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INTERPLAY BETWEEN ASSET PROTECTION, ESTATE PLANNING, AND BANKRUPTCY

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When bankruptcy filings skyrocketed about nine (9) years ago, publications were inundated with articles about how bankruptcy law impacted on a variety of other areas of law and vice versa. As non-bankruptcy lawyers found even their most stable and long-term clients seeking bankruptcy protection, this information became crucial so practitioners could continue to properly represent individuals and businesses now facing bankruptcy concerns for the first time. Now, most pundits anticipate a skyrocketing number of filings as the pandemic wreaks havoc on our economic system.

Despite the overwhelming amount of data that was available for non-bankruptcy lawyers to better understand how bankruptcy would impact on their practices, almost nothing has been written on the topic of this presentation. This dearth of material was surprising, though it may be the result of most bankruptcy experts not considering potential estate planning ramifications when their clients filed for bankruptcy and estate planning attorneys not being forewarned by their clients when bankruptcy issues arose.

As I began preparing for this discussion which I initially presented in 2018, I realized that notwithstanding the paucity of formal materials, the number of issues which can arise when these areas of the law intersect are staggering. Therefore, this writing will focus on simply identifying those issues so the practitioner can recognize them when they arise and react accordingly.

I will begin by over-viewing asset protection and estate planning concerns an individual encounters when preparing for financial difficulties.

I. EFFECTIVE ESTATE PLANNING THAT PROVIDES ASSET PROTECTION?

Oftentimes, the public cannot differentiate between estate planning and pre-bankruptcy planning. Many individuals who have engaged in extensive estate planning assume that that same estate planning will shield their assets from creditors, either in or out of bankruptcy. Presumably those individuals are aware that proper estate planning could minimize their tax exposure and assume that the same is true as to other creditor exposure.

Nothing could be further from the truth as to asset protection afforded by traditional estate planning. Traditional estate planning provides little, if any, such protection. However, some estate planning can provide asset protection benefits.

Before touching upon the ways that estate planning could be used for asset protection purposes, I will provide verbiage that I incorporate into my initial letter with every client that my firm and I represent who is seeking individual bankruptcy protection. This 0verbiage covers issues and concerns a client should have when considering bankruptcy and allows the client to understand which prepetition conduct may be acceptable and which may lead to further complications.

PROPERTY OF YOUR ESTATE AND EXEMPTIONS

When you file for bankruptcy, all property that you have an interest in becomes property of your bankruptcy estate. This includes both tangible and intangible property and your interest in corporations, LL.C s, partnerships, or any business entity. Property of your estate is an all-encompassing concept and includes rights of action, personal and real property, claims and money owed to you as of the time of bankruptcy filing though not payable at that time, such as a tax refund. Any inheritance that you become entitled to within 180 days after your bankruptcy filing also becomes property of your bankruptcy estate.

Under Bankruptcy and Arizona law, you are allowed to exempt certain of your property. Exemptions exist so that debtors do not become wards of the state because of bankruptcy. The exemptions in Arizona are relatively liberal and include $150,000 worth of equity in your house (unless you have owned the house for less than 40 months, in which case your exemption cap is just less than $150,000) and most household goods and possessions. You may also claim as exempt property $6,000 equity per car in two different cars (if filing a joint petition), although only $300 per spouse can be claimed in a single bank or credit union deposit account. You must include checks that have not cleared in calculating that balance. You must also anticipate that such accounts may be frozen by the financial institution upon its notification of your bankruptcy filing, and you must be prepared to terminate any automatic payments and deposits or provide a new account created after your bankruptcy filing to accommodate those transactions. Seventy-Five Percent (75%) of any wages owed at the time of your bankruptcy filing are exempt. If an asset contains equity above and beyond the exemption amount, then your trustee can seize and liquidate it and distribute the proceeds to your creditors.

Though monies invested in a qualified retirement plan are normally exempt, any contributions you may make to that plan within 120 days of bankruptcy are not.

Additionally, assets that are held in a living trust are not exempt except for your homestead.

Changes made in 2005 in the bankruptcy law impacts on certain of these exemptions. However, as a general rule, the Arizona exemptions will still be allowed as long as you have resided in Arizona for at least two years prior to filing for bankruptcy protection.

State law also provides that you can 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. What is uncertain at this juncture is the definition of what constitutes fuel since the statute was written many years ago at a time in which fuel probably consisted of firewood, heating oil, and the like, but trustees have normally permitted the prepaying of electricity, gas, and water with little objection. It is not clear as to whether telephone and cell phone service and cable are included; since the amounts involved are normally not that great, it is not commonly challenged. But in 2010 one Judge ruled against a debtor on this issue. On the other hand, you cannot claim this exemption by purchasing a gift card from a grocery store or pre-pay on a gas credit card because doing so does not actually constitute the purchase of fuel and provisions, but rather the right to buy such provisions or the like in the future.

VALUING YOUR ASSETS

We are relying upon the information you have provided us concerning the value of your assets and the current balances and enforceability of any liens or claims secured by those assets. As already explained to you, 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.

Nevertheless, if you have any concern or questions about the value of any asset you are listing of substantial worth, we strongly recommend that either you or we retain an expert to value that asset. We strongly recommend this because if you overvalue your asset and this results in equity in excess of your exemption or the current lien balance, your bankruptcy trustee will have an absolute right to seize and liquidate that asset for the benefit of your creditors.

Similarly, if you are unsure or cannot provide us with confirmation of the lien balances and evidence of perfection of those liens (vehicle titles, recording information, etc.), we will need to investigate those matters as well. As just explained above, if a miscalculation of the enforceability or balance of a lien creates vulnerable equity for your trustee, that asset may be lost.

Additional cost will be incurred if we need to help you in this regard, but it is money well spent if you can avoid potentially unexpected and unpleasant consequences.

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.

In July of 1996, In re Elia became the first Arizona published opinion on pre-bankruptcy planning. The judge found nothing inappropriate with buying a house right before bankruptcy and other similar strategies. However, that case is persuasive but not binding on the other judges. In other courts throughout the country, this issue has been addressed and in certain instances, the pre-bankruptcy planning vilified by the bankruptcy judges. Though no single test has been universally accepted by the courts in determining whether or not to tolerate pre-bankruptcy planning, a number of criteria continuously surface in case after case:

1. What is the amount of the transfer to exempt property?

2. What is the proximity to the bankruptcy filing?

3. Did the conversion to exempt property involve newly acquired funds or previously secured property?

4. Did the conversion benefit insiders of the debtor?

5. Did the debtor mislead creditors during the conversion?

Other courts have considered additional circumstances in determining whether or not the pre-bankruptcy planning is reproachable, but the best way to summarize whether or not pre-bankruptcy planning will succeed is to consider the old maxim, "pigs get fat, and hogs get slaughtered."

Your attorney would also be incurring some risk if the planning progresses to a stage where it could be interpreted as a fraud upon creditors. Though normally the bankruptcy courts do not sanction the attorneys for the planning, but rather punish the debtors, in past non-bankruptcy settings, the Arizona courts have penalized attorneys for

overly zealous asset protection tactics.

Debtors whose pre-bankruptcy planning has been successfully challenged face a number and variety of repercussions. Oftentimes, the courts order that transfers be set aside and/or reversed. For example, if a debtor has utilized cash to increase his homestead by $50,000 in advance of bankruptcy, an intolerant court can either require that the debtor find the means to replace the $50,000, or, in extreme circumstances, compel the debtor to sell the exempt property and remit $50,000 to the estate. In certain instances, reversing what has occurred is simple while at other times generates a new set of problems for the debtor.

In some situations, courts have found the pre-bankruptcy planning to be so egregious as to justify the denial of a discharge. Though this result is rare, being deprived of a discharge defeats the entire reason behind bankruptcy and is disastrous for the debtor. **This risk is now even more pertinent because of the following change in the law.**

One of the changes in the bankruptcy law which went into effect on April 20, 2005, specifically provides that the Court has the power to reduce a state law homestead exemption by any transfers of nonexempt property made to increase that exemption for an extended period of time (10 years) prior to bankruptcy filing if such transfers were done in fraud of creditors. Though this has always been the law, this change now incorporates the case law into the Bankruptcy Code itself although courts have been inconsistent in their enforcement of it. Unfortunately for you, it may increase the chances that your pre-bankruptcy planning could be successfully challenged, though you may still need to engage in the planning, nevertheless.

The BAPCPA was specifically designed to discourage debtors from engaging in pre-bankruptcy planning and in particular to stop the practice of Chapter 7 debtors paying down their mortgages in advance of bankruptcy. Some experts have even gone so far as to recommend that pre-bankruptcy planning be limited.

In simplest terms, most pre-bankruptcy planning will be tolerated subject to two other conditions. As the following section, which is also incorporated into my initial letters, explains, an individual cannot utilize fraudulent or preferential transfers so as to accomplish that plan.

FRAUDULENT TRANSFERS AND PREFERENCES

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.

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 (I) 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. It may be a fraudulent transfer because in certain instances, if the debtor has exercised control over that estate interest, renouncing it in advance of bankruptcy may be a designed effort to deprive creditors of that same interest upon the filing of a bankruptcy. This is not to suggest you do not have a right to renounce an interest in
a will or a trust within four years of bankruptcy, but there may be a situation in which such activity can be challenged.

Because there are many intricate rules and a number of exceptions, you need to consult with me about any transaction that may be fraudulent or preferential. Sometimes there are ways to reverse or rectify the transaction in advance of bankruptcy and by doing so, eliminate the problem.

None of the above discussion provides any guidance to an individual trying to incorporate estate planning into an asset protection strategy.

So, what are the options available to an individual who would like his estate planning to also provide creditor protection as well?

1. 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.[1] At one point, because of an unexpected opinion from the Ninth Circuit Bankruptcy Panel called *Hummel,* policies were only protected if the beneficiary was a dependent family member, but the Ninth Circuit Court of Appeals ultimately reversed the lower court and ruled that such policies are protected as long as the beneficiary was either a family member *or* a dependent. This protection is conditioned upon a party not engaging in a fraudulent transfer to fund the annuity or the life insurance, but in almost all instances, the protection is absolute. Furthermore, presumably because of a legislative oversight, no cap is currently in place under Arizona law.

Therefore, a high likelihood exists that if you have a client with a substantial amount of assets who wants to plan for the future, one way of doing so is using this alternative, though of course your client would not want to do so for fraudulent purposes and would need to have such planning in place for at least two years to ensure that it could be successful.

Two cases demonstrate the value of life insurance planning. *ML Servicing Co., Inc. v. Coles,* 235 Ariz. 562 (2014) holds that even a life insurance policy purchased with money "misappropriated" by one breaching a fiduciary duty, is protected because the creditor's remedies were limited to recovery of the premium paid and the creditor had no claim to the death benefit. ("As discussed above, § 20-1131 provides a proper remedy at law when creditors have been defrauded in order to pay life insurance premiums--the creditor may recover the amount of premiums paid in fraud of the creditor, plus interest. A.R.S. § 20-1131.B. This is an adequate remedy at law because it makes Appellants whole by placing them in the same position they would have been in but for Cole's alleged misuse of those funds to pay the Policies' premiums."). There is a brief but unresolved petition for review pending, however, in ML Servicing. In a similar vein, the Court of Appeals recently held, in an unpublished decision, that a post-judgment transfer of a term life insurance policy to an ILIT for the expressed purpose of making sure that the insured's family would enjoy the policy proceeds to the exclusion of his and his family's creditors, was not a fraudulent transfer relying on In re Estate of King, 228 Ariz. 565 (App.2012). *MidFirst Bank v. Barness*, 2014 W.L. 6456046.

2. Spendthrift trust – Under bankruptcy law, an interested party can look back for as many as 10 years to investigate and potentially challenge spendthrift trusts and the like, 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. Of course, this presupposes that your client can wait the four years and is willing to relinquish control of the corpus, but in many instances, if your client has the foresight to engage in such planning, the protection is very effective.

3. 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. Because this type of planning is very fact intensive, this topic will not be discussed further except to note that surviving a rigorous challenge will depend upon, a) whether the planning otherwise made business sense; b) the consideration that was provided to the conveying party; and c) the passage of time between the planning and the financial problems.

4. 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. An in-depth discussion of these options is beyond the scope of this presentation.

There are a few other quick considerations that the practitioner always needs to consider for clients looking for protection from creditors.

1. 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. Though in most cases the amount of assets that may be exposed by a couple would be capped at $10,000 to $20,000, it is exposure that can be avoided if consideration is paid to this issue. You need to be familiar with your respective state's laws in this area.

2. Make sure that if your debtor client dies, that his creditors cannot otherwise get to his estate. If your client dies within 180 days of filing for bankruptcy[2] 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. The author has not ever faced the issue of a client dying within 180 days of a bankruptcy filing who had named his living trust as the beneficiary of his life insurance policies, but

this practice seems very risky.

Now let's consider concerns your client may have if your client is the beneficiary of an inheritance and contemplating bankruptcy.

II. 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 he 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.

I will now discuss options to consider if your client is seeking bankruptcy and does not want to risk his inheritance.

1. Disclaim the inheritance once financial difficulties arise – This is the easiest and most straightforward option. Obviously, if the client later on realizes disclaimer was not necessary, the client may not be able to reverse what has occurred, especially if the grantor/trustor does not cooperate.

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. Despite challenges to the contrary, the courts have consistently held that such a disclaimer does not constitute improper action or a fraudulent transfer because the requisite elements of a fraudulent transfer are not met by such tactics.

3. Have the grantor/trustor remove you 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. This option is especially flexible because the grantor/trustor can remove the beneficiary's name even after the beneficiary files for bankruptcy protection. This can be a valuable strategy in circumstances in which an individual files for bankruptcy and then a trustor/grantor, who has named your client in a will or trust, becomes terminally ill within 180 days of your client's bankruptcy filing.

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. This leaves the question of whether a beneficiary can disclaim any payment that may be paid within 180 days of that party's bankruptcy filing. Of course, a

party contemplating this strategy needs to make sure that such a disclaimer is proper and can be limited to just the 180-day period.

Finally, a recent U.S. Supreme Court decision could have a major impact on planning of this type.

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. Now, clients possessing such inheritances are no longer able to exempt them upon filing for bankruptcy protection. This may require them to engage in planning regarding those inheritances or to ask the grantor/trustor to modify his estate planning in certain instances.

Whether the inherited IRA is protected may depend upon whether your state has a statute which specifically exempts inherited IRAs. If it does, most experts believe state law will control. This was not an issue in the *Clark v. Rameker* decision because the subject state did not have such a statute.

III. 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.

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[1] Other Southwestern states have similar statutes.

[2] Under the Bankruptcy Code, a bankruptcy trustee is entitled to any rights in an inheritance a debtor is entitled to within 180 days of a bankruptcy filing.