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Timing Key in Protecting Equitable Distribution Awards in Bankruptcies

FROM THE perspective of a non-propertied spouse who is saddled with unmanageable debts, care should be taken to assure that an equitable distribution award obtained during the course of a divorce action is not lost to creditors in the event that spouse chooses to file a petition in bankruptcy. To the extent timing is in the spouse's control, the spouse should be able to avoid the equitable distribution award being distributed to creditors in a bankruptcy case.

In sum, if at the time a bankruptcy petition is filed, no equitable distribution award has been made and is



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not made within 180 days of the filing of the bankruptcy petition, the debtor's *inchoate* equitable distribution rights in marital property are not included in the bankruptcy estate. If the award is made within 180 days of the petition being filed, the property interests awarded do become property of the estate and available to creditors. If the award is made after 180 days of the petition being filed, the property interests remain the property of the debtor.

In New York, matrimonial courts have long been empowered in connection with divorce actions to determine issues of title to property and to make directions pertaining to the possession of property. Then, in July 1980, New York enacted an equitable distribution law.¹

Equitable distribution creates a classification of property known as "marital property". Marital property

refers to "all property acquired by either or both spouses during the marriage and before the execution of a separation agreement or the commencement of a matrimonial action, regardless of the form in which title is held."² Under equitable distribution, the matrimonial court can direct the distribution of marital property between the spouses in the final divorce judgment.³ Alternatively, the matrimonial court may make a distributive award where equitable distribution is impractical or burdensome, or where the distribution of an interest in a business, corporation or profession would be contrary to law. The court may also make a distributive award to supplement, facilitate or effectuate the distribution of marital property.

Bankruptcy Estate

A voluntary bankruptcy case is commenced by the filing of a bankruptcy petition.⁴ The commencement of a case creates a bankruptcy estate which consists of all the debtor's legal or equitable interests in property as of the commencement of the case.⁵

Since the terms "property" and "interests" are not defined in §541 of the Bankruptcy Code, property rights are created and defined by state law.⁶ State law determines whether the debtor's interest in any particular item of property is sufficient to bring it within the ambit of "property of the estate", that is sufficient to confer on the bankruptcy estate a property right in the item.⁷ However, while property interests are generally created and defined by state law, the question of what constitutes property of the bankruptcy estate is ultimately a federal question.⁸

A spouse's rights in marital property do not vest under New York law until entry of a judgment dissolving the marriage. There are no vested present or contingent property rights or interests, legal or equitable, in marital property solely because it is marital property.⁹ Therefore, the debtor's "right" to an equitable distribution in a divorce action pending at the time the bankruptcy petition is filed is not property of the estate.

*Cooper v. Frederes*¹⁰ illustrates this principle quite clearly. There, at the time the husband filed a Chapter 7 bankruptcy petition, a matrimonial action was pending during the course of which a judgment of divorce was granted which provided that 115 acres of vacant land would be retained by the non-debtor wife. Three months later, the debtor's trustee commenced an adversary proceeding against the ex-wife claiming a one-half equitable interest in the land since the property at the time of the filing of the debtor's bankruptcy petition was "marital

property" within the meaning of New York Domestic Relations Law §236 subject to disposition by an award of equitable distribution. The trustee lost.

The bankruptcy court distinguished the situation where the property at issue was jointly owned by the debtor and non-debtor spouse in which case the debtor would have had a legal interest in the asset such that the asset would be property of the bankruptcy estate. But, the case is different where the property is not jointly owned and title is only in the name of the non-debtor spouse because in New York rights in equitable distribution vest only when there is an actual judgment of divorce awarding distribution of marital property. There are no vested present or contingent property rights or interests, legal or equitable, in such marital property solely because it is marital property under the New York Domestic Relations Law.

Since there had not been an equitable distribution award when the debtor filed his petition and his only potential interest in the property was because it was marital property, neither he nor the bankruptcy estate had any legal or equitable interest in the property within the meaning of 11 USC §541(a)(1). The Bankruptcy Court noted, however, that if in the matrimonial action the Supreme Court had made an award of an interest in the property in favor of the debtor

within 180 days of the date of filing the petition, such interest would have become property of the estate in accordance with the provisions of 11 USC §541(a)(5).¹¹

'Hohenberg' Decision

What happens when the equitable distribution award is made *after* 180 days from the filing of the bankruptcy petition? *Blair v. Hohenberg (In re Hohenberg)*¹² teaches that the bankruptcy trustee may not enlarge the debtor's estate by such interest and any such award in the debtor's favor would not become part of the bankruptcy estate.

In *Hohenberg* the husband's bankruptcy case preceded the matrimonial action by eight months. The debtor and his wife eventually entered into a consensual marital dissolution agreement including their respective property interests. The trustee argued that the debtor had claims and rights to an equitable division of marital property which the debtor could not surrender to the detriment of his bankruptcy estate, while the non-debtor wife argued that the trustee had no basis to assert any claims against property retained by or awarded to her. The trustee again lost.

As in New York, the Bankruptcy

Court found that marital property under the applicable state statute is not a preexisting property interest, and the existence of the term "marital property" and its concepts do not grant the bankruptcy court any authority to divest marital property out of one spouse and place in into the bankruptcy estate. Bankruptcy estate property is not created as a result of a state court's post-bankruptcy classification of property as marital property except in the limited environment of 11 USC §541(a)(5).

So, after more than 180 days from a bankruptcy filing, the classification of marital property does not give a bankruptcy trustee an additional basis upon which to enlarge the bankruptcy estate. If the debtor/husband acquires an interest through the divorce proceedings in the wife's separate property, he would be acquiring those interests well outside of the 180 days of §541(a)(5), thus any such interest would not automatically become part of his estate.

Conversely, if the debtor is the protected spouse, property which is marital property, but as to which an equitable distribution award has not been made, passes into the debtor's estate free of claims by the non-debtor or spouse, rendering it wholly available to the debtor's creditors unless otherwise exempt. *Goldberg v. Hilsen (In re Hilsen)*¹³ reached this result following the principles expounded in *Cooper*.

'Hilsen' Ruling

In *Hilsen*, in the matrimonial action which was commenced first, the state court judge ordered that three properties be sold, including two Manhattan apartments of which the husband was the exclusive owner. Thereafter, the husband filed a Chapter 11 bankruptcy petition. The parties stipulated in the bankruptcy court to permit the state court to render a decision and judgment on all issues then sub judice including the nature and extent of each party's respective interests in the apartments. The state court's determination that the wife was the sole

owner of one apartment and owner of 50 percent of the other apartment was embodied in a judgment of divorce entered one year after the commencement of the bankruptcy case. Thereafter the case was converted to a Chapter 7 case, and the trustee sought a declaration that both apartments were the exclusive property of the bankruptcy estate and the wife a general unsecured creditor. The trustee won.

The bankruptcy court started its analysis with the principle that the filing of a bankruptcy case creates an estate whose property rights vest as of the date of the filing of the petition. The wife argued that since equitable

distribution arises upon the commencement of the matrimonial action, her interests in the apartments superseded the rights of the debtor and any trustee whether or not such interests ripened into an award prior to the bankruptcy filing. The bankruptcy court found that this was simply not true.

While the commencement of a matrimonial action triggers the possibility that an equitable distribution of marital property may ensue, the commencement of the action does not guarantee that an award will be made; an award may not be made as the court's power is discretionary. As a

result, no rights in equitable distribution vest upon commencement of the matrimonial action.

Since no equitable distribution award had vested at the time of the filing of the petition, the apartments came into the estate free of the wife's claims. To the extent the state matrimonial court later adjudicated an equitable distribution award in favor of the wife, such award became a claim. The wife's claim is an entitlement against the debtor's estate, and the wife becomes a general unsecured creditor.

On the other hand, if the divorce judgment is entered before bankruptcy and vests the spouse's rights in certain marital property, those items never become property of the bankruptcy estate.¹⁵

Interplay of Courts, Law

A spouse in a matrimonial action who is also a debtor in a bankruptcy case finds him or herself in two different courts at the same time, each of which seek to adjudicate the rights of others in and to property to which the debtor/spouse holds title: the state matrimonial court and the federal bankruptcy court.

One of the objectives of the Bankruptcy Code is to give the debtor a fresh start, while that of the state court is to provide the non-debtor spouse with adequate means of support. The overlap raises the questions of the Bankruptcy Court's jurisdiction over the debtor's property over which the spouse seeks an equitable award, the jurisdiction of the state court over assets of the debtor which may consist of property of the estate, and the criteria and guidelines upon which such decisions will be made.¹⁶

Since the subject of domestic relations generally belongs to the laws of the states, to the extent no overriding compelling federal question exists, federal courts will not interject themselves into a state court matrimonial proceeding. Indeed, to the extent the state matrimonial court adjudicates personal rights, custodial relationships and property entitlements, not

only is there no overriding compelling federal question, but except to the extent specifically enumerated in 28 USC §157, the bankruptcy court has no jurisdiction to adjudicate such matters.¹⁷ So, while the automatic stay applies to the determination by the state court of the parties' respective equitable distribution rights in a pending divorce action, bankruptcy courts may grant relief from the stay to permit the matrimonial action to proceed, short of distribution of any property.¹⁸

Indeed, it is with the distribution of property of the estate that the federal question arises. While the matrimonial court is uniquely qualified to determine the nature and extent of a spouse's entitlement against the debtor's estate, the bankruptcy court is exclusively authorized to adjudicate the impact of that entitlement upon any property subject to the claims of other creditors of the estate.¹⁹

Unfortunately, the line is not so bright.

In the last decade there have been substantial increases in both bankruptcy filings and divorce actions. Numerous commentators have expressed the concern that these two growing areas of the law have been developing in parallel with little or no integration. Often . . . rights and interests of various parties are directly or indirectly involved in both proceedings, but neither legislative body appears to have fully taken into account the ramifications and impact of one proceeding on the other or the overlapping rights and interests of the various parties involved. Creditors, trustees, attorneys, both commercial and matrimonial, and the courts would welcome clear legislative guidance on the respective rights and priorities of the parties to matrimonial actions and their creditors.²⁰

Until then, timely may truly be everything.

See *Goldberg v. Hilsen* (In re Hilsen), 119 B.R. 435 438 (SDNY 1990); *In re Greenwald*, 134 B.R. 729, 730 (Bankr. SDNY 1991).

(6) *Butner v. United States*, 440 U.S. 48, 51 (1979).

(7) *Crysen/Montenay Energy Co. v. Esselen Associates, Inc.* (In re Crysen/Montenay Energy Co.), 90 F.2d 1098, 1101 (2d Cir. 1990); *Sanyo Elec., Inc. v. Howard's Appliance Corp.* (In re Howard's Appliance Corp.), 874 F.2d 88, 93 (2d Cir. 1989).

(8) *Cooper v. Frederes* (In re Frederes), 141 B.R. 289, 291 (Bankr. W.D.N.Y. 1992).

(9) *In re Cole*, 202 B.R. 356, 360 (Bankr. SDNY 1996); *Cooper*, 141 B.R. at 291-92.

(10) 141 B.R. 289.

(11) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

. . . Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date . . .

(B) as a result of a property settlement agreement with debtor's spouse, or of an interlocutory or final divorce decree . . .

(12) 174 B.R. 487, 494 (Bankr. W.D. Tenn. 1994). While this case involves Tennessee state law, the court noted that "the applicable New York statute is similar enough to the Tennessee statute to justify a comparison of the statutes and to find [New York authority] persuasive."

(13) 100 B.R. 708, 711 (Bankr. SDNY 1989), *rev'd on other grounds*, 119 B.R. 435 (SDNY 1990).

(14) *Accord In re Cole*, 202 B.R. at 360; *In re Palmer*, 78 B.R. 402, 406 (Bankr. EDNY 1987). The District Court in *Hilsen*, acknowledging the correctness of the Bankruptcy Court's analysis, nevertheless reversed the bankruptcy court's determination and remanded based on the separate issue of whether a constructive trust should be imposed on one of the apartments based on the debtor allegedly having purchased the apartment in his sole name despite the fact that the wife had been the sole occupant, arguably a violation of New York General Business Law §352-eeee(2)(d)(ix). The District Court was no doubt persuaded that "The record demonstrates unequivocally that [the husband] was using the bankruptcy process to avoid state court actions and to defraud his wife of her share of the parties' marital property." 119 B.R. at 440.

(15) *In re Greenwald*, 134 B.R. at 731.

(16) *In re Palmer*, 78 B.R. at 404-05.

(17) *Hilsen*, 100 BR at 710; *In re Palmer*, 78 B.R. at 405.

(18) See, e.g., *In re Cole*, 202 B.R. 356 (granting relief from stay); *In re Palmer*, 78 B.R. 402 (vacating stay). *But see In re Becker*, 136 B.R. 113, 116 (Bankr. D.N.J. 1992) (declining to abstain, although other aspects of a divorce case such as dissolution of the marriage, child custody issues and collection of alimony, maintenance and support from post-petition earnings are not stayed);

(19) *In re Palmer*, 78 B.R. at 406.

(20) *Cooper*, 141 B.R. at 293.

(1) N.Y. Dom. Rel. Law §236 (McKinney 1986 and Supp. 1997).

(2) N.Y. Dom. Rel. Law §236B(1)(c) (McKinney 1986).

(3) N.Y. Dom. Rel. L. §236B(5)(a) (McKinney Supp. 1997).

(4) 11 U.S.C.A. §301 (1993).

(5) 11 U.S.C.A. §541(a) (1993) provides:

The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.