



1 of 1 DOCUMENT

Collier Family Law and the Bankruptcy Code

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CHAPTER 2 Property Interests of the Debtor and Other Family Members Affected by a Bankruptcy Case

1-2 Collier Family Law and the Bankruptcy Code P 2.04

P 2.04 Property Excluded from the Estate.

[1] Property Interests Acquired by the Debtor After the Bankruptcy Petition Is Filed.

[a] General Rule; Property Acquired Postpetition Not in Estate.

The earnings of an individual debtor after the commencement of a bankruptcy case, unlike the proceeds or profits of the property that went into the bankruptcy estate, or the earnings of a corporate or partnership debtor, generally do not become a part of the estate.ⁿ¹ This principle is an important implementation of the fresh start concept, which frees the debtor's postbankruptcy future from most of the debts of the prebankruptcy past. Similarly, if the debtor acquires property after the petition is filed from sources other than the property in the estate, such as gifts or property purchased with postpetition earnings, such property is also excluded from the estate.

Thus, in *U.S. v. Sutton*² the Court of Appeals for the Fifth Circuit held that a trustee could not pay the living expenses of an individual chapter 11 debtor's wife and children out of property of the bankruptcy estate, because the duty of support was that of the debtor and not that of the estate. When the wife and children were not rendering any services to the estate, nothing in the Code justified distributions to them as administrative expenses, their claims for unmatured future support were not allowable,ⁿ³ and the debtor was required to pay the support from his own postpetition income.

However, it is unclear whether such decisions continue to be good law after the 2005 amendments to the Bankruptcy Code.^{n3a} As discussed below,^{n4a} those amendments added section 1115, which provides that property acquired by an individual debtor after the petition, including earnings, is included in property of the estate. The debtor is permitted to pay reasonable living expenses as part of a new disposable income test in section 1129(a)(15) and therefore, it would seem, must pay expenses for his or her dependents from property of the estate. In any event, when the debtor has an ongoing business operated as a sole proprietorship, determining which part of postpetition earnings is from personal services and which part is from income attributable to property already in the estate is sometimes not a simple matter.ⁿ⁴

[b] Exceptions to the Rule for Certain Property Acquired Within 180 Days After Petition.

There are several specific exceptions to the general rule that income or property acquired postpetition by an individual debtor does not become property of the estate. These exceptions bring into the estate certain interests that, once acquired, may substantially improve the debtor's financial picture.

Specifically, in cases under all chapters of the Code, property acquired by the debtor within 180 days by bequest, devise or inheritance,ⁿ⁵ as a result of a marital property settlement agreement or divorce decree, or as a beneficiary of a life

insurance policy or death benefit plan, becomes property of the estate.ⁿ⁶ Thus, a debtor able to predict that one of these events will occur in the near future is not permitted to file a bankruptcy case before the event occurs and thereby shield the property to be acquired from prepetition creditors. If such property is received during the specified time period, the debtor must file supplemental schedules listing all such property.ⁿ⁷

One issue arising under the 180 day rule is its impact in cases where property is owned by husband and wife as tenants by the entirety. The Court of Appeals for the Fourth Circuit has dealt with this issue in a variety of contexts. In *In re Birney*ⁿ⁸ the court held that when only one of two cotenants files a bankruptcy petition and the other dies within 180 days, the rule does not apply, because the surviving spouse did not "inherit" the deceased spouse's interest but rather continued full ownership alone. However, in *In re Cordova*,ⁿ⁹ the court held that when the debtor and her nondebtor spouse divorced within the 180 days, their property lost its entirety exemption because the estate "acquired" the additional rights she had to alienate her interest. Thus, the debtor's interest was subject to the claims of her nonjoint creditors as well as joint creditors.ⁿ¹⁰

Obviously, the provisions relating to property acquired in a marital property settlement or divorce decree are usually of greatest concern in the family law context. A client who expects to receive property in a dissolution proceeding should avoid commencing a bankruptcy case, voluntary or involuntary, if the debtor wants to protect such property and cannot do so through the exemptions available.ⁿ¹¹ Alternatively, for a debtor already in bankruptcy or a debtor who cannot avoid the filing of a bankruptcy case, it may be possible and advisable to delay the acquisition of property rights in the dissolution proceeding beyond the 180 day period, although the debtor should be careful not to take any steps that might be considered actions to conceal rights to such property if they do exist, thereby endangering the right to receive a discharge.ⁿ¹²

However, the problem of after-acquired property under section 541(a)(5)(B) may not be limited to property settlement distributions. Several courts have broadly construed the section's language, which speaks of bringing into the estate any property acquired "as a result of a property settlement agreement ... or of an interlocutory or final divorce decree." These courts have held that the section renders all alimony or other divorce-related spousal support received within six months after the bankruptcy petition a part of the estate.ⁿ¹³ If these payments cannot be exempted, as is true in some states, the result of such holdings is that the payments due in the six months after the petition must all be turned over to the trustee.ⁿ¹⁴ Obviously, such holdings can cause enormous hardships for a debtor dependent upon alimony or support after a divorce, who may have no other source of income. Although the result is consistent with the literal language of the statute, it is doubtful that it was intended by Congress. More persuasive decisions, including that of the Court of Appeals for the Tenth Circuit in *Peters v. Wise (In re Wise)*^{n14a} and the Bankruptcy Appellate Panel for the Eighth Circuit in *In re Jeter*^{n14b} have held that section 541(a)(5)(B) does not apply to alimony, maintenance or support. As the *Wise* court noted, section 541(a)(5), unlike other Code provisions, does not mention alimony or maintenance, which indicates that Congress did not intend them to be included.^{n14c}

[c] Exception for Property Acquired Postpetition in Chapter 11, 12 and 13 Cases.

Because an individual debtor in a chapter 11, 12 or 13 case normally must commit his or her future income to a plan of rehabilitation, the concept of property of the estate is extended in those chapters to include income and property obtained after the bankruptcy petition is filed.ⁿ¹⁵ By bringing this property into the estate, the Code provides protection to it under the automatic stay, including protection against collection of alimony, maintenance and support debts outside of the bankruptcy case, so that the plan will not be disrupted.ⁿ¹⁶ The issues relating to the extent of this protection are discussed elsewhere in this text.ⁿ¹⁷

It is not altogether clear when and to what extent property acquired postpetition at some point ceases to be property of the estate and, therefore, unprotected by the automatic stay against collection of alimony, maintenance or support. Some courts have held that, except to the extent the debtor's postpetition income is necessary to make plan payments, such property ceases to be property of the estate upon confirmation of the plan, unless the order confirming the plan provides

otherwise.ⁿ¹⁸ However, some courts have also noted that, upon confirmation, the property of the estate vests in the debtor "free and clear of any claim ... provided for in the plan,"ⁿ¹⁹ thus apparently preventing a spouse or former spouse from pursuing the property if that person's claim is provided for by the plan. This issue is also discussed below in connection with the extent of the automatic stay in relation to family court proceedings.ⁿ²⁰

[2] Personal Services Contracts.

If the debtor is a party to a contract for which the debtor is required to perform personal services, the debtor's interest in that contract does not become part of the bankruptcy estate.ⁿ²¹ Accordingly, the trustee cannot assume and assign an executory contract if applicable law would excuse the nondebtor party from accepting performance from or rendering performance to an entity other than the debtor.ⁿ²² If the nature of the contract is based on the unique personal skills of the debtor, forcing the debtor to perform would so resemble involuntary servitude as to make dealing with such contracts impermissible under the Bankruptcy Code.ⁿ²³

If services were complete before the bankruptcy was filed and nothing further is required of the debtor, then the right to receive the proceeds of the contract passes to the bankruptcy estate.ⁿ²⁴

[3] Beneficial Interest in Trust Property.

Section 541(c)(2) maintains in bankruptcy the effectiveness of restrictions on transfers of a debtor's beneficial interest in trust property that are enforceable under applicable nonbankruptcy law.ⁿ²⁵ The most common type of situation in which such restrictions occur is that of the spendthrift trust, in which the debtor has no control over when distributions are made.ⁿ²⁶ Thus, property in a spendthrift trust of which the debtor is a beneficiary does not come into the bankruptcy estate. However, if distributions from the trust are actually made during the 180 days after the bankruptcy petition is filed, such distributions might become property of the estate under section 541(a)(5)(A), subject to the debtor's rights, if any, to exempt that property.ⁿ²⁷

The principal questions arising under this provision relate to its applicability to pensions. As discussed above, courts generally agree that if a pension plan qualifies as a spendthrift trust under state law the debtor's interest in the plan does not come into the bankruptcy estate.ⁿ²⁸ They disagree, however, regarding whether the restriction on alienation required in an ERISA-qualified plan, by itself, constitutes "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law," as specified in section 541(c)(2), if the plan is not a spendthrift trust under state law.ⁿ²⁹

[4] Property Held for the Benefit of Another.

Section 541(d)ⁿ³⁰ reemphasizes that the estate's interest in property is limited to the debtor's interest in the property.ⁿ³¹ When the debtor holds property for the benefit of another, such as when the debtor is a trustee for another or other situations when the debtor has legal but not equitable title, the equitable rights to the property do not come into the estate.ⁿ³² Similarly, under section 541(b)(1), a power that the debtor may exercise solely for the benefit of another does not become property of the estate.ⁿ³³

In the family law context, the primary application of this doctrine beyond the conventional trust situation may be in cases in which child support is owed to the debtor at the time of the petition. In *In re Welchn*ⁿ³⁴ the bankruptcy court interpreted Kansas law to find that child support belonged to the child and not the parent. Therefore, the debtor's right to collect child support was a right that she could exercise only on behalf of another person, namely the child.ⁿ³⁵ Alternatively, in such a situation a court could find that a debtor held the right to collect child support payments in trust, or as a fiduciary of some other sort, for the child or children who were to benefit from the support.ⁿ³⁶

[5] Education Savings

The 2005 amendments to the Bankruptcy Code³⁷ added new exclusions from property of the estate for certain types of education savings in which a debtor may have an interest. Section 541(b)(6) provides that the bankruptcy estate does not include funds placed in an education IRA as defined in *Internal Revenue Code section 530(b)(1)* for a child, stepchild, grandchild or stepgrandchild of the debtor. However the exclusion does not apply to amounts that are pledged or are excess contributions. It also does not apply to contributions within the 365 days before the petition or to contributions of over \$5,000 per beneficiary made between 365 and 720 days before the petition. Section 541(b)(6) provides a similar exclusion, with similar limitations, for funds in state tuition savings plans under *Internal Revenue Code section 529(b)(1)(A)*. Section 541(e) further defines how to determine whether the family relationships in these provisions exist for adopted and foster children.

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 541(a)(6)*. See 5 *Collier on Bankruptcy*, P 541.17 (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. *U.S. v. Sutton*, 786 F.2d 1305, 14 C.B.C.2d 681 (5th Cir. 1986) .

(n3)Footnote 3. *U.S. v. Sutton*, 786 F.2d 1305, 14 C.B.C.2d 681 (5th Cir. 1986) . See also *11 U.S.C. § 502(b)(5)*; P 8.03[1] *infra* .

(n4)Footnote 3a. Pub. L. No. 109-8 (2005), effective with respect to cases filed on or after October 17, 2005.

(n5)Footnote 4a. P 2.04[1][c].

(n6)Footnote 4. See *In re Fitzsimmons*, 725 F.2d 1208, 10 C.B.C.2d 73 (9th Cir. 1984) ; *In re Cooley*, 87 B.R. 432 (Bankr. S.D. Tex. 1988) .

(n7)Footnote 5. See *In re Chenoweth*, 3 F.3d 1111, 29 C.B.C.2d 980 (7th Cir. 1993) (debtor became entitled to acquire property bequeathed in will when the testator died, and not when the will was admitted to probate; therefore, property was property of the estate and the debtor could not disclaim her legacy after it became property of the estate). Cf. *In re Smith*, 179 B.R. 66 (Bankr. N.D. Ohio 1995) (debtor who had exempted interest in entireties property and whose wife died within 180 days of bankruptcy filing did not acquire her interest by way of bequest, devise or inheritance and, therefore, that interest did not come into the bankruptcy estate).

(n8)Footnote 6. *11 U.S.C. § 541(a)(5)*. See 5 *Collier on Bankruptcy*, P 541.16 (Matthew Bender 15th Ed. Revised).

(n9)Footnote 7. *Fed. R. Bankr. P. 1007(h)*. See 9 *Collier on Bankruptcy*, P 1007.08 (Matthew Bender 15th Ed. Revised).

(n10)Footnote 8. *In re Birney*, 200 F.3d 225 (4th Cir. 1999) . See also *In re Martin*, 269 B.R. 119 (Bankr. M.D. Pa. 2001) (when debtor acquired complete ownership of former entireties property within 180 days of petition pursuant to property settlement, previously claimed exemption in entireties interest protected entire property because entireties interest had extended to entire property and § 522(b) expressly trumped section 541). Cf. *Fairfield v. U.S.* (*In re Ballard*), 65 F.3d 367, 84th Cir. & D.C. Bankr. Ct. Rep. 216, 65 F.3d 367, 34 C.B.C.2d 1108 (4th Cir. 1995) (when joint bankruptcy case was filed and one entireties cotenant died within 180 days, entireties exemption was lost and property distribution was not limited to joint creditors).

(n11)Footnote 9. *In re Cordova*, 73 F.3d 38, 84th Cir. & D.C. Bankr. Ct. Rep. 622, 73 F.3d 38, 34 C.B.C.2d 1457 (4th Cir. 1996) .

(n12)Footnote 10. See P 2.05[4] for discussion of the entireties exemption.

(n13)Footnote 11. If after-acquired property comes into the estate which the debtor may claim as exempt, the debtor is permitted to amend the exemptions previously claimed. *Fed. R. Bankr. P. 1009(a)* permits a debtor to amend

the schedules, including the schedule on which exemptions are claimed at any time before the case is closed. *See* 9 *Collier on Bankruptcy*, P 4003.02[2] (Matthew Bender 15th Ed. Revised).

(n14)Footnote 12. *See* 11 U.S.C. § 727(a)(2).

(n15)Footnote 13. *In re Anders*, 151 B.R. 543 (Bankr. D. Nev. 1993) .

(n16)Footnote 14. *In re Anders*, 151 B.R. 543 (Bankr. D. Nev. 1993) .

(n17)Footnote 14a. 346 F.3d 1239 (10th Cir. 2003) .

(n18)Footnote 14b. *In re Jeter*, 257 B.R. 907 (B.A.P. 8th Cir. 2001) .

(n19)Footnote 14c. 346 F.3d at 1243 .

(n20)Footnote 15. 11 U.S.C. §§ 1115, 1207(a) 1306(a). *See* 8 *Collier on Bankruptcy*, P 1306.02 (Matthew Bender 15th Ed. Revised). 11 U.S.C. § 1115, added by Pub. L. No. 109-8 (2005), effective with respect to cases filed on or after October 17, 2005, extends this concept to individual debtors in chapter 11 cases.

(n21)Footnote 16. *See* 11 U.S.C. § 362(b)(2), which does not extend the exception to the automatic stay for collection of alimony, maintenance or support to property of the estate.

(n22)Footnote 17. *See* P 5.03[3][a][ii] *infra* .

(n23)Footnote 18. 11 U.S.C. § 1327(b). *See* 8 *Collier on Bankruptcy*, P 1327.03 (Matthew Bender 15th Ed. Revised).

(n24)Footnote 19. 11 U.S.C. § 1327(c). *See* 8 *Collier on Bankruptcy*, P 1327.04 (Matthew Bender 15th Ed. Revised).

(n25)Footnote 20. *See* P 5.03[3][a][ii] *infra* .

(n26)Footnote 21. *In re Noonan*, 5 C.B.C.2d 1536, 17 B.R. 793 (Bankr. S.D.N.Y. 1982) .

(n27)Footnote 22. 11 U.S.C. § 365(c)(1). *See* 3 *Collier on Bankruptcy*, P 365.07 (Matthew Bender 15th Ed. Revised).

(n28)Footnote 23. *In re Noonan*, 5 C.B.C.2d 1536, 1541, 17 B.R. 793, 797-98 (Bankr. S.D.N.Y. 1982) . *See also In re Carrere*, 15 C.B.C.2d 407, 64 B.R. 156 (Bankr. C.D. Cal. 1986) .

(n29)Footnote 24. *In re Ryerson*, 739 F.2d 1423, 11 C.B.C.2d 121 (9th Cir. 1984) .

(n30)Footnote 25. 11 U.S.C. § 541(c)(2). *See* 5 *Collier on Bankruptcy*, P 541.25 (Matthew Bender 15th Ed. Revised).

(n31)Footnote 26. *Compare Drewes v. Schonteich*, 31 F.3d 674, 31 C.B.C.2d 1373 (8th Cir. 1994) (valid spendthrift trust interest of debtor excluded from estate) *with In re Markmueller*, 51 F.3d 775 (8th Cir. 1995) (corpus of invalid spendthrift trust included in bankruptcy estate). *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 369 (1977), *reprinted in* Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 989, 95th Cong., 2d Sess. 83 (1978), *reprinted in* Vol. C *Collier on Bankruptcy*, App. Pt. 4(e)(I) (Matthew Bender 15th Ed. Revised).

(n32)Footnote 27. *In re Moody*, 837 F.2d 719, 18 C.B.C.2d 881 (5th Cir. 1988) . *See* P 2.04[1][b] *supra* .

(n33)Footnote 28. *See P 2.02[6][c] supra .*

(n34)Footnote 29. *See P 2.02[6][c] supra .*

(n35)Footnote 30. *11 U.S.C. § 541(d). See 5 Collier on Bankruptcy, P 541.27* (Matthew Bender 15th Ed. Revised).

(n36)Footnote 31. *See P 2.01[3] supra .*

(n37)Footnote 32. *See In re O'Malley, 252 B.R. 451 (Bankr. N.D. Ill. 1999)* (debtor's spouse permitted to claim interest in property conveyed to debtor before bankruptcy was held by debtor in resulting trust); *Gresk v. Brown (In re Brown), 227 B.R. 875 (Bankr. S.D. Ind. 1998)* (property awarded to debtor's parents in a divorce decree could not be recovered as a preference because debtor and his former spouse had always held property in constructive trust; therefore, property was not property of the debtor). However, if the trust is a revocable trust, the power to revoke comes into the estate, so that the estate may acquire the property in the trust. *In re Ross, 162 B.R. 863 (Bankr. D. Idaho 1993)* . *See also Beatrice v. Braunstein (In re Beatrice), 296 B.R. 576 (B.A.P. 1st Cir. 2003)* (because debtor retained broad power in self-settled trust for his children, including right to terminate trust, trust property, in which debtor resided, was property of the bankruptcy estate).

(n38)Footnote 33. *11 U.S.C. § 541(b)(1). See 5 Collier on Bankruptcy, P 541.19* (Matthew Bender 15th Ed. Revised).

(n39)Footnote 34. *In re Welch, 9 C.B.C.2d 208, 31 B.R. 537 (Bankr. D. Kan. 1983)* .

(n40)Footnote 35. *In re Poffenbarger, 281 B.R. 379 (Bankr. S.D. Ala. 2002)* (under Alabama law, parent had no interest in child support payments, so estate acquired no interest); *In re Welch, 9 C.B.C.2d 208, 31 B.R. 537 (Bankr. D. Kan. 1983)* ; *Warsco v. Hambright (In re Hambright), 762 N.E.2d 98 (Ind. 2002)* (child support arrearages were not part of mother's bankruptcy estate because custodial parent has no property interest in them, even if custodial parent has made up a shortfall).

(n41)Footnote 36. *See In re Gardner, 243 F. Supp. 258 (D. Or. 1965)* , *aff'd, 365 F.2d 242 (9th Cir. 1966)* (custodial parent deals with child support as fiduciary and claim to child support arrearages was not property of estate under former Bankruptcy act).

(n42)Footnote 37. Pub. L. No. 109-8 (2005), effective with respect to cases filed on or after October 17, 2005.