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MARITAL PROPERTY LIABILITY ISSUES AND PROPERTY OF THE BANKRUPTCY ESTATE (WHAT COMES IN UNDER THE SECTION 541(a)(2) TENT)

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TABLE OF CONTENTS

- I. INTRODUCTION 1
 - A. Section 541(a)(2) 1
 - B. Spousal Debt and Property of the Bankruptcy Estate 1
 - C. Purpose 1

- II. MARITAL PROPERTY CHARACTERIZATION 1
 - A. Article XVI, Sec. 15 2
 - B. The True Test for Community 2
 - C. Traditional Means of Creating Separate Property 2
 - D. 1980 Amendment..... 3
 - E. 1987 Amendment..... 3
 - F. 1999 Amendment..... 3
 - G. Community Presumption 4
 - H. Quasi-Marital Property 4
 - I. Personal Injury Recoveries 4
 - J. Observations 5

- III. MANAGEMENT OF MARITAL PROPERTY 5
 - A. Matrimonial Property Act, 1967 5
 - B. Texas Family Code 5
 - C. Special Community 6
 - D. Presumptions..... 6

- IV. MARITAL PROPERTY LIABILITY 6
 - A. Texas Family Code 6
 - B. Other Factors 7
 - C. Legislative Mandate..... 8
 - D. Summary 8
 - E. Warning to Creditors Acting Unilaterally..... 9

- V. PROPERTY OF THE BANKRUPTCY ESTATE AND THE CLAIM OF EXEMPTIONS 9
 - A. Exemption Claims 9
 - B. 11 U.S.C. Section 522..... 9
 - C. In re Thompson and In re Kim..... 10

- VI. MISNOMER OF COMMUNITY DEBT 11
 - A. A Mockery 11
 - B. *Cockerham v. Cockerham* 12
 - C. Prof. McKnight’s Explanation..... 13
 - D. Bottom Line 13

- Hypothetical 14-16

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I. INTRODUCTION

What is property of the bankruptcy estate under 11 U.S.C. Section 541(a)(2)? The question sounds simple enough. Yet, it can become rather complicated if the debtor is married (while there is a joint case, there are two separate and distinct bankruptcy estates). Or, perhaps only one spouse files. Further, since there is no such animal as community debt in Texas, what property rights of the filing and non-filing spouse are impacted. There is his debt, there is her debt, and there is their debt. Yet, there is also his property, her property and their property. Debtors tend to be all over the board in the presentation of property of the estate in the schedules, with many of the approaches being dubious in accuracy.

A. Section 541(a)(2)

Commencement of a case under 11 U.S.C Sections 301, 302, or 303 creates a bankruptcy estate. 11 U.S.C Section 541 sets forth what type of property constitutes the bankruptcy estate. 11 U.S.C Section 541(a)(2) provides that the debtor's bankruptcy estate shall consist of the 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 interest is so liable. (Note: The remaining provisions of 11 U.S.C Section 541 relating to property of the estate is beyond the focus of this paper.

B. Spousal Debt and Property of the Bankruptcy Estate

Therefore, the property of the bankruptcy estate analysis is dependent upon state law. *Butner v. United States*, 440 U.S. 48, 54, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979). In turn, the state law analysis is centered upon property liability issues, and necessarily involves the following queries:

(1) Whose debt is it? It is either the debt of the husband, the debt of the wife, or both spouses' debt.

(2) When was the debt incurred? It was incurred either prior to or during the marriage.

(3) What type of debt is it? It is either tortious in nature or contractual in nature.

(4) Are there any other substantive, non-marital rules of law which would make one spouse personally liable for the debts of the other spouse?

C. Purpose

Accordingly, the purpose of this paper is to assist a practitioner to accurately complete Schedule A (real property includable in the debtor's bankruptcy estate), Schedule B (personal property includable in the debtor's bankruptcy estate), and Schedule C (property concerning which the debtor can claim an exemption), with the gathering arms of 11 U.S.C Section 541(a)(2) in mind. Therefore, the above four questions must be answered with the Texas Constitution, Texas Family Code the Texas Property Code, and Texas case law primarily in mind.

II. MARITAL PROPERTY CHARACTERIZATION

The Supreme Court of Texas in *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925) and *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902) made it clear to practitioners and the legislature that it is the Texas Constitution which ultimately defines what is separate or community property and not the legislature or the parties involved. Accordingly, in order to properly characterize marital assets in Texas, it is necessary to understand the Texas Constitution.

A. Article XVI, Sec. 15

All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; provided that persons about to marry and spouses, without the intention to defraud preexisting creditors, may by written instrument from time to time partition between themselves all or part of their property, then existing or to be acquired, or exchange between themselves the community interest of one spouse or future spouse in any property for the community interest of the other spouse or future spouse in other community property then existing or to be acquired, whereupon the portion or interest set aside to each spouse shall be and constitute a part of the separate property and estate of such spouse or future spouse; spouses may also from time to time, by written instrument, agree between themselves that the income or property from all or part of the separate property then owned or which thereafter might be acquired by only one of them, shall be the separate property of that spouse; and if one spouse makes a gift of property to the other that gift is presumed to include all the income or property which might arise from that gift of property; spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse; and spouses may agree in writing that all or part of the separate property owned by either or both of them shall be the spouses' community property.

B. The True Test for Community

It is important to note that the Constitution does not define community property. *Arnold v. Leonard*, supra, explained the significance of the Texas constitutional approach to characterization: if an asset does not fall within the constitutional definition of separate property, it must be community property — "the rule of implied exclusion." A logical extension of this rule leads to a more practical definition for the term "community property": that property of the marriage which is not proven to be separate property. See II.G, infra.

The court in *Graham v. Franco*, 488 S.W. 2d 390 (Tex. 1972), resorted to a more historical Spanish/Mexican approach and affirmatively defined community property as ". . . that property is community which is acquired by the works, efforts, or labor of the spouses. . . ." See also *Whittlesey v. Miller*, 572 S.W.2d 665 (Tex. 1978); *Bounds v. Caudle*, 560 S.W.2d 925 (Tex. 1977).

Absent an agreement of the parties and notwithstanding these cases, the author is of the opinion that "the rule of implied exclusion" remains the true test of what is community property. The affirmative test mentioned in *Graham* has been used only in those situations where the implied exclusion rule would have worked an awkward result such as in personal injury recoveries.

C. Traditional Means of Creating Separate Property

Consequently, the first step of characterization is ascertaining the facts and circumstances surrounding the acquisition of an asset -- "the inception of title rule." *Creamer v. Briscoe*, 109 S.W. 911 (Tex. 1908). The second step is determining whether those facts and circumstances place the asset within the definition of separate property. Prior to the 1980 Amendment to Art. XVI, Sec.15, there were limited means of creating separate property in Texas. Separate property was limited to:

1. PREVIOUSLY EXISTING

Property owned prior to marriage. Tex. Fam. Code Sec. 3.001.

2. GRATUITOUS TRANSFERS

Property acquired during marriage by gift, devise or descent. Tex. Fam. Code Sec. 3.001.

3. TRACEABLE MUTATIONS

Property acquired during marriage which was traceable as a mutation of previously owned separate property. *Love v. Robertson*, 7 Tex. 6 (1851).

4. MARITAL PARTITIONS

Property resulting from the partition of presently existing community property. Tex. Fam. Code Sec. 4.102.

5. CERTAIN CREDIT ACQUISITIONS

Property acquired on credit during marriage is separate property if the creditor agreed to look only to separate property for repayment. *Broussard v. Tian*, 156 Tex. 371, 295 S.W.2d 405 (1956). See IV, *infra*.

6. CERTAIN PERSONAL INJURY RECOVERIES

Personal injury recoveries (other than for loss of earning capacity). Tex. Fam. Code Sec. 3.001.

D. 1980 Amendment

The 1980 amendment to Art. XVI, Sec. 15 authorized the creation of separate property in new ways:

1. PREMARITAL PARTITIONS

Persons intending to marry can partition and exchange community property not yet acquired. See also Tex. Fam. Code Sec. 4.003.

2. SPOUSAL PARTITIONS

Spouses may now partition and exchange not only presently existing community property but also community property not yet in existence into the spouses' separate properties. See also Tex. Fam. Code Sec. 4.102.

3. INCOME FROM SEPARATE PROPERTY

Spouses may also agree that income from one spouse's separate property will be that spouse's separate property. See also Tex. Fam. Code Sec. 4.103.

4. SPOUSAL DONATIONS

A gift by one spouse to the other spouse will be presumed to include the income generated by the donated property so that both the gift and the future income from the gift are the donee spouse's separate property. See also Tex. Fam. Code Sec. 3.005.

E. 1987 Amendment

The 1987 amendment to Art. XVI, Sec. 15 did not authorize a new way to create separate property. It simply allowed spouses to create survivorship rights with their community property.

F. 1999 Amendment

The 1999 amendment to Art. XVI, Sec. 15 permitted spouses to convert by agreement separate property into community property beginning on January 1, 2000.

G. Community Presumption

Notwithstanding the significance of the substantive rules of characterization, the importance of the community presumption cannot be ignored. Generally, all assets of the spouses on hand

during the marriage and upon its termination are presumed to be community property, thereby placing the burden of proof on the party (e.g., a spouse, or that spouse's personal representative, or the heirs/devisees of the spouse) asserting separate character to show by "clear and convincing evidence" that a particular asset is, in fact, separate. Tex. Fam. Code Sec. 3.003. A "clear and convincing evidence" standard is somewhere between "preponderance" and "reasonable doubt". *Faram v. Gervitz-Faram*, 895 S.W.2d 839 (Tex. App.—Ft. Worth 1995, no writ). However, the Texas Supreme Court has held that the requirement of a clear and convincing evidence standard is another way of stating that a legal conclusion must simply be supported by factually sufficient evidence. See *Meadows v. Green*, 524 S.W.2d 509, 510 (Tex. 1975), (A decision prior to the 1987 amendment to the predecessor to Sec. 3.003 which codified the clear and convincing evidence standard.)

1. MANAGEMENT PRESUMPTION

The fact that an asset is held in one spouse's name only, or is in the sole possession of a particular spouse, is not determinative of its marital character and only raises a presumption that the asset is subject to that spouse's sole management and control while the community presumption dictates it is presumptively community. Tex. Fam. Code Sec. 3.104.

2. FORM OF TITLE

The fact that record title is held in a particular way due to certain circumstances may cause the community presumption to vanish in favor of a rebuttable separate presumption. See *Smith v. Strahan*, 16 Tex. 314 (1856); *Higgins v. Johnson's Heirs*, 20 Tex. 389 (1857); *Story v. Marshall*, 24 Tex. 305 (1859). The other spouse may not be allowed to rebut the presumption if that spouse was a party to the transaction. *Lindsay v. Clayman*, 151 Tex. 593, 254 S.W.2d 777 (1952).

H. Quasi-Marital Property

According to the Texas Family Code, the separate property of a spouse which was acquired while the spouses were not residing in Texas, but what would have been community had they resided in Texas at the time of acquisition, will be treated in a divorce proceeding as if it were community property. Tex. Fam. Code Sec. 7.002. See *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982). A 2003 amendment to Sec. 7.002 treats as separate property any community property that was acquired while the couple resided in another state that would have been separate had they resided in Texas at the time of its acquisition. Quasi-community property is still treated as separate if the marriage terminates by reason of a spouse's death. *Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987). Presumably "quasi-separate" property would be treated as community property if the marriage terminates by reason of a spouse's death, if the reasoning of the *Hanau* case, *supra*, is followed.

I. Personal Injury Recoveries

Personal injury recoveries for loss of earning capacity during marriage are defined as community property. Tex. Fam. Code Sec. 3.001(3). Notwithstanding this statutory provision, the author is of the opinion that actual "lost earnings" should be deemed community property while "loss of earning capacity" should be considered separate property. Lost earnings are properly characterized as community property since the community estate will be liable for payment of medical expenses and will suffer as a result of losing one spouse's community earnings. However, characterizing the recovery for lost earning capacity as community property requires a presumption that the husband and wife will remain married indefinitely. In reality, should the spouses divorce following the injury, community recoveries will be divided on a just and right basis; or should the non-injured spouse die, his estate will be entitled to one-half of the entire recovery. Since the primary purpose of a personal injury recovery is to compensate the injured spouse, classifying lost earning capacity as community property and giving the non-

injured spouse a one-half interest therein may leave the injured spouse with only a fraction of the amount awarded. The potential for such a situation clearly warrants a distinction between lost earnings and lost earning capacity which characterizes the former as community and the latter as separate.

J. Observations

Today, in order to properly characterize the assets that become property of the bankruptcy estate, the practitioner will need to be thoroughly familiar with the ever changing rules of characterization and be alert to the possibility that in either a premarital or marital agreement the parties changed the legal result. For example, income from separate property is not always community property.

III. MANAGEMENT OF MARITAL PROPERTY

Unlike characterization, rules relating to the management of marital property are within the rulemaking authority of the legislature. *Arnold v. Leonard*, supra. During the marriage, the Texas Family Code prescribes which spouse has management powers over the marital assets.

A. Matrimonial Property Act, 1967

Historically in Texas, the husband managed not only the community property of the marriage but also the separate property of both spouses. A women's rights reform movement began in 1913 with the gradual expansion over the next fifty years of the wife's right to manage her own separate property and personal earnings. One of the early changes was to grant to the wife the right to manage her own personal earnings and the income from her separate property. This reform movement culminated in 1967 when both spouses were granted separate but equal rights in the management of their respective separate properties. The Matrimonial Property Act of 1967 also granted women for the first time the right to manage their special community property and equal rights with their husbands to manage their joint community property. This reform movement also introduced a complementary system of divided liability of community property, which also incorporated two related, but separate concepts: (i) liability of property and (ii) the personal liability of a spouse. These concepts were initially codified as Sections 5.61 and 5.62 of the Texas Family Code enacted in 1969, effective Jan. 1, 2000, and are codified currently as Sections 3.201, 3.202 and 3.203 of the Texas Family Code. See Joseph W. McKnight, "Recodification and Reform of the Law of Husband and Wife" (Texas Bar Journal, Jan. 1970).

B. Texas Family Code

1. SEPARATE PROPERTY

Each spouse has sole management, control and disposition of his or her separate property. Tex. Fam. Code Sec. 3.101.

2. SOLE MANAGEMENT COMMUNITY PROPERTY

Each spouse has sole management, control and disposition of the community property that he or she would own, if single, including personal earnings, revenue from separate property, recoveries for personal injuries and increases and revenues from his or her "special community property." Tex. Fam. Code Sec. 3.102(a).

3. JOINT MANAGEMENT COMMUNITY PROPERTY

All other community property is subject to both spouses' joint management, control and disposition – "the joint community property." Tex. Fam. Code Sec. 3.102(b).

C. Special Community Property

The term “special community property” was originally defined by Texas courts as that portion of the community estate which was under the wife’s exclusive control and not liable for the husband’s debts following the landmark decision of *Arnold v. Leonard*, supra, where the Texas Supreme Court held that the legislature could not define the rents and revenue from the wife’s separate property and her personal earnings as her separate property, but could exempt those assets, her “special community property,” from his debts. *Moss v. Gibbs*, 370 S.W.2d 452 (Tex. 1963). Today, it is common practice to refer to the community assets subject to either spouse’s “sole management, control and disposition” under Section 3.102(a) as his or her “special community property.” One spouse’s special community property is generally not liable during the marriage for the other spouse’s contractual debts or any debts of the other spouse that were incurred prior to marriage. See *Patel v. Kuciemba*, 82 S.W.3d 589 (Tex. Civ. App. Corpus Christi, 2002 pet. denied) and IV, A.2., infra.

D. Presumptions

Notwithstanding the community presumption of Section 3.003, an asset titled in one spouse’s name (or is untitled but is in the sole possession of one spouse) is presumed to be subject to that spouse’s sole management and control. Tex. Fam. Code _ 3.104. See II, G supra. Thus, an asset held in either spouse’s name is presumed to be that spouse’s special community property.

IV. MARITAL PROPERTY LIABILITY

In *Arnold v. Leonard*, supra, the Texas Supreme Court held that “. . . the Legislature may rightfully place such portions of the community as it deems best under the wife's separate control, and . . . it may likewise exempt the same from payment of the husband's debts, without the exemption being open to successful constitutional attack by either the husband or his creditors." Prior to the Matrimonial Property Act of 1967, Texas law was relatively simple. The husband was generally personally liable for all community debts, and the wife was not. See *Leatherwood v. Arnold*, 66 Tex. 414, 1 S.W. 173(1886). Further, all community property other than the wife’s special community property was liable for the husband’s debts. *Arnold v. Leonard*, supra. The rules changed when the legislature passed the Matrimonial Property Act of 1967 and codified its concepts into the Texas Family Code.

A. Texas Family Code

The legislature's basic rules of marital property liability are found in Sec. 3.202 and Sec. 3.203 of the Texas Family Code.

1. SEPARATE PROPERTY EXEMPTION

A spouse's separate property is not subject to the liabilities of the other spouse. Tex. Fam. Code Sec. 3.202(a).

2. SPECIAL COMMUNITY EXEMPTION

A spouse's special community property is not subject to any of the liabilities incurred by the other spouse prior to the marriage or any nontortious liabilities of the other spouse incurred during the marriage. Tex. Fam. Code Sec. 3.202(b).

3. OTHER RULES OF LAW

The above exemptions exist unless both spouses are personally liable under "other rules of law." Tex. Fam. Code Sec. 3.202(a) and (b).

4. CREDITOR'S RIGHTS

A spouse's separate property and special community property and the spouses' joint community property are subject to any liabilities of that spouse incurred before or during the marriage. In addition, the special community estates of both spouses are subject to the tortious liabilities of either spouse incurred during marriage. Tex. Fam. Code Sec. 3.202 (c) and (d).

5. ORDER OF EXECUTION

A judge may determine, as deemed just and equitable, the order in which particular separate or community property is subject to execution and sale to satisfy a judgment. In determining the order, the court is to consider the facts and circumstances surrounding the transaction or occurrence on which the debt is based. Tex. Fam. Code Sec. 3.203.

B. Other Factors

1. JOINT OBLIGATIONS

Of course, both spouses may sign a contract or commit a tort which would make them jointly and severally liable and thereby subjecting all of the marital assets to liability.

2. VICARIOUS LIABILITY

The law has defined situations where any person can be held personally liable for certain acts of another. These situations include the following relationships: respondeat superior, principal/agency, partnership, joint venture, etc. These special relationships can exist between husband and wife and can impose vicarious liability on an otherwise innocent spouse. See *Lawrence v. Hardy*, 583 S.W.2d 795 (Tex. App.—San Antonio 1979, writ ref'd n.r.e.). However, the marriage relationship alone is not sufficient to generate vicarious liability. Tex. Fam. Code Sec. 3.201.

3. DUTY TO SUPPORT

Each spouse has a duty to support the other spouse and a duty to support a child generally for so long as the child is a minor and thereafter until the child graduates from high school. Tex. Fam. Code Secs. 2.501 and 154.001. Accordingly, all marital assets are liable for such "necessaries." Prior to 2007 legislation, unless otherwise agreed in writing or ordered by a court, a parent's child support obligation ended when the parent died. SB 617 (2007) amended the family code to provide that court ordered child support obligations survive the obligor's death. Tex. Fam. Code Sec. 154.006. New sections of the family code now also provide that the obligor's child support obligations will be accelerated upon the obligor's death and a liquidated amount will be determined using discount analysis and other means. Tex. Fam. Code Sec. 154.015. An amendment to the probate code makes the liquidated amount a class 4 claim. Tex. Prob. Code Sec. 322. The court can also require that the child support obligation be secured by the purchase of a life insurance policy. Tex. Fam. Code Sec. 154.016.

4. TAX LIABILITY

Because each spouse only owns one-half of the community income, notwithstanding the rules of management, if the spouses file separate income tax returns, each spouse is to report one-half of his/her community income and one-half of the other spouse's community income, thereby becoming personally liable for the tax liability of one-half of the total community income. However, it appears as if the IRS can attach (i) one-half of the special community property of the other spouse and (ii) all of the deficient spouse's special community property to satisfy the tax liability of the deficient spouse. See *Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989).

5. EXEMPT PROPERTY

Of course, the family homestead and certain items of personal property are generally exempt from most debts, notwithstanding the Family Code rules. Tex. Prop. Code Secs. 41.001 and 42.001. Such exemptions may extend beyond the death of the owner if the owner is survived by a constituent family member. Sec. 42.0021 of the Texas Property Code also exempts certain retirement benefits.

6. EFFECT OF DEATH

The death of a spouse can change the statutory framework of marital property liability. For example, the Texas Probate Code appears to allow the decedent's one-half interest in the other spouse's special community property to be reached in order to satisfy a nontortious debt incurred during marriage by the decedent. See VII, *infra*.

C. Legislative Mandate

As previously noted, the legislature prescribes a logical liability system which depends on a multiple step process to determine which assets are liable for which debts:

1. Whose debt is it? It is either the debt of the husband, the debt of the wife or both spouses' debt.
2. When was the debt incurred? It was incurred either prior to or during the marriage.
3. What type of debt is it? It is either tortious in nature or contractual.
4. Are there any other substantive, non-marital rules of law which would make one spouse personally liable for the debts of the other spouse?

After answering these four questions, one can look to Sec. 3.202 and Sec. 3.203 for the proper result.

D. Summary

The bankruptcy estate created under 11 U.S.C Section 541(a)(2) includes property the debtor manages under state law or property that is liable for a debt of the debtor under state law. Therefore, the analysis of whether an asset is property of the estate is summarized as follows:

1. A debtor's separate property and special community property, as well as the joint community property, are liable for the debtor's debts and are therefore property of the bankruptcy estate. If the liability is a tort debt incurred during the marriage, the debtor's spouse's special community property is also liable for the debt and is property of the bankruptcy estate.

2. If the debt is not a tort debt (that is, contractual in nature) incurred during the marriage, the other debtor's spouse's separate property and special community property are exempt from the debt and not property of the bankruptcy estate (unless the other spouse is personally liable under other rules of law). In the event of liability under "other rules of law," the debtor's spouse's property (i.e., that spouse's special community and separate) is liable as well and would be part of the bankruptcy estate of the debtor. See IV, B *supra*.

3. The hypothetical set forth at the end of this paper illustrates the above considerations. The completion of Schedules A, B and C of the bankruptcy schedules must be a reasoned presentation of what actually constitutes the bankruptcy estate of the debtor.

E. Warning to Creditors Acting Unilaterally

1. However, a creditor should be extremely careful about taking actions against property based on the unilateral determination that the property is not property of the bankruptcy estate. In *In re Chesnut*, 300 B.R. 880 (Bankr. N.D. Tex. 2003), Judge D. Michael Lynn was faced with the following fact situation: 1) Wife purchased real property and the deed recited she owned it as her “sole and separate property and estate,” and wife alone signed all the relevant documents (note and deed of trust) relating to the transaction; 2) Wife defaulted on the note payments and the secured creditor noticed the property for a foreclosure sale; 3) Husband filed bankruptcy (Wife did not file); 4) Husband listed the secured creditor as a creditor of his bankruptcy estate; and 5) secured creditor, though on notice of the filing of Husband’s bankruptcy proceeding, foreclosed on the property after Husband’s bankruptcy filing (and without bankruptcy court permission) on the belief that it was Wife’s separate property and therefore not property of Husband’s bankruptcy estate.

2. The bankruptcy court did not make a determination of the characterization of the real property (whether separate property or community property), but concluded that the secured creditor violated the automatic stay since it was on notice that Husband claimed an interest in the property. The secured creditor appealed and the federal district court reversed after concluding that the real property was the separate property of Wife, not property of the Husband’s bankruptcy estate, and not subject to the automatic stay. In *re Chesnutt*, 311 B.R. 446, 450 (N.D. Tex. 2004). The debtor appealed and the Fifth Circuit Court of Appeals reversed the district court and affirmed the bankruptcy court, concluding that the real property was “arguable property” of the bankruptcy estate and that the automatic stay protected the real property from unilateral action. *Brown v. Chesnutt*, 422 F.3d 298, 306 (5th Cir. 2005).

3. It is interesting to note that the most likely characterization of the real property, based on the fact situation presented, is either Wife’s separate property or Wife’s special community property. Assuming that the debts listed in Husband’s bankruptcy proceeding were non-tortious, the real property ultimately would not have been properly included in Husband’s bankruptcy estate. Therefore, the case should be instructive to creditors to proceed with caution and to seek bankruptcy court approval rather than acting unilaterally, even if the creditor is confident that the property is not property of the bankruptcy estate.

V. PROPERTY OF THE BANKRUPTCY ESTATE AND THE CLAIM OF EXEMPTIONS

A. Property constituting property of the bankruptcy estate under 11 U.S.C. Section 541 remains in the estate until the debtor’s exemptions are allowed under F.R.B.P. 4003(b) [or until the property is removed through abandonment or otherwise]. Federal bankruptcy law determines a debtor’s ability to claim exemptions. An exemption is an interest withdrawn from property of the bankruptcy estate for the benefit of the debtor. *Owen v. Owen*, 500 U.S. 305, 308, 111 S.Ct. 1833, 114 L.Ed.2d 350 (1991).

B. 11 U.S.C. Section 522 determines what property of the bankruptcy estate can be exempted by debtors. 11 U.S.C. Section 522(b)(2) allows states to prohibit debtors in bankruptcy from choosing the federal exemptions set forth in 11 U.S.C. Section 522(d) [most states have “opted out” and forced debtors to use the exemptions of that state]; however, Texas allows debtors to choose either the federal or state exemptions. In *In re Kim* (Case No. 07-36293-hdh11; Adv. No. 08-03440), a decision by Bankruptcy Judge Harlin D. Hale (Northern District of Texas, Dallas Division), the court noted that the term “state exemptions” is a misnomer since “it is federal law that gives the debtors the power to exempt property out of the estate in Section 522, gives the states the power to opt-out in Section 522(b)(2), and determines the applicable state law under Section 522(b)(3).”

C. A large number of consumer cases involve married couples. Often, the married couple files a joint case under 11 U.S.C. Section 302(a). 11 U.S.C. Section 302(b) states, “After commencement of a joint case, the court shall determine the extent, if any, to which the debtors’ estates shall be consolidated.” In the event the cases are not consolidated, each debtor in a joint case has a separate estate consisting only of property in which such debtor has an interest. See *In re Cohen*, 263 B.R. 724 (Bankr. D.N.J. 2001). This rationale is consistent with 11 U.S.C. Section 522(m) relating to the claim of exemptions, which states that Section 522, “shall apply separately with respect to each debtor in a joint case.” See *In re Cohen*. Two cases by local bankruptcy courts illustrate the interaction between what constitutes property of the bankruptcy estate and what property can be exempted under Section 522.

1. *In re Thompson*, Case No. 03-92057-dml7 -- In *In re Thompson*, a decision by Bankruptcy Judge D. Michael Lynn (Northern District of Texas, Fort Worth Division), the court considered a joint case filing in which Mrs. Thompson attempted to claim a federal wildcard exemption on real estate that had been inherited by Mr. Thompson. The chapter 7 trustee objected to the exemption, claiming that the debtor could not exempt property that is not property of the debtor’s estate. Applying 11 U.S.C. Section 542(a)(2), the separate real property of Mr. Thompson was property of his bankruptcy estate (since it is liable for his debts), but was not property of the bankruptcy estate of Mrs. Thompson (since it is not liable for her contractual or tortious debts). As such, Judge Lynn concluded that “the federal ‘wildcard’ exemption is only allowed to the extent of the debtor’s interest in the property such debtor seeks to exempt from the bankruptcy estate” and that “because [Mrs.] Thompson has no interest in the [husband’s separate property], she may not utilize section 522(d)(5) to exempt the [husband’s separate property] from her bankruptcy estate.”

2. *In re Kim* (Case No. 07-36293-hdh11; Adv. No. 08-03440) -- In *In re Kim*, Judge Hale faced an interesting interplay between the exemption rights of Husband (who was a debtor in bankruptcy) and the exemption rights of Wife (who was not a debtor in bankruptcy). Husband and Wife owned a homestead with a value in excess of \$1,100,000 and Husband claimed the entire homestead as exempt under the Texas exemptions allowed by 11 U.S.C. Section 522(b)(3)(A). A creditor in Husband’s bankruptcy proceeding objected to the exemption claim under 11 U.S.C. Section 522(p) [homestead exemption amount limited to \$136,875, since the homestead was purchased within 1215-day period preceding the filing of the bankruptcy], and the court found that the exemption was so limited.

a. Husband then filed an adversary proceeding in Husband’s bankruptcy proceeding seeking a declaratory judgment relating to the extent of Wife’s exempt homestead interest in the property, whether any such interest would preclude a sale of the homestead in Husband’s bankruptcy proceeding and, if such a sale occurs, whether wife is entitled to remuneration from the sale. In this regard, Wife further argued that she owned approximately 25% of the property as her separate property (or her sole management community property) since it was purchased with proceeds from a distribution to her from a family limited partnership.

b. Judge Hale held the following at a summary judgment hearing relating to these issues: 1) The exemption limitation found in 11 U.S.C. Section 522(p) was intended by Congress to override the state exemption; 2) Wife does not have an independent right to claim an exemption as a non-debtor, since “only the debtor may exempt property that has become property of the estate, which effectively eliminates the rights of a non-debtor spouse to manage and control community property;” 3) the homestead exemption that would have been afforded Wife under state law “does not create a vested property interest that would provide an argument for

compensation” ... “that would prevent the sale of the property;” and 4) the approximate 25% interest in the property claimed to be the separate property (or special community property) of Wife may not be property of Husband’s bankruptcy estate if it is properly classified as Wife’s separate property or Wife’s special community property; however, the court did not rule on this issue since the evidence was insufficient to make a determination on a summary judgment basis.

VI. THE MISNOMER OF “COMMUNITY DEBT”

Despite the plain import of the statutory plan enacted by the legislature, some courts continue to create confusion for the practitioner by referring to the term “community debt” or “community obligation” as if the community was an entity separate and apart from the spouses, which “entity” could own property and incur debts. Similarly, some courts still rely on opinions expressed in cases decided prior to the Matrimonial Property Act of 1967 and the subsequent enactment of the Texas Family Code.

A. A Mockery

A recent Texas court of appeals decision stated: “Unless it is shown that [a] creditor agreed to look solely to the separate estate of the contracting spouse for satisfaction, Section 3.201 has no effect on the long standing presumption that debts contracted during the marriage are presumed to be on the credit of the community and, thus, are joint community obligations.” *Mock v. Mock*, 216 S.W.3d 370, 374 (Tex. App. _Eastland 2006, pet. denied).

1. SECTION 3.201

Again, a Texas court ignores the legislative mandate of the Texas Family Code. Section 3.201 limits the personal liability of one spouse for the debts of the other spouse to only situations where (i) the debtor spouse incurs the debt acting as the agent of the other spouse or (ii) the debtor spouse incurs a debt for “necessaries.” Further, the marital relationship, in and to itself, does not create a principal/agency relationship among the spouses. See IV, B supra.

2. THE SO CALLED PRESUMPTION

There is no presumption that debts contracted during the marriage are on the credit of the community and joint community obligations. The long standing presumption is that property acquired on credit is community property unless the creditor agreed to look only to the acquiring spouse’s separate property for satisfaction. See II, C, 5, supra. The *Mock* court’s statement conflicts directly with Section 3.201 and is inconsistent with today’s legislative marital liability mandate. (Recall, the Texas Supreme Court has held that marital liability is defined by the legislature. See *Arnold v. Leonard* 114 Tex. 535, 273 S.W.799 (1925)) *Mock*’s inaccurate statement is misleading dicta.

3. THE REAL ISSUE

The actual issue before the court in *Mock* was whether a divorce court could order a wife to pay her husband’s credit card debts out of the joint community property and the husband’s special community property (the divorce court had already properly awarded the joint community and husband’s special community property to the wife). The court of appeals held that the trial court did not err in so ordering the wife to pay the husband’s debts under the circumstances.

4. ERRONEOUS STATEMENTS

Nevertheless, the court included the misleading quote referring to the “long standing presumption”, citing as its authority, *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975) (Recall, *Arnold v. Leonard* was ignored in the majority opinion of the *Cockerham* decision). *Mock* also cites *Kimsey v. Kimsey*, 965 S.W.2d 690, 702 (Tex. App. _El Paso 1998, pet. denied)

which cites Cockerham as its authority, as well as other court of appeals decisions which cite Cockerham. Cockerham is the source of all of this confusing and misleading rhetoric.

B. COCKERHAM v. COCKERHAM

In *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975), the Texas Supreme Court stated that ". . . debts contracted during marriage are presumed to be on the credit of the community and thus are joint community obligations, unless it is shown the creditor agreed to look solely to the separate estate of the contracting party for satisfaction." The Cockerham court erroneously cited as its authority for the concept of "community debt" the cases of *Broussard v. Tian*, 156 Tex. 371, 295 S.W.2d 405 (1956) and *Gleich v. Bongio*, 128 Tex. 606, 99 S.W.2d 881 (1937).

1. BROUSSARD & GLEICH

A review of *Broussard* and *Gleich* reveals that both cases were characterization cases, not liability cases, where the courts explain that property acquired during the marriage on credit is community absent a showing that the creditor agreed to look only to the decedent's separate property for satisfaction. The Texas Supreme Court had earlier explained why property acquired on credit is generally community property. It is because the status of property is determined at the time the loan was secured, and such a transaction is not an exchange of separate property and the property acquired was not acquired by gift, device or descent. Thus, it is community property under the "rule of implied exclusion." *Heidenheimer v. McKeen* 63 Tex. 229 (1885).

Gleich simply confirms that property acquired on credit is presumptively community property. The court does make references to "community obligations" and "credit of the community," but the decision is a 1951 case, prior to the 1967 change in law. *Broussard* explains the exception to the general rule that property acquired on credit is community property unless there is proof of an agreement to make the note a "separate property obligation." In other words, since a spouse's separate property cannot be the "obligor," the creditor has agreed to look only to the borrower's separate property for satisfaction (i.e., the creditor agrees not to look to any community property for satisfaction).

While the *Broussard* court again makes reference to a "community obligation," meaning absent the lender's agreement so described, community property is liable for the debt, it is important to again note that this is a pre-1967 case. At the time *Broussard* and *Gleich* were decided, the husband managed all of the community, save and except the wife's "special community property" as described in *Moss v. Gibbs*, supra. That special community of the wife was exempt from the husband's debts. See *Arnold v. Leonard*, supra. Prior to 1967, the wife was not personally liable for the husband's debts and her special community property was exempt from her husband's debts. References to "community debt" or "community obligation" were to the debts of the husband that could be satisfied out of all of the community property except the wife's special community property. "Texas statutes do not define the term "community debt." *Brooks v. Brooks*, 515 S.W.2d 730, 733 (Tex. App. Eastland 1974, writ ref'd n.r.e.) Thus, the terms "community debt" and "community obligation" must be interpreted within a particular statute or opinion within the parameters set by the time and circumstances of the issue presented.

2. COCKERHAM DISSENT

Three of Texas' most respected jurists, Thomas M. Reavely, Joe R. Greenhill and Ruel C. Walker, understood the legislative mandate, as evidenced in Justice Reavley's well-reasoned dissent in *Cockerham* where he wrote:

I had supposed that the Texas Family Code as enacted and amended by the 61st, 62nd and 63rd Legislatures places a creditor who deals with one spouse in a position where, in the event of subsequent unpaid debts and liabilities, he might not be able to reach that community property which is not held solely in the name of the spouse with whom he deals. Section 5.24 protects the creditor to the extent that he can assume the spouse has sole management of property in that

spouse's name. However, the other community property may well be under the sole management of the other spouse by the terms of § 5.22, which so specifies for property that the other spouse "would have owned if single" and which also gives effect to agreements between the spouses, whether or not the agreement is known to the creditor. If the other spouse has sole management, under § 5.61 that property is beyond the creditor's reach. If that state of the law was disturbing to creditors, they can now relax while spouses with separate estates do the worrying. The Court today seems to hold that a wife (or husband) who assents to the husband (or wife) spending community funds in a venture thereby subjects her (or his) total estate to any liability that the husband's (or wife's) venture may precipitate.

3. TOTALITY OF THE CIRCUMSTANCES

Cockerham also seemed to extend the facts and circumstances under which one spouse could be held liable for the debts of the other spouse by announcing, in effect, a "totality of the circumstances" test and thereby placed at risk all of the assets of either spouse whenever either spouse incurred a liability during the marriage, a result obviously not contemplated by the legislature in enacting the predecessor to Sec. 3.202.

4. JUDICIAL/LEGISLATIVE INCONSISTENCIES

References to "community debts" imply that the "community" is liable for the debt (i.e. all community property can be used to satisfy the debt); it also suggests that both spouses are personally liable because they are the community. This result is inconsistent with legislative mandate and the statutory plan of the Texas Family Code. For example, a wife's special community property is not liable for the husband's contractual debts unless she is liable under another substantive rule of law. Marriage itself does not create joint and several liability.

5. ANTI-COCKERHAM LEGISLATION

1987 legislation should be interpreted as putting an end to the Cockerham rules. Texas Family Code Sec. 3.201 provides that one spouse will be personally liable for the acts of the other spouse only if the other spouse acts as the agent of the otherwise innocent spouse or the other spouse incurs a debt for "necessaries." Tex. Fam. Code Sec. 3.201. In addition, the predecessor to Sec. 3.202 was amended to refer specifically to the predecessor to Sec. 3.201 in determining when one spouse's special community property would be liable for the debts of the other spouse. Hopefully, this legislation will place the determination of marital property liability where it belongs - the statutory plan of Sec. 3.202. Some court of appeals' opinions indicate that the courts understand the legislative mandate. See *Patel v. Kuciemba*, 82 S.W.3d 589 (Tex. App., Corpus Christi, 2002), "The fact that Manu and Ilaben were married As a matter of law, this cannot be evidence of apparent authority because a spouse does not act as agent for the other spouse solely because of the marriage relationship." See also *Montemayor v. Ortiz*, 208 S.W.3d 627 (Tex. App.—Corpus Christi 2006, no writ) and *Carr v. Houston Business Forms, Inc.*, 794 S.W.2d 849 (Tex. App.—Houston [14th Dist.] 1990, no writ).

C. Prof. McKnight's Explanation

Over twenty-five years ago, Professor McKnight in his annual survey of Texas Family Law, 37 S.W.L.J. 65 at 77 (1983) said: The phrase "community debt" has long been useful in characterizing borrowed money or property that a spouse buys on credit. If the lender or seller does not specifically look to the borrower's or buyer's separate property for payment, it is clear that a community debt has been incurred, and thus that the money borrowed or property bought is community property. But to take the phrase out of this context, as well as to say that the designation of such a debt as "community" makes both spouses liable for it (when only one of them has contracted it), is clearly contrary to the express terms of section 5.61. [Tex. Fam. Code Ann.] (the predecessor to Section 3.201). Under Texas law as amended and recodified in 1969, a

community debt means nothing more than that some community property is liable for its satisfaction. A community debt may at the same time be a separate debt, unless the creditor agrees to seek satisfaction from community property only. Hence when the creditor has not agreed to limit recovery from one marital estate or the other, he may proceed against either for satisfaction. Confining the term community debt to its traditional characterization context would remove a great source of confusion and discourage the tendency of some courts to find separate debts where a section 5.61 community debt was clearly intended by the parties concerned.

Note: Of course, Professor McKnight was instrumental in the drafting and enactment of the marital property laws that ushered in the Texas Family Code. It is time that all Texas courts get on board with the legislative mandate.

D. Bottom Line

Reliance on Cockerham, Broussard and Gleich, as authority for the so called “long standing presumption that debts contracted during the marriage are joint community obligations,” is reliance on a single statement in Cockerham taken out of context from Broussard and Gleich. Those two cases were decided by the Texas Supreme Court when Texas law, in a “by gone era,” held that a husband is personally liable for all community debts, that a wife is not personally liable for community debts, and further a surviving wife is not liable for community debts. See *Leatherwood v. Arnold*, 66 Tex. 414, 1. S.W. 173 (1886). Of course, *Leatherwood* was decided prior to *Arnold v. Leonard*, which led to the new concept of “wife’s special community property.” But, the point is that reliance on any pre-1967 case is not necessarily good authority to resolve an issue today involving marital property management and liability.

Hypothetical

Pat and Kris were married in 1999. Pat filed a personal chapter 11 bankruptcy proceeding since he had personally guaranteed a note for a failed business, and was liable for a deficiency claim (judgment recently entered) of \$900K. Kris decided not to file bankruptcy.

I. The marital estate

- A. Pat's separate property (PSP) - - "Pat"
 - 1. Blackacre, f/m/v \$500K, debt \$250K
 - 2. ABC common stock, f/m/v \$1M
 - 3. Partnership, insolvent, f/m/v -0-

- B. Kris' separate property (KSP) - - "Kris"
 - 1. Whiteacre, f/m/v \$400K, debt \$200K
 - 2. DEF common stock, f/m/v \$1M

- C. Their joint community property (JCP) - - "Pat and Kris"
 - 1. Greenacre, f/m/v \$1M, debt \$600K
 - 2. GHI common stock, f/m/v \$1M
 - 3. Home, f/m/v \$600K, debt \$400K
 - 4. Personalty, f/v/v \$100K

- D. Pat's special community property (PCP) - - "Pat"
 - 1. Purpleacre, f/m/v \$800K, debt \$500K
 - 2. JKL common stock, f/m/v \$1M

- E. Kris' special community property (KCP) - - "Kris"
 - 1. Redacre, f/m/v \$800K, debt \$600K
 - 2. MNO common stock, f/m/v \$1M.

II. Debts of Pat and Kris

A. "Community Debts" [THERE'S NO SUCH THING]

B. Joint debts of Pat and Kris

1. Home mortgage, \$400K
2. Hospital bills, \$100K
3. Credit cards, \$50K

C. Pat's debts

1. PSP mortgage, \$250K
2. PCP mortgage, \$500K
3. Partnership guarantee, \$200K
4. Auto accident, \$200K
5. Deficiency Judgment, \$900k
6. Tort Liability, 100k

D. Kris' debts

1. KSP mortgage, \$200K
2. KCP mortgage, \$600K
3. Unsecured note, \$100K
4. Malpractice, \$400K

Note: Both Pat and Kris were personally liable for the joint debts. Kris did not have any personal liability for Pat's debts. Pat did not have any personal liability for Kris' debts

III. Section 541(a)(2) Property of the Bankruptcy Estate (Pat)

- A. Pat's separate property
 - 1. ABC stock
 - 2. Blackacre

- B. Pat's special community property (100%)
 - 1. JKL stock
 - 2. Purpleacre

- C. Joint community property (100%)
 - 1. GHI stock
 - 2. Greenacre

- D. Kris' special community (Kris' special community property becoming property of Pat's bankruptcy estate should be limited to an exposure of \$100K [the tort liability of Pat])
 - 1. MNO stock
 - 2. Redacre