

INTERPLAY BETWEEN ASSET PROTECTION, ESTATE PLANNING, AND BANKRUPTCY

RANDY NUSSBAUM



Introduction

In this presentation we will discuss:

- How Bankruptcy law is impacted by Estate Planning & Asset Protection and vice versa
- What issues can arise when these certain areas of law intersect
- What the differences are between Estate Planning and Pre-Bankruptcy Planning
- How Estate Planning can be used for asset protection
- Issues and concerns a client should have when considering pre-bankruptcy planning

Effective Estate Planning That Provides Asset Protection

- It is often difficult to differentiate between estate planning and pre-bankruptcy planning.
- Proper estate planning could minimize tax exposure.
- Traditional estate planning provides little, if any, bankruptcy protection.

Property of the Bankruptcy Estate and Exemptions

- All property in which the debtor has an interest becomes property of the bankruptcy estate.
- This includes tangible and intangible property and the debtor's interest in business entities.
- Property of the bankruptcy estate includes rights of action, personal and real property, claims and money owed to the debtor.
- An inheritance received within 180 days after the bankruptcy filing also becomes property of the bankruptcy estate.

Property of the Bankruptcy Estate and Exemptions (cont.)

- Under bankruptcy and Arizona law, debtors are allowed to exempt certain property.
- Exemptions include \$150,000 of home equity.
- Exemptions also include \$6,000 equity per car (maximum two); and \$300 per spouse in a single bank or credit union deposit account. Property of the bankruptcy estate includes rights of action, personal and real property, claims and money owed to the debtor.
- An inheritance received within 180 days after your bankruptcy filing also becomes property of the bankruptcy estate.

Property of the Bankruptcy Estate and Exemptions (cont.)

- Seventy-Five Percent (75%) of any wages owed at the time of the bankruptcy filing are exempt.
- Though monies invested in a qualified retirement plan are normally exempt, any contributions made to that plan within 120 days of bankruptcy are not.
- Additionally, assets held in a living trust are not exempt except for the homestead.
- State law also allows debtors to protect six months' worth of "food, fuel and provisions," which historically has allowed a Chapter 7 debtor to purchase six months' worth of groceries and pre-pay necessary utilities for six months prior to filing for bankruptcy.

Valuing Assets

- We rely on the information provided by the debtor concerning the value of assets and the current balances and enforceability of any liens or claims secured by those assets.
- The personal property valuation should be based upon its liquidation or "garage sale" value, whereas real estate should be valued at what a ready, willing, and able buyer would pay under normal market conditions.

Pre-Bankruptcy Planning

- Pre-bankruptcy planning is the converting of non-exempt assets into exempt assets. This practice is not illegal or improper; Bankruptcy Code legislative notes specifically permit this type of activity. This is not to say that this procedure is without risk.
- Debtors whose pre-bankruptcy planning has been successfully challenged may face repercussions. In some situations, courts have found the pre-bankruptcy planning to be so egregious as to justify the denial of a discharge.
- The BAPCPA was designed to discourage debtors from engaging in pre-bankruptcy planning and to stop Chapter 7 debtors from paying down mortgages in advance of bankruptcy. Some experts recommended that pre-bankruptcy planning be limited.

Fraudulent Transfers and Preference Payments

- Certain transfers and payments are prohibited under the Bankruptcy Code. These prohibitions were designed to ensure that individuals contemplating bankruptcy do not dispose of their property to place outside the reach of creditors or pick and choose certain creditors to pay unless certain rules are followed.
- A fraudulent transfer is any transfer of property for which inadequate consideration is received at a time in which the transferor is insolvent or rendered insolvent by the transfer. Insolvency is generally defined as having debts that exceed your assets. If such a transfer occurs within two years of filing bankruptcy, and in certain instances, even longer, the bankruptcy trustee has the right to recover the property or an amount equivalent in cash from the transferee.

Fraudulent Transfers and Preference Payments

- A preference is a payment made within 90 days of bankruptcy on account of an old debt and in the case of insiders, within one (1) year of bankruptcy. There are exceptions to this rule, but if a preferential payment is made, the trustee may recover the payment from the recipient. A preferential payment does not have to be in the form of cash; any transfer received from a third party within the statutory guidelines on account of an old debt can create a preference.
- Starting in 2003, the U.S. Trustee's Office has demanded that debtors disclose whether they have renounced any interest in any estates within four *years* of bankruptcy. This question is being asked because if an individual has renounced such an interest, the U.S. Trustee's Office believes that such action may be a fraudulent transfer.

Estate Planning with Creditor Protection

- The cash value of annuities and life insurance can be protected. Arizona law provides that if your client owns an annuity or has cash value in life insurance in which the beneficiary has been the same for at least two years prior to a bankruptcy filing or creditor action, the cash value is protected as long as the beneficiary is a dependent or family member.
- Spendthrift trust - Under bankruptcy law, an interested party can look back for as many as 10 years to investigate and potentially challenge spendthrift trust, but as a general proposition, if your client follows state law in the creation of a spendthrift trust and has the luxury of waiting at least four years before encountering financial difficulties or bankruptcy, a high likelihood exists that the planning would be effective.
- Other forms of trust and business entities - Other options exist, including the ability to transfer assets into an LLC controlled by beneficiaries and, in particular, children, in return for a membership interest in that LLC.

Estate Planning with Creditor Protection

(cont.)

- Use of QPRTs and QTIPs—If implemented a substantial period before bankruptcy and/or creditor actions, a Qualified Personal Residence Trust (QPRT) and Qualified Terminable Interest Property Trust (QTIP) can be invaluable.
- The law is unclear as to whether personal property in the name of a living trust is protected under Arizona exemptions laws. The Arizona legislature has specifically extended protection to a homestead that is conveyed into a living trust, but not personal property.
- If your debtor client dies, ensure that his creditors cannot otherwise get to his estate. If your client dies within 180 days of filing for bankruptcy and has named his own living trust as the beneficiary under his life insurance policy, those proceeds may not be protected. Almost all courts consider a living trust to simply be an extension of that individual, which is why an individual seeking bankruptcy protection needs to understand that placing assets in a living trust will not shield them from creditors.

Protecting Your Bankrupt Client's Rights to an Inheritance

As a preliminary matter, if your client is a beneficiary under a will or trust, the courts have been very generous in tolerating the disclaimer of any such future interest by the beneficiary. Of course, a beneficiary is always risking that once she relinquishes such right, the trustor/grantor will not reinstitute it, but normally the beneficiary is willing to take that chance if that person trusts the trustor/grantor.

1. Disclaim the inheritance once financial difficulties arise - This is the easiest and most straightforward option
2. Once the grantor/trustor dies, disclaim any interest in the estate - The case law provides that a client can do so even in the face of financial difficulties.
3. Have the grantor/trustor remove your client as a beneficiary - This is the most absolute option, but if later on you want that party to reinstate your client as a beneficiary, that party may not be willing to do so.

Protecting Your Bankrupt Client's Rights to an Inheritance (cont.)

4. Have the grantor/trustor leave the interest in a spendthrift trust - Though this option can be a little more expensive than the others, by having the grantor/trustor leave any interest to the beneficiary in the form of a spendthrift trust, the exposure of the beneficiary's interest is normally limited to the amounts that may be paid within 180 days of the beneficiary's bankruptcy filing.
5. In the *Clark v. Rameker* decision, the Supreme Court ruled unanimously that an inherited IRA is not exempt and therefore is subject to trustee seizure when a bankruptcy is filed in states in which inherited IRAs were not exempt by state law. Prior to this somewhat surprising Supreme Court decision, individuals holding inherited IRAs could exempt those IRAs upon filing for bankruptcy as though they were their own IRAs and if an individual inherited such an IRA within 180 days of bankruptcy, the IRA would be protected as well notwithstanding the 180 day inheritance rule.

Conclusion

Over the years I have had a number of clients filing for bankruptcy engage in planning to minimize the impact of a potential inheritance on that filing. Clients have been willing to pay for such planning even when after the fact it is proven to have been unnecessary.

On the other hand, when a few years ago a client with a very ill father elected not to have the parent consider any alternative planning, the client effectively lost her entire inheritance when her dad died within 180 days of her bankruptcy filing. This was very unfortunate. Since the client had been warned and knowingly and willingly elected her course of conduct, she accepted the consequences.

The outcome would have been far different, though, if that same client had not been educated and then discovered one day that she had lost her entire inheritance because she was unaware of other options that may have been available for her and her dad.



Randy Nussbaum

Randy is a Certified Bankruptcy Specialist (Arizona Board of Legal Specialization) and a Certified Business Bankruptcy Specialist (American Board of Certification). His areas of practice include complex bankruptcy law and litigation, construction, real estate, and contract law.

He is a popular lecturer and author on topics regarding bankruptcy, construction, and real estate for the State Bar of Arizona, Maricopa County Bar Association, American Bankruptcy Institute, and other professional organizations.

Randy has been named to Super Lawyers' "Top 50 Arizona" list of attorneys multiple times and has been selected by *The Best Lawyers in America*® every year since 2010. *Best Lawyers*® also has twice selected Randy as its "Lawyer of the Year" (Scottsdale), in Bankruptcy and Creditor Debtor Rights (2019) and in Bankruptcy Litigation (2021).



Randy.Nussbaum@SacksTierney.com
480-212-1682

Sacks Tierney