ANALYZING COMMUNITY PROPERTY ISSUES IN THE DEBTOR CREDITOR AND BANKRUPTCY CONTEXT UNDER WASHINGTON STATE LAW[1]

INTRODUCTION

It is important to understand how community property laws work if you are practicing in a community property state, These laws then need to be taken into account in every bankruptcy and every case involving the debtor-creditor relationship. The failure to do so can lead to dire consequences and may be malpractice. The failure to understand the difference between separate and community liability by debtors'/defendants' counsel had lead to terrible consequences. These materials are not exhaustive but should present a good starting point for your analysis.

These materials organized by looking at the liability, property, and finally the bankruptcy implications. They are written by a Washington State attorney under Washington State community property law. It is important to review the specifics of your own state laws.

LIABILITIES

The first step is to identify the character of a liability. Liability under state Community Property law is generally either individual (separate) or community. Washington for instance does not subscribe to the entity theory of community property and there is not a separate entity called the community. *Household Finance Corp. of Souix Falls*

v. Smith 70 Wash. 2d 401, 423 P. 2d. 621 (1967): *Gen Ads LLC v. Breitbart*, 435 F. Supp 2d 1116 (W.D. Wash. 2006).

Liabilities incurred before marriage (separate liabilities) may not be asserted against community property, provided, that the post marital earnings of a husband or wife may be subject to process on account of their own pre marital debt if that debt is reduced to judgment within three years after the marriage. RCW 26.16.200. This is sometimes called "marital bankruptcy."

Liabilities generally fall into two categories, consensual (contractual) and non-consensual (tort).

Contractual obligations entered after marriage give rise to individual (separate) liability against the contracting spouse. *Northern Bank and Trust Co. v. Graves 140 P. 328, 79 Wash. 411 (1914), Churchill v. Miller 156 P. 851, 90 Wash. 694 (1916).* That liability may or may not also be a community liability. If it is community liability, the individual incurring the debt and the community are liable.

The spouse who did not participate in incurring the liability has no individual liability unless the contract is for items incurred for the health, etc. of the family. In this case the "family necessity doctrine" will impose separate liability on the non acting spouse as a matter of public policy. *In re De Nisson's Guardianship, 84 P. 2d. 1024, 197 Wash* 265 (1938)

Obligations incurred by one spouse without the consent of the other spouse may or may not create community liability.

If a contract obligation is incurred for the purpose of furthering community purpose or a community business, community liability arises, perhaps even if the non contracting spouse objects to the contract. *Underwood v. Sterner 387 P. 2d 366, 72 Wash. 2d 360* (1963) (community personal property found liable for husband's contract to purchase real property over objection of wife).

Generally, contracts are presumed to be for the benefit of the community. *Sunkidd Venture*, 87 Wash.App. at 215 ("The key test [in determining whether a debt is community debt] is whether, at the time the obligation was entered into, there was a reasonable expectation the community would receive a material benefit from it"). *But see, contra, Colorado Nat. Bank of Denver v. Merlino*, 35 Wash.App. 610, 668 P.2d 1304 (1983).

If the liability is incurred for some other purpose, the community is not liable and the creditor cannot collect the liability from community property. In the case of contractual individual (separate) liability, the creditor may **not** reach **any** of the community assets. Stone v. U.S. 255 F. Supp 201 (W.D. Wash. 1963); *In re Merlino,* 62 B.R. 836; (Bkrtcy.

Practice Pointer: the result of the above is that when one party signs a contract such as a credit card agreement or auto purchase, there is usually community liability and separate liability for the individual who signed. The spouse who did not contract has no separate individual liability. When a collection suit is commenced (or proof if claim filed or debt listed in bankruptcy schedules) it is important that the answer deny the separate liability of the spouse if appropriate. Demand a copy of the signed credit application or note to confirm who signed for what.

Query: Does a collection suit filed against both spouses individually and the marital community violate Rule 11 if only one spouse signed the credit application? Does the collection attorney have a duty to investigate separate liability of the spouse? Is there a violation of the FDCPA if the collection suit inappropriately alleges separate liability of the non signing spouse?

W.D. WA 1986) A gift of community property requires donative intent by both

members of the community. Thus, contracts amounting to gifts, such as the guarantee of the debt of another for no consideration do not generally create community liability. *Nichols Hills Bank v. McCool, 104 Wash. 2d 78, 701 P. 2d 1114 (1985).*

Liability not arising in contract: In the case of an individual tort, the tortfeasor has separate liability.

The creditor of the individual tortfeasor may reach that individual's portion of the community assets. *Milbrandt v. Margaris, 103 Wash. 2d 337, 693 P.2d 78 (1985)*

Where the tort is committed in the furtherance of a community purpose, all of the community assets are subject to the liability. *deElche v. Jacobson*, 95 Wn.2d 237, 245, 622 P.2d 835 (1980).

PRACTICE POINTER The normal complaint names John Doe and Jane Doe and the marital community composed thereof. This results in separate liability for both spouses and community liability. In the case where one spouse is not liable, it is extremely important to defend the non-liable spouse. The failure to do so can have long lasting and dire consequences. It is, in the author's opinion, malpractice to not so defend. *See, American Discount Corp. v. Shepherd* 129 Wash. App. 345, 120 P.3d 96 (2005) *aff'd* ___ W.2d ____ 156 P.3d 858 (2007) where the wife had never signed the original agreement and had no liability but was pursued for 20 years because of a failure to defend in the first instance.

QUERY: Is the attorney filing a case against spouses when only one is liable subject to sanctions pursuant to CR 11 for filing an action with absolutely no merit?

QUERY: In the normal credit card case, is the collector liable for FDCPA damages for suing a spouse who has not signed the agreement or is only liable as an "additional user?"

Liens attaching to community property

Voluntary liens: A voluntary lien may be created against community property.

A voluntary lien against community real property must be agreed to and endorsed by both members of the community. RCW 26.16.030

A purchase money lien against personal property may be created by either spouse by appropriate document RCW 26.16.030(5) but a non-purchase money lien requires joint consent.

A community business is different. If only one spouse participates in the business, that spouse may obligate the community. However, if the business is operated by both members of the community, then both spouses must participate in selling or creating the lien. RCW 26.16.030(6)

B. Judgment liens: A judgement lien entered during the marriage in favor of a community creditor will attach to community real property. *Knittle V. Knittle* 2 Wash. App. 208, 467 P.2d 200 (1970).

The judgment must be entered during the marriage when the community exists. A judgment entered post dissolution is not a community judgment and may or may not affect formerly community property. *Griggs v. Averbeck Realty, Inc*. 92 Wash.2d 576, 599 P.2d 1289 (1979).

It is clear that after the dissolution occurs a judgment community creditor can pursue property that was community property at the time of the judgment. *Griggs, supra*. However, it is important to determine exactly what that property is. Thus in *Watters v. Doud*, 95 Wash.2d 835, 631 P.2d 369 (1981) the Court held that post dissolution appreciation is the separate property of the spouse receiving it and is not available for creditors of the formerly community property, assuming that they do not have a judgment against the spouse in her separate capacity.

Liens arising from dissolution proceedings. An award resulting from a division of marital property in a dissolution proceeding, creates a lien on the property in favor of the non owner spouse. The best practice is to have a separate mortgage or deed of trust executed. This is not, however, legally necessary.

The imposition of a lien in the Decree of Dissolution will establish a lien on the property. The decree must clearly create a lien; Judge Overstreet has ruled that awarding the property "subject to" a requirement of a payment is not enough. The decree or other instrument creating the lien must clearly grant a security interest and/or use the word lien to

be effective. This case involved a 3rd party, the bankruptcy trustee. If it were a foreclosure action to enforce the payment, there might be a different result. Oral Ruling, not published.

The dissolution lien, viewed as a lien arising from a defacto purchase by the spouse taking title, is an *owelty* lien. The court in *In re Marriage of Wintermute*, *supra*. discussed the process holding at 744:

> The decree of dissolution attempted to distribute the marital property equitably, yet preserve the family home for Florence and the children during their minority. Thus, the trial court awarded the home to Florence and a compensating sum of $12,000 to Leslie. This kind of equalization derives from the ancient doctrine of owelty, *Hartley v. Liberty Park Assocs.*, 54 Wash.App. 434, 437, 774 P.2d 40, *review denied*, 113 Wash.2d 1013, 779 P.2d 730 (1989), and is authorized by statute, RCW 7.52.440. A judgment for owelty creates an equitable lien on the property in the nature of a vendor's lien. *Adams v. Rowe*, 39 Wash.2d 446, 236 P.2d 355 (1951); *Hartley*, *supra.*

A judgment in owelty prevails over the homestead right of the spouse receiving title. *In re Marriage of Foley* 84 Wash.App. 839, 930 P.2d 929 (1997). The *Foley* court held at 845

> When a court awards the family home to one party in a dissolution and awards the other party a compensating sum, the equalization is done under the doctrine of owelty. *In re Marriage of Wintermute*, 70 Wash.App. 741, 744, 855 P.2d 1186 (1993), *review denied*, 123 Wash.2d 1009, 869 P.2d 1084 (1994). A judgment in owelty is an equitable lien on the property specified in the nature of a vendor's lien. It prevails over a homestead exemption. *Adams v. Rowe*, 39 Wash.2d 446, 449, 236 P.2d 355 (1951); *see also Hartley v. Liberty Park Assocs.*, 54 Wash.App. 434, 438, 774 P.2d 40, *review denied*, 113 Wash.2d 1013, 779 P.2d 730 (1989).

As yet the owelty lien has not been applied to dissolution of meretricious relationships. Judge Overstreet, in *In re Goodale*, 298 B.R. 886, 892 (Bkrtcy WDWA 2003) recognized the existence of an owelty lien arising out of a partition of real property.

Goodale involved a gay couple and personal property. Judge Overstreet found the doctrine inapplicable in that context.

A lien arising in owelty is a judgment and a lien on the property whether or not the claiming spouse has recorded it. *In re Washburn*, 98 Wn.2d 311, 654 P.2d700 (1982); *Adams v. Rowe*, 39 Wn.2d 446, 236, P.2d 355 (1951). Recording is only necessary if the lien is a judgment lien and the property is homesteaded. The judgment establishes the owelty lien and, since the owelty lien attaches to homesteaded property ahead of any excess value, recordation is not necessary. *Hartley v. Liberty Park Associates* 54 Wash.App. 434, 774 P.2d 40 (1989). The lien takes its priority from the date of the judgment.

The division of property in a dissolution action may give rise to an avoidance action by the trustee in bankruptcy. In *Britt v. Damson*, 334 F.2d 896 (9th Cir. 1964) the court determined that an award of property was an avoidable transfer under the fraudulent conveyance sections of the Bankruptcy Act of 1898, to the extent that the husband/bankrupt did not receive "fair value."

In re Roosevelt 176 B.R. 200 (9th Cir. BAP (Cal.),1994) the court again addressed the issue and again held that to the extent that fair value was not given the transfer might be avoided.

In, *In re Bledsoe*, 350 B.R. 513 (Bkrtcy.D.Or.,2006), however, the court found that unless extrinsic fraud could be shown the fraudulent conveyance action was an

> impermissible collateral attack against the dissolution judgment entered by the state court and the state law claims must therefore be dismissed. Because there are no allegations of collusion, actual intent to defraud, or that the dissolution judgment was not obtained pursuant to a regularly conducted

> proceeding under state law, the transfers made pursuant to the dissolution judgment conclusively establish reasonably equivalent value for purposes of Bankruptcy Code § 548(a)(1)(B).

PROPERTY

The next step is to identify the character of property as separate property or community property. That status will determine whether the judgment creditor has a claim against the property. In the absence of an agreement the status of property is established at the time that is acquired.

> The character of property as separate or community is established at the point of acquisition. . . .*In Re Marriage of Skarbek*, 100 Wn. App 444, 447, 997 P.2d 447 (2000)

Separate property is property acquired before marriage or acquired after marriage by gift, bequest, devise, or descent. RCW 26.16.010, .020; *Brown v. Brown*, 100 Wn.2d 729, 737, 675 P.2d 1207 (1984). Otherwise, an asset acquired during a marriage is presumed to be community property. *In re Marriage of White*, 105 Wn. App. 545, 550, 20 P.3d 481 (2001).

The marriage is terminated for purposes of community liability and property acquisition when the parties separate. Separation occurs when the partners no longer live together as husband and wife and both husband and wife have given up all hope of reconciliation. *In re Marriage of Short 125 Wash 2d 865, 940 P.2d* 12 (1995).

> Property, retains its status as long as it can be traced and identified.
>
> Once established, separate property retains its separate character unless changed by deed, agreement of the parties, operation of law, or some other direct and positive evidence to the contrary. *In re Estate of Witte*, 21 Wn.2d112,125, 150 P2d 595 (1944) *In re Estate of Madsen*, 48 Wn.2d 675,

676-77 (296 P.2d 518 (1956). Separate property will remain separate "through all of its changes and transitions" so long as it n be traced and identified *Witte* 21 Wn.2d at 125, *Baker v Baker*, 80 Wn.2d 736, 745, 498 P.2d 315 (1972); *In re Marriage of Pearson-Maines*, 70 Wn. App. 860, 865, 855, P.2d 1210 (1993) The burden is on the spouse [or creditor] asserting that separate property has transferred to community to prove the transfer by clear and convincing evidence, usually a writing evidencing mutual intent. *In re Marriage of Shannon* 55 Wn. App. 137, 140, 777 P.2d 8, (1989).

Property which is commingled with property of a different character can lose its original character.

When separate funds become so commingled with community funds so it is no longer possible to trace and identify them, the asset becomes community. *In re Estate of Witte*, 21 Wn.2d 112, 125, 150 P.2d 595 (1944). The burden is on the spouse or creditor claiming that separate property has been commingled or converted to community property to prove the change in character by clear and convincing evidence. *See, also, In re Marriage of Shannon, supra* at 140.

There are a number of presumptions used in tracing. One is the "Presumption of the Proper Fund." It states that if the spouse has sufficient separate and community funds and pays as separate or community obligation, it is presumed that funds from the proper fund were used. *In re Finn's Estate* 106 Wash. 137, 179 P. 103 (1919). *In re Marriage of Pearson-Maines*, 70 Wash.App. 860, 855 P.2d 1210 (1993)

Similarly, if an asset is presumptively community property, the burden is on the spouse or creditor claiming it is separate property to present clear and convincing evidence tracing the asset to a separate source. *In re Estate of Binge*, 5 Wn.2d 446, 466, 105 P.2d 689 (1940).

A decree of dissolution without anything more will create separate property in the spouse receiving the property. Consequently, after entry of the decree, the house belonged to the spouse receiving it and no quit claim deed was necessary. (See practice pointer below) *Richardson v. Superior Fire Insurance Company, 192 Wn. 553, 74 P.2d 192 (1937).*

> The marital community of appellant and her husband was completely dissolved by the decree of divorce. In that proceeding, their community property was divided. There was no community property after the community was dissolved.
>
> The court went on to hold specifically that:
>
> **The transfer to her in the divorce proceeding of the insured property was a change of title.** By the divorce, there was a dissolution of the marital community for the benefit of which the contract was made. **On the dissolution of that community, there was a division of property. The community interest of the husband was transferred to the wife. That property then became her separate property.** [emphasis supplied]

Similarly, in *In re Marriage of Penry*, 119 Wn. App. 799, 82 P.3rd 1231 (2004) the court found that the dissolution decree established the wife as an owner of the property.

Practice Pointer: This means that even though there is no recorded deed, the spouse receiving the property is its owner as of the date of the divorce decree. Recording a deed is a ministerial act that does not effect a change in title. Consequently, for bankruptcy avoidance purposes (preference or fraudulent conveyance) the transfer took place when the decree was entered, not when the deed was recorded. Entry of the decree thus starts the clock ticking for avoidance actions.

Notwithstanding the above, by far the best practice is to document the distribution with commonly accepted real estate documents. Such filings clearly put the world on notice as to the status of title. The execution and recordation of a Deed, Deed of Trust and/or other real estate documents facilitates dealings with title companies and makes dicussions with

trustees much less hostile. If the distribution and lien[2] are set forth in the decree, however, that is sufficient to vest title and create an enforceable right that should not be avoidable by the trustee or as an impairment of the homestead in a community property state.

COMMUNITY PROPERTY IN BANKRUPTCY

The Bankruptcy Code makes special provisions to account for community property. Community is not a defined term in the Bankruptcy Code. Consequently, it is necessary to look to state law to determine the character of a particular property in the proceeding.

Community Property in the estate. The bankruptcy estate includes all of the separate and community property of the debtor. 11 U.S.C. 541(a)(2)

> (2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is--
>
> (A) under the sole, equal, or joint management and control of the debtor; or
>
> (B)liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such that such interest is so liable.

Practice Pointer: In a case of separated debtors, it is necessary to list all community property even if it is in the possession of a non filing spouse. Such community property is property of the estate. If it is overlooked, you may find you have a problem with exemptions and, maybe, even discharge. In addition, the status of property as community or separate may become important, and each asset should be identified as

[2]Judge Overstreet recently ruled that deeding the property "SUBJECT TO" a requirement of payment was not sufficient. The Decree had to use words specifically impressing a lien. There is no written decision.

The Community discharge[3]. In exchange for exposing all community property, to administration and liquidation by the trustee in bankruptcy, all of the community debts are discharged, even if they are not the separate liability of the filing spouse.

The law is clear that when a case is filed by one member of the community the entire community gets a discharge and creditors cannot pursue the non-discharged spouse's interest in community property even for the separate debts. *In re Costanza* 151 B.R. 588 (Bkrtcy.D.N.M.1993) the court succinctly explained the law:

> The discharge received by defendant's wife provides her a fresh start. It shields all her after acquired property from the claim of her creditors, including community claims based upon her husband's wrongdoing. It provides the marital community, of which she is an equal member, a fresh start. FN5 Such is the clearly stated policy of Congress.
>
> > FN5. Section 524(a)(3) is only available to the marital community. Upon dissolution of the marriage its protection no longer exists. Collier, 3 COLLIER ON BANKRUPTCY, ¶ 524.01[2] at n. 16 (15th ed. 1992); Pedlar, COMMUNITY PROPERTY AND BANKRUPTCY REFORM ACT of 1978, 11 St. Mary's L.J. 349 (1979) at n. 134.

This passage was recently expanded by the court in *In re Kummel* 2007 WL 1111248 (Bkrtcy. N.D. Cal. 2007).

> For those who wish to pursue the matter, there may be no better source than the article written by Alan Pedlar, COMMUNITY PROPERTY AND THE BANKRUPTCY REFORM ACT OF 1978, 11 St. Mary's L.J. 349 (1979) ["Pedlar, Community Property "]. The article suggests the possibility that "the Devil himself could effectively receive a discharge in bankruptcy if he were married to Snow White." Id. at 382. To this I would add: if he does not treat her better than his creditors, she will, by divorcing him, deny his discharge. [[FN8]]

---

[3] *See Also,* LIABILITY OF COMMUNITY PROPERTY FOR ANTENUPTIAL DEBTS AND OBLIGATIONS, 68 A.L.R.4th 877

> FN8. A footnote omitted from the above quote states: "Section 524(a)(3) is only available to the marital community. Upon dissolution of the marriage its protection no longer exists. Collier, 3 Collier on Bankruptcy, ¶ 524.01[2] at n. 16 (15th ed.1992); Pedlar, COMMUNITY PROPERTY AND THE BANKRUPTCY REFORM ACT OF 1978, 11 St. Mary's L.J. 349 (1979) at n. 134." Costanza, 151 B.R. at 589 n. 5.
>
> The cases are uniform in recognizing this effect of Section 524(a)(3). *See, e.g., Soderling*, 998 F.2d at 733 ("[a]ll claims against a marital community are discharged," except for nondischargeable community claims); *In re Homan*, 112 B.R. 356, 360 (9th Cir.BAP1989) (stating in dicta that after-acquired community property is immune from collection efforts, even if creditor's claim is only against nondebtor spouse); *In re Hull*, 251 B.R. 726, 732 (9th Cir.BAP2000) (recognizing effect of Section 524(a)(3)); *In re Rollinson*, 322 B.R. 879, 883 (Bankr.D.Ariz.2005) (creditor's claim barred by Section 524(a)(3)); *In re Strickland*, 153 B.R. 909 (Bankr.D.N.M.1993) (same); *In re Schmiedel*, 236 B.R. 393 (Bankr.E.D.Wis.1999) (same).

Bankruptcy Administration and distribution:

When a married couple files bankruptcy, two separate estates are created. *In re Ageton*, 14 B.R. 833, 835 (9th Cir. BAP 1981); *In Re: Estrada*, 224 B.R. 132; (Bkrtcy S.D. Ca 1998). Even though they are administered jointly they are **not** substantively consolidated unless the court enters a separate order, on notice, doing so. *In re Reider*, 31 F.3d 1102, 1111 (11th Cir. 1994) *Ageton, supra.* Thus the claims are paid from the separate and community estates according to the statute.

In joint cases, costs of administration are to be allocated between community and separate assets as justice requires. 11 U.S.C. 726(c)(1). Factors that might be considered include a) the relative size of the estates, b) the time expended and difficulty of dealing with the assets of differing character, c) the cost of preserving or recovering a particular asset,

and d) the cooperation received from the respective parties seeking to control the distribution from a particular asset.

There are two classes of general unsecured non-priority claims in every unconsolidated bankruptcy filed in a community property state.

The first of these is an individual or separate claim against the debtor. Except for property which comes into the estate pursuant to §541(a)(2) as community property, all property in a bankruptcy estate is separate.

The second is a "community claim." A community claim is a defined term under the Bankruptcy Code. Section 101(a)(7) contains the definition. It provides:

> "community claim" means claim that arose before the commencement of the case concerning the debtor for which property of the kind specified in section 541(a)(2) of this title is liable, whether or not there is any such property at the time of the commencement of the case;

Section 541(a)(2) specifies community property; to the extent a separate liability of one spouse is not changeable against community property, a claim arising from a separate liability is not a community claim.

Subsections 726(c)(2) A, B, and D control the distribution of community property. Subsection C controls the distribution of separate property, i.e. all property other than community property. This includes the recovery from preference and avoidance actions. In *In re Merlino* 62 B.R. 836 (Bkrtcy. W.D.WA. 1986), one of the few reported cases analyzing section 726(c)(2) Judge Volinn discussed the four sub-estates as follows:

> Subestate A consists of Section 541(a)(2) property (i.e. community property) which is available for payment of community claims.

> Subestate B consists of Section 541(a)(2) community property which is solely liable for claims against the debtor. That is, if there is a provision in State law for certain community property to be liable for debts of the debtor (presumably including separate debts) it would be available in bankruptcy for those same debts. **[This class of property does not exist in Washington.**]
>
> Subestate C consists of non-541(a)(2) property (i.e separate property) which is available for satisfaction of separate claims as well as any community claims not satisfied in Subestates (A) and (B). It should be noted that non-541(a)(2) property includes 541(a)(3) property which consists of "any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title." It may be that the scheme mandated by the Code would at this point permit payment of a separate claim from recovery of transferred community assets under one of the denominated sections. That result might conflict with State law. In that event the Supremacy Clause issue would arise. However, this case has been pending since 1984 and there is no indication that such a recovery can or will occur.
>
> Subestate D consists of all remaining property of the estate which the Code makes available to satisfy community claims not satisfied in the preceding subestates. It is available to satisfy separate claims....

While this appears to be complicated language, the analysis breaks down reasonably under a step by step analysis.

First, the separate property of a non filing spouses is not property of the estate and hence is not administered in the bankruptcy estate at all. *In re Robertson* 203 F.3d. 855, (5th Cir. 2000).

Second, community property in the estate is used to pay community claims. 726(c)(2)(A).

Third, community property may be used to pay a separate claim incurred by the debtor under 726(a)(2)(B) , if, and only if, there is a state law basis for asserting the separate claim against the community property. If there is no basis for asserting the separate claim

against community property or a portion thereof, then the claim cannot recover from community property. *In re Merlino, supra.*

Fourth, separate property of the debtor(s) is applied pro-rata to all separate claims of the debtor regardless if they are also community claims. If the debtor has individual liability, the separate property is distributed under this class. 726(c)(2)(C). Collier on Bankruptcy 15th Ed ©2000 ¶726.05 describes this section as follows:

> Third, subestate (C) property, consisting of all the property of the estate other than section 541(a)(2) property, is paid to all creditors of the debtor. The creditors of the nondebtor spouse, including holders of community claims, are excluded from participation in subestate (C). The claims of holders of community claims against the debtor should participate at their full face value in the pro rata distribution of subestate (C), without reduction for dividends received from subestates (A) and (B), with the exception that if the distribution would result in more than a 100% payment, the surplus should be returned to subestate (C). [footnote omitted]. Any surplus from subestate (C) flows into subestate (D).

Fifth, if there is any property, community or separate, left over after distribution under Subsections A to C above, then that property is paid to remaining community claims. Collier opines at COLLIER ON BANKRUPTCY 15th Ed ©2000 ¶726.05:

> If there is a surplus from subestate (C), again, by definition, all creditors of the debtor in that particular priority class must have been paid in full. Accordingly, the subestate (C) assets become available to pay the holders of community claims against the nondebtor in the same priority class through subestate (D).

This is stated more clearly in the footnote to the section ¶306.06, Note 10

> Under provisions governing the distribution of assets, separate property of a spouse is distributed solely to that spouse's creditors until they have been paid in full. Only then is the separate property of a spouse available to creditors of the other spouse. *See* 11 U.S.C. § 726(c)(2)(C) and (D); S. REP. NO. 989, 95th Cong., 2d Sess. 32 (1978), reprinted in App. Pt. 4(e)(I) *infra*; H.R. REP. NO. 595, 95th Cong., 1st Sess. 321 (1977). . .

Sub-estate D is the category for claims which the debtor's spouse. This is a federal preemption of state law and, if the separate property of one debtor comes into the estate, it may be distributed here, even if the debtor would not have any individual liability. In Washington, there is a possible exception since there may be an exemption. *See*, RCW 6.15.040 *infra*.

Senate Report 989 in describing the meaning of §726(c)(2)(D) states:

> Fourth, if any community obligations against the debtor or the debtor's spouse remain unpaid, they are paid from whatever property remains in the estate. **This would occur if community claims against the debtor's spouse are large in amount and most of the estate's property is property solely liable, under nonbankruptcy law, for debts of the debtor.** [emphasis supplied]

Practice pointer: Subsection D makes separate property of either one of joint debtors liable for claims for which they would not normally be liable under state law. Thus, where one member of a marital community has a significant amount of separate property, it would be unwise to file that spouse in a joint case because the separate property would be in the estate and applied the separate debt of the spouse under subsection C, and, under subsection D to community debt for which it would not otherwise be liable under state law. It would be far better to file the spouse without separate property in an individual case and obtain a discharge of the community debt without exposing the separate property of the non filing spouse. The separate property is, however, still liable for the separate debts of that spouse.

RCW 6.15.040 provides exemption for the separate property if the claim is solely a community claim.

> SEPARATE PROPERTY OF SPOUSE EXEMPT.
>
> All real and personal property belonging to any married person at the time of his or her marriage, and all which he or she may have acquired subsequently to such marriage, or to which he or she shall hereafter become entitled in his or her own right, and all his or her personal earnings, and all the issues, rents and profits of such real property, shall be exempt from execution, attachment, and garnishment upon any liability or judgment against the other spouse, so long as he or she or any minor heir of his or her body shall be living: PROVIDED, That the separate property of each spouse shall be liable for debts owing by him or her at the time of marriage.

This has never been litigated (at least in a reported case) so it is impossible to opine what it might mean in the context of a bankruptcy distribution.

The application of these rules can have interesting effects. *In re Whitus*, 240 B.R. 705 (Bankr. W.D. Tex. 1999) is such a case. The *Whitus* court disallowed a community claim of the IRS from being paid with separate property. The court held:

> If under any circumstances a creditor could satisfy a portion of its claim from community property of the type described in section 541(a)(2) [footnote omitted], then that creditor would be accorded the status of a holder of a community claim. State law provisions limiting a creditor to only certain kinds of community property are not acknowledged under the Bankruptcy Code. COLLIER ON BANKRUPTCY, ¶101.07[2] (15 ed. rev. 1997).
>
> Thus, an entity that holds a claim against a non-debtor spouse enforceable against any kind of community property will, under the Bankruptcy Code, hold a claim against all the community property in the debtor's estate regardless state law limitations (subject to the limitations of §726(c), discussed

> *infra.*). **By the same token, however, the holder of a community claim does not hold a general claim payable out of the entire estate assets. The claim is limited to satisfaction out of the community property**. COLLIER ON BANKRUPTCY, ¶101.07[1] (15 ed. rev. 1997) [emphasis supplied].

The plan could be confirmed and the best interests of creditors' liquidation analysis could be satisfied because the IRS would not receive a distribution in a Chapter 7, they only had a community claim, not a separate one. Consequently, they did not need to be paid in the Chapter 13 case.

Judge Overstreet, in an unpublished decision seems to have reached a contrary result at least once.

Making a decision to file one or both members of a marital community.

The 1979 Amendments to the Bankruptcy Code allowed joint petitions by married debtors. Filing of a joint petition provides both benefits and burdens. It is the author's opinion that in the vast majority of circumstances filing a joint petition is a mistake. Just because you can do it does not mean that it should be done.

Benefits of Filing a Joint Petition

The following are the benefits of a Joint Filing:

1. Both parties get an a discharge.

    a. both have license suspensions for accidents if the filing is for the purpose of getting a license reinstated.

    b. the debtors are from a non community property state and are trying to clear up a credit report to be able to purchase a house

2. The parties are in the process of getting divorced and, after the bankruptcy the divorce will be finalized. There will no longer be a community and both

spouses wish to continue their lives without the debts incurred during the marriage.

3. Both spouses need to get the debts off of their credit reports to facilitate obtaining credit in the future.

The following are the burdens of problems of a joint filing.

1. You must deal with both clients. This presents a possible conflict of intersts (particularly with an imminent divorce).

2. The separate property of one can be used to pay community claims incurred by the other. This is a result of federal preemption discussed *supra.*

3. The remaining spouse can not file for 8 years. While the community probably can't get another discharge, *In re Marusic* 139 B.R. 727 (Bankr.W.D.Wash. 1992). The spouse can legitimately file an individual case. A separate property agreement may be in order.

Benefits of not filing a joint case.

1. Both the individual and the community get a discharge.[4]

2. The non-filing spouse can file in the future.

3. There are outstanding issues as to inclusion of income in the means test.

4. There is only one client to get to hearings, etc. and only one client from whom to obtain documents.

5. Reaffirmation. In an individual case, one spouse remains individually liable on the obligation and has never filed bankruptcy. Consequently, even though a creditor will not be able to collect from the community there exists the possibility of a separate judgment against the non-filing spouse.

   In this context, the BAPCPA modifications regarding acceleration in the event of bankruptcy will not apply. As long as the payments are kept current and the property is insured, there is no basis for a repossession. One of the obligors has not ever filed a bankruptcy even though there is little or no likelihood that the creditor will ever be able to collect. In this case "ride through" is unchanged.

[4]A copy of our form letter to creditors of community creditors is attached as Appendix A. It is published as one of the letters in "Letters for Bankruptcy Lawyers" by Joel Pelofsky and Marc S. Stern ABA Press 2005.

CONCLUSION

Community Property concepts are oftentimes ignored by practitioners. Failure to properly analyze and consider both the application of community property and liability can create problems for both clients and their attorneys. On the other hand, a thorough understanding of the concepts can lead to beneficial results.

MARC S. STERN[5]
Attorney at Law
1825 NW Sixty Fifth Street
Seattle, Washington 98117

(206) 448-7996 Fax: (206) 297-8778
E-Mail: mstern@abanet.org

November 12, 2007

Re:

Date
Name
Company Name
Address 1
Address 2
City, State, Zip Code

Re:

Dear Sir or Madam:

Please be advised that I represent the debtor in the above-referenced bankruptcy matter. I have been provided proof of your attempts to collect a debt from the debtor's non-filing spouse subsequent to her bankruptcy filing. **You must immediately stop your attempt to collect the pre-petition debt against the debtor's spouse, Mr. _____.** Failure to stop your collection action may be a violation of the automatic stay codified at 11 U.S.C. § 362 and/or the discharge injunction provided for in 11 U.S.C. § 524, and sanctions may be entered against you by the Bankruptcy Court.

You were listed as a creditor in _____'s bankruptcy proceeding. A discharge has been granted. This obligation was incurred while _____ was married to the debtor. Under Washington (or other community property state) law, this debt became a debt owed by the community, or a "community debt," as defined by the Bankruptcy Code pursuant to 11 U.S.C. § 524(a).

Since community property could be recovered to satisfy the debt prior to the filing, the obligation is a "community claim" under 11 U.S.C. § 101(7). Upon

[5] Letters for Bankruptcy Lawyers 2005 ABA Press
Based upon a form provided by David H. Krieger and used with permission.

_____

_____'s discharge, you will be barred from collecting against *either* spouse's interest in community property, such as wages, bank accounts or other property, even though he will not receive a discharge. 11 U.S.C. § 524(a)(3). *In re Passmore,* 156 B.R. 595, 3 (E.D. Wis. 1993); *Collier on Bankruptcy* § 524.01[2].

As a community claim, your claim is subject to the discharge injunction. 11 U.S.C. § 524(a)(3). *See also In re Smith,* 140 B.R. 904 (N.M. 1992), where the court found that a bankruptcy petition filed by one spouse passes all community property into the estate of the filing spouse under § 524(a)(2). *In re Homen*, 112 B.R. 356 (9th Cir. BAP 1989).

A discharge of the debts therefore includes community claims and prohibits you from proceeding against community property acquired after the petition was filed, even against the nondebtor spouse. § 524(a)(3); *Green v. United States*, 12 B.R. 594 (Bankr. N.M. 1981). Accordingly, in community property states, there is no need for both spouses to file to receive the benefit of the discharge. *In re Constanza,* 151 B.R. 588 (N.M. 1993).

Further, unitary treatment under 11 U.S.C. § 362 of both spouses' interests in the assets classified as marital property is consistent with treatment of community property under other sections of the Bankruptcy Code. *See In re Passamore*, 156 B.R. 595 (E.D. Wis. 1993).

Accordingly, your collection action against _____ may violate the stay/injunction and subject you to sanctions, **including my attorney's fees in filing an action against your client to stop your collection efforts.**

Be guided accordingly.

Sincerely yours,

Marc S. Stern

MSS:sb

cc: