

Bankruptcy & Estate Planning:

A primer on fundamental bankruptcy principles
and examination of selected intersections
between estate planning and bankruptcy

*A presentation for the Estate Planning Council of SE
Denver*

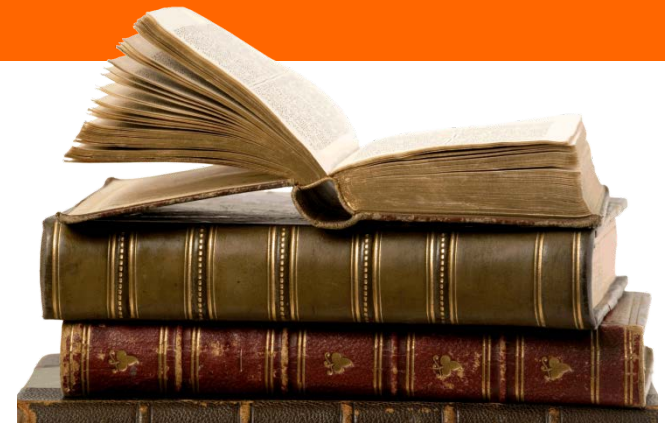
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Roadmap for Today



- ❧ Bankruptcy Overview and 5 Fundamental Bankruptcy Principles
- ❧ What is Property of the Bankruptcy Estate
- ❧ Spendthrift Provisions Inside Bankruptcy
- ❧ Property Received by Bequest, Devise or Inheritance
- ❧ Prepetition Conduct: Amendments and Disclaimers
- ❧ Fraudulent Transfer Risk to Self Settled Trusts

Primer on Fundamental Bankruptcy Principles



Bankruptcy



Why Bankruptcy?

∞ Individuals

∞ Businesses

∞ Creditors

What Does Bankruptcy Look Like?



- ❖ Chapter 7 – liquidation (individuals and entities)
- ❖ Chapter 9 – municipalities (only if authorized under state law*)
- ❖ Chapter 11 – reorganization (individuals** and entities)
- ❖ Chapter 12 – reorganization (family farmers or fishermen)
- ❖ Chapter 13 – reorganization (individuals**)
- ❖ Chapter 15 – cross-border insolvencies (individuals and entities)

* Only 18 states, including Colorado, have enacted legislation to authorize municipal bankruptcy filings. *See* Colo. Rev. Stat. §§ 32-1-1403, 37-32-102 (regarding taxing, irrigation and drainage districts).

** Eligibility for Chapter 13 requires the individual debtor's unsecured debts not exceed \$394,725 and secured debts not exceed \$1,184,200. *See* 11 U.S.C. § 109(e). If the individual debtor's debts exceed these limits, then the debtor may only seek relief under Chapter 7 or Chapter 11.

The Key Players in Each Case

- ❖ The Debtor
- ❖ The Bankruptcy Judge
- ❖ The United States Trustee
- ❖ The Chapter 7 Trustee
- ❖ The Chapter 13 Trustee
- ❖ A Chapter 11 Trustee
- ❖ Secured Creditors
- ❖ Unsecured Creditors
- ❖ Creditors Committees
- ❖ Equity Interest Holders
- ❖ The Estate's Professionals



Fundamental Bankruptcy Principles

Creation of the “Bankruptcy Estate”

The filing of a bankruptcy petition creates an “estate” comprised of numerous property interests, wherever located and by whomever held, including:

- ❖ All legal or equitable interests of the Debtor in property.
- ❖ All interests of the Debtor and Debtor’s spouse in community property that is: (A) under the management or control of the Debtor; or (B) liable for a claim against the Debtor or Debtor’s spouse.
- ❖ Any interest in property that the Debtor acquires or becomes entitled to acquire within 180 days of the petition date if received by: (A) bequest, devise, or inheritance; (B) property settlement agreement with Debtor’s spouse; or (C) being a beneficiary under a life insurance policy or death benefit plan.
- ❖ Other broadly defined property interests.

See 11 U.S.C. § 541(a)(1)-(7).

Fundamental Bankruptcy Principles

The “Automatic Stay”

The automatic stay operates as a stay against:

- ❖ The commencement or continuation of judicial, administrative or other action or proceeding against the Debtor;
- ❖ The enforcement of a prepetition judgment against the Debtor or property of the estate;
- ❖ Any act to obtain possession of, or exercise control over, property of the estate;
- ❖ Any act to create, perfect, or enforce any lien against property of the estate;
- ❖ Any act to collect, assess, or recover on a prepetition claim;
- ❖ The setoff of any prepetition debt against any claim; and
- ❖ The commencement or continuation of proceedings before the U.S. Tax Court that concern the tax liability of the Debtor for the period before the Debtor is in bankruptcy.

See 11 U.S.C. § 362(a)(1)-(8).

Fundamental Bankruptcy Principles

Discharge versus Non-Dischargeability

“Discharge” refers to a Debtor’s ability to be relieved from future personal liability on all prepetition debts, through either the discharge provisions of Chapter 7 or completion of plan payments in Chapters 9, 11, 12, or 13.

“Non-Dischargeability” refers to specific debts that, for policy reasons, are not subject to discharge and therefore follow the Debtor post-bankruptcy.

See 11 U.S.C. §§ 523, 727, 944, 1141, and 1328.

Fundamental Bankruptcy Principles

“Avoidance Powers”

- ❖ Preferences
- ❖ Fraudulent Transfers
 - Federal Law
 - State Law
- ❖ “Strong Arm” Powers

See 11 U.S.C. §§ 544, 547, 548, 549, 550, and 551.

Fundamental Bankruptcy Principles

Priority Amongst Claimants

A fundamental purpose of bankruptcy is to “treat similarly situated creditors equally.”

- ❖ Secured Creditors
- ❖ Priority Claimants
 - Domestic Support Obligations
 - Administrative Expenses
 - Involuntary “Gap” Claims
 - Employee Wages (Limited to \$12,475 within 180 days prepetition)
 - Claims for Contributions to an Employee Benefit Plan
 - Claims of Grain Raisers and Fishermen Against Debtors Engaged in Such Industries
 - Claims for Deposits Relating to Purchases/Leases of Consumer Services/Property
 - Claims of Governmental Units for Various Taxes
 - Claims of a Federal Depository Institution for Failure to Maintain Capital Levels
 - Claims for Personal Injury/Death Resulting From Driving While Intoxicated
- ❖ Unsecured Claims
- ❖ Equity Interest Holder Claims

See 11 U.S.C. § 507(b).

Common Estate Planning Issues Occurring in a Bankruptcy Case



Bankruptcy Estate Property or Merely an Expectancy of the Debtor?

To determine if a particular property interest is part of the bankruptcy estate, conduct a 2-step analysis:

1. Legal
2. Factual



Bankruptcy Estate Property or Merely an Expectancy of the Debtor?

Step 1—Legal Analysis

- ❖ Recall the general rule that all property interests of the Debtor, including all legal and equitable interests, are property of the bankruptcy estate. 11 U.S.C. § 541(a).
- ❖ Property rights are created and defined under state law but federal law determines to what extent such property rights are part of the bankruptcy estate. *Parks v. Dittmar (In re Dittmar)*, 618 F.3d 1199, 1204-05 (10th Cir. 2010).

Bankruptcy Estate Property or Merely an Expectancy of the Debtor?

Step 1—Legal Analysis

- ❖ The key question becomes, under state law, does the Debtor have a vested property right in the particular interest at issue?
 - Is the interest irrevocable?
 - Does the interest have value?
 - Can it be sold? Transferred? Conveyed? Pledged?
 - Can the holder sue on account of the property interest?

Bankruptcy Estate Property or Merely an Expectancy of the Debtor?

Step 2—Factual Analysis

- ❖ What does the particular trust agreement require the trustee to do?
 - Discretionary distributions?
 - Mandatory distributions?

- ❖ If there is no right to compel a distribution, then the interest is likely an expectancy and therefore not property of the bankruptcy estate.

Bankruptcy Estate Property or Merely an Expectancy of the Debtor?

Key Takeaways

- ❖ Note that the bankruptcy trustee has only whatever rights state law and the particular trust agreement provide – the Bankruptcy Code does not confer greater rights.
- ❖ Identify the particular interest at issue under state law.
- ❖ Examine the document granting the interest to determine whether distributions can be compelled.
- ❖ Beware of bankruptcy trustee shakedowns!

Spendthrift Provisions Outside of Bankruptcy in Colorado

- ❖ Definition - A “spendthrift trust” is a trust created to provide a fund for the maintenance of the beneficiary, and at the same time to secure it against his improvidence or incapacity. *See In re Cohen*, 8 P.3d 429, 430 (Colo. 1999).
- ❖ Validity - In general, spendthrift trusts are valid and enforceable in Colorado. *See University Nat'l Bank v. Rhoadarmer*, 827 P.2d 561, 563 (Colo. App. 1991). Courts analyze the following factors to determine validity of a spendthrift: (1) existence of a spendthrift clause; (2) is settlor the beneficiary; and (3) extent of dominion and control the beneficiary possesses over the trust corpus. *In re Alagna*, 107 B.R. 301 (Bankr. D. Colo. 1989).
- ❖ Advantages - Valid spendthrift trust assets cannot be garnished. *Brasser v. Hutchison*, 549 P.2d 801, 803 (1976).
- ❖ Limitations - Following distributions of trust property to beneficiaries, creditors may reach such property. *See generally* Restatement (Third) of Trusts § 58 cmt. d(2) (2003). Once distributions to beneficiaries are mandatory, then property can be subjected to creditors' claims. *Beren v. Beren (In re Estate of Beren)*, 2013 COA 166 (Colo. Ct. App. 2013).

Spendthrift Provisions Inside Bankruptcy

General Rule of Property of the Estate: Property of the bankruptcy estate is intended to be broad and include all property interests the Debtor may hold as of the commencement of the bankruptcy case. 11 U.S.C. § 541(a).

Anti-Alienation Provisions Unenforceable: The following provisions are unenforceable in bankruptcy: (i) anti-alienation provisions; (ii) forfeiture provisions based upon the insolvency or financial condition of the Debtor; and (iii) forfeiture provisions based upon the appointment of a trustee, receiver, or similar custodian. 11 U.S.C. § 541(c)(1) .

Spendthrift Carveout: The bankruptcy code carves out from property of the bankruptcy estate property subject to a restriction on the transfer of a beneficial interest of the Debtor *in a trust* that is enforceable under applicable nonbankruptcy law. 11 U.S.C. § 541(c)(2).

Affirmative Election: In order to claim the benefits of a spendthrift in a bankruptcy case, the Debtor *must* affirmatively identify which property is protected thereunder. *In re Amerson*, 839 3d. 1290 (10th Cir. 2016).

Spendthrift Provisions Inside Bankruptcy: Example No. 1

Facts

- Mom and Dad execute two identical revocable trusts that contain valid spendthrift provisions;
- Both trusts give both settlors income from trust property, and upon death of the settlor the trust grants a life estate to surviving parent;
- Upon death of the remaining life beneficiary, the Trusts provide that the remaining trust property is to be divided equally among Mom and Dad's 3 kids;
- Middle Child is successor trustee of Mom's trust;
- Mom dies in 1997, Dad dies in 2000;
- Middle Child files for Chapter 7 in 2003;
- The Chapter 7 Trustee files a turnover action requesting that Middle Child turn over his residue in the trusts because it is property of the bankruptcy estate.

Considerations

- What is Middle Child's interest in the residue?
- Is the spendthrift provision valid?
- Is the trust still valid?
- Can the Chapter 7 Trustee reach these assets?

Conclusion

- The Chapter 7 Trustee wins in this case. Both the trusts and the UTC require distribution of the residue upon termination of the trusts as there is nothing further to administer and no remaining trust purpose exists.
- *In re Hilgers*, 371 B.R. 465 (10th B.A.P. 2007) (interpreting a Kansas law trust under the KUTC).

Spendthrift Provisions Inside Bankruptcy: Example No. 2

Facts

- Parents establish the Irrevocable Family Trust and convey all of their interest in some real property to their Daughter as Trustee of the Family Trust.
- Parents are the only beneficiaries of Family Trust and are to receive, in their Daughter's discretion, so much of the net income/gains for their comfort, support, and maintenance.
- Upon death, the Trust assets shall pass to their Daughter if she survives.
- Trust contains a spendthrift provision that says "any payment of principal or income shall be free from interference and control from creditors . . ."
- Daughter files for Chapter 7.
- Chapter 7 Trustee files a motion to sell the Daughter's contingent interest in the Family Trust.

Considerations

- What is the Debtor's interest in the Family Trust?
- Is the Debtor's interest in the Family Trust part of the bankruptcy estate?
- Is the spendthrift provision valid under applicable state law?

Conclusion

- Debtor has a contingent remainder interest in the Family Trust assets.
- The broad spendthrift provision was valid under Massachusetts law *as applied* to the Debtor even when the Parents die and the Family Trust terminates.
- The Trustee's motion to sell was denied.
- *In re Alamed*, 2014 Bankr. LEXIS 3033 (Bankr. D. Mass. July 15, 2014).

Spendthrift Provisions Inside Bankruptcy: Colorado Case Law

- ❖ The spendthrift carveout cannot be applied to a will. *In re Blakely*, 2011 Bankr. LEXIS 3646 (Bankr. D. Colo. 2011).
- ❖ The spendthrift carveout cannot be applied to an annuity. *In re Olson*, 2009 U.S. Dist. LEXIS 112755 (D. Colo. 2009).
- ❖ The spendthrift carveout does not apply to sham trusts and invalid trusts under state law. *Peters v. Bryan*, 2010 U.S. Dist. LEXIS 109733 (D. Colo. 2010).

Questions on What is Property of the Bankruptcy Estate and Spendthrift Provisions Inside Bankruptcy



Property Received By Bequest, Devise or Inheritance: § 541(a)(5)(A)

Recall, the general rule that property of the bankruptcy estate is broadly interpreted to include numerous property interests the Debtor holds as of the petition date.

Property of the bankruptcy estate specifically includes “[a]ny interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date – (A) by bequest, devise, or inheritance . . .”

11 U.S.C. § 541(a)(5)(A).

Relevant Tenth Circuit Bankruptcy Case Law Concerning § 541(a)(5)(A)

- ❖ The terms “bequest”, “devise”, and “inheritance” are narrowly interpreted. *Williamson v. Hall (In re Hall)*, 441 B.R. 680 (10th Cir. B.A.P. 2009) (holding that interests in property passing by “TOD” and “POD” instruments are not considered “inheritances” under Kansas law).
- ❖ Beneficial interest in a revocable inter vivos trust is not property of the bankruptcy estate under § 541(a)(5)(A). *Hukill v. Johns (In re Johns)*, 2013 Bankr. LEXIS 524 (Bankr. E.D. Okla. Feb. 8, 2013) (analyzing Oklahoma law); *In re Mattern*, 2006 Bankr. LEXIS 326 (Bankr. D. Kan. Mar. 9, 2006) (analyzing Kansas law).
- ❖ Beneficial interest in testamentary trust is property of the bankruptcy estate under § 541(a)(5)(A). *In re Roth*, 289 B.R. 161 (Bankr. D. Kan. 2003) (applying Kansas law).

Prepetition Conduct: Amendments and Disclaimers

- ❖ Prepetition amendments are not without risk.
 - What is the Debtor's current property interest?
 - What is the relationship between Debtor and Settlor?
Debtor and Trustee?
- ❖ Prepetition disclaimers are not without risk.
 - Has acceptance of the interest already occurred?
 - Has the Debtor's conduct demonstrated dominion and control over the property?
- ❖ Colorado Uniform Trust Decanting Act?
- ❖ The Bankruptcy Court is a court of equity!

10 Year Clawback for “Fraudulent Transfers” to Self-Settled Trusts



A bankruptcy trustee may seek to avoid, *i.e.*, undo, transfers of the Debtor’s property that occurred within 10 years before the petition date, when:

- (1) Such transfer was to a self-settled trust or similar device;
- (2) Such transfer was by the Debtor;
- (3) The Debtor is a beneficiary of such trust or similar device; and
- (4) The Debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the Debtor was or became, on or after the date that such transfer was made, indebted.

11 U.S.C. § 548(e)(1).

10 Year Clawback for “Fraudulent Transfers” to Self-Settled Trusts



Intent to hinder, delay, or defraud is determined by analyzing the requisite “badges of fraud”:

- (a) The transfer or obligation was to an insider;
- (b) The debtor retained possession or control of the property transferred after the transfer;
- (c) The transfer or obligation was disclosed or concealed;
- (d) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
- (e) The transfer was of substantially all the debtor's assets;
- (f) The debtor absconded;
- (g) The debtor removed or concealed assets;
- (h) The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
- (i) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
- (j) The transfer occurred shortly before or shortly after a substantial debt was incurred; and
- (k) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Schlosser v. Kendall (In re Kendall), 2012 Bankr. LEXIS 3607, 16-17 (Bankr. D. Colo. Aug. 6, 2012) (citing *Schempp v. Lucre Management Group, LLC*, 75 P.3d 1157, 1161 (Colo. App. 2003)).

Practical Takeaways



- ❖ Determine whether the interest at issue is part of the bankruptcy estate (state law rights and trust agreement).
- ❖ Determine whether the spendthrift clause is enforceable under state law.
- ❖ Be aware of fraudulent transfer provisions under state law and the bankruptcy code.
- ❖ Bankruptcy trustees have a fiduciary duty to creditors of the estate, which often leads them to be aggressive!
- ❖ Consult with an experienced bankruptcy attorney from the outset.