pitzer*, 249 B.R. 303, 308 (Bankr.S.D. Ind. 2000). Thus, the language of the dissolution decree is determinative of the parties' interest in the property.

Transfers of property from one spouse to another have traditionally been considered highly suspicious, however, when made shortly before a debtor's bankruptcy filing. When property is transferred shortly before filing, fraud becomes a consideration. The trustee has three possible tools with which to challenge questionable transfers made in accordance with a dissolution property settlement prior to the debtor's filing: avoidance as a preference under §547, as a fraudulent transfer under §548, and as a fraudulent transfer under state law through §544. Overall, preference avoidance under §547 is generally the most used of the trustee's avoidance powers; it is used to recoup payments made to creditor within 90 days prior to the bankruptcy filing. *11 U.S.C. §547*. The power to avoid fraudulent transfers, both under the Bankruptcy Code and state law, is used to challenge conveyances made with the intent to hinder or delay creditors or that leave the debtor insolvent. As we will discuss, some of the provisions work better than others in the context of questionable dissolution property distributions.

Preference Avoidance
Section 547(b).

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property –

  (1) to or for the benefit of a creditor;
  (2) for or on account of an antecedent debt owed by the debtor before any transfer such transfer was made;
  (3) made while the debtor was insolvent;

(4) made –
 (A) on or within 90 days before the date of the filing of the petition; or
 (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if –

 (A) the case were a case under chapter 7 of this title;
 (B) the transfer had not been made; and
 (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

As set forth above §547 sets out various mechanical qualifications that must be met in order for a transfer to constitute a preference. The key considerations to our analysis are whether there was a transfer to a creditor, whether an antecedent debt existed, and whether the transfer was made during the relevant time period. In the context of a transfer made pursuant to a dissolution decree, the two later requirements create problems that often make §547 preference avoidance an inappropriate remedy.

A transfer must have been "for or on account of an antecedent debt owed by the debtor before such transfer was made" in order for the trustee to avoid a transfer of a debtor's interest in property as a preference. *In reHaskell*, 1998 Bankr. LEXIS 1489, 30 (N.D. Ill. 1998) (*citing 11 U.S.C. §547*). This requirement excludes most property distribution transfers from the trustee's avoidance powers, because spouses generally do not have obligations to each other during marriage. *In re Parker*, 81 B.R. 583 (9th Cir. 1987).

The division of marital property usually does not qualify as debt under the Code. *Haskell*, 1998 Bankr. LEXIS at 30. Under the Code, a debt is defined as "a liability on a claim". *11 U.S.C. §101(12).* The Code provides for two types of claims: a "right to payment" and a "right to an equitable remedy for breach of performance". *11 U.S.C. §101(5).* A debt as described by the first type of claim does not usually exist, because the resolution of property division issues under a divorce decree involves the equitable distribution of property, not the payment of debts. *Haskell*, 1998 Bankr. LEXIS at 31. The second definition fails "because there has been no "breach of performance" by the Debtor that would give rise to a right to payment." *Id.* Thus, there is no antecedent debt to be paid, and no preference to be avoided.

The timing requirements of §547 may also be problematic to the Trustee when using its preference avoidance powers. To be avoidable, a transfer must be made to a creditor within 90 days of filing or to an "insider" within one year of filing. The courts, however, do not readily extend "insider" status to former spouses to allow the trustee the much needed extension time. Because the former spouse is not a blood relative and thus not within in the definition of "relative", the courts more closely scrutinize alleged "insider" relationships. *In re Schuman*, 81 B.R. 583, 587 (9th Cir. 1987); In *re Busconi*, 177 B.R. 153, 158 (Bankr. D. Mass 1995). "It would seem from these examples that Congress intended to include those whom the debtor looked kindly upon and those who have significant influence on the debtor even though not "in control" of the debtor." *Id.* The situation where the transfer is in response to a court ordered property distribution is not one involving the type of influence that would often lead to the development of "insider" status.

Avoidance of Fraudulent Transfers
Section 548(b).

(a)(1) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily –

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation. . .

Section 544.

(b)(1) Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

IC 32-2-7-15. Indiana Uniform Fraudulent Transfer Act

Sec. 15. A transfer made or an obligation incurred by a debtor is fraudulent as to a creditor whose claim arouse before the transfer was made or the obligation was incurred if:

(1) the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation; and
(2) the debtor:
    (A) was insolvent at the time; or
    (B) became insolvent as a result of the transfer or obligation.

Sections 544 and 548 of the Bankruptcy Code both provide the Trustee with powers with which to avoid transfers as fraudulent conveyances. The powers given under each section are similar in nature. Generally, the trustee may avoid transfers made with the intent to hinder, delay or defraud creditors or made for less than reasonably equivalent value. *11 U.S.C. §548*. However, the reach-back period under §544(a) is typically longer than under §548 due to its incorporation of state fraudulent conveyance law. *In re Chevrie*, 2001 Bankr. LEXIS 97, 23 (N.D. Ill. 2001). Because these avoidance powers relating to fraudulent transfers are similar, identical standards are applied.

In reviewing a dissolution property distribution as a possible fraudulent conveyance, the courts are usually reluctant to question the outcome of the dissolution action. However, they are not precluded from reviewing the order. *Haskell*, 1998 LEXIS at 14. Collateral estoppel and res judicata can not be used by the debtor to prevent the review, because the trustee was not a party to the dissolution action and the factors determining a "just and reasonable" division of marital property according to state law are different from what constitutes reasonably equivalent value for the purposes of §548. *Id.* at 23.

> Although judicial approval of a marital settlement agreement may represent a determination that the agreement is fair and equitable as between the parties to the divorce, it does not represent a determination that the agreement perpetrates no fraud upon the creditors of one spouse, particularly where the claims of creditors are not made known to the court or provided for in the decree. *Chevrie*, 20001 Bankr. LEXIS at 31.

The fraudulent conveyance provisions of §544 and §548 provide two separate grounds exist for challenging a transfer: actual fraud and constructive fraud. *Id.* at 21.

Actual Fraud

Actual fraud requires a showing of an intent to hinder, delay or defraud, and therefore, is often hard to prove. "It is often impractical, on direct evidence, to demonstrate an actual intent to hinder, delay or defraud creditors. Consequently, as under the common law of fraudulent conveyances, bankruptcy courts frequently infer fraudulent intent from the circumstances surrounding the transfer." *Id.* at 28.

When reviewing the circumstances of a property distribution, the court looks for certain "badges of fraud". *Id.* A single questionable condition is not sufficient to render a conveyance void; "the confluence of several can constitute conclusive evidence of actual intent, absent significantly clear evidence of a legitimate supervening purpose for the transfer." *Id.* Those events that might give rise to a suspicion of fraud are also examples of evidence commonly used to develop an inference of fraud: a dissolution shortly before a liability arises, a "fast track" dissolution proceeding, a large differential in value given to each party, the parties continuing to reside together post-dissolution, and the distribution being made by settlement agreement. If, when taken together, the individual instances of questionable behavior give rise to an inference of fraud, the bankruptcy court may allow the trustee to avoid the transfer made by the property distribution order as a fraudulent conveyance.

In *Chevrie*, the court found in favor of the trustee on the grounds of both actual fraud and constructive fraud. The parties, during their marriage, had acquired three properties, which were all placed in the wife's name. Upon dissolution, all three properties were awarded, pursuant to a marital settlement agreement, to the wife. *Id.* at 2. In addition, the dissolution proceedings were instituted shortly before a creditor began proceedings to collect a $80,000.00 judgment against the debtor. *Id.* at 8. Wife appeared pro se, and the parties continued to reside together after the dissolution. *Id.* at 9. The court found sufficient indices of actual fraud in addition to sufficient evidence of constructive fraud. *Id.* at 34. The transfers were thus avoided as fraudulent.

In *Kardynalski v. Fisher*, 135 Ill. App. 3d 643 (Ill. App. 1985), found the test for fraud satisfied by the debtor's actions. The debtor and his wife had obtained a divorce while a workers' compensation claim was pending against Mr. Fisher. *Id.* at 645. The parties negotiated a property settlement, which stripped Mr. Fisher of his assets and left him unable to pay the workers' compensation award. *Id.* at 646. The debtor and his former wife continued to live together even after the divorce. In addition, Mr. Fisher sold his home and transferred the proceeds to his son without consideration. *Id.* Based on this evidence, the court found that Ms. Fisher had not given reasonably equivalent value for the assets she received pursuant to the dissolution distribution and allowed the trustee to reach the property in Ms. Fisher's hands. *Id.* at 650.

Constructive Fraud

Typically, a dissolution property distribution is a reasoned division of marital assets and liabilities based on some measure of exchanged value. In analyzing a distribution for evidence of constructive fraud, the focus is on the adequacy or equivalence of consideration given in exchange for the transfer, not the intent of the parties. "Courts have found that, in a state where dissolution is governed by the "equitable distribution" principle, a spouse has a property right in the marital property such that a spouse's creditors may attack a distribution as a fraudulent transfer should it turn out to be unjustifiably unequal." *In re Lankry*, 263 B.R. 638, 643 (Bankr. M.D. Fla. 2001).

Assuming a property distribution agreement is negotiated at arms-length and involves the tradeoff and division of marital assets and liabilities, including those for future support, the resulting bargain would presumably be a justified agreement exchanging reasonably equivalent values.

> It must be shown that the property division was the result of arms-length bargaining in the light of the likely range of distribution that the divorce court might order if the matter went to a contested trial. Settlements reached in the shadow of an imminent bankruptcy filing would raise a clear factual question as to the bona fides of such bargaining. *In re Pilavis*, 233 B.R. 1, 11 (Bankr. D. Mass. 1999).

This determination is made "by comparing the value of what was transferred with the value of what was received." _Id._ at 30. In addition, the court must find that the debtor was insolvent or rendered insolvent by the dissolution property distribution in order to avoid a transfer based on the grounds of constructive fraud.

Although unequal distributions create suspicion, they are not always invalidated even when the difference in value received is significant. Finding the settlement agreement entered into by the parties to be within the range of possible court-ordered equitable distributions, the court in _In re Riso_ found in favor of the debtor who received only 42% of the marital property. 102 B.R. 280 (Bankr. D. N.H. 1989). The release from further property settlement obligations in addition to the property received by the debtor was deemed reasonably equivalent to the excess property given to the non-debtor spouse in exchange.

Similarly, in _Haskell_, the court upheld a property distribution giving the debtor's spouse 70% of the marital assets. 1998 Bankr. LEXIS at 2. The court found the agreement to be fair and reasonable in light of the circumstances. Mr. Haskell was a self-employed real estate entrepreneur; Mrs. Haskell, who never finished college, was primarily a homemaker during their marriage. The parties had been married for twenty-six years. The spouse waived all claims to maintenance or support, was given custody of the parties' daughter with a limited amount ($1,500/month), and agreed to pay her college expenses. _Id._ The judge hearing the dissolution proceeding, incorporated the agreement into his judgment of dissolution. _Id._ The bankruptcy court found the circumstances justified such distribution, and thus refused to disturb the distribution. _Id._

Even though such release from liability does not immediately benefit a debtor's creditors, it can be considered adequate consideration for the purpose of fraudulent conveyance analysis as it was here. _Id._ at 22. However, it is not always found to be sufficient; in _In re Williams_, 159 B.R. 648 (Bankr. D. R.I. 1993), the court found the debtor's transfer of all the marital assets to his spouse in a "fast track" divorce proceeding to be inequitable, even in exchange for a release from liability for alimony. One constant through the analysis of constructive fraud is that, in each case, the court's conclusions are based on the specific circumstances involved.

Conclusion

Although the preference avoidance powers of §547 are of limited utility, §544 and §548 can be useful tools in attacking suspicious pre-bankruptcy transfers between spouses pursuant to a pre-bankruptcy dissolution property distribution order. The analysis is, however, extremely fact sensitive. The trustee must have adequate "badges of fraud" to evidence a debtor's intent to hinder, delay or defraud his or her creditors. In the alternative, the trustee may argue for avoidance based on constructive fraud. In order to prevail, however, the bankruptcy court must review the decision of the state divorce court, which it is often reluctant to do. To construe a conveyance as fraudulent, the bankruptcy court must find that the unequal division of property was not justified and thus the distribution was for less than reasonably equivalent value. Although some cases may be difficult to prove, the fraudulent conveyance provisions provide a tool which the trustee may use to prevent debtor's from abusing the system by transferring all their assets pursuant to a decree of dissolution to their former spouse to place them outside the reach of their creditors.

Questions for Discussion:

1. Is the Rooker-Feldman Doctrine implicated?

2. If the bankruptcy court sets aside transfers made pursuant to a decree of dissolution as fraudulent conveyances, does the non-filing ex-spouse have grounds for modification of the dissolution decree?

3. What would be the result if, as part of the dissolution decree, debtor becomes liable to pay antecedent debts of non-filing ex-spouse? May payments made toward those debts be avoided? What if the debts were joint debts?