The Bankrupt Beneficiary and the Bootstrap:
How Can the Estate Planning Attorney Anticipate a Bankruptcy Filing?

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Reprinted From the New Jersey Law Journal, May 24, 2000

The recipients of large inheritances may not necessarily be well-off themselves. It is not unheard of for the child of a wealthy family to file for bankruptcy.

Although a spendthrift clause will generally prevent assets held in trust from being exposed to creditors' claims, one of the provisions of the Bankruptcy Code may unexpectedly cause an inheritance to pass into the bankruptcy estate, even where the decedent dies after the debtor-beneficiary files for bankruptcy.

If a person files for Chapter 7 bankruptcy, and thereafter becomes entitled to an "inheritance", "life insurance policy" or "death benefit plan" in the next 180 days, then the full amount will be pulled into the bankruptcy estate to satisfy the claims of creditors. 11 U.S.C. 541(a)(5)(A). This rule is well known to bankruptcy attorneys, but is less well known among estate planning lawyers.

This poses a dilemma for a person who anticipates both a bankruptcy filing and the receipt of a significant inheritance. He may seek to file for bankruptcy protection prior to the death of a wealthy relative, but then must wait for the 180 day look-back period to expire.

Bankruptcy attorneys sometimes advise debtors to request family members to change their Wills to avoid outright distributions to them. This can be an embarrassing and delicate task. The relatives may later be asked to change their Wills again six months after the bankruptcy filing.

The cases are clear that it is the date of death, not the actual settlement and distribution of the estate which vests the property in the debtor. This is true even when it requires a will contest to establish the debtor's rights. In re Elliott, 81 B.R. 460 (N.D.Ill. 1987).

One court has held that where the debtor filed for bankruptcy, and her husband died within 180 days, leaving her as the surviving tenant by the entireties of real property, then the property did not pass "by bequest, devise or inheritance", but instead by operation of law. In re Alderton, 179 B.R. 63 (E.D.Mich. 1995). An intervivos trust has also been held to be outside Section 541(a)(5)(A). In re Newman, 903 F.2d 1150 (7th Cir. 1990).

Could a testator divest a person in the event of a bankruptcy, or divert the assets into a spendthrift trust if the 180 day rule would otherwise apply? One case at least implies this, yet other hazards remain.

The Estate Planner's Role.

A careful estate planning attorney may anticipate a bankruptcy with the creation of a spendthrift trust, rather than a complete disinheritance. The will could even provide that in the event the beneficiary has filed a bankruptcy petition within six months, the outright distribution shall not be made, but instead shall pass to a trustee of a spendrift trust, perhaps for a later distribution.

But the testator's death is not the only trigger for 11 U.S.C. 541(a)(5)(A). A trust held for a prospective bankrupt may require a distribution to him at a certain age. If the person becomes entitled to the distribution within 180 days following the bankruptcy filing, it will fall into the hands of the bankruptcy trustee. In re Moody, 837 F.2d 719 (5th Cir. 1988); In re Hecht, 54 B.R. 379 (S.D.N.Y. (1985).

This should be considered by the bankruptcy attorney, but the estate planning attorney may be able to avoid the problem by specifying that a bankruptcy filing will result in a delayed distribution or a further trust.

There is no clear authority as to whether such a bootstrap provision would be effective. There is room for a bankruptcy trustee to take the position that it is void. In any event, the provision may give the bankrupt beneficiary a basis not to disclosure the matter.

Disclosure of the Subsequent Inheritance.

A bankruptcy trustee may ask the debtor under oath at a section 341 meeting of creditors, whether he has received an inheritance since the time of filing, or has had a relative pass away since that time.

Further, the Bankruptcy Rules specifically require a debtor to file a disclosure of the receipt of an inheritance after the commencement of a bankruptcy action. Under Bankruptcy Rule 1007(h), if the debtor acquires or becomes entitled to property under 11 U.S.C. 541(a)(5), "the debtor shall within 10 days after the information comes to the debtor's knowledge or within such further time the court may allow, file a supplemental schedule in the chapter 7 liquidation case, chapter 11 reorganization case, chapter 12 family farmer's debt adjustment case, or chapter 13 individual debt adjustment case. If any of the property required to be reported under this subdivision is claimed by the debtor as exempt, the debtor shall claim the exemption in the supplemental schedule."

Would the bootstrap-into-a-spendthift clause be an "exemption" to be disclosed under Rule 1007(h)? Arguably, this is not a situation where property existed pre-bankruptcy, and then is being exempted. Here, the asset is not pre-bankruptcy property, and there is nothing to pull it into the bankrupt estate but the special rule of Section 541(a)(5)(A),(C). On the other hand, all equitable interests are initially within the bankrupt estate, and it is only 11 U.S.C. 541(c)(2) which is an exemption for spendthrift clauses.

The "Ipso Facto" Hazard.

The greatest danger to a diversion conditioned on a bankruptcy filing is that it could be considered an "ipso facto" clause by the bankruptcy trustee.

Under 11 U.S.C. 365(e)(1)(B) a provision in a lease or other contract which purports to terminate or modify the debtor's rights under the contract upon bankruptcy is void, and the bankruptcy trustee can decide whether to affirm or discharge any such contracts.

While many contracts and leases do provide that the tenant or party to the contract loses certain rights by filing a bankruptcy petition, such a clause is simply unenforceable under 11 U.S.C. 365.

Even a partnership agreement which on its face converts a general partnership interest into limited partnership interest upon the filing of a bankruptcy petition is ineffective. Summit Investment and Development Corp. v. Leroux, 69 F.3d 608 (1st Cir. 1995).

However, a will is not a contract, and a beneficiary has merely an unenforceable expectancy in the estate of a relative.

Margaret McGuire's Last Will and Testament.

One case has held that a testator may simply choose to change her last will and testament because of the bankruptcy. In re McGuire, 209 B.R. 580 (D.Mass. 1997), involved a debtor whose mother's will made him a equal residuary beneficiary with his sister. However, three months after he filed a chapter 7 petition, his mother Margaret executed the following codicil:

"Until the date of October 15, 1996, I hereby exclude my son, Robert McGuire from the provisions of this Will and intend by this exclusion that he shall receive nothing from my estate should I decease prior to October 15, 1996. All bequests, devises and legacies to my son, Robert McGuire, are left to my daughter, Margaret Ellen McGuire-Garcia.

"As of October 16, 1996, the provisions of this Codicil are no longer effective."

October 16, 1996 was the day when the 180 day look-back period would expire for her son.

Margaret McGuire died on August 27, 1996. Her son's bankruptcy trustee filed an adversary proceeding against the executor claiming the codicil was "void against public policy because it conditionally disinherited the Debtor solely for the purpose of avoiding the provisions of 11 U.S.C. Section 541(a)(5)."

The bankruptcy trustee cited authorities showing that a disclaimer by the debtor would be ineffective, but the Court held that under Massachusetts state law the debtor held merely an expectancy, and that any time prior to her death Mrs. McGuire could have disinherited her son, her daughter or any one else. "The execution of the codicil was within her prerogative as she had no duty to underwrite the creditors of her son's bankruptcy estate." 209 B.R. at 582.

Another interesting aspect of the McGuire case is that the debtor's father had died shortly prior to his mother's passing. The father's death was three months after the chapter 7 filing, and the father's will stated that he left everything to his wife, except that if his wife failed to survive him by 90 days, then his wife would receive nothing under the will, and everything would pass in equal shares to his son and daughter.

As it turned out, the debtor's mother failed to survive the 90 days. Both deaths occurred within the 180 days of 11 U.S.C. 541(a)(5). Half the father's estate would have vested in the debtor within the 180 day window. However, because all of the property was held jointly by the spouses with a right of survivorship, and there was nothing to pass according the father's will. The McGuire court did not address whether the failure of Mrs. McGuire to survive the 90 days caused the father's probate estate to pass to the son and into the hands of the bankruptcy trustee under Section 541(a)(5).

Certainly after the bankruptcy filing and the father's death, the debtor and his counsel raised the estate planning issue with Mrs. McGuire before it was too late.

The Danger of the Bootstrap.

The facts in the McGuire case are slightly different from what would occur if a will or codicil provides that a bankruptcy filing diverts the debtor-beneficiary's share into a spendthrift trust which later disburses to him.

Mrs. McGuire's will clearly considered the bankruptcy, but it was not the filing for bankruptcy which triggered a disinheritance. Instead, Mrs. McGuire directed a disinheritance which would extend only so long as the look-back period was in effect. This is not what is commonly referred to as a bootstrap.

It might be argued by a bankruptcy trustee that the bootstrap nature of the condition should make it void as against public policy.

In F.W. Proctor v. Commissioner, 142 F.2d 824, 44-1 USTC Para. 10,110 (4th Cir.), a taxpayer attempted to make a gift subject to a condition that if any portion of the transfer was determined by a court to be subject to gift tax, then the taxable portion of the transfer would be void. The Court held that such a devise was a condition subsequent which must be void as against public policy. See also Rev. Rul. 65-144, 65-1 C.B. 442.

It is not clear that the public policy necessary in tax administration would apply in interpreting the will or codicil of a testator who has the same rights of disposition as Mrs. McGuire. The danger of a bootstrap could be avoided by absolutely placing the bequest directly into a spendthrift trust, and leaving any disbursement to the trustee's discretion.

Conventional Spendthrift Clauses.

Generally speaking, a trust with a "spendthrift clause" will not be considered an equitable interest which may be claimed by the bankruptcy trustee, depending on state law. "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." 11 U.S.C. 541(c)(2).

But spendthrift trusts must be carefully drafted if the claims of creditors are to be entirely avoided. If a spendthrift trust requires a distribution of principal or income to the bankrupt beneficiary, state law will control whether the distributions to which the bankrupt beneficiary becomes entitled during the 180 day period are subject to the claims of creditors. In New Jersey, distributions of income are subject to the claims of creditors. N.J.S.A. 2A:17-50. This alone may cause the drafter to make all distributions subject to the discretion of the trustee.

Clearly any interest in question must be vested to be claimed by the bankruptcy trustee, and state law will govern this determination. A vested remainder following a life estate thus became an asset of the bankruptcy estate where the death of the testator occurred during the 180 day look-back period. In re Weddle, 43 B.R. 415 (W.D.Va. 1984). But where the remainder is contingent it is not available to the bankruptcy trustee. In re Hicks, 22 B.R. 243 (N.D.Ga. 1982).

Drafting to Divert the Inheritance.

Hereafter follows possible language to be used to prevent an inheritance from becoming part of the Section 541 estate. A standard spendthrift clause would also be needed.

"Regardless of anything herein to the contrary, in the event that any beneficiary of an outright distribution or from a trust shall have filed a petition for bankruptcy during the period beginning 181 days prior to my passing, and extending to the day after my passing, then such beneficiary shall not be entitled to any distribution.

"In such event, the distribution shall instead be held by my trustee for the benefit of such beneficiary, and the income and principal therefrom shall be distributed to such beneficiary in the sole and absolute discretion of my trustee at a time no later than 180 days following my passing; or if such beneficiary survives me, but shall not survive to the time of actual distribution selected by my trustee, then the same shall be distributed as though such beneficiary had predeceased me."

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