

Estate Planning, Divorce and Bankruptcy: When Worlds Collide

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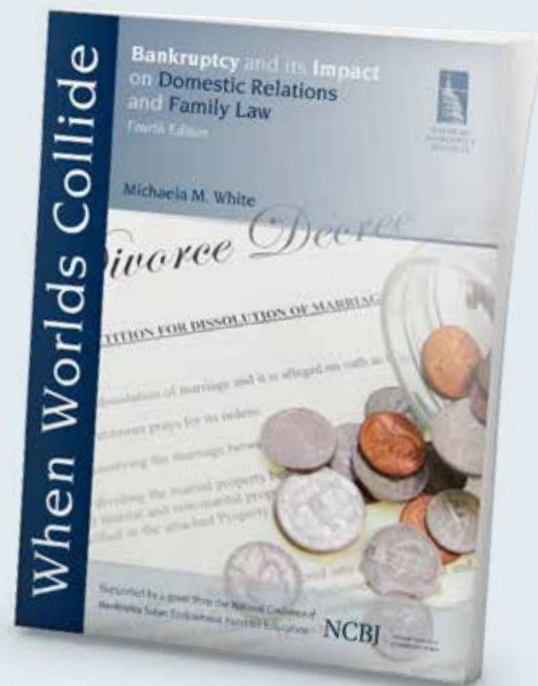
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When Worlds Collide

Bankruptcy and Its Impact on Domestic Relations and Family Law, Fourth Edition

Divorce and bankruptcy are similar in that each attempts to provide a “fresh start.” However, the objectives of divorce are not necessarily consistent with the goals of bankruptcy. The Bankruptcy Code makes it harder to discharge certain obligations that arise in divorce. This desk book provides a brief, readable primer on the bankruptcy law that impacts their subject-matter jurisdictions. These materials provide a satisfactory starting point for any domestic-relations lawyer who needs a basic understanding of how bankruptcy intersects with family law. Appendices feature relevant sections of the Code, as well as a list of cases and articles on the issues discussed within the text.



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**ESTATE PLANNING, DIVORCE AND
BANKRUPTCY: WHEN WORLDS
COLLIDE**

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TRUSTS IN BANKRUPTCY

By Stephen Berken, Esq.

I. NUTS-AND-BOLTS OF TRUSTS FOR BANKRUPTCY ATTORNEYS

Typically there are three parties to any trust: 1) the Settlor or Trustor - this person is the original owner of the property used to fund the trust; 2) the Trustee - this person is who manages the trust property and who must take care of the property (and the technical “owner” of the property); and finally 3) the Beneficiary - this is the person for whose benefit the trust is created.

The Settlor establishes the trust by transferring legal title of specific assets to the trustee. The trustee is then the legal owner of the assets and has the duty to manage the trust property for the benefit of the beneficiary. There are several types of trusts that benefit debtors – both trustors and beneficiaries – some of which provide greater protection from creditors than others.

The goal of all trusts is two-fold: (1) remove the debtor’s name from the legal ownership or title to the assets, but do so (2) in such a way so that the debtor may retain some beneficial enjoyment from the property.

To accomplish these goals, a trust must: (1) be irrevocable; (2) include a spendthrift or support clause; (3) benefit someone other than the trustor; and (4) provide the trustee with as much discretion as possible.

What to Watch for as a Bankruptcy Practitioner and the No-No in Trust creation

Self-Settled Trusts: If a trust is for the benefit of the trustor, the trust is deemed self-settled, and the beneficial interest retained by the trustor is not protected from creditors of the trustor. A self-settled trust is a trust created by a trustor for his or her own benefit, such as a revocable “living trust.”

GLOSSARY OF TRUST TERMS

Beneficiary. The beneficiary is the individual who is entitled to a benefit under the trust. Beneficiaries can be current beneficiaries or contingent beneficiaries.

Complex Trust. A complex trust is typically irrevocable, meaning the settlor (the trust maker, also known sometimes as the grantor) has not retained the ability to make amendments or to revoke the trust. A complex trust allows the trustee to have discretion as to whether or not to distribute anything, whether principal or income, to a given beneficiary in a given year.

Corpus. A corpus is the property that is funded into the trust which the trustee will administer for the benefit of the beneficiaries.

Fiduciary Duty. Individuals acting in a place of trust for others stand in a special position and thus a fiduciary duty is imposed. That duty requires that the fiduciary, here the trustee, put aside any personal interest that the entity or person might have and act at all times in good faith when making decisions for the benefit of the beneficiaries.

Income Beneficiary. An income beneficiary is an individual who is entitled to a stream of income payable from a trust. Income beneficiaries can be limited to the disposable net income produced by the trust. Income beneficiaries who have a right to distribution are entitled to a right to distribution no less than annually, unless a different frequency is set forth in the trust agreement.

Irrevocable Trusts. An irrevocable trust is one in which the terms of the trust agreement cannot be changed absent a court order or the agreement of all interested parties. Irrevocable trusts are considered complex trusts and must have a unique tax payer identification number.

Revocable Trusts. As the name implies, a revocable trust is one which can be freely amended by the terms of the trust agreement, typically by one or more of the Settlers/Grantors of the trust.

Settlor. The settlor is the person who is originally creating and funding the trust with his or her property. The settlor can be referred to by other terms, including grantor and trust maker. These terms are fairly synonymous.

Spendthrift Clause. A spend thrift clause in a trust is intended to make the trust one which is

purely discretionary. Purely discretionary trusts vests with the trustee the sole decision making for making any trust distributions, including whether to make a trust distribution. The purpose of a spend thrift trust is to protect the trust corpus and income from the claims of the creditors of any beneficiaries. Spend thrift clauses are intended to withstand a challenge by either a beneficiary, or such beneficiary's creditors, to compel distribution and normally contain anti-alienation provisions.

Trust Agreement. The trust agreement is the document that governs the terms of the trust and the administration of the trust. The trust agreement will generally set forth the different beneficiaries, name the trustees, including successor trustees, and will set forth the basic criteria for payment under the terms of the trust.

Trust. When property ownership is given to a party that does not directly benefit from the transfer, rather they simply manage the trust for the true owner. Or when business of a similar kind consolidate to become one large one. Trusts can be revocable or irrevocable. An equitable or beneficial right or title to property held for the beneficiary(s) by another person, in whom resides the legal title or ownership, recognized and enforced by courts of chancery. *See Goodwin v. McMinn*, 193 Pa. 046, 44 Atl. 1094, 74 Am. St. Rep. 703; *Beers v. Lyon*, 21 Conn. 613; *Seymour v. Freer*, 8 Wall. 202, 19 L. Ed. 300. (Black's Law Dictionary).

Trustee. The trustee is the person or entity who is appointed by the settlors (also known as grantors, trust makers) to administer the terms of the trust. The trustee owes a fiduciary duty to the beneficiaries.

WHY USE TRUSTS?

It is sometimes helpful to know why we have trusts, and to understand the typical uses for trusts to help you to decipher when the potential client has a present interest. Trusts are a basic tool for estate planning attorneys. Trusts can be a very effective method of managing various assets, especially if located in multiple states. For instance, if an individual has property interests, in Colorado, and another state, and that individual dies (as we all do), then it would require a probate in both states in order to effectively transfer title to all of the properties.

However, if all of the properties are put into a single trust, then upon the death of the settlor of the trust, there would be no need for probate. Instead the successor trustee would step into the shoes of the decedent and be able to effectively manage and transfer all trust assets. This is not without any expense, but it is usually a far less expensive process then having multiple probate proceedings in two different states.

CONSTRUING TRUST AGREEMENTS

The Colorado Supreme Court issued an opinion confirming the proper approach to construing a trust instrument under Colorado law in *The Denver Foundation v. Wells Fargo Bank, N.A.*, 163 P.3d 1116 (Colo. 2007). The Colorado Supreme Court (with highlighting of the most helpful language) instructs that:

Our object in construing this trust, as with any other contract or will, is to **determine the intent of the settlors**. *In re Ferguson Trusts*, 929 P.2d at 35; *Meier v. Denver US. Nat'l Bank*, 164 Colo. 25, 29, 431 P.2d 1019, 1021 (1967) ("The cardinal rule in the construction of a Will is that the Court shall determine the actual intent of the testator from the instrument in its entirety and, having ascertained that intent, shall carry it out, provided that the testator's intent conforms to law and public policy.").

To ascertain this intent, **we read and interpret all the various documents at issue, as a whole, to give effect to the ["Settlor's"] wishes** in establishing the Trust. *Section 15-11-510, C.R.S.* (2006) ("A writing in existence when a will is executed may be incorporated by reference if the language of the will manifests this intent and describes the writing sufficiently to permit its identification."); *U.S. Nat'l Bank v. Brunton*, 112 Colo. 442, 448, 150 P.2d 527, 528 (Colo. App. 1982) (finding settlor's intent is discerned from entire instrument); 11 Richard A. Lord, *Williston on Contracts* § 30.25 (4th ed. 1999) (explaining that a document incorporated into a contract should be construed as a single instrument). Likewise, we construe the Trust instruments in their entirety to harmonize and give effect to all the provisions, rendering none meaningless or superfluous. *US. Fid. & Guar. Co. v. Budget Rent-A-Car Sys., Inc.*, 842 P.2d 208, 213 (Colo. 1992); *Pepcol Mfg. Co. v. Denver Union Corp.*, 687 P.2d 1310, 1313 (Colo. 1984); *US. Nat'l Bank*, 112 Colo. At 448, 150 P.2d at 299. Finally, we also consider relevant circumstances in effect at the time the Trust Agreement was executed to understand and find meaning in the instrument. *Powder Horn Constructors, Inc. v. City of Florence*, 754 P.2d 356, 368 (Colo. 1988); *Bd. Of County Commirs v. City and County of Denver*, 40 P.3d 25, 29 (Colo. App. 2001).

Therefore, the overarching question is: what was the intent of the Settlor? As noted by the *Denver Foundation* Court, the intent should be determined from the four corners of the estate planning document. Language is key and is the first "go-to" item to determine the Settlor's intent. If the intent expressed is to create a fully vested present interest in the Trust corpus, then the client will have a problem with the bankruptcy. Further if the document is ambiguous, then reference to the circumstances prompting the creation of the trust and other extrinsic evidence is proper.

In reviewing trusts, there are several issues that you should to be aware of. There is a

different treatment for trusts which are self-settled and trusts which were settled by a third-party. **A self-settled trust is one in which the client has established a trust initially for his or her benefit and he or she is the current beneficiary. These tend to be revocable trusts.**

If the trust is not self-settled, and was settled by a third party, the inquiry then turns to what interest does the client have in the trust? Your analysis begins with reviewing the following:

- Copy of trust agreement.
- Copy of any and all amendments to the trust agreement.
- Schedule A of trust agreement which typically identifies the property originally used to fund the trust.
- Copies of actual conveyances into the trust which can include deeds, life insurance designations as trust beneficiary, etc.
- Current copy of any statements for financial accounts which have been funded into the Trust.
- Trust accountings.
- Trust tax returns.
- Copy of completed trust inventory if performed.

II. INTERESTS IN NON-SELF SETTLED TRUSTS CAN BE EXCLUDED FROM THE BANKRUPTCY ESTATE

As the bankruptcy practitioner, the preferable trust is one settled by a third-party. Also, interests which are either a mere expectancy or subject to a valid spendthrift provision are excluded from the bankruptcy estate and thus beyond the reach of the trustee.

Under § 541(a)(1), a bankruptcy estate is created upon a debtor's filing for bankruptcy, and the bankruptcy estate includes, "[e]xcept as provided in ... (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case." Section 541(c)(2) provides "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," and the Tenth Circuit BAP has interpreted § 541(c)(2) to mean that a debtor's beneficial interest in a spendthrift trust is entirely excluded from the bankruptcy estate. *See Case v. Hilgers (In re Hilgers)*, 371 B.R. 465, 468 (10th Cir. BAP 2007) ("Section 541(c)(2) of the Bankruptcy Code excludes from property of the estate a debtor's beneficial interest in a spendthrift trust.").

11 U.S.C. §541

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law--

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

(2) 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.

The Sixth Circuit BAP has held that "[d]ebtors bear the burden of demonstrating that all the requirements of § 541(c)(2) have been met before the property in question can be effectively excluded from the estate." This Court adopted the same standard in *In re McDonald* stating that

[t]o exclude property from the bankruptcy estate under § 541(c)(2), Debtors must satisfy three criteria. First, they must show that they have a beneficial interest in a trust. Second, they must show that there is a restriction on the transfer of that interest. Third, they must show that the restriction is enforceable under nonbankruptcy law.

III. HOW TO ATTACK TRUSTS IN BANKRUPTCY SELF-SETTLED TRUSTS

"Self-settled" trusts are those which were created primarily for the benefit of the client during his or her (or their) lifetime, perhaps as a method of avoiding probate. These trusts have implications in bankruptcy and should be **carefully** examined for the revocability of the instrument, and, to determine whether or not the trust was actually funded. The main issue with self-settled trusts is that the trustee can recover as a fraudulent transaction any transfer made to the trust within the past 10 years.

Fraudulent Conveyance -- 11 U.S.C. § 548(e)

(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—

- (A) such transfer was made to a self-settled trust or similar device;
- (B) such transfer was by the debtor;
- (C) the debtor is a beneficiary of such trust or similar device; and
- (D) 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.

Fraudulent conveyances are transfers made by an individual with either the actual intent to avoid the claims of creditors or a deemed or constructive intent to evade the claims of creditors. It is worth noting that this specific section of the Code does not contain some of the “safe harbors” which exist elsewhere in § 548.

BADGES OF FRAUD

As set forth in *In re Wreford*, 505 B.R. 47 (Bankr. D. N.M. 2014), indicia of fraud can take on a laundry list of attributes.

Like the meaning of "intent to hinder, delay, or defraud," the reliance on badges of fraud to determine whether the requisite fraudulent intent is present derives from English law. *BFP*, 511 U.S. at 540-41, 114 S.Ct. 1757.

The **badges of fraud** include:

- (1) the lack or inadequacy of consideration;
- (2) the family, friendship or close associate relationship between the parties;
- (3) the retention of possession, benefit or use of the property in question;
- (4) the financial condition of the party sought to be charged both before and after the transaction in question;
- (5) the existence or cumulative effect of the pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and
- (6) the general chronology of events and transactions under inquiry.

In re Soza, 542 F.3d 1060, 1067 (5th Cir.2008) (citations omitted); *Moore v. Lang* (*In re Lang*), 246 B.R. 463, 469 (Bankr.D.Mass.2000)(same) (citations omitted).

Additional indicia of fraud courts apply to determine whether a transfer was made with actual intent to hinder delay or defraud creditors include:

- (7) whether the transfer was disclosed or concealed;

- (8) whether the debtor made the transfer before or after being threatened with suit by creditors (a variant of factor (5));
- (9) whether the transfer involved substantially all of the debtor's assets;
- (10) whether the debtor absconded; and
- (11) whether the debtor was or became solvent at the time of the transfer.

Friedrich v. Mottaz, 294 F.3d 864, 870 (7th Cir.2002) (the Seventh Circuit also listed some of the badges of fraud recited in items 1 through 6 above). *See also Dionne v. Keating (In re XYZ Options, Inc.)*, 154 F.3d 1262, 1271 (11th Cir. 1998) (applying similar indicia of fraud).

These are similar to the non-exclusive list of badges of fraud set forth in the Uniform Fraudulent Transfer Act. *See Taylor*, 133 F.3d at 1338 (listing the badges of fraud under the Uniform Fraudulent Transfer Act).

Not all badges of fraud must be present before a Court may infer fraudulent intent; nor need they be given equal weight. *See Woodfield*, 978 F.2d at 518 (not all badges of fraud need be present in order to infer fraudulent intent from the circumstances surrounding the transaction);

SPENDTHRIFT TRUSTS

The bankruptcy code gives deference to state law when construing the validity of a "spendthrift trust." As with almost every state, spendthrift trusts are valid in Colorado. *In re Matteson*, 58 B.R. 909 (1986). The *Matteson* court outlined characteristics of a valid spendthrift trust in Colorado as follows:

1. A spendthrift trust is one which by the terms of the trust, restrains the voluntary or involuntary transfer of the beneficiary's interest;
2. A spendthrift trust which names the settlor as beneficiary is invalid; and
3. The operative issue is the extent of dominion and control a beneficiary possesses over the trust corpus.

WHAT PROPERTY RIGHTS DOES THE DEBTOR HAVE?

The question becomes what "property" rights the Debtor has in the trust under state law. *In re Marriage of Balanson*, 25 P.3d 28 (Colo. 2001). The *Balanson* Court was considering the basic question of what constitutes a property right under Colorado law.

We have also recognized a definition of "property" that includes "everything that has an exchangeable value or which goes to make up wealth or estate." *Id.* (citing

Black's Law Dictionary 1382 (4th ed.1968)). Finally, we have recognized a number of factors that should be considered when determining whether something constitutes property: "whether it can be sold, transferred, conveyed, or pledged, or whether it terminates on the death of the owner." *Id.* at 432, 574 P.2d at 77. We have also held that while enforceable contractual rights constitute property, interests that are merely speculative are mere expectancies. *Miller*, 915 P.2d at 1318; *Jones*, 812 P.2d at 1155; *In re Marriage of Grubb*, 745 P.2d 661, 664 (Colo.1987).

The issue in *Balanson* was determining whether a beneficiary had a vested property right in an irrevocable trust where there was a current income beneficiary. The income beneficiary was entitled to income, including distribution of principal if necessary, to meet his needs. The Court found that using the ascertainable standard for support set forth in the trust agreement that while the income beneficiary could potentially deplete the trust, the beneficiary's right to income was not without limit. The ascertainable standard contemplated and used by most trust agreement includes standards for the beneficiary's maintenance, education, safety and health. These standards, while broad, do impose a limitation on a trustee's ability to make distributions. The contingent beneficiary in *Balanson* was entitled to whatever remained in the corpus on the date of the income beneficiary's death and that interest was both present and vested.

Thus, the definition of property is broad and becomes enforceable once there is a vested right or interest, meaning that the right or interest in question is fixed by the happening of some event. *In re Question Submitted by the United States Court of Appeals for the Tenth Circuit*, 191 Colo. 406, 553 P.2d 382 (1976). With respect to trusts, the typical "fixing" of the right is when a trust becomes irrevocable at which time a named beneficiary has an interest spelled-out in the trust agreement. On the other hand, if the interest at the time of consideration is in a purely discretionary trust, then the particular beneficiary right is unenforceable and constitutes an "expectancy," but not a present property interest. *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991). An enforceable contract right under a trust agreement is a vested interest whereas an unenforceable interest is merely an expectancy and thus not a property interest. *Id.* The crucial question is: what discretion does the trustee have to make distributions?

If there is discretion, the beneficiary is unable to compel a distribution and if the beneficiary can not compel a distribution, neither can the bankruptcy trustee. The bankruptcy trustee can only reach a present interest in property, assuming the debtor has one, absent a spendthrift clause or other provision.

Whether a Debtor has any interest in a trust, whether a vested interest or an expectancy, depends on the powers that the trustee has, per the terms of the trust agreement, to use both principal and the corpus to pay for beneficiary expenses, and whether the Debtor/beneficiary has a vested remainder in the trust corpus. Even if a current beneficiary may receive distributions from the corpus of the trust at the sole discretion of the trustee, but does not possess a vested remainder interest in the corpus, the beneficiary has no presently vested property interest. *In re*

Marriage of Guinn, 93 P.3d 568 (Colo. App. 2004).

Where the existence of a right to receive income distributions is a vested property interest, the *Guinn* Court noted that the trustee could use discretion in determining what is allocable to principal and interest. The beneficiary had no right to principal (under the express terms of the particular trust agreement), and the beneficiary had no right to direct the investment of trust assets. Under that scenario, there could be instances where no distribution was mandated.

However, whenever there is an ability of a trustee to not only distribute net income but to also invade the trust corpus, if necessary, it is best if the beneficiary is not also a trustee or a co-trustee. In *United States v. Delano*, 182 F.Supp.2d 1020 (D. Colo 2001) the Court construed a trust under Colorado law and determined that the beneficiary in that interest had a present interest in the entirety of the trust corpus. In *Delano*, the trust agreement required, (in the Court's opinion, by the use of the word "shall,") the trustee was required to pay both the income and/or principal to the beneficiary. It did not help matters that the beneficiary was also a co-trustee of the trust. Under all of the facts, the Court determined that the beneficiary could in fact cause the trust to be liquidated, since the trust was reachable by a creditor.

In the case of a purely discretionary trust, wherein the beneficiary does not hold a remainder interest in the corpus of the trust, the beneficiary has no power to compel a distribution. A remainder interest in the corpus of a trust is a future interest in the principal (which these materials have referred to alternatively as the corpus) of a trust. Trusts often name beneficiaries whose rights are limited to income for life (for example) as in *Balanson*. Income beneficiaries fall broadly into two categories: those entitled solely to distributions of "distributable" net income (basically the income generated by the trust from the investment of the trust assets/corpus), and income beneficiaries who may invade the trust principal as well. Typically upon the death of such a beneficiary, the contingent beneficiaries (oftentimes the lineal descendants of the lifetime income beneficiary) will have a remainder interests in the trust corpus.

Also worth noting is that the existence of a right to receive income is not a vested right of a beneficiary, depending on the language of the trust agreement. The language of the spendthrift clause can be determinative of whether a distribution is mandatory for the trustee or merely discretionary. A beneficiary may have no present property interest in the corpus of a trust, even though a current income beneficiary (including the ability to invade principal if necessary), where the trustee retains the sole and complete authority to withhold distribution. *In re the Marriage of Rosenblum*, 602 P.2d 892 (Colo. App. 1979).

The significance a "spendthrift clause" is obvious. Its existence will protect property in an irrevocable third-party trust from the bankruptcy trustee as it is specifically excluded from the bankruptcy estate. What is the desired language to be contained in a spendthrift clause? Does the existence of a discretionary right to income affect the protections afforded by the spendthrift language?

A spendthrift clause is an instruction contained in a trust agreement which limits the ability of a beneficiary (and thus the beneficiary's creditors) to alienate any portion of the trust.

The following example below is of a spendthrift clause that has withstood creditor attacks (from a former spouse of the beneficiary) and thus is worth considering to see why it would keep trust income and principal safe from the claims of a bankruptcy trustee.

Example Spendthrift Provision:

No beneficiary shall have any right to anticipate, sell, assign, mortgage, pledge or otherwise dispose of or encumber all or any part of any trust estate established for his or her benefit under this agreement. No part of such trust estate, including income, shall be liable for the debts or obligations of any beneficiary or be subject to attachment, garnishment, execution, creditor's bill or other legal or equitable process. In addition, under no circumstances can any beneficiary compel a distribution from the trust for any purpose. In conferring discretion upon my Trustee in other portions of this will, it has been my intention to create a "discretionary trust" as that term is interpreted under present Colorado law, so that my Trustee shall have sole and absolute discretion with respect to making or failing to make distribution to or on behalf of any beneficiary of mine, to the end that no creditors, including any state or federal agencies who may furnish services, spouse of my beneficiary, trustee in bankruptcy, or any other creditor, may intercept or cause payments or benefits to a beneficiary hereunder, nor shall any creditor have any right to any of the income or principal of any trust created. Specifically if the beneficiary is involved in a bankruptcy, insolvency, divorce or other proceeding that would deprive the beneficiary of complete freedom to use or enjoy the trust asset, then the trustee, using his or her discretion, need not distribute the assets, but may hold the assets in trust until the beneficiary's situation changes and the restrictions and conditions are removed.

The restrictions on alienation in the above are numerous and the trustee clearly has full authority to make a distribution or not. The trust agreement using this provision would likely not be subject to a motion for turnover from the bankruptcy trustee.

Property received from inter vivos trust was not “bequest, devise, or inheritance”

Property received by the Chapter 7 debtor in the 180 days postpetition was not property of the estate, where (1) the debtor's parents established a revocable, inter vivos trust during their lifetimes; (2) under a pour-over provision in the debtor's mother's will, upon her death her assets were transferred to the trust; and (3) at that point, the trust corpus was distributed to the trust beneficiaries, one of whom was the debtor. Property rights are determined by state law, and,

under California law, distributions from an inter vivos trust do not constitute testamentary dispositions. Thus, the debtor's receipt of his share of the value of the trust's assets, although within 180 days postpetition, was not a "bequest, devise, or inheritance" for the purposes of Code § 541(a)(5)(A).

In re Cook, Case No. CC-08-1091-HMoD (9th Cir. BAP, Nov. 3, 2008), aff'd, 2010 WL 828529 (9th Cir., March 9, 2010). While the *Cook* case dealt with the receipt of an interest via a trust with a pour-over will provision, it would seem that payment of income would have a similar treatment.

WHERE THE TRUST CORPUS IS UNREACHABLE PER A VALID SPENDTHRIFT CLAUSE, BUT THERE ARE BENEFICIARY DISTRIBUTIONS

There are alternating treatments of the income which is distributed by a trustee. Assuming that there is a valid spendthrift clause or provision, there still remains an issue as to the treatment of the distributions. This issue regards what happens to the distributions made by the trustee directly to the beneficiary either prior to bankruptcy or after the bankruptcy is filed. Of course cases go both ways.

In re Massillon, 2010 WL 916891 (Bankr. D. Mass., March 10, 2010)

Trust distributions were not excluded from bankruptcy estate by Code § 541(c)(2):

While the debtor's interest in a spendthrift trust established under New York law was excluded from her bankruptcy estate by Code § 541(c)(2), distributions to the debtor from the trust were not excluded. Under § 541(c)(2), the distributions would be excluded from the estate only if they were subject to a "restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law." However, N.Y. C.P.L.R. § 5205(d)(1), which governed creditors' access to distributions from trusts subject to New York law, was a simple exemption statute, and not a statute that satisfied the requirements of § 541(c)(2), as § 5205(d)(1) limited only transfers by creditors, and not also transfers by the debtor.

OTHER ISSUES INVOLVING TRUST PROVISIONS

TRUST FUNDING

With any trusts, one of counsel's first inquiries is—what does the trust have? The existence of a trust is never going to be an issue with respect to a bankruptcy filing if the trust was **not** funded. Funding of the trust is exactly as the word suggests, i.e., not only has a trust been created by creating a class of beneficiaries with conditions, and a trustee to manage the trust, but that trust has to have a *corpus* to protect. (It is not unusual to find trusts that were

created with no follow-through as to placing assets in the trusts.)

WHEN TO GO TO COURT TO GET A JUDICIAL QUESTION ANSWERED ARISING DURING THE ADMINISTRATION OF THE TRUST

While “advisory opinions” are looked at askance in everyday practice, it is sometimes possible to obtain judicial clarification of the meaning of a trust agreement to determine the rights of creditors. In Colorado, as in most states, an interested party may seek clarification from the District Court of any questions which arise during the administration of a trust. The authorizing statutes can be found at C.R.S. C.R.S. § 15-16-201, *et seq.*

If there is any uncertainty as to the proper construction of a specific provision, but certainly, if there is any uncertainty with respect to the spendthrift provision, the best practice is to have the court issue a “comfort order.”

Once the state court has weighed in on the inquiry, a bankruptcy court would be hard-pressed to revisit the issue. The Rooker-Feldman doctrine prohibits federal courts review of decisions of state courts or claims inextricably intertwined with an earlier state-court judgment. The federal claim is inextricably intertwined with the state-court judgment if the federal claim succeeds only to the extent that the state court wrongly decided the issues before it. Where federal relief can only be predicated upon a conviction that the state court was wrong, it is difficult to conceive the federal proceeding as, in substance, anything other than a prohibited appeal of the state-court judgment. *See Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (U.S. 1923) and *D.C. Court of Appeals v. Feldman*, 460 U.S. 462 (U.S. 1983). The first case held that the power to hear appeals from state court judgments is exclusively held by the United States Supreme Court. The United States Supreme Court held in the second case that federal district courts do not have jurisdiction to hear challenges to certain state-court decisions.

IV. AMENDING THE TRUST WHEN THE DEBTOR IS A CONTINGENT BENEFICIARY

What if a potential debtor is a **contingent beneficiary under a trust**, but the trust itself is **fully revocable**. In that instance, consider counseling the client to approach the settlor about an amendment, which may be only temporary, or having the client disclaim his or her interests. Advising the client that if his interests “vests” during the 180 days post-filing of the bankruptcy. or during the lifetime of the Chapter 13 Plan, he may lose the *res* of the trust.

If the trust is revocable and if the settlor is willing to amend the trust, this will provide about as much security as can be given to ensure that the client’s potential interest in the trust is

protected against the claims of any and all creditors, namely the bankruptcy trustee. Of course, this method requires that one or both settlors have their capacity, meaning they are not incompetent, and of course, it does mean that someone will have to pay an elder law's fee for a trust amendment.

Disclaimer.

It may be possible for the Debtor to disclaim his or her interest in the trust prior to filing for bankruptcy with the disclaimer not treated as a transfer and thus a fraudulent conveyance.

At common law a disclaimer is generally considered to be:

The repudiation or renunciation of a right or claim vested in a person or which he had formerly alleged to be his. The refusal, waiver, or denial of an estate or right offered to a person. The disavowal, denial, or renunciation of an Interest, right, or property imputed to a person or alleged to be his. Also the declaration, or the instrument, by which such disclaimer is published. *Moore v. Clackamas County*, 40 Or.536, 67 P. 662. Of estates. The act by which a party refuses to accept an estate which has been conveyed to him. *Watson v. Watson*, 13 Conn. 85; *Kentucky Union Co. v. Cornett*, 112 Ky. 677, 66 S. W. 728 (Black's Law Dictionary).

Colorado law concerning probate disclaimers (among others) was updated in 2011 by the adoption of the Colorado Version of the Disclaimer of Property Interests Act codified at **C.R.S. § 15-11-1201, et. seq.** This Act sets forth the requirements.

While there is no Colorado case law, or Tenth Circuit case law which addresses disclaimers, it does appear that there would be a very good argument that the disclaimer would be effective and that a trustee in bankruptcy could not pursue a fraudulent conveyance argument if the disclaimer is properly done. While the best practice would be to refer a client to probate counsel to specifically discuss the disclaimer, and to have probate counsel prepare the disclaimer, included in the appendix is a sample form disclaimer which may be used for this very purpose. It is worth noting the statutory language with relevant provisions set forth below:

C.R.S. § 15-11-1205. Power to disclaim - general requirements - when irrevocable

(1) A person may disclaim, in whole or in part, any interest in or power over property, including a power of appointment. A person may disclaim the interest or power even if its creator imposed a spendthrift provision or similar restriction on transfer or a restriction or limitation on the right to disclaim.

(2) Except to the extent a fiduciary's right to disclaim is expressly restricted or limited by another statute of this state or by the instrument creating the fiduciary relationship, a

fiduciary may disclaim, in whole or in part, any interest in or power over property, including a power of appointment, whether acting in a personal or representative capacity. A fiduciary may disclaim the interest or power even if its creator imposed a spendthrift provision or similar restriction on transfer or a restriction or limitation on the right to disclaim, or if an instrument other than the instrument that created the fiduciary relationship imposed a restriction or limitation on the right to disclaim.

(3) To be effective, a disclaimer shall be in writing or other record, declare the disclaimer, describe the interest or power disclaimed, be signed by the person making the disclaimer, and be delivered or filed, and, with regard to an interest in real property, be recorded in the manner provided for in section 15-11-1212. In this subsection (3), "record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

(4) A partial disclaimer may be expressed as a fraction, percentage, monetary amount, term of years, limitation of a power, or any other interest or estate in the property.

(5) A disclaimer becomes irrevocable when it is delivered or filed and, with regard to an interest in real property, recorded pursuant to section 15-11-1212, or when it becomes effective as provided for in sections 15-11-1206 through 15-11-1211, whichever occurs later.

(6) A disclaimer made pursuant to this part 12 is not a transfer, assignment, or release.

(7) No person obligated to distribute an interest disclaimed under this part 12 shall be liable to any person for distributing the interest as if the interest were not disclaimed unless the person obligated to distribute the interest receives a copy of the disclaimer prior to distributing the interest.

C.R.S. § 15-11-1212. Delivery or filing

* * * * *

(2) Subject to subsections (3) to (15) of this section, delivery of a disclaimer may be effected by personal delivery, first class mail, or any other method likely to result in its receipt.

Since we are contemplating that the Debtor is disclaiming an interest in a trust the notice would be given to the current trustee. It would seem possible that if the client is concerned about any inheritance becoming property of the bankruptcy estate, the client may consider disclaiming his or her interests. A few bankruptcy courts have reached the question of whether or not a disclaimer is a fraudulent transfer, and the answer seems to be no so long as the timing of the

disclaimer is done before the bankruptcy filing. Whether or not a disclaimer is valid is determined by state law. *In re Stanford*, 369 B.R. 609 (B.A.P. 10th Cir. 2007).

APPLICABLE CASES CONSTRUING PROPERTY OF THE ESTATE VIS-A-VIS' A DISCLAIMER

While Rhode Island law permitted the Chapter 7 debtor to disclaim her one-quarter remainder interest in certain real property, upon her bankruptcy filing the right to disclaim the property interest because property of the estate and could only be exercised by the Chapter 7 trustee. See *In re Stambaugh*, 2010 WL 3724773 (Bankr. N.D. Iowa 2010). Furthermore, a postpetition disclaimer by the debtor would be an unauthorized postpetition transfer subject to avoidance under Code § 549. See *Williams v. Chenoweth*, 132 B.R. 161 (Bankr. S.D. Ill. 1991), aff'd on other grounds, *In re Chenoweth*, 143 B.R. 527 (S.D. Ill. 1992), aff'd, 3 F.3d 1111 (7th Cir. 1993). *In re Cotto Colon*, 2013 WL 209156 (Bankr. D. Puerto Rico, Jan. 17, 2013) (case no. 3:11-bk-4001; adv. proc. no. 3:12-ap-2) (Chief Bankruptcy Judge Enrique S. Lamoutte) also: *In re Costas*, 346 B.R. 198 (9th Cir. BAP 2006)“. . .[U]nder [Arizona] state law, a debtor's prepetition effective disclaimer of an inheritance is not avoidable as a fraudulent transfer under section 548.” *In re Bright*, 241 B.R. 664 (9th Cir. BAP 1999) is still good law. Whether the disclaimer is effective, may turn in some instances on the exact language of state law, particularly as noted by the *Costas* court.

SPENDTHRIFT PROVISIONS IN COLORADO

SECTION 502. SPENDTHRIFT PROVISIONS
UNIFORM TRUST CODE COMMITTEE

ARTICLE 5

CREDITOR CLAIMS; SPENDTHRIFT; AND DISCRETIONARY TRUSTS

1. UTC SECTION 502

2. SUBJECT

SPENDTHRIFT PROVISION

3. UTC STATUTE

(a) A spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest.

(b) A term of a trust providing that the interest of a beneficiary is held subject to a "spendthrift trust," or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.

(c) A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this [article], a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.

**4. NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS
COMMENTS**

Under this section, a settlor has the power to restrain the transfer of a beneficiary's interest, regardless of whether the beneficiary has an interest in income, in principal, or in both. Unless one of the exceptions under this article applies, a creditor of the beneficiary is prohibited from attaching a protected interest and may only attempt to collect directly from the beneficiary after payment is made. This section is similar to Restatement (Third) of Trusts § 58 (Tentative Draft No. 2, approved 1999), and Restatement (Second) of Trusts §§ 152-153 (1959). For the definition of spendthrift provision, see Section 103(15).

For a spendthrift provision to be effective under this Code, it must prohibit both the voluntary and involuntary transfer of the beneficiary's interest, that is, a settlor may not allow a beneficiary to assign while prohibiting a beneficiary's creditor from collecting, and vice versa. *See*

Restatement (Third) of Trusts § 58 cmt. b (Tentative Draft No. 2, approved 1999). *See also* Restatement (Second) of Trusts § 152(2) (1959). A spendthrift provision valid under this Code will also be recognized as valid in a federal bankruptcy proceeding. See 11 U.S.C. § 541(c)(2).

Subsection (b), which is derived from Texas Property Code § 112.035(b), allows a settlor to provide maximum spendthrift protection simply by stating in the instrument that all interests are held subject to a "spendthrift trust" or words of similar effect.

A disclaimer, because it is a refusal to accept ownership of an interest and not a transfer of an interest already owned, is not affected by the presence or absence of a spendthrift provision. Most disclaimer statutes expressly provide that the validity of a disclaimer is not affected by a spendthrift protection. *See, e.g.,* Uniform Probate Code § 2-801(a). Releases and exercises of powers of appointment are also not affected because they are not transfers of property. See Restatement (Third) of Trusts § 58 cmt.

A spendthrift provision is ineffective against a beneficial interest retained by the settlor. See Restatement (Third) of Trusts § 58(2), approved 1999. This is a necessary corollary to Section 505(a)(2), which allows a creditor or assignee of the settlor to reach the maximum amount that can be distributed to or for the settlor's benefit. This right to reach the trust applies whether or not the trust contains a spendthrift provision.

A valid spendthrift provision makes it impossible for a beneficiary to make a legally binding transfer, but the trustee may choose to honor the beneficiary's purported assignment. The trustee may recommence distributions to the beneficiary at any time. The beneficiary, not having made a binding transfer, can withdraw the beneficiary's direction but only as to future payments. See Restatement (Third) of Trusts § 58 cmt. d (Tentative Draft No. 2, approved 1999); Restatement (Second) of Trusts § 152 cmt. i (1959).

CASE LAW¹

Property owned by debtor's self-settled revocable trust was property of estate:

Under Hawaii law, a self-settled revocable trust is not a separate legal entity from the settlors, so that property owned by the trust is considered to be owned by the settlors. Thus, here, property titled in the name of the Chapter 7 debtors' self-settled revocable trust belonged to the debtors and was property of their bankruptcy estates.

In re Nielsen, 526 B.R. 351 (Bankr. D. Hawai'i, March 11, 2015)

(case no. 1:14-bk-974; adv. proc. no. 1:14-ap-90044) (Bankruptcy Judge Robert J. Faris)

Indian tribe's per capita payments were not excluded from estate in absence of trust:

Surveying and adhering to prior cases from the district, the court held that a debtor's per capita payments from an Indian tribe were property of the estate, even though the debtor's interest in future payments was a contingent interest, and that the payments were not excluded from the estate under Code § 541(c)(2) because no trust existed.

In re McDonald, 519 B.R. 324 (Bankr. D. Kan., Oct. 27, 2014)

(case nos. 5:14-bk-40529, 5:14-bk-40543) (Bankruptcy Judge Janice Miller Karlin)

Assets of revocable trust were property of bankruptcy estate:

Because the Chapter 7 debtors, as trustees of a trust, had the absolute power to revoke the trust, the assets of the trust were property of the debtors' bankruptcy estates, at least where, as here, the debtors, as the settlors of the trust, retained a general power of appointment. See *In re Tougas*, 338 B.R. 164 (Bankr. D. Mass. 2006), distinguishing *George v. Kitchens by Rice Bros., Inc.*, 665 F.2d 7 (1st Cir. 1981).

In re Vanbuskirk, 511 B.R. 220 (Bankr. D. Mass., May 20, 2014)

(case no. 4:13-bk-41947) (Bankruptcy Judge Melvin S. Hoffman)

EXCLUSION FROM ESTATE AS SPENDTHRIFT TRUST

¹ Excerpts printed with the consent of Robin Miller, Esq. and her marvelous *Consumer Bankruptcy Abstracts & Research*. www.cbar.pro

Entire trust principal was estate property despite spendthrift clause:

Where the Chapter 7 debtor was one of the settlors (along with her now-deceased husband) of a trust under which she was also a beneficiary, with rights to both the lifetime net income of the trust as well as distributions of principal necessary for the debtor's "proper care, maintenance or support," both the debtor's right to trust income and her right to a distribution of trust principal were property of the estate. While the trust had a spendthrift provision, Cal. Prob. Code § 15304(a) rendered the spendthrift clause unenforceable against a transferee or creditor of a settlor who, like the debtor, was also a beneficiary, and the Chapter 7 trustee was a transferee of the debtor under Code § 541. While Cal. Prob. Code § 15304(b) limits a creditor's right to reach trust assets to the amount of a settlor's "proportionate contribution to the trust," *In re Cutter*, 398 B.R. 6 (9th Cir. B.A.P. 2008) held that "[i]f, however, the trust agreement allows the debtor-beneficiary to exercise control over and reach trust property contributed by others, the estate is entitled to the maximum amount that the trust could pay or distribute to the debtor-beneficiary." Accordingly, the bankruptcy estate was entitled to the entire trust principal.

In re Salkin, 526 B.R. 31 (Bankr. C.D. Cal., Feb. 26, 2015)

(case no. 6:13-bk-28775) (Bankruptcy Judge Mark S. Wallace)

Ninth Circuit certifies question as to amount of beneficiary's interest in spendthrift trust that enters bankruptcy estate:

In an appeal from *In re Reynolds*, 479 B.R. 67 (9th Cir. B.A.P., August 24, 2012), the Court of Appeals certified to the California Supreme Court the question: "Does section 15306.5 of the California Probate Code impose an absolute cap of 25 percent on a bankruptcy estate's access to a beneficiary's interest in a spendthrift trust that consists entirely of payments from principal, or may the bankruptcy estate reach more than 25 percent under other sections of the Probate Code?" The California Supreme Court accepted the certified question; the case is docketed as *Frealy v. Reynolds*, Case No. S224985 (Cal. Sup. Ct., filed May 11, 2015). The case involves a debtor whose interest as a beneficiary of a spendthrift trust consists of principal that is payable to the debtor but has not yet been paid; the debtor acquired the interest upon the death of his father.

Frealy v. Reynolds, 779 F.3d 1028 (9th Cir., March 9, 2015)

(case no. 12-60068)

Annuity was not spendthrift trust excluded from bankruptcy estate:

Language in a structured settlement annuity contract, providing that “[t]o the extent allowed by law and subject to the policy's provisions, all benefits and money available or paid to any person and relating in any manner to this policy will be exempt and free from such person's debts, contracts and engagements, and from judicial process to levy upon or attach the same,” did not render the annuity a spendthrift trust excluded from the bankruptcy estate under Code § 541(c)(2). The court said that it had been Callicott replaced and unable to locate any case law in which the proceeds of a structured settlement were found to be held in trust for a payee-annuitant, and none appeared to exist. In any event, the legal requisites for the creation of a trust under California law, such as manifestation of an intent to create a trust, had not been satisfied.

In re Pipkins, 2014 WL 2756552 (Bankr. N.D. Cal., June 16, 2014)

(case no. 3:13-bk-30087) (Bankruptcy Judge Dennis Montali)

Debtor's interest in trust was protected by spendthrift provision and therefore excluded from estate:

The debtor's contingent remainder interest in a family trust was protected by a spendthrift provision in the documents establishing the trust and therefore was excluded from property of the estate under Code § 541(c)(2). The trust documents provided that “[a]ny payment of principal or income shall be free from the interference and control of creditors and from all marital control and shall not be anticipated by way of assignment, whether voluntary or by process of law, and each such payment shall be so protected until its actual receipt by the appropriate recipient as authorized hereunder.” As this language was sufficient to encompass the payment of the remaining trust assets to the debtor upon the death of her parents, the debtor's remainder interest in the trust was within the scope of the spendthrift provision.

In re Alamed, 2014 WL 3534004 (Bankr. D. Mass., July 15, 2014)

(case no. 3:13-bk-30356) (Bankruptcy Judge Henry J. Boroff)

“Spendthrift” provisions in debtor's life insurance policies did not cause exclusion of policies from bankruptcy estate under Code § 541(c)(2):

“Spendthrift” provisions in the Chapter 7 debtor's life insurance policies, which stated that “[s]o far as permitted by law, no amount payable under this policy shall be subject to the claims of creditors of the payee,” did not exclude the policies from the debtor's bankruptcy estate under Code § 541(c)(2), as the provisions applied only to payees who were “beneficiaries” designated by the owner, and the debtor, though both the owner of and the insured under the policies, was not a beneficiary under the policies, and in any event § 541(c)(2) applies only to trusts.

In re Lee, 514 B.R. 578 (Bankr. C.D. Ill., July 23, 2014)

(case no. 1:13-bk-82374) (Bankruptcy Judge Thomas L. Perkins)

Debtor's interest in trust was protected by spendthrift provision and therefore excluded from estate:

The debtor's beneficial interest in a trust was excluded from the bankruptcy estate by Code § 541(c)(2) where the document creating the trust contained a spendthrift clause that was valid under Nebraska law to create a spendthrift trust. The trust document did not give the debtor the right to withdraw his interest in the trust at any time; the Chapter 7 trustee asserted that the debtor had such a right and that this destroyed the spendthrift nature of the trust.

In re Odell, 2014 WL 2987434 (Bankr. D. Neb., July 1, 2014)

(case no. 8:14-bk-80602) (Chief Bankruptcy Judge Thomas L. Saladino)

Debtor's right to distribute trust assets was not excluded from estate by Code § 541(b):

The debtor's power to distribute assets of a trust named for his wife was property of the estate, and was not excluded from the estate by Code § 541(b), which applies to "any power that the debtor may exercise solely for the benefit of an entity other than the debtor." Where the trust document stated that "[t]he trustees shall distribute to me or apply for my benefit such amounts of net income and principal ... as the trustees believe desirable from time to time for the health, support in reasonable comfort, best interests, and welfare of [the debtor or his wife] and me," it was unmistakable that the debtor, as co-trustee, had the authority to distribute amounts of net income and principal to or for the benefit of his wife and himself. Accordingly, the debtor's powers were not exercisable solely for the benefit of someone else.

Spendthrift provisions were valid so that trust assets were excluded from estate:

The spendthrift provisions in two trusts were valid under Missouri law, so that the assets of the trusts were excluded from the debtor's bankruptcy estate under Code § 541(c)(2).

In re Reuter, 499 B.R. 655 (Bankr. W.D. Mo., Sept. 12, 2013)

(case no. 2:07-bk-21128; adv. proc. no. 2:12-ap-2028) (Chief Bankruptcy Judge Dennis R. Dow)

Debtor's power of appointment under trust rendered spendthrift provision unenforceable:

An unexercised power of appointment possessed by the Chapter 7 debtor, as a beneficiary of a spendthrift trust established by the debtor's deceased father for the benefit of the debtor and his siblings, to demand immediate payment of his distributive share of the trust following the father's death was included in property of the debtor's bankruptcy estate. Because the Chapter 7 trustee could exercise the power, the trust's spendthrift provision was unenforceable, and Code § 541(c)(2) did not exclude the debtor's trust interest from the bankruptcy estate.

In re Behan, 506 B.R. 8 (Bankr. D. Mass., Feb. 25, 2014)

(case no. 1:12-bk-14921; adv. proc. no. 1:13-ap-1376) (Bankruptcy Judge Joan N. Feeney)

Debtor's authority as trustee of trust did not supersede trust's spendthrift provision:

The Chapter 7 debtor's authority as the trustee of a trust to distribute net income and principal to herself as a beneficiary of the trust did not constitute a "power of withdrawal" that, under Kansas law, would supersede the trust's spendthrift provision and render inapplicable, at least in part, the exclusion of the trust under Code § 541(c)(2) from property of the estate.

In re Skubitz, 2014 WL 222103 (Bankr. D. Kan., Jan. 21, 2014)

(case no. 6:12-bk-11544) (Bankruptcy Judge Dale L. Somers)

Annuity under which debtor received payments was not trust excluded from bankruptcy estate:

While an annuity under which the debtor wife received periodic payments prohibited the wife from assigning her right to receive the payments under the annuity, and the anti-assignment clause was valid, the presence of the anti-assignment clause did not render the annuity a spendthrift trust. Rather, the clause's presence was required in order to confer favorable tax treatment on the firm that owned the annuity. Therefore, the debtor's right to receive payments from the annuity was not excluded from the debtor's bankruptcy estate by Code § 541(c)(2).

In re Greenly, 481 B.R. 299 (Bankr. E.D. Pa., Oct. 12, 2012)

(case no. 2:11-bk-15397) (Bankruptcy Judge Magdeline D. Coleman)

Annuity contract was not trust excluded from bankruptcy estate by Code § 541(c)(2):

An annuity contract under which the debtor received monthly payments was not excluded from property of the estate under Code § 541(c)(2). While the contract contained anti-alienation language, there was no evidence that, under Nebraska law, the contract created a trust.

In re Drake, 2012 WL 1095501 (Bankr. D. Conn., March 29, 2012)

(case no. 2:07-bk-21678; adv. proc. no. 2:08-ap-2118) (Bankruptcy Judge Albert S. Dabrowski)

Hawaii law governed spendthrift trust, which was excluded from property of estate:

In a 2-1 decision, the BAP held that the bankruptcy court did not err in concluding that a spendthrift trust, of which the Chapter 7 debtor was the trustee and the beneficiary, was governed by Hawaii, rather than California, law. When the debtor's mother created the trust, which specified that Hawaii law controlled, in 1978, she was domiciled in Hawaii, her assets were located in Hawaii, and the debtor, one of the beneficiaries, was domiciled in Hawaii and remained a citizen of Hawaii for over 70 years. Furthermore, the trust was administered by a Hawaii corporate trustee. Because Hawaii had a substantial relationship to the parties and a reasonable basis otherwise existed for the choice of law, the mother's choice of law would be enforced unless the Chapter 7 trustee could establish both (1) that the chosen law was contrary to a fundamental policy of California and (2) that California had a materially greater interest in the determination of the particular issue. As the trustee did not make these showings, the corpus of the trust was excluded from the state by Code § 541(c)(2), as under Hawaii law spendthrift trusts were immune from creditors' claims. Had California law controlled, the trustee may have been able to reach up to 25% of the principal of the trust. Moreover, the distributions of income from the trust did not become property of the estate under Code § 541(a)(5)(A).

In re Zukerkorn, 484 B.R. 182 (9th Cir. B.A.P., Dec. 19, 2012), appeal filed, Case No. 13-60003 (9th Cir., filed Jan. 16, 2013)

(case no. 11-1506)

Trust was spendthrift trust under North Carolina law and hence was excluded from estate:

Under N.C. Gen. Stat. § 36C-5-502, as interpreted by the bankruptcy court, the Chapter 7 debtor's one-third beneficial interest in a trust created by her parents was protected by a valid spendthrift provision and was therefore excluded from her bankruptcy estate by Code § 541(c)(2), despite the debtor's ability under the trust instrument, as the sole trustee of a trust with multiple beneficiaries, to exert dominion and control over the trust.

In re Trawick, 497 B.R. 572 (Bankr. C.D. Cal., August 29, 2013), appeal filed, Case No. 2:13-cv-06852 (C.D. Cal., filed Sept. 17, 2013)

(case no. 2:12-bk-12581; adv. proc. no. 2:12-ap-2039) (Bankruptcy Judge Robert Kwan)

Trust was not excluded from estate under Code § 541(c)(2) as spendthrift trust:

Even if the corpus of a trust had been contributed by the debtor's husband, and the trust documents had a spendthrift provision, the assets of the trust were property of the debtor's bankruptcy estate where, on the petition date, she was both the trustee and the sole beneficiary of the trust, so that, under Virginia law, all of the assets of the trust were reachable by the debtor's creditors.

In re Salahi, 2012 WL 1438213 (Bankr. E.D. Va., April 25, 2012)

(case no. 1:11-bk-16621) (Bankruptcy Judge Brian F. Kenney)

COLORADO CASES

Trust was sham trust rather than valid spendthrift trust under Colorado law:

Affirming *Peters v. Bryan*, 2010 WL 3894035 (D. Colo., Sept. 29, 2010), which had affirmed in part and reversed in part *In re Bryan*, 415 B.R. 454 (Bankr. D. Colo., Sept. 4, 2009), the Court of Appeals found no error in the bankruptcy court's conclusion that, under Colorado law, a trust established by the Chapter 7 debtor and his wife was a sham trust rather than a valid spendthrift trust. Accordingly, the debtor's interest in the trust was not excluded from his bankruptcy estate by Code § 541(c)(2).

In re Bryan, 495 Fed. Appx. 884 (10th Cir., August 23, 2012)

(case no. 10-1503)

Will did not create spendthrift trust:

The Chapter 13 debtor's father's will did not create a spendthrift trust to hold the property devised to the debtor in the will, although the will contained a spendthrift provision, as the will created a trust only if a beneficiary was under the age of 21 or under a disability at the time of the father's death, and neither was true of the debtor.

In re Blakely, 2011 WL 4458830 (Bankr. D. Colo., Sept. 23, 2011)

(case no. 1:11-bk-13674) (Bankruptcy Judge Michael E. Romero)

Divorce and Bankruptcy

Hypothetical One

General principles of bankruptcy and divorce proceedings.

Bill files for bankruptcy relief in the Bankruptcy Court for the District of Arizona. Post-petition, his wife Hillary files for divorce in Arizona Superior Court. Hillary seeks child support for the couple's two children and spousal maintenance. The couple owns a home in upstate New York, and is currently renting an apartment here in Arizona while Bill completes a four-year commitment teaching ethics at Arizona State University.

The state court issues a dissolution decree in which it orders Bill to pay Hillary \$2,000 a month in child support and \$3,000 a month in spousal maintenance. The court also awards Hillary the family home with all its furnishings, one automobile, and half of the couple's cash on hand. Hillary is responsible for making all monthly payments on the home and car moving forward. Bill gets to keep his \$200,000 IRA account, but is ordered to make an equalization payment to Hillary of \$100,000 representing half of the 401K balance. Bill is responsible for paying off the couple's \$15,000 credit card balances. The court issues a dissolution decree setting forth these settlement terms and dissolving the marriage.

a. Do any of these actions violate the automatic stay in Bill's bankruptcy?

Yes. 11 U.S.C. section 362(a) provides for a statutory stay that goes into effect automatically upon the filing of a bankruptcy petition. It prevents creditors and others from taking any action to collect on a debt or otherwise interfere with the property of the bankruptcy estate or administration of the case. Prior to BAPCPA, this meant that dissolution proceedings could not proceed without stay relief. However, subsection (b) to 362 now permits prosecution of a dissolution proceeding without seeking bankruptcy relief. Subsection (b)(2) includes various other exceptions to the stay, including proceedings treating with the establishment of paternity, modification of domestic support and/or orders regarding child custody, dissolution of marriage or incidents of domestic violence. A court may not, however, make a determination for the division of property that is property of the estate. This inability often makes it difficult to enter a final decree in the case until the bankruptcy court has determined how to proceed with the estate property. This requirement drives state court judges crazy.

The division of community assets and liabilities in the above hypothetical runs afoul of the stay. The child support and spousal maintenance order do not violate the stay, nor does the actual dissolution of the marriage. Additionally, the assignment of the IRA to Bill would presumably not violate the stay because the account is exempt from the reach of creditors and not property of the estate pursuant to 11 U.S.C. § 522(b)(3)(C) and A.R.S. § 33-1126(B).

b. May Hillary actually collect the child support and spousal maintenance obligation while Bill is in bankruptcy and, if so, from what property?

Prior to BAPCPA, confusion existed as to what property could be used to pay support obligations. Generally, in a chapter 13 or 11, post-petition earnings of individual debtors are property of the estate until the case is closed, dismissed or converted to another chapter and, therefore, would not be available to pay any of the debtor's debts other than in accordance with the terms of his/her bankruptcy plan. 11 U.S.C. §§ 1306 & 1115. Under chapter 7, post-petition earnings are not property of the estate and, therefore, are available to pay debtor's obligations, including support obligations.

Section 362(b)(2)(C), however, now provides that a state court may withhold income that is property of the estate or property of the debtor in payment of a “domestic support obligation.” This resolves the earlier confusion as to whether post-petition income in a chapter 13 or 11 may be ordered to pay the support obligation. Such property is available, as long as there is a judicial or administrative order (or statute). Additionally, a chapter 7 debtor’s post-petition income is available, as well as property acquired after filing the petition. Property not claimed as exempt, is also available. Finally, those owing post-petition support should be aware of the inherent powers of family courts to obtain support payments (e.g., use of the “magic room”).

Hypothetical Two **Consequences of not paying attention to a pending bankruptcy.**

Bill receives his § 727 discharge, but the case has not been fully administered or closed. The state court enters a divorce decree dissolving Bill and Hillary’s marriage and dividing the community property and debt. To achieve an equitable division of community property, the court orders Bill to reimburse Hillary one-half of their 2014 tax refund and to pay her one-half of the proceeds from the trustee’s liquidation of their rental properties. Both the tax refund and the rental properties are indisputably property of Bill’s estate under § 541(a)(2). In addition, the trial court finds Bill responsible for any credit card debts incurred after filing for divorce but prior to filing bankruptcy. After the trial court enters its dissolution decree, Hillary files an amended proof of claim in Bill’s bankruptcy case for half of the 2014 tax refund and half of the proceeds from the sale of the rental properties. Bill objects and files a motion to enforce his discharge injunction, arguing the state court’s order violated his discharge injunction.

a. Did any of these actions violate the automatic stay in Bill’s bankruptcy?

Yes. The trial court violated the discharge injunction by attempting to impose personal liability on Bill for his discharged debts. Any prepetition debts were discharged as to Bill personally and as to the community (but not as to Hillary personally). Additionally, the tax refund was property of the estate and only the trustee in the bankruptcy court had authority to pay out those funds. Similarly, with respect to the rental property proceeds, these were community proceeds that are required to go first to pay community liabilities. While Hillary retains an equity interest in these proceeds, she only recovers from these proceeds if there is any equity interest left after paying the couple’s community liabilities. As a result, the state court’s property division was null and void. *In re Kostenko*, BAP No. AZ-14-1381-JuKiPa (July 9, 2015).

While the bankruptcy discharge prevents the trial court from ignoring Bill’s discharge, it does not “terminate the matter of division and distribution as between the divorcing spouses. Jurisdiction over the division and distribution of the parties’ property as between themselves pursuant to the divorce returns to the state court’ once the bankruptcy is closed.” *Kostenko*, at p. 21 (quoting *Shulkin Hutton Inc. v. Treiger (In re Owens)*, 2007 WL 7540999, at *6 (9th Cir. BAP June 25, 2007)). In the hypothetical above, Hillary may hold a nondischargeable equitable claim that may be determined by the state court case once the bankruptcy case is closed. Some states permit their courts to allocate community liabilities between the parties to effectuate an equitable division. “[W]hile the expungement of [wife’s] Amended [bankruptcy proof of claim] may affect her right to distribution from bankruptcy estate property, it does not prevent her from pursuing collection of a prepetition debt even if Debtor received his discharge because debts for property division in divorce decrees are nondischargeable under § 523(a)(15).” *Id.* at 22. The state court may have been more successful in

simply awarding a fixed dollar amount to Hillary, as opposed to awarding her specific property that was in fact property of the estate.

If one is unsure about proceeding with a marital dissolution proceeding, it may be best for an interested party to file a motion or other appropriate pleading with the bankruptcy court and have the bankruptcy court determine whether the automatic stay applies. If proceedings result in a judgment that is later determined to have been in violation of the automatic stay, the judgment may be void or voidable by the bankruptcy court. *See In re Schwartz*, 954 F.2d 569 (9th Cir. 1992).

Hypothetical Three **To whom do the exemptions belong?**

Bill claims a \$150,000 homestead exemption pursuant to Arizona's homestead exemption statute in the couple's home in upstate New York. He also claims a total exemption of \$12,000 in the couple's Cadillac Escalade, claiming \$6,000 as his exemption and \$6,000 as Hillary's exemption under A.R.S. § 33-1125.

a. Can Bill essentially double the automobile exemption under A.R.S. § 33-1125?

Yes. With respect to personal property, a single filing spouse in Arizona may generally double the amount each spouse could claim as a single person when only one spouse files for bankruptcy. *See* A.R.S. § 33-1121.01 ("In the case of married persons, each spouse is entitled to the exemptions provided in this article, which may be combined with the other spouse's exemption in the same property or taken in different exempt property."); *In re Perez*, 302 B.R. 661 (Bankr. D. Ariz. 2003)(allowing the doubling of personal exemptions where only one spouse files for bankruptcy). *But see In re Fox*, 302 P.3d 1137 (Nev. 2013)(holding that Nevada exemption law does not allow a debtor to claim an exemption on behalf of the nonfiling debtor). As of the petition date, in our hypothetical, the parties are still married and all community property becomes property of the estate under 541(a)(2)(A). There is no prohibition on one spouse claiming both spouse's personal property exemptions.

b. Can Bill claim Arizona's homestead exemption on a property he does not currently reside in and that is located out of state?

Maybe. At least one Arizona bankruptcy judge has concluded that nothing in A.R.S. § 33-1101, or any other law, prohibits extraterritorial application of Arizona's homestead exemption law, as long as the debtor intends to reside in the home and has not abandoned the homestead. *In re Weaver*, 15-bk-00792-MCW (2015). Even though debtor may not be physically present at the property for an extended period of time, a temporary absence will not defeat a homestead claim if the debtor intends the premises to be his residence. *See In re Garcia*, 168 B.R. 403 (D. Ariz. 1994).

Bill is entitled only to one homestead exemption. Unlike his ability to double up on personal exemptions, there is no doubling up of homestead exemptions in Arizona. By its very terms, "[o]nly one homestead exemption may be held by a married couple or a single person under this section. The value as specified in this section refers to the equity of a single person or married couple." A.R.S. § 33-1101(B).

Hypothetical Four
What debts are discharged?

Upon filing bankruptcy, Bill owed the Bank of Arkansas \$5,000 in outstanding credit card debt he accrued prior to marriage. This was his sole and separate liability. He and Hillary also owed \$25,000 to Government Motors (G.M.) for a Cadillac Escalade they purchased a few years back and an additional \$15,000 in credit card debt accrued by both during their marriage. In addition, during their marriage, a judgment was entered against Hillary for fraud. Bill listed this debt as a community debt, and the judgment creditor was provided notice of Bill's bankruptcy filing. Nonetheless, the judgment creditor failed to object to discharge, and Bill was granted a discharge.

Bill's bankruptcy estate consists of all his sole and separate property and all of the couple's community property. *See In re Peterson*, 437 B.R. 858, 866 (D. Ariz. 2010). Subject to any exemptions, the trustee would be able to sell any of Bill's sole and separate property and community property to pay the estate's debts. Bill would receive a personal discharge, discharging him from his separate and community debts (his debts to both credit card companies and GM). Bill would not be liable for any of Hillary's sole and separate debts, whether they were incurred prior to or after they were married. Hillary would be liable for those debts as her sole and separate obligations.

Because the trustee may sell the community's assets to pay the estate's debts, Hillary will lose her one-half interest in the couple's community assets. However, in exchange, she will receive what is colloquially referred to as a community discharge pursuant to 11 U.S.C. § 523(a)(3). The community discharge is not technically a discharge, but is more properly characterized as an injunction prohibiting creditors from collecting against any after-acquired community property of the nonfiling spouse for any of the discharged debts. Hillary, as the nonfiling spouse, is still responsible for her separate *and* community debts, but the community discharge limits the property against which a creditor may proceed, removing the couple's community property from collection by the creditor.

Additionally, because the judgment creditor did not object, Bill receives a personal discharge as to the judgment debt. Hillary would remain liable on the judgment debt, but the judgment creditor would be enjoined from pursuing any of the couple's community assets. If Hillary has little to no separate property, the judgment creditor may be left with no assets against which to recover against Hillary.

If the judgment creditor had objected to discharge in Bill's bankruptcy, a question would have arisen as to whether the debt was really a community debt or a sole and separate debt of Hillary's. While generally debts incurred during marriage are considered community obligations, this presumption can be overcome by clear and convincing evidence. Bill may argue that he had no knowledge of this debt, did not consent to Hillary's fraudulent conduct, or did not participate in the fraud himself to establish that the debt is Hillary's sole and separate obligation. However, where a debt is incurred for the benefit of the community, the debt is generally considered a community obligation, regardless of the innocence or lack of knowledge by the spouse not incurring the debt. *In re Rollinson*, 322 B.R. 879, 882 (Bankr. D. Ariz. 2005). The innocent spouse defense only applies when seeking to determine the *liability* of the innocent spouse's sole and separate property for that debt. *Id.* at 881-82.

Assuming the judgment is community debt, and the court concludes it is nondischargeable under 523(a)(2), future community property will be liable for this debt, despite Bill's personal discharge

and the community discharge. 11 U.S.C. 524(a)(3). “This happens automatically by operation of §§ 524(a)(3) and (b), without the necessity for any determination as to the knowledge or participation of the ‘innocent’ spouse, so long as the debt is community debt. This is true regardless of whether the spouse filing for bankruptcy is ‘an innocent spouse.’” *Rollinson*, 322 B.R. at 883. There is no community discharge available for a community claim where either spouse engaged in wrongful conduct. 4 Collier on Bankruptcy, ¶ 524.02[3][a], at 524-28 (15th ed. Rev. 2005). The guilty spouse cannot hide behind the discharge of the innocent spouse. *In re Le Sueur*, 53 B.R. 414, 417 (Bankr. D. Ariz. 1986); *In re Bush*, 2005 WL 6960185 * 4 (9th Cir. BAP). If that were the case, Bill and Hillary’s after-acquired community property would be liable for this debt.

The next question, however, is the scope of the discharge (or more appropriately the scope of nondischargeability) beyond the community discharge. If the judgment creditor objects and the debt is in fact a community obligation, is Bill entitled to discharge this debt as to his sole and separate property? This question focuses on whether he is in fact an “innocent spouse.” To attribute liability to Bill personally for this debt, a creditor would have to establish some kind of agency relationship between Bill and Hillary, other than simply the fact that they are spouses, or establish fraudulent intent/culpable conduct by Bill. See *In re Tsurukawa*, 258 B.R. 192, 198 (9th Cir. BAP 2001); *In re Oliphant*, 221 B.R. 506, 511 (Bankr. D. Ariz. 1998)(holding that “‘in order for the debt to be nondischargeable in the ‘innocent’ spouse’s [separate] bankruptcy,’ the plaintiff seeking a nondischargeability order ‘must show culpable conduct or fraudulent intent on the part of the ‘innocent’ spouse.’”). Fraudulent intent can be shown inferentially, although it will not be presumed. “The innocent spouse’s knowledge of the other spouses’ fraudulent conduct may be relevant to an inference of fraudulent intent, depending on the nature and extent of such knowledge and on whether there are other relevant facts that bolster the inferential value of the knowledge. In certain cases, knowledge itself may be inferred where the facts and circumstances are so egregious that denial of knowledge is simply not credible. Fraudulent intent also may be inferred from other facts. For example, the nature and extent of the benefit conferred to the “innocent” spouse may be so great or unusual that it is reasonable to conclude that the “innocent” spouse engaged in fraudulent activity him or herself. *Id.* Without such evidence, the debt will be discharged as to the innocent spouse’s sole and separate property. *In re Rollinson*, 322 B.R. 879, 880 (Bankr. D. Ariz. 2005).

Once the parties’ divorce is finalized, moreover, the community discharge is essentially undone and Hillary would lose the benefit of the community discharge. This is because once the marriage is dissolved and the community divided between the spouses, the community property loses its community property status and becomes the individual’s sole and separate property. That sole and separate property is available for a creditor to collect against, as the community discharge only applies to prevent collection against community property. Bill would still have his personal discharge, meaning his prepetition creditors could not pursue him for the debts for which he received a discharge.