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Feature

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When Bankruptcy Breaks Your "Asset-Protection" Plan

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The irony of asset-protection vehicles is that they do not always protect your assets. While estate-planning efforts are generally successful in adding an extra layer of protection for your property and/or providing a tax shelter, they are not always "bulletproof," especially if a bankruptcy filing is in the near future. There is no shortage of bankruptcy case law making it clear that estate-planning instruments are not out of the reach of a debtor's creditors.[1]

The most common form of estate planning is the creation of trusts, which come in all shapes and sizes.[2] This article focuses on a very specific type of trust called a qualified personal residence trust (QPRT) and the potential impact that filing for bankruptcy may have on a single property — the primary residence — transferred to the QPRT.

Estate Planning: Timing Can Be Everything

In a QPRT, the transferor transfers the primary residence to a trust while retaining the right to live in the property, typically rent- or mortgage-free, for a specified amount of time (the "trust term").[3] Once the trust term expires, the residence automatically transfers to the beneficiaries.[4] One of the main goals of a QPRT is to eventually transfer the primary residence, which often has sizeable equity and value, to an insider, usually the transferor(s) children.[5] The transferor benefits from the transfer by retaining the right to live at the residence for a specified amount of time, and the transferee eventually benefits by receiving ownership of the property at a significant discount while also avoiding having to pay costly inheritance or gift taxes (assuming that the trust term expires prior to the death of the transferor).[6]

QPRTs are irrevocable trusts[7] (in other words, the transferor gives up all management and control over the property being transferred).[8] While "irrevocable" may, in some instances, equate to a stronger layer of protection from those seeking to pierce the assets held in the trust, it does not necessarily mean that the assets are being protected from creditors simply because the transferor is no longer in control of these assets. While QPRTs can be great "gifting" vehicles for successfully avoiding massive estate taxes on the future appreciation of one's residence, they certainly do not provide "asset protection" in any traditional sense, particularly in a bankruptcy case.

In fact, in the bankruptcy realm, even an "irrevocable" trust can be dismantled as a result of a fraudulent-transfer claim brought by a bankruptcy trustee.[9] If the transfer of the residence to the QPRT was made with the intent to keep the asset out of the reach of creditors, then it could be scrutinized as a fraudulent transfer, or the debtor's retained right to live at the property could be seen as a valuable asset.[10] When it comes to QPRTs, timing can be everything.

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1 *In re Mastro*, 465 B.R. 576, 601-02 (Bankr. W.D. Wash. 2011) ("Pre-petition transfers of residential properties from [a] long-standing revocable trust into newly created irrevocable trust were undertaken ... with the intent to hinder, delay, or defraud his creditors, as required to establish actual fraudulent transfers, where properties were among most valuable assets of debtor ... and were transferred for no consideration ... and irrevocable trust was designed to give [the] debtor and his wife use of [the] properties, or their proceeds, while depriving creditors of ability to recover from those assets."); *see also In re Earle*, 307 B.R. 276, 293 (Bankr. S.D. Ala. 2002) (depending on facts of each case, transfer to QPRT might be set aside, even though it was done as part of valid estate-planning tool).

2 *See generally Restatement (Third) of Trusts* § 2 (2003).

3 *See* "Qualified Personal Residence Trusts," Asset Protection Planners Inc., *available at* assetprotectionplanners.com/services/qualified-personal-residence-trust; *see also* "Qualified Personal Residence Trusts," Lawyers.com, *available at* trusts-estates.lawyers.com/qualified-personal-residence-trust.html (unless otherwise indicated, all links were last visited March 29, 2016).

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 "Why Assets in an Irrevocable Trust Are Not Yours Anymore," Everplans, *available at* everplans.com/articles/why-assets-in-an-irrevocable-trust-arent-yours-anymore.

9 *In re Mastro*, 465 B.R. 576, 601-02 (Bankr. W.D. Wash. 2011).

10 *In re Wells*, 448 B.R. 909 (Bankr. W.D. Tex. 2011) (remainder interest in life estate is valuable interest in property); *see also Snowden v. Sec'y of Health, Ed. and Welfare*, 648 F.2d 1082, 1084 (6th Cir. 1981).

QPRTs Are Subject to Fraudulent-Transfer Claims

When one files a chapter 7 petition, all of their property, as determined by applicable state law, becomes property of their bankruptcy estate.[11] A bankruptcy trustee will review every transfer of property that the debtor made (within the time period that the trustee can reach back under the statutes), prior to the petition being filed, to determine whether any of the transfers made were fraudulent.[12] Real property that the debtor previously transferred to a QPRT may no longer be in the debtor's name, but the debtor's right to live in the residence rent-free might be a valuable personal property asset that qualifies as "property of the estate."[13] Some courts will consider evidence of the fair monthly rental value (reduced to present value) in fixing the personal property value of a life estate.[14] More significantly, depending on when the QPRT was created or when the property was legally transferred via a grant deed to the beneficiaries of the trust, the QPRT may also come under attack as a fraudulent transfer under 11 U.S.C. § 548 (or an applicable state fraudulent-transfer statute), permitting the trustee to avoid the transfer of the residence into a QPRT and bringing the entire residence back into the bankruptcy estate to be liquidated through a bankruptcy sale.[15]

There are two types of fraudulent transfers under title 11 of the Bankruptcy Code: actual intent and constructive intent.[16] A transfer is considered fraudulent if the debtor made the transfer with the actual intent to hinder, delay or defraud his/her creditors.[17] However, a transfer can also be considered fraudulent if the transfer was made for less than reasonably equivalent value in exchange for the transfer.[18] For a transfer to be fraudulent under the Bankruptcy Code, it also must be made two years prior to the petition date.[19] However, some state fraudulent-conveyance statutes allow for transfers to be avoided that were made more than two years before the petition date.[20]

Whether a transfer is fraudulent will depend on a number of factors. The Uniform Fraudulent Transfer Act (UFTA) provides a nonexclusive list of indicia or "badges" of fraud that act as guides to help determine whether the actual intent to hinder, delay or defraud a creditor is present.[21] These badges of fraud include, but are not limited to, whether (1) the transfer was made to an insider of the debtor; (2) the debtor retained possession or control of the property being transferred; (3) the transfer was concealed; (4) the debtor was sued or threatened with a suit before the transfer was made; (5) the transfer included all or substantially all of the debtor's assets; (6) the debtor absconded; (7) the debtor removed or concealed assets; (8) the debtor did not receive reasonably equivalent value for the transfer; (9) the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer or shortly thereafter; (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; or (11) the debtor transferred the essential assets of a business to a creditor, who then in turn transferred those assets to an insider.[22] Many bankruptcy courts will consider these indicia of fraud, among other factors, in determining whether a transfer was made with actual intent to defraud creditors. However, courts will also examine all relevant factors and circumstances surrounding the transfer, then determine under a totality-of-the-circumstances approach whether the transfer was fraudulent.[23]

While QPRTs are not your typical form of fraudulent transfer pursued in a bankruptcy context, if a bankruptcy trustee discovers that a debtor made a transfer of a primary residence to a QPRT, naming another family member as the QPRT trustee and/or the intended beneficiary of the transfer, he/she will carefully look at the timing of the transfer and the surrounding circumstances to determine whether actual or constructive fraud exists to support a fraudulent-transfer claim. Since QPRTs are typically transferred to the transferor's children (considered to be insiders under the Bankruptcy Code[24]), whether or not enough of the other badges of fraud are present, the QPRT can be attacked as a fraudulent transfer.

Case Example

In fact, this is almost exactly what happened in a recent case in the Central District of California. The authors' firm recently represented a chapter 7 trustee in a fraudulent-conveyance action against the debtors' children, the beneficiaries of the QPRT. Prior to filing their bankruptcy petition, the debtors operated a fire alarm business that, in turn, made a loan to another business. The debtors, as individuals, personally guaranteed this loan. Eventually the business deal went south, and as a result, the debtor's business failed. Thereafter, the debtor's business filed for bankruptcy.

Within two years of the petition date and around the time the debtors' business failed, the debtors created QPRTs, naming their two children as the trustees of the QPRTs and the intended beneficiaries of such trusts. However, no deeds were ever executed or recorded evidencing the transfers to the QPRTs. Prior to the creation of the QPRTs, the debtor's primary residence had been held in a revocable living trust.

Two months after the QPRTs were created, the debtors were sued on the personal guarantee to recover the balance of the loan. Just after being sued, the debtors notarized and recorded quit claim deeds, conveying all of their interests in their residence to the QPRTs (for the benefit of their children) for no consideration, with the right for the debtors to continue living at the residence for a period of 20 years. Upon expiration of the trust term, the residence would pass to their children. Almost 13 months after the transfer, the debtors filed a joint bankruptcy petition seek-

11 *See* 11 U.S.C. § 541.
12 Transfers may also fall into the realm of a preferential transfer treated under 11 U.S.C. § 547.
13 *In re Wells*, 448 B.R. 909 (Bankr. W.D. Tex. 2011).
14 *See Stahl v. C.I.R.*, 53 T.C.M. (CCH) 1273 (T.C. 1987).
15 *See* 11 U.S.C. § 544; *see also* 11 U.S.C. § 548(a)(1); *see also* Cal. Civ. Code § 3439, *et seq.*; *see also* 11 U.S.C. § 363.
16 11 U.S.C. § 548(a)(1).
17 11 U.S.C. § 548(a)(1)(A).
18 11 U.S.C. § 548(a)(1)(B).
19 11 U.S.C. § 548(a)(1).
20 *See also* Cal. Civ. Code § 3439.04(a)(1) (action based on actual intent to defraud creditor must be brought within four years after transfer was made); *see also* Cal. Civ. Code § 3439.04(a)(2)(A)-(B) and Cal. Civ. Code § 3439.05 (where fraudulent intent can be imputed, action must be brought within four years of time that transfer was made); *see also* Cal. Civ. Code § 3439.09 (no action may be brought for fraudulent transfers more than seven years after transfer was made notwithstanding any other provision of law).
21 *See* UFTA § 4(b).
22 *Id.*
23 *See* UFTA § 4, comment 5-6.
24 11 U.S.C. § 101(31)(A)(i).

ing to discharge, among other things, the loan debt that they personally guaranteed. While the debtors listed more than $1 million of debt on their bankruptcy petition, because of the transfer of their residence to the QPRTs, there were little to no nonexempt assets for the trustee to liquidate in order to pay off the debtor's creditors.

The debtors' statement and schedules did not list the real property transferred to the QPRT nor make any mention of the creation of the QPRT. The statement and schedules also neglected to list the trust term held by the debtors at their primary residence. However, the asset transfer was "discovered" during the trustee's line of questioning at the 11 U.S.C. § 341(a) meeting of creditors when the trustee inquired about the debtors' current primary residence.

The trustee clarified that while the debtors need not have listed the real property in their Schedule A because the asset was now being held in an irrevocable trust, the debtors still retained a right to live in the residence, and the asset itself, which had a value, was required to have been listed in Schedule B (personal property). During the course of the examination, counsel for the debtors explained that the creation of the QPRT had been part of their ordinary, decade-long estate-planning strategy crafted by their estate-planning counsel. Upon further questioning, the trustee learned that the QPRTs were created two months prior to litigation brought against the debtors to recover the loan that they had personally guaranteed, which was the impetus for the filing of the bankruptcy petition. The chips then quickly fell into place.

The trustee and his counsel, upon further questioning about timing, discovered that the real property had been in various revocable trusts before the transfer to the QPRT. Once the debtors' business failed, however, the debtors (who had personally guaranteed a sizeable business loan) knew that they would soon be sued on the debt and quickly took steps to create the irrevocable QPRT in an effort to protect their residence from being used to satisfy their creditors' claims. Within just a few short days after being sued upon their personal guarantee, the debtors executed and recorded the transfer deeds to complete the transfer of title to the personal property to their children as trustees (and the intended beneficiaries) of the QPRT, which had been created only a few months earlier.

When property is transferred to a family member prior to a bankruptcy, the transfer is scrutinized more closely to determine whether the transferor's intention was to defraud the debtor's creditors.[25] While QPRTs often involve children as beneficiaries, this case had the added "badges" of fraud (*i.e.*, the debtors were sued just before the transfer was made, and that transfer included all or substantially all of the debtor's assets). All of the circumstances surrounding the transfer made it clear to the trustee that the debtors' intent was to hide/protect their assets from creditors: (1) the QPRTs were created shortly before the debtors were sued; (2) just after being sued, the debtors immediately executed and recorded the transfer deeds; (3) the residence was transferred to an irrevocable trust for the benefit of their children; (4) the transfer left the estate with little to no nonexempt property; and (5) the transfer was made within two years of the petition date.[26] Under the totality of the circumstances, it appeared that the debtors intended to avoid their creditors with the transfer, and as a result, the trustee filed an adversary proceeding against the debtors seeking to avoid the transfer to the QPRT for the benefit of the bankruptcy estate.

While the case did not go to trial, with the facts strongly favoring a fraudulent transfer, the debtors and their children instead settled the claims with the trustee for a sizable sum rather than risk their home becoming property of the estate and subject to liquidation through a bankruptcy sale.[27]

This example illustrates how "irrevocable" asset-protection vehicles such as QPRTs, while potentially advantageous in providing all sorts of tax benefits, can still be open for attack if created in close proximity to a bankruptcy filing.[28] QPRTs are certainly not bulletproof and can be dismantled for the benefit of creditors in bankruptcy,[29] and the property, which often already holds sizeable equity, can be brought back into the debtor's bankruptcy estate for liquidation.[30]

The moral of the story is that timing is everything. You might be successful if you are planning on utilizing a QPRT as an estate-planning vehicle to save loads of future estate taxes and "protect" your assets from future creditors. However, if a bankruptcy filing is coming, the trustee might look closely at QPRTs to see if any existing creditors were the motivation for QPRT's creation. Be mindful of the timing of "asset-protection" vehicles, and be aware of the potential risk involved with any such transfer if you are or plan to be in front of the bankruptcy courts. **abi**

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25 37 *Am. Jur. 2d Fraudulent Conveyance and Transfers* § 31.

26 *See* 11 U.S.C. § 548.

27 *See* 11 U.S.C. § 541; *see also* 11 U.S.C. § 363.

28 *In re Mastro*, 465 B.R. 576, 601-02 (Bankr. W.D. Wash. 2011); *In re Earle*, 307 B.R. 276, 293 (Bankr. S.D. Ala. 2002).

29 *In re Earle*, 307 B.R. 276, 293 (Bankr. S.D. Ala. 2002); *In re Mastro*, 465 B.R. 576, 601-02 (Bankr. W.D. Wash. 2011).

30 *See In re Mastro*, 465 B.R. 576, 601-02 (Bankr. W.D. Wash. 2011).