When an Inheritance Gets Entangled in a Bankruptcy Proceeding, Smart Estate Planning Can Help

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The purpose of bankruptcy is twofold: (1) to provide the party filing for bankruptcy—the "debtor"—with a fresh start, and (2) to fairly distribute the debtor's non-exempt assets to creditors in accordance with the priority scheme set forth in the U.S. Bankruptcy Code. This may sound relatively simple, but accomplishing these dual objectives can be difficult. One of the challenges in all bankruptcy cases is determining the scope and extent of assets that constitute "property of the estate" which are available for distribution to creditors.

The purpose of this article is to explore some aspects of the intersection between inheritance and bankruptcy; specifically, what happens when a debtor receives assets from a decedent. It is an issue that has been analyzed by many courts, and the outcome depends on many factors, including the timing and nature of such transfers. Three scenarios in which these issues arise, each of which is addressed in detail below, include:

- Payable on Death Accounts
- Pre-Petition Inheritance and Bequests
- Post-Petition Inheritance and Bequests

However, before diving in to explore how each of these scenarios are treated in bankruptcy, it's important to understand how an "estate"—that is, the property available for distribution to creditors—is created in bankruptcy.

Property of the Estate

When a debtor files for bankruptcy under Chapter 7 or Chapter 13 of the Bankruptcy Code, their non-exempt assets come under the control of a bankruptcy trustee. The Bankruptcy Code provides that a bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). Property of the estate also includes any interest in property that would have been property of the estate if such interest had been

an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date.

Payable on Death Accounts

A payable on death account ("POD") names a beneficiary if the account owner dies. Upon death, money in the account is automatically transferred to the control of the beneficiary. The issue of whether a POD account is property of the estate subject to the claims of creditors has been analyzed in a number of bankruptcy cases. The general consensus among the courts is that monies received by a debtor from a POD account during the 180 days following a bankruptcy filing are not to be considered property of the estate.

In several cases that have considered this issue, trustees have argued that such monies are property of the estate under 11 U.S.C. § 541(a)(5), which provides that an inheritance, bequest, or devise received by a debtor within the 180 days from the date of a bankruptcy is property of the estate. But courts have distinguished assets received pursuant to a POD account from those received pursuant to an inheritance, bequest, or devise.

For example, in the case of *Williamson v. Hall (In re Hall)*, 441 B.R. 680 (B.A.P. 10th Cir. 2009), a debtor received funds from a POD account following the postpetition death of her father. The court excluded the funds from the property of the estate, finding that the debtor's claim to the funds based on the pay on death provision of the bank accounts was more akin to a mere expectancy rather than an actual property interest. Accordingly, the funds were not made available to pay creditor claims.

Prepetition Inheritances and Bequests

A debtor's prepetition assets include "all legal or equitable interests of the debtor in property as of the commencement of the case." To avoid having assets become property of the estate, prior to filing for bankruptcy some debtors will attempt to transfer assets to third parties. Depending on the timing and nature of such transfers, the bankruptcy trustee and/or creditors in the case will seek to have such transfers "avoided" as fraudulent under Section 548 of the Bankruptcy Code. To the extent that a bankruptcy court finds that a transfer is fraudulent, the assets at issue are brought back into the bankruptcy estate.

Courts have considered whether the action of a debtor disclaiming an inheritance before filing for bankruptcy is a fraudulent transfer. For example, in the case of *Lowe v. Brajkovic*, 151 B.R. 402 (Bankr. W.D. Tex. 1993), the debtor's grandfather died on November 30, 1990 and bequeathed land to the debtor and her brother. The debtor executed a valid disclaimer on August 28, 1991, which had the effect of passing her interest in the land to her four minor children. On October 15, 1991, the debtor and her husband filed for Chapter 7 bankruptcy, and listed themselves as guardians for their children's property, including the land that was disclaimed.

After the transfer affected by the disclaimer was challenged as fraudulent, the bankruptcy court determined that under Missouri law, an interest in the property vested immediately upon the death of the benefactor. The court held that the transfer was voidable by the trustee under Section 548 of the Bankruptcy Code.

However, in a subsequent decision, the Fifth Circuit Court of Appeals expressly disapproved of the bankruptcy court's decision in *Lowe v. Brajkovic,* finding that properly executed disclaimers of inheritance that occur prepetition are not avoidable under Section 548 of the Bankruptcy Code. The Fifth Circuit distinguished between disclaiming an inheritance prepetition versus one that is disclaimed postpetition, and explained that executing a disclaimer postpetition could be avoided as a fraudulent transfer. According to the Fifth Circuit, what distinguishes a prepetition disclaimer from a postpetition one is the fact that the testamentary interest indisputably becomes property of the estate at the time of the filing of the bankruptcy. Therefore, disclaiming such an interest after the bankruptcy filing deprives creditors of assets they are entitled to recover from.

Postpetition Inheritance and Bequests

As discussed previously, the timing of a decedent's death and the actions taken by a debtor entitled to an inheritance or bequest either before or after a bankruptcy filing impact whether assets become property of the estate. For example, courts have analyzed whether actions taken post-petition to prevent assets subject to a will from becoming available to creditors are valid.

In the case of *Lassman v. McGuire (In re McGuire)*, 209 B.R. 580 (Bankr. D. Mass. 1997), the bankruptcy court held that a codicil to a will executed by the debtor's mother after the debtor filed for bankruptcy, pursuant to which she revoked "[a]ll bequests, devises and legacies" to her son, was effective. The court found that the debtor had a mere expectancy of inheriting property at the time of his mother's death and not a vested interest in such property. The mother had a right to revoke the gift.

Similarly, in the case of *In re Connelly*, No. 05-10969 (DHS), 2006 Bankr. LEXIS 4100 (Bankr. D.N.J. Mar. 27, 2006), the court found that a will to which the debtor was a beneficiary made clear that no portion of the decedent's estate was to be used to benefit a creditor of any beneficiary. Again, because of the will's language, the debtor merely had an expectation of inheriting property.

Avoiding Bankruptcy Complications When it Comes to Estate Planning

There are many complex and unintended consequences that can arise when estate planning issues get intertwined with bankruptcy issues. These complications can be avoided through smart planning. One of the best ways to avoid having your assets get tangled up in a bankruptcy fight is to leave property in a revocable living trust, rather than in a will—or worse, subject to probate proceedings without a will. While every situation is fact and law specific, and you should consult with a qualified and experienced estate planning attorney on any estate planning issue, courts have generally found that assets subject to a living trust are not part of a bankruptcy estate.

If you have any questions about how estate planning can be used in a bankruptcy proceeding, please contact Scott Chernich at 517.371.8133 or at schernich@fosterswift.com. For all other inquiries on estate planning, please contact a member of Foster Swift's estate planning practice group.

This article was adapted from a presentation prepared by the Honorable James W. Boyd-US Bankruptcy Judge, Western District of Michigan, Kelly M. Hagan-Chapter 7 Trustee with Hagan Law Offices, George Bearup-Senior Trust Advisor with Greenleaf Trust, Scott Chernich & Michael Cassar-Foster Swift Collins & Smith, PC at the Federal Bar Association Bankruptcy Section seminar in Traverse City, Michigan: July 27, 2018.