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Distribution of Property Overseen by Family Courts Will Not Bar Constructive Fraudulent Transfer Claims

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Introduction

In general, a transfer made by a debtor may be avoided under title 11 of the United States Code (the "Bankruptcy Code") or applicable state law, if the transfer was actually or constructively fraudulent. Actual fraudulent transfer claims require a showing of actual intent to hinder, delay, or defraud creditors. Constructive fraudulent transfer claims do not require proof of actual intent. Instead, a transfer will generally be constructively fraudulent if it is shown that (1) the debtor was insolvent at the time of, or rendered insolvent by, the transfer and (2) so long as the debtor received "less than a reasonably equivalent value" for the transfer.¹ Under Section 548 of the Bankruptcy Code, the alleged fraudulent transfer must have been made within two years of filing for bankruptcy.²

In addition, Section 544(b) of the Bankruptcy Code allows the trustee to avoid a transfer under applicable non-bankruptcy law, including the Uniform Fraudulent Transfer Act ("UFTA").³ If a trustee pursues a claim under applicable non-bankruptcy law, it will not

¹ 11 U.S.C. § 548(a)(1)(B)(ii)(I) (2012).

² *Id.*

³ See, e.g., *In re Bledsoe*, 569 F.3d 1106, 1109 (9th Cir. 2009).

necessarily be limited to the two-year period set forth in Section 548.⁴ Instead, it will be subject to the period set forth in the non-bankruptcy law, which is generally longer than two years.⁵

Property transferred pursuant to a marital separation agreement, or a domestic partnership dissolution agreement, can be subject to avoidance under Sections 544(b) and 548.⁶ This is because bankruptcy courts and family courts have different criteria when evaluating the distribution of property under a reasonably equivalent value standard, thus sometimes creating conflicting results under a Section 548 analysis.⁷ Bankruptcy courts will look specifically at monetary value to determine whether the debtor received reasonably equivalent value for the property transferred, whereas family courts will look to equitable, non-monetary factors as well.⁸ Bankruptcy courts can also focus on the creditor status of the ex-spouse when determining whether to avoid a prepetition transfer of property that was pursuant to the directives of a family court.⁹ Bankruptcy courts can avoid transfer by applying relevant non-bankruptcy law that results in viewing the ex-spouse as an unsecured creditor and the trustee as a hypothetical judgment lien creditor.¹⁰ The claim of the trustee would then be prioritized due to having a higher status, even if the disputed property was part of a divorce decree or agreement executed by a family court.

This memorandum examines how bankruptcy courts can avoid property distributions made under the auspices of a family court. Section I explains how bankruptcy law, specifically pursuant to Section 548 of the Bankruptcy Code, permits avoidance of a transfer as constructive

⁴ See John F. Rabe Jr., *Golden Creditors, Copper Rules: An Analysis of Avoidance Actions Under Section 544(b) of the Bankruptcy Code in Cases Where a Federal Creditor Holds a Claim*, 82 BROOKLYN L. REV. 1755 (2017).

⁵ *Id.* (explaining that over eighty percent of states have four-year statute of limitations for their codified versions of UFTA).

⁶ See generally *In re Bledsoe*, 569 F.3d at 1109; *In re Scarbrough*, 2018 Bankr. LEXIS 1974 (Bankr. M.D. Tenn. June 28, 2018).

⁷ See *Corzin v. Fordu (In re Fordu)*, 201 F.3d 693, 707 (6th Cir. 1999).

⁸ See *id.*; see also *In re Scarbrough*, 2018 Bankr. at *12.

⁹ See e.g., *In re Kelley*, 304 B.R. 331 (Bankr. E.D. Tenn. 2003).

¹⁰ See 11 U.S.C. § 544(b).

fraud. Section II discusses how, under Section 544(b) of the Bankruptcy Code, additional applicable federal, state, and local laws can result in avoidance of family court equitable distribution agreements despite bankruptcy law.

I. Bankruptcy Courts Have the Power to Undo Property Distributions Approved by Family Courts Under § 548.

A. Domestic Relations Courts: Prioritizing Equitable Factors

During the dissolution of a partnership, family courts are inclined to take equitable factors into consideration when distributing property. Equitable factors take far more than just monetary value into consideration. Instead, equitable factors focus on fairness when determining what should be deemed marital property for the purpose of a dissolution agreement.¹¹

Domestic relations courts specifically act with familial best interests in mind and therefore take fairness into consideration rather than simply focusing on monetary value.¹² Therefore, domestic relations courts are not restricted by the “reasonably equivalent value” standard and instead consider equitable factors.¹³ Such factors can include, but are not limited to: duration of a marriage, age and health of both parties, loss of health insurance, retirement benefits, and the loss of inheritance and pension rights.¹⁴ When equitable factors are taken into consideration, it is possible for domestic relations courts to make determinations like those seen

¹¹ See, e.g., *In re Marriage of Dowd*, 991 N.E.2d 555, 559 (Ill. App. Ct. 2013) (giving the ex-wife a future 20% interest in her ex-husband’s work bonuses after considering the extent to which she contributed financially to the building of their home during the marriage); *Elkus v. Elkus*, 169 A.D.2d 134, 572 N.Y.S.2d (1st Dep’t 1991) (finding that the ex-wife’s status as a celebrity was marital property as her ex-husband spent large amounts of time travelling with her, photographing her for magazines, and more); *Postema v. Postema*, 471 N.W.2d 912, 915 (Mich. Ct. App. 1991) (“a spouse who did not earn an advanced degree [can] be compensated whenever the advanced degree is of a *concerted family effort* involving mutual sacrifice and effort by both spouses”) (emphasis added).

¹² *Contra In re Fordu*, 201 F.3d at 707.

¹³ *Id.* at 708.

¹⁴ See e.g., OHIO REV. CODE ANN. § 3105.171(F) (1996); N.Y. DOM. REL. LAW § 236(5)(d) (1980).

in *In re Scarbrough*, because the court determined that social factors and future gains or losses balanced out the monetary transfer.¹⁵

B. Bankruptcy Courts: Value and Financial Condition Considered

Unlike family courts addressing domestic relations matters, bankruptcy courts will consider the financial condition of the debtor as well as the value exchanged. For example, the Tennessee Bankruptcy Court in *In re Scarbrough* concluded that property transferred pursuant to an agreement to terminate a domestic partnership was subject to avoidance under Section 548.¹⁶ In April 2014, the debtor and her partner ended their romantic relationship; a relationship which had merged assets.¹⁷ Pursuant to a dissolution agreement, the debtor retained three vehicles while her partner retained two properties, three vehicles, and all artwork acquired during the ten-year partnership.¹⁸ Thereafter, the debtor filed a voluntary petition under chapter 7 of the Bankruptcy Code and listed liabilities of over one million dollars, and assets of slightly over fifty thousand dollars.¹⁹ The chapter 7 trustee sued the debtor's former partner to recover the assets the non-debtor received under the dissolution agreement.²⁰ The bankruptcy court held that the transfer of property to the defendant could be avoided under constructive fraud, and recovered by the trustee.²¹

Under a two-part analysis, the Tennessee Bankruptcy Court in *In re Scarbrough* determined that the debtor was insolvent at the time of transfer.²² The court reviewed the debtor's balance sheet and determined that her cumulative liabilities exceeded her cumulative

¹⁵ 2018 Bankr. LEXIS 1974 *2.

¹⁶ *Id.* at *14.

¹⁷ *Id.* at *2.

¹⁸ *Id.*

¹⁹ *Id.* at *6.

²⁰ *Id.*

²¹ *Id.* at *14.

²² *Id.* at *13.

assets thus rendering her insolvent.²³ Additionally, it was undisputed that the debtor had filed for bankruptcy within two years of the transfer.²⁴

The court then analyzed whether the debtor received reasonably equivalent value for the property she transferred. The court decided she had not, thus making transfer avoidable under Section 548. There is a consensus among the majority of circuits that when looking to whether transferred property was met with reasonably equivalent value, bankruptcy courts will look specifically to monetary value.²⁵ “Equivalent value” does not permit equitable factors to be considered.²⁶ Instead, the court looks to value transferred versus value received.²⁷ This is to protect the rights of unsecured creditors.²⁸ If unsecured creditors are not placed in a worse situation due to the acts of the debtor, a transfer of property will not be avoided.²⁹

C. A Distribution Approved by Domestic Relations Court is Not Subject to Preclusive Effect in a § 548 Claim

The reasonably equivalent value standard of bankruptcy courts is distinguishable from the equitable factors of domestic relations courts. Due to the vast differences between these standards, courts typically decline to grant preclusive effect to divorce decrees and dissolution agreements in instances of alleged fraudulent transfer.³⁰ Claim preclusion would bar the re-

²³ *Id.* at *12.

²⁴ *Id.* at *8.

²⁵ See e.g., *Corzin v. Fordu (In re Fordu)*, 201 F.3d 693 (6th Cir. 1999); *Barber v. Golden Seed Co., Inc.*, 129 F.3d 382 (7th Cir. 1997); *Harman v. First American Bank*, 956 F.2d 479 (4th Cir. 1992).

²⁶ *In re Fordu*, 201 F.3d at 707 (explaining that measuring reasonably equivalent value in bankruptcy court is significantly different than fairness standards in domestic relations courts).

²⁷ See *Barber v. Golden Seed Co., Inc.*, 129 F.3d at 387 (citing *In re Bundles*, 856 F.2d 815, 825 (7th Cir. 1988) (explaining that the transfer does not need to be “dollar-for-dollar” as the various uses of the word “value” in the Bankruptcy Code demonstrate that Congress did not intend for it to mean fair market value, although fair market value should still be one of several considerations of the court)); see also *In re Scarbrough*, 2018 Bankr. LEXIS 1974 *12 (making the transferred versus received comparison in the form of a balance sheet).

²⁸ *Harman*, 956 F.2d at 484.

²⁹ *Id.*

³⁰ See *In re Fordu*, 201 F.3d at 708.

litigation of claims and defenses accessible in a previous suit.³¹ However, this would be problematic in the context of domestic relations cases because reasonably equivalent value is not the standard applied.³² This creates a new claim resulting in avoidance of the transfer of property made pursuant to the equitable factors discussed above.³³

II. Bankruptcy Courts Can Turn to Other Applicable Laws Under § 544(b) to Avoid Prepetition Property Distributions Overseen by Family Courts

Section 544(b) of the Bankruptcy Code allows a trustee to step into the shoes of a creditor to avoid an unperfected lien as a hypothetical judgment lien creditor.³⁴ After a trustee steps into the shoes of an already existing creditor, who is prevented from bringing their claim as the result of an automatic stay, property from the avoided transfer is returned to the estate for distribution to all creditors, rather than exclusively to that specific creditor.³⁵ The property from the transfer is “clawed back” pursuant to applicable non-bankruptcy law which includes federal, state, and local laws, meaning the statute of limitations can surpass two years.³⁶

Property distributed pursuant to divorce agreements does not automatically perfect an interest for the non-debtor spouse.³⁷ Avoidance under Section 544(b) is also permissible when the debtor incurs an obligation.³⁸ For example, in *In re Kelley*, a divorce decree awarded the family home to the debtor’s ex-spouse and instructed the debtor to execute a quitclaim deed,

³¹ Jeffrey Thomas Ferriell, *The Preclusive Effect of State Court Decisions in Bankruptcy*, 58 AM. BANKR. L.J. 349, 349–50 (1984).

³² See *In re Fordu*, 201 F.3d at 708.

³³ See *id.* (“Given these divergent decisional standards, we believe that the Dissolution Decree cannot be afforded claim-preclusive effect.”).

³⁴ See *Williams v. Tomer*, 147 B.R. 461, *12 (S.D. Ill. 1993).

³⁵ See Rabe, *supra* note 4 at 1755–56.

³⁶ See *id.* at 1756 (explaining that oftentimes, the applicable law is a state’s codified version of the UFTA, typically with a four-year statute of limitations although four states have a six-year statute of limitations).

³⁷ See e.g., *Perlow v. Perlow*, 128 B.R. 412 (E.D.N.C. 1991) (finding that because the ex-wife did not file *lis pendens* she failed to perfect her interest, as state domestic laws only granted a right to equitable distribution not an automatic vesting of interest, and thus she had the status of an unsecured creditor, permitting the trustee to avoid the transfer).

³⁸ See *In re Kelley*, 304 B.R. 331 (Bankr. E.D. Tenn. 2003).

which she failed to do.³⁹ Over three years later, the trustee filed an adversary proceeding and noted that under Tennessee law deeds are to be formally recorded, and the divorce decree was not.⁴⁰ Under state law, while an unrecorded deed holds effect on the participating parties and their heirs, it has no effect on others and is therefore void to creditors.⁴¹ Tennessee law also mandated that if partition of property was impracticable the trustee could sell the property in its entirety, clear of all other liens such as that of the non-debtor ex-spouse.⁴² Therefore, the trustee avoided the transfer under Section 544(b) and sold the debtor's—and his ex spouse's—interest in the home to meet the claims of creditors thus overriding the previously issued family court divorce decree.⁴³

Conclusion

Sections 548 and 544(b) of the Bankruptcy Code create risks for individuals entering into dissolution agreements and divorce decrees that have been issued by family courts. Under Section 548, a trustee can avoid a transfer that renders the debtor insolvent and was transferred for less than equivalent value, for two years following the transfer regardless of if the non-debtor was given property in consideration of other equitable factors. Additionally, a trustee may use applicable non-bankruptcy law to avoid a transfer under Section 544(b), so long as an existing creditor impacted by an automatic stay would have a viable claim. Since statutes of limitations vary by jurisdiction there is no set claw back period under this Section. This potentially exposes an ex-spouse to an even longer reach back period than seen in Section 548, even if they were granted the property through a family court agreement or decree.

³⁹ *Id.* at 334.

⁴⁰ *Id.* at 336.

⁴¹ *Id.*

⁴² *Id.* at 337.

⁴³ *Id.* at 340.