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Community Property and Divorce—Effect of Subsequent Bankruptcy

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COMMUNITY PROPERTY AND DIVORCE— EFFECT OF SUBSEQUENT BANKRUPTCY

Plaintiff, trustee in bankruptcy of defendant's former husband, brought suit in federal district court to set aside as a fraudulent conveyance a Washington court's award of community property to the defendant incident to her divorce.[1] The district court granted summary judgment for defendant on the ground that the trustee's attack on the award depended upon the community nature of the property which had been terminated by the divorce. On appeal, the Ninth Circuit Court of Appeals reversed and remanded. *Held:* Because a Washington marital community is not an entity with separate legal existence, an award of community property by a Washington divorce decree is a "transfer" from one spouse to the other under section 1(30) of the Bankruptcy Act. *Britt v. Damson,* 334 F.2d 896 (9th Cir. 1964), *cert. denied,* 85 Sup. Ct. 661 (1965).

"Transfer" is defined in section 1(30) of the Bankruptcy Act.[2] The definition in the Act of 1938 was considered by Congress to employ "sweeping language," yet it was further expanded in 1952.[3] Extensive research reveals no case in which the characterization of a property award by a divorce court as a "transfer" under the Bankruptcy Act has been litigated, but the language of section 1(30) clearly includes all property awards by divorce courts.[4]

Having determined that the award of community property to defendant was a "transfer" from her husband, the Ninth Circuit remanded the principal case for hearing on the issues of insolvency and fair consideration to determine whether the "transfer" was a fraudulent conveyance.[5]

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[1] "Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent (a) as to creditors existing at the time of such transfer or obligation, if made or incurred without fair consideration by a debtor who is or will be thereby insolvent, without regard to his actual intent; or (b) as to then existing creditors and as to other persons who become creditors during the continuance of a business or transaction, if made or incurred without fair consideration by a debtor who is engaged or is about to engage in such business or transaction, for which property remaining in his hands is an unreasonably small capital, without regard to his actual intent...." Bankruptcy Act §§ 67d(2)(a)-(b), 11 U.S.C. §§ 107d(2)(a)-(b) (1958).

[2] "'Transfer' shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings...." Bankruptcy Act § 1(30), 11 U.S.C. § 1(30) (1958).

[3] H.R. REP. No. 2320, 82d Cong., 2d Sess. 3 (1952).

[4] See generally 1 COLLIER, BANKRUPTCY ¶ 1.30 (14th ed. 1964).

[5] See note 1 *supra.*

The court offered a formula for the district court's application and, further, designated recipients of the assets recovered from defendant by the trustee in the event a fraudulent conveyance was found.

The Ninth Circuit indicated that the district court's decision might be sustained if the marital community was a separate legal entity under Washington law. The "entity theory," as applied to the Washington marital community, is an elusive concept denoting the legal incidents of the form of co-tenancy peculiar to community property in Washington and connoting the existence of a legal entity in the marital community separate and distinct from the spouses. The Ninth Circuit found that the entity theory had been rejected in Washington in *Bortle v. Osborne,*[6] and "for the reasons indicated the judgment [could not] ... be sustained on the ground relied upon by the district court."[7] *Bortle* was a tort case, and previous efforts to employ that decision in non-tort litigation have been uniformly rejected or ignored.[8] In view of the questionable authority of *Bortle,* the Ninth Circuit might have applied the federal abstention doctrine and refused to decide the "entity" status of the Washington marital community until the parties had litigated the matter in the state courts.[9] Washington, however, lacks special procedural rules for considering abstention cases, and application of the abstention doctrine would have required the parties to follow normal judicial procedure in Washington by bringing suit in superior court.[10]

The Washington marital community has been treated as an entity by implication in bankruptcy litigation, although the marital communities of other states have not been deemed legal entities for bankruptcy purposes.[11] The Washington marital community has been allowed to petition and be discharged in bankruptcy[12] even though only legal entities

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[6] 155 Wash. 585, 285 Pac. 425 (1930).

[7] 334 F.2d 896, 899 (1964).

[8] *E.g.,* Stone v. United States, 225 F. Supp. 201, 203 (W.D. Wash. 1963); Household Fin. Corp. v. Corby, 61 Wn.2d 184, 377 P.2d 441 (1963). For discussion of Bortle v. Osborne, and the "entity theory" of the Washington marital community, see generally 1 DE FUNIAK, PRINCIPLES OF COMMUNITY PROPERTY 267-69 (1943); MARSH, MARITAL PROPERTY IN CONFLICT OF LAWS 22-24 (1952) Cross, *The Community Property Law in Washington,* 15 LA. L. REV. 640, 664 (1955); Moore, *The Community Property System and the Economic Reconstruction of the Family Unit: Insolvency and Bankruptcy,* 11 WASH. L. REV. 61, 69-72 (1936); Mechem, *Creditor's Rights in Community Property,* 11 WASH. L. REV. 80, 86 (1936).

[9] See Thompson v. Magnolia Petroleum Co., 309 U.S. 478 (1940).

[10] This procedural deficiency was resolved by passage of Federal Court Local Law Certificate Procedure Act, S. 129, 39th Reg. Sess., Wash. State Legislature.

[11] See generally 1 COLLIER, *op. cit. supra* note 4, at 103-09.

[12] See, *e.g.,* Household Fin. Corp. v. Corby, 61 Wn.2d 184, 377 P.2d 441 (1963); Minder v. Gurley, 37 Wn.2d 123, 222 P.2d 185 (1950); Conley v. Moe, 7 Wn.2d 355, 110 P.2d 172 (1941). See Moore, *supra* note 8, at 70.

may be adjudged bankrupts.[13] Although research reveals no case in which the Ninth Circuit has considered whether a Washington marital community may be adjudicated a bankrupt, the Washington Supreme Court has considered numerous cases involving "community bankruptcy" without expressing disfavor.[14]

The decision in the principal case that the Washington marital community is not an entity for purposes of ownership of community property suggests that the community does not qualify as the "legal entity" which is essential to an adjudication of bankruptcy.[15] The decision thus raises the question whether past discharges are void for lack of jurisdiction over the person when only the community has proceeded through bankruptcy. The answer to this question might be found in *Household Fin. Corp. v. Corby*,[16] where plaintiff finance company sought judgment against defendant husband and wife for a community obligation, following a discharge in bankruptcy in which only the marital community had been listed on the petition. The Washington Supreme Court held that discharge of the community had also discharged the spouses individually. This decision assumes that the bankruptcy court acquired jurisdiction over the husband and wife as individuals. It may be inferred, therefore, that past discharges of the marital community alone are not void for lack of jurisdiction over the person.

The Ninth Circuit designated the disposition to be made of any assets recovered from defendant by the trustee by stating, in dictum, that only those creditors of the bankrupt who were creditors of the former marital community could share in any recovery from defendant.[17] This statement is contrary to the leading case of *Moore v. Bay*,[18] in which the United States Supreme Court held that all general creditors must share equally in a bankrupt's estate. Because *Moore v. Bay* is one of the most important cases in the bankruptcy field, the failure of the Ninth Circuit to follow or even mention that decision may indicate that the court had reversed its reasoning at the end of its opinion. The only

[13] See Moore, *supra* note 8, at 71; *cf.* Pope & Cottle Co. v. Fairbanks Realty Trust, 124 F.2d 132 (1st Cir. 1941).

[14] See *e.g.*, cases cited note 12 *supra*.

[15] See authorities cited note 13 *supra*; Vallely v. Northern Fire & Marine Ins. Co., 254 U.S. 348 (1920).

[16] 61 Wn.2d 184, 377 P.2d 441 (1963); *accord*, Minder v. Gurley, 37 Wn.2d 123, 222 P.2d 185 (1950).

[17] *But see* Heffron v. Duggins, 115 F.2d 519, 520 (9th Cir. 1940): "Under the Bankruptcy Act the trustee may set aside such a transfer as here claimed to be made in fraud of creditors though but one of the several creditors would be entitled to such relief in the absence of bankruptcy, and the property when recovered by the trustee is held for the benefit of all the credtiors."

[18] 284 U.S. 4 (1931). See generally 4 COLLIER, *op. cit. supra* note 4, at 1794-95.

apparent reason for excluding the bankrupt's separate creditors from the assets recoverable by the trustee is that the marital community has a separate legal existence.

The distinction between separate and community debts under Washington's community property system[19] may need to be preserved in bankruptcy if the community property system is to survive. For example, under present Washington law the assets of the marital community cannot be reached by a judgment creditor of either spouse when the judgment arises from the commission of a "personal" tort.[20] If the judgment creditor is able to force the individual spouse into bankruptcy proceedings, however, it may be inferred from the Ninth Circuit's decision in the principal case that the tortfeasor's undivided one-half interest in community assets could be reached by the trustee for the benefit of the judgment creditors.

Remanding the question of fair consideration[21] for factual determination, the Ninth Circuit offered a formula for the district court's application. This formula combines objective and subjective tests to determine whether one spouse has received fair consideration for a property award to the other spouse.

The Ninth Circuit stated the objective portion of the formula twice, inconsistently. The court first stated, "[T]o the extent that the value of the community property awarded to Mrs. Damson was offset by the value of the community property awarded to Mr. Damson, the 'transfer' to Mrs. Damson was, as a matter of law, supported by 'fair consideration' . . . ."[22] Shortly thereafter the court stated, "To the extent that the award of community property to Mrs. Damson may have exceeded half of the total value of the community property, there is a question whether, under all of the circumstances, Mr. Damson received fair consideration as a matter of law."[23] Under the first statement, fair consideration for the award to defendant existed, as a matter of law, in an amount equivalent to the value of the award to her former husband. Under the second statement, that portion of defendant's award which might not have been supported by fair consideration was, as a matter

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[19] See generally Cross, *supra* note 8, at 661-67.

[20] Smith v. Retallick, 48 Wn.2d 360, 293 P.2d 745 (1956); *cf.* MacKenzie v. Sellner, 58 Wn.2d 101, 361 P.2d 165 (1961).

[21] "For the purposes of, and exclusively applicable to, this subdivision d: . . . (e) consideration given for the property or obligation of a debtor is 'fair' (1) when, in good faith, in exchange and as a fair equivalent therefor, property is transferred. . . ." Bankruptcy Act § 67d(1)(e), 11 U.S.C. § 107d(1)(e) (1958).

[22] 334 F.2d at 903.

[23] *Ibid.*

of law, only that in excess of one-half of the total value of the community property. Conversely, fully one-half of the total value of the community property could have been awarded to defendant without any question of "fair consideration" arising, as a matter of law. The difference between the two statements may be illustrated by assuming that defendant received 70 per cent of the community property and her husband 30 per cent. Under the court's first statement the initial 30 per cent of defendant's award would be supported, as a matter of law, by fair consideration, but the balance of 40 per cent would not be so supported. Under the second statement, however, only the last 20 per cent of defendant's award might not be supported by fair consideration as a matter of law, as her award exceed "half of the total value of the community property" by that percentage.

The subjective portion of the Ninth Circuit's formula was stated in footnote thirteen of the opinion:

> It could be argued that obtaining one's release from a marriage, pursuant to a decree of divorce, and in connection therewith, obtaining a limitation upon the obligation, not terminated by divorce, to provide future support, such limitation being effectuated by a provision for alimony, give rise to a conclusive presumption of "fair consideration" for any transfer of community property made under that decree, unless made in bad faith or fraudulently. It may also be noted that, in this case, the obligation of Mr. Damson to provide future support for Mrs. Damson, was perhaps greater than in the ordinary case because Mrs. Damson was totally blind.[24]

It is unfortunate that the court did not elaborate more fully on this suggestion. Such a "conclusive presumption" would acknowledge the elusive considerations inherent in domestic relations matters, whereas the mechanical objective test outlined in the body of the opinion would not. A presumption of fair consideration would also take cognizance of the statutory obligation of the trial court in a divorce action to dispose of the property of the parties "as shall appear just and equitable."[25] The Washington Supreme Court accords the trial court in a divorce action a strong presumption of fairness and regularity, and will not substitute its own judgment unless there has been a "manifest abuse of

[24] *Id.*, n. 13.

[25] "[The trial court in a divorce action shall grant a decree] ... making such disposition of the property of the parties, either community or separate, as shall appear just and equitable, having regard to the respective merits of the parties, to the condition in which they will be left by such divorce or annulment, to the party through whom the property was acquired...." WASH. REV. CODE § 26.08.110 (1958).

discretion."[26] Wide discretionary powers are given the trial court because it observes the parties in the trial and is in the best position to evaluate intangible factors pertinent to a just decision. The inefficiency and even impossibility of relitigating the property distribution incident to a divorce in subsequent bankruptcy proceedings could be avoided by the federal courts' grant of this same presumption to state trial courts' decisions in divorce actions.

The Ninth Circuit's decision does not add to the recovery rights of the former community creditors, as a recent Washington decision[27] established their right to recover assets of the former community from this particular defendant, independent of the trustee. With the former community creditors unaided and the separate creditors excluded, the only benefit conferred upon creditors by the decision in the principal case is the pro rata distribution of assets required of the trustee. Although precluding a race by creditors for assets of the community held by defendant, the decision effects a reduction in the assets available for distribution to creditors by the amount of the trustee's statutory remuneration.[28]

The decision in the principal case poses several significant problems, with no available solutions under the current law. Public policy considerations of stability and consistency in the law suggest that the Bankruptcy Act should not operate to defeat the policy of the Washington community property system, nor subject a court's property award incident to a divorce to subsequent alteration in bankruptcy litigation. However, because of federal supremacy in bankruptcy law,[29] only Congress may ameliorate the effect of the principal case. Until Congress acts, the litigants in divorce cases involving property awards must rely on the "conclusive presumption" concept suggested by the Ninth Circuit. The effect of the principal case on Washington's community property system will depend upon how far counsel and trustees in bankruptcy pursue in future litigation the implications of the Ninth Circuit's reasoning.

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[26] Friedlander v. Friedlander, 58 Wn.2d 288, 362 P.2d 352 (1961); Edwards v. Edwards, 47 Wn.2d 224, 287 P.2d 139 (1955).

[27] Dizard & Getty v. Damson, 63 Wn.2d 526, 387 P.2d 964 (1964).

[28] Bankruptcy Act. § 48c, 11 U.S.C. § 76c (1958), as amended, 11 U.S.C. § 76c (Supp. V, 1964).

[29] See McKenzie v. Irving Trust Co., 323 U.S. 365 (1945).