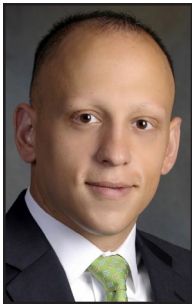


Fidelity & Surety Law Committee



THE EFFECTS OF A BANKRUPTCY ON PROPERTY CONCURRENTLY OWNED BY A DEBTOR AND NON-DEBTOR

By: Greg Trif

It is not uncommon for property to be concurrently owned by two indemnitors or by an indemnitor and a non-indemnitor. This can be problematic for a surety seeking to enforce a judgment against an indemnitor on concurrently owned property. The situation may be further complicated where one of the concurrent owners files for bankruptcy protection under Title 11 of the United States Code¹. This article generally explains the rights of a surety where a debtor-indemnitor concurrently owns property with a non-debtor.

A. Types of Concurrent Ownership

There are generally three forms of concurrent property ownership under common law: tenancy in common, joint tenancy, and tenancy by the entirety.² The most common form today is the tenancy in common. Under that structure, each owner generally holds a separate fractional share in undivided property; and each tenant may unilaterally alienate their share through sale, gift, encumbrance, or testate.³

In a joint tenancy, on the other hand, each tenant possesses the entire estate, rather than a fractional share of the property. While joint tenants enjoy many of the same rights as tenants in common, joint tenants also have a right of automatic inheritance known as “survivorship.”⁴ Joint tenants typically may unilaterally

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1 Hereinafter Bankruptcy Code.
 2 U.S. v. Craft, 535 U.S. 274, 279 (2002).
 3 *Id.*
 4 *Id.* at 280

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sever the relationship by simply converting the estate to a tenancy in common or through an overt act that denotes an intent to effectuate a severance.⁵

The third form of concurrent ownership under the common law is tenancy by the entirety, which only exists between married persons.⁶ Similar to a joint tenancy, tenants by the entirety each have a right of survivorship.⁷ A tenancy by the entirety, however, cannot be easily severed unilaterally. To the contrary, severance generally requires either the consent of the spouses or divorce.⁸

Certain states recognize another form of concurrent property ownership known as community property,⁹ but that form of ownership is not recognized under common law.¹⁰ Instead, community property derives its existence solely from legislation.¹¹ In most jurisdictions that recognize community property, there is a general presumption that property acquired during a marriage is community property unless the document evidencing ownership expressly provides otherwise.¹²

B. The Bankruptcy Estate and Applicability of the Automatic Stay

The commencement of a bankruptcy case immediately creates a bankruptcy estate.¹³ The automatic stay prevents, among other things, the enforcement of a judgment against property as long as that property is part of the bankruptcy estate.¹⁴ Considering the automatic stay and the consequences for violating that statute, the first inquiry for determining whether a surety can enforce

a judgment against property concurrently owned by a debtor and a non-debtor begins with identifying whether such property falls within the bankruptcy estate.

Section 541(a) enumerates the types of property that are to be included in the bankruptcy estate. The expansive list includes “all legal or equitable interests of the debtor in property as of the commencement of the case.”¹⁵ The Bankruptcy Code does not define “equitable interest,” but property of the estate is meant to be interpreted broadly.¹⁶ Property is included in the bankruptcy estate irrespective of where it may be located and by whom it may be held.¹⁷ As a result, courts have generally recognized that the debtor’s interest in property – even where that property is held concurrently with a non-debtor – is included in the bankruptcy estate and thereby subject to the automatic stay.¹⁸

The Bankruptcy Code also explicitly addresses the statutorily created community property form of concurrent ownership. Section 541(a)(2) identifies the following as being within the bankruptcy estate:

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;¹⁹ 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 interest is so liable.²⁰

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 281.

⁸ *Id.*

⁹ NORTON BANKRUPTCY LAW AND PRACTICE 3d § 61:8 (2012). The eight states currently recognizing community property are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

¹⁰ 15B AM. JUR. 2D *Community Property* § 1 (2012).

¹¹ *Id.*

¹² 9A AM. JUR. 2D *Bankruptcy* § 1248 (2012).

¹³ 11 U.S.C. § 541(a).

¹⁴ 11 U.S.C. § 362; *see also* In re Herter, 455 B.R. 455, 466-67 (Bankr. D. Idaho 2011).

¹⁵ 11 U.S.C. § 541(a).

¹⁶ Grant v. Himmelstein, 203 B.R. 1009, 1011 (Bankr. M.D. Fla. 1996); *see also* In re Strausbough, 426 B.R. 243 (E.D. Mich. 2010).

¹⁷ *Id.*

¹⁸ In re Lowery, 203 B.R. 587 (Bankr. D. Md. 1996)(holding that § 541(a) encompasses property held as tenants in common); In re Berg, 387 B.R. 524 (Bankr. N.D. Ill. 2008)(holding that § 541(a) encompasses property held in joint tenancy); In re Bradby, 455 B.R. 476 (Bankr. E.D. Va. 2011)(holding that § 541(a) encompasses property held in a tenancy by the entirety). It has, however, also been held that property held in a tenancy by the entirety is outside the bankruptcy estate where only one spouse has filed for bankruptcy protection. *See* 9A AM. JUR. 2D *Bankruptcy* § 1251 (2012).

¹⁹ *See* In re McCloy, 296 F.3d 370, 373 (5th Cir. 2002)(affirming the bankruptcy court’s jurisdiction over a parcel of community property owned by the debtor and his non-debtor spouse because the record demonstrated that the debtor maintained sole management of the property).

²⁰ 11 U.S.C. § 541(a).

The Bankruptcy Code, however, does not define the phrase “community property.” Instead, the characterization of property as either separate or community property – and whether such property is integrated into a bankruptcy estate – is determined according to applicable state law.²¹ For purposes of concurrent ownership analysis and application of the automatic stay, any property held separately by a debtor’s spouse is not within the bankruptcy estate.²²

C. Certain Concurrently Owned Property Is Subject to Exemption

Even though property concurrently owned by a debtor and a non-debtor is included in the bankruptcy estate, the Bankruptcy Code allows a debtor to declare certain concurrently owned property exempt from the estate. Specifically, 11 U.S.C. § 522(b) provides, in relevant part, as follows:

Notwithstanding section 541 of this title [Bankruptcy Code], an individual debtor may exempt from property of the estate . . . any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety or joint tenant to the extent that such interest as a tenant by the entirety or joint tenant is exempt from process under applicable nonbankruptcy law.²³

Thus, under the Bankruptcy Code, an individual debtor who, at the time the bankruptcy case commenced, owned a concurrent interest in property as either a tenant by the entirety or joint tenant may declare that property exempt. The claimed exemption, however, is contingent on whether that property is exempt from process under applicable non-bankruptcy law. If exempt, the property is excluded from the bankruptcy estate. The exemption survives and continues to protect the property from creditors of the debtor even if the non-debtor concurrent owner dies during or after the bankruptcy.²⁴

In order for an individual debtor to claim an exemption on property held as a tenant by the entirety or joint tenant, Bankruptcy Rule 4003(a) requires that

debtor to list that property on the schedule of assets required to be filed by Rule 1007.²⁵ Once the exemption is claimed, Bankruptcy Rule 4003(b) permits a party in interest, such as the surety, to file an objection to the debtor’s listed exemptions.²⁶ The objecting party carries the burden of proving that the exemptions are not properly claimed.²⁷

Because property law in general and the law of co-tenancies in particular are creatures of state law, the applicable non-bankruptcy law referenced in section 522(b) is the relevant state law.²⁸ Section 522(b) of the Bankruptcy Code does not create an additional federal exemption with regard to concurrently owned property, but simply recognizes that such exemption may be permitted under state law. Thus, a creditor who is precluded from reaching concurrently owned property under state law is equally precluded from reaching such property under the Bankruptcy Code.

The applicable state law is not trumped by, or otherwise subject to, the 2002 decision of the United States Supreme Court in *U.S. v. Craft*. There, the Court held that the statutory powers of the Internal Revenue Service, as enumerated in 26 U.S.C. § 6321, permitted it to satisfy the tax obligation of one spouse by dividing property held in tenancy by the entirety.²⁹ The Eleventh Circuit, as well as certain bankruptcy courts, have rejected attempts to extend *Craft*’s holding to bankruptcy creditors.³⁰

Each state has its own distinct laws on whether properties held in joint tenancy and those held in tenancy by the entirety are exempt from the reach of creditors of an individual spouse or joint tenant. States may even treat properties held in joint tenancy and those held in tenancy by the entirety differently for purposes of determining a creditor’s rights to such property. For instance, under Virginia law, properties held by the entirety are immune from the claims of creditors of one spouse, but a joint tenancy with rights of survivorship is subject to partition by a creditor of one of several joint tenants.³¹

21 *Id.*; *In re McCloy*, 296 F. 3d at 373.

22 *In re Herter*, 456 B.R. at 465.

23 11 U.S.C. § 522.

24 *In re Bradby*, 455 B.R. 476, 482 (Bankr. E.D. Va. 2011).

25 Fed. R. Bankr. P. 4003(a).

26 Fed. R. Bankr. P. 4003(b).

27 Fed. R. Bankr. P. 4003(c).

28 *Napotnik v. Equibank & Parkvale Saving Ass’n*, 679 F. 2d 316, 318 (3rd Cir. 1982).

29 *Craft*, 535 U.S. at 288-89.

30 *In re Simmreich*, 391 F. 3d 1295 (11th Cir. 2004).

31 *Wolfe v. Sprouse*, 183 B.R. 739, 741 (W.D. Va. 1995).

The majority of states recognizing tenancy by the entirety hold that a creditor of one spouse cannot reach the debtor spouse's share in the property.³² In most of those states, however, courts allow creditors to execute on property held in a tenancy by the entirety where both spouses are jointly indebted.³³ Under such a scenario, to the extent the debtor and the non-debtor spouse are indebted jointly, property held in tenancy by the entirety may not be subject to full exemption.³⁴

In the jurisdictions that follow the minority view, property held as tenants by the entirety are exempt and do not become property of the bankruptcy estate where only the indebted spouse filed a bankruptcy petition.³⁵

D. Sale of Concurrently Owned Property

The non-exempt property of the bankruptcy estate may be sold for the benefit of creditors. 11 U.S.C. § 363(h) specifically provides, in relevant part, as follows:

The trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, only if—

- (1) partition in kind of such property among the estate and such co-owners is impracticable;
- (2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;
- (3) the benefit to the estate of a sale of such property free of the interests of co-owners

outweighs the detriment, if any, to such co-owners; and

- (4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

Pursuant to section 363(h), the bankruptcy estate can generally realize the value of property that is concurrently owned with a non-debtor by selling such property without obtaining the consent of that concurrent owner.³⁶

Notwithstanding the explicit reference to tenants by the entirety, certain courts have held that property held by a debtor and non-debtor spouse as tenants by the entirety cannot be sold pursuant to section 363(h).³⁷ Other courts, on the other hand, have allowed such a sale after analyzing each element of the statute.³⁸

E. Distribution of the Proceeds From a Sale of Concurrently Owned Property

The final and critical issue is determining the manner in which the proceeds from a sale of concurrently owned property are distributed. Generally, 11 U.S.C. § 726 provides the distribution scheme for property of the estate. The well-established rule requires that property recovered by a trustee, like any other asset of the estate, is to be distributed pro rata to all creditors under the bankruptcy distribution scheme.³⁹ For property sold pursuant to section 363(h), however, 11 U.S.C. § 363(j) provides that:

the trustee shall distribute to the debtor's spouse or the co-owners of such property, as the case may be, and to the estate, the proceeds of such sale, less the costs and expenses, not including any compensation of the trustee, of such sale, according to the interests of such spouse or co-owners, and of the estate.

32 1 THE LAW OF DEBTORS AND CREDITORS § 6:84 (2011). Thirty states and the District of Columbia still recognize tenancy by the entirety. The remaining states (California, Connecticut, Louisiana, Maine, Minnesota, Montana, Nevada, New Hampshire, New Mexico, North Dakota, Ohio, South Carolina, South Dakota, Washington, West Virginia, Wisconsin, Idaho, Kansas, Texas, and Utah) have either abolished tenancy by the entirety or only refer to that type of property ownership in statutes based on uniform acts. *Id.*

33 *See, e.g.*, *In re Williams*, 104 F. 3d 688 (4th Cir. 1997); *In re Cross*, 255 B.R. 25 (Bankr. N.D. Ind. 2000).

34 The value of the exemption may be the value of the equity in the property less the mutual debt owed by the debtor and non-debtor spouse. 9A AM. JUR. 2D *Bankruptcy* § 1463.

35 *In re Campbell*, 214 B.R. 411, 414 (M.D. Fla. 1997). The law in those states generally provides that the property held by a husband and a wife as tenants by the entirety belongs to neither individual spouse, but rather to a separate entity referred to as the "unity" or the "marriage." *Id.* at 413.

36 9B AM. JUR. 2D *Bankruptcy* § 1701. Section 363(h) has been held not to violate the Takings Clause of the United States Constitution as applied to a Chapter 7 debtor's non-debtor spouse. *Id.* (citing *In re Bernier*, 176 B.R. 976 (Bankr. D. Conn. 1995)).

37 9B AM. JUR. 2D *Bankruptcy* § 1702 (citing *In re Shaw*, 5 B.R. 107 (Bankr. M.D. Tenn. 1980) and *In re Thomas*, 14 B.R. 423 (Bankr. N.D. Ohio 1981)).

38 *Id.* (citing *In re Persky*, 893 F.2d 15 (2d Cir. 1989)).

39 *Himmelstein*, 203 B.R. at 1015 (citing *Moore v. Bay*, 284 U.S. 4, 5 (1931)).

State law governs the determination of the interests of the debtor and the non-debtor spouse or concurrent owner.

The analysis is more complicated when the property is held by the entirety. In those instances, most jurisdictions that hold that properties held by the entirety may be reached by joint creditors also hold that such property should be distributed among only the joint creditors.⁴⁰ Under that scenario, the trustee is generally authorized to liquidate the entireties property for the benefit of the joint creditors of the individual debtor and that debtor's non-filing spouse.⁴¹ Any balance from the proceeds of the entireties property after satisfying joint debts would be exempt.⁴² Other courts, conversely, have distributed the entireties property among all creditors.⁴³

F. Conclusion

The automatic stay generally precludes a surety from enforcing its judgment against property concurrently owned by a debtor and non-debtor as that property is normally included in the bankruptcy estate. A debtor, however, can claim an exemption on property that is held as either a tenant by the entirety or joint tenant provided that the property is exempt from process under the governing state law. Stated differently, certain concurrently owned property that is exempt from process under applicable state law is generally also exempt from the bankruptcy estate. If exempt, a surety would generally have no recourse against the property.

In order to avoid a debtor's claimed exemption to concurrently owned property, a surety is permitted to object to the claimed exemption. The viability of the

objection would be dependent on the applicable state law. In many instances, a surety can succeed in avoiding a claimed exemption when the subject property is concurrently owned by a debtor indemnitor and another indemnitor. In certain jurisdictions, however, a debtor will be permitted to claim an exemption to concurrently owned property irrespective of whether the non-debtor owner is jointly liable for the debt.

Once concurrently owned property is deemed property of the bankruptcy estate, the property may be sold. The applicable state law determines the interests of the debtor and non-debtor for purposes of allocating the proceeds of the sale. The proceeds that remain in the bankruptcy estate can be distributed to the surety and the other creditors in accordance with the Bankruptcy Code's distribution scheme.

The distribution, however, becomes more complex when the property is held by the entirety. Under that situation, the majority of jurisdictions limit the distribution of the proceeds from the sale of the property to only the joint creditors of the individual debtor and non-debtor. In those jurisdictions, therefore, a surety would generally be entitled to share in the proceeds from the sale of property concurrently owned by its debtor indemnitor and its non-debtor indemnitor. Conversely, in these same jurisdictions, a surety may be precluded from sharing in the proceeds from a sale of property concurrently owned by a non-indemnitor. ⚖️

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⁴⁰ In re Garner, 952 F. 2d 232 (8th Cir. 1991); In re Lyon, 2011 WL 5299229 (Bankr. W.D.N.C. 2011); In re Raynard, 354 B.R. 834 (6th Cir. BAP 2006); *Himmelstein*, 203 B.R. 1009; In re Cochrane, 178 B.R. 1011 (Bankr. D. Minn. 1995).

⁴¹ In re Strausbough, 426 B.R. 243, 247 (Bankr. E.D. Mich. 2010).

⁴² *Himmelstein*, 203 B.R. at 1016.

⁴³ In re Boyd, 121 B.R. 622 (Bankr. N.D. Fla. 1989); *see also* In re Raynard, 327 B.R. 623 (Bankr. W.D. Mich. 2005).

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