BANKRUPTCY FOR ESTATE PLANNERS:
WHAT YOU NEED TO KNOW, OR AT LEAST BE AWARE OF

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BANKRUPTCY FOR ESTATE PLANNERS: WHAT YOU NEED TO KNOW, OR AT LEAST BE AWARE OF

I. INTRODUCTION[1]

Bankruptcy is a complicated area of practice, and our federal bankruptcy system can seem isolated and convoluted to outsiders. Although our bankruptcy laws are created by federal statute, bankruptcy courts are routinely required to interpret and apply relevant state law to disputes and determine rights of parties. Often when bankruptcy and state laws intersect, navigating through the issues is challenging. As a University of Texas law professor recently said to his class, "bankruptcy court is like going through the rabbit hole into Wonderland, where all the rules are reversed, nothing makes sense, and anything is possible." This can be especially true for trusts and estates practitioners when they are required to get involved in a bankruptcy case.

At first glance, bankruptcy laws and probate laws are vastly different. The bankruptcy system is established by federal law and preempts conflicting state law. The probate system, on the other hand, is left up to individual states, and federal law (outside of taxes) has remarkably little say in how a testator can distribute his or her estate. However, bankruptcy laws and probate laws actually have some commonality. In both systems, an estate is created and administered by a fiduciary, and there is a specialized court vested with jurisdiction over the estate. Although it fortunately does not happen frequently, bankruptcy and probate laws sometimes collide, and when it does occur, courts and practitioners on both sides may be forced to address unfamiliar issues. Trying to navigate either system of laws without competent assistance can often lead to disastrous consequences.

Bankruptcy lawyers certainly should be aware of relevant probate laws. However, for our purposes, this paper seeks only to highlight the more significant aspects of bankruptcy laws for estate planning and probate lawyers. The goal of this paper is to help the reader become aware of potential issues that may come up when a probate proceeding is related to a bankruptcy case or proceeding.

First, this paper will provide a brief history of the development of our federal bankruptcy laws. Second, the paper will examine bankruptcy court jurisdiction and the impact of the probate exception on the jurisdiction. Third, the paper will provide a high level overview of the Bankruptcy Code and how the provisions will affect probate matters. Finally, several miscellaneous (but important) areas of intersection between bankruptcy and probate laws will be explored.

II. BRIEF HISTORY OF THE DEVELOPMENT OF BANKRUPTCY LAWS

To better understand our federal bankruptcy laws and the tension which exists between federal bankruptcy laws and state probate laws, a brief summary of the development of our federal bankruptcy laws is helpful.

A. Bankruptcy Act of 1800

The United States Constitution authorized Congress to enact "uniform Laws on the subject of Bankruptcies throughout the United States."[2] It took over ten years after the Constitution was ratified before Congress enacted the first federal laws relating to bankruptcy – the Bankruptcy Act of 1800.[3] The 1800 Act was considered very creditor oriented. Among other things, only creditors could initiate a bankruptcy and only an individual who was a merchant was eligible to be a debtor. Under the 1800 Act, commissioners were appointed by the United States District Courts to oversee the process, and the commissioners would appoint assignees to effect the liquidation of assets and distributions to creditors. The 1800 Act permitted a debtor to exempt necessary wearing apparel of the debtor and the debtor's wife and children. Although the 1800 Act provided a discharge of debts, the discharge was only granted if the commissioners certified to the district court that the debtor has cooperated and two-thirds of the creditors (both in number and amount of the claims) consented to the discharge. In 1803, the 1800 Act was repealed by Congress due to complaints of corruption and favoritism.

B. Bankruptcy Act of 1841

Thirty-eight years after the repeal of the 1800 Act, Congress enacted the Bankruptcy Act of 1841.[4] The 1841 Act permitted both involuntary and voluntary bankruptcy, and it did not limit eligibility to merchants. Any individual could be a debtor, but involuntary bankruptcy was limited to a merchant. Permitting a voluntary bankruptcy was revolutionary in the realm of insolvency law. In addition, the 1841 Act allowed certain basic federal exemptions, including (i) necessary household and kitchen furniture, as well as such other articles and necessaries needed for the debtor and the debtor's family, up to a value not exceeding $300, and (ii) wearing apparel of the debtor and the debtor's wife

[1] Special thanks to the late David B. Young, whose in-depth article on the intersection of bankruptcy and probate helped the authors immensely. *See* David B. Young, *The Intersection of Bankruptcy and Probate*, 49 S. Tex. L. Rev. 351 (2007).

[2] U.S. Const. art. I, § 8, cl. 4.

[3] Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803).

[4] Act of Aug. 19, 1841, ch. 9, 5 Stat. 440 (repealed 1843).

and children. With respect to discharge, the 1841 Act provided that every debtor who surrendered his or her non-exempt property and complied with the Act would receive a discharge. A discharge would be denied only through a written dissent by majority of the debtor's creditors (both in number and amount of claims). The 1841 Act vested the district courts with jurisdiction and assignees were appointed to liquidate assets and make distributions to creditors. The 1841 Act did not provide for the use of commissioners. From a creditor perspective, the 1841 Act was a failure because it resulted in small dividends to creditors, high administrative costs, and it was much easier for a debtor to receive a discharge. In 1843, less than two years after its enactment, the 1841 Act was repealed by Congress.

C. Bankruptcy Act of 1867

Congress' next attempt to establish federal bankruptcy laws was in 1867. The Bankruptcy Act of 1867[5] was largely the result of Northern creditors seeking federal laws to assist them to collect from their Southern debtors. Like the 1841 Act, the 1867 Act authorized both voluntary and involuntary bankruptcy. Unlike the 1841 Act, the 1867 Act permitted an involuntary bankruptcy against any person (not just a merchant) and it extended eligibility to a corporation. The 1867 Act required that a petitioning bankrupt take an oath of allegiance and fidelity to the United States. Although the district courts were vested with original jurisdiction in all bankruptcy matters, they were required to appoint "registers in bankruptcy" to assist the district courts in the performance of their duties. The 1867 Act continued the use of assignees to supervise the liquidation of assets. The 1867 Act made it more difficult to get a discharge by requiring the debtor to affirmatively apply for a discharge by filing an application in the district court. The application, however, would not be granted unless a majority of creditors consented or at least a fifty percentdividend was paid to creditors. The 1867 Act also included numerous grounds for denying a discharge. Important to a debtor, the 1867 Act broadened the exemptions by permitting debtors to avail themselves of federal and state exemptions. Federal exemptions were expanded to, among other things, exempt articles and necessaries up to a value not exceeding $500 and exempt uniforms, arms and equipment of debtors who are or were a soldier in the militia or in the service of the United States. In 1878, in response to complaints that the 1867 Act was resulting in small dividends, high fees and expenses, and lengthy delays, Congress repealed the 1867 Act.

D. Bankruptcy Act of 1898

After the economic panics of 1884 and 1893, Congress enacted the 1898 Bankruptcy Act,[6] which remained in effect until it was replaced by the Bankruptcy Reform Act of 1978. The 1898 Act was considered very pro-debtor. Among other things, it made it easier for a debtor to receive a discharge by eliminating the condition of creditor consent to the discharge, it limited the number of grounds for denial of discharge, and it allowed the debtor to claim only state exemptions.[7] The 1898 Act permitted both voluntary and involuntary bankruptcy, but limited a voluntary bankruptcy to individuals. The 1898 Act granted creditors more control over the bankruptcy process by allowing them to elect the trustee (formerly known as the assignee) and creditors' committee. District courts were vested with bankruptcy jurisdiction, but they were authorized to appoint "referees in bankruptcy" to handle most judicial and administrative work in connection with bankruptcy matters. Referees essentially exercised much of the jurisdiction given to the district courts, including exclusive jurisdiction involving the administration of the bankruptcy estate. State court, however, had concurrent jurisdiction of many bankruptcy-related issues including disputes between the bankruptcy trustee and third parties. In addition, the 1898 Act included a provision for a composition in lieu of liquidation.[8] For the composition to be approved, a majority of creditors (both in number and amount of claims) had to accept it and the district court had to find (i) the composition is in the best interest of creditors, (ii) the debtor was not guilty of an act which would bar discharge, and (iii) the terms of the compromise are in good faith.

E. Bankruptcy Act of 1978

Over the next eighty years, Congress passed many amendments to the 1898 Act. Then in 1978, Congress enacted the Bankruptcy Reform Act of 1978,[9] which was a comprehensive reform of our federal bankruptcy laws. The 1978 Act created the Bankruptcy Code, which remains the bankruptcy law today. The Bankruptcy Code is codified in title 11 of the United States Code. The 1978 Act has been amended several times since its enactment, most significantly in 1984, 1986, 1994, and 2005. One of the most significant aspects of the 1978

[5] Act of Mar. 2, 1867, ch. 176, 14 Stat. 517 (repealed 1878).

[6] Act of June 30, 1898, ch. 541, 30 Stat. 544 (repealed 1978).

[7] The Supreme Court subsequently held the use of only state exemptions violated the mandate in the United States Constitution for uniform bankruptcy laws. *See Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188-90 (1902).

[8] Composition is a written agreement between the debtor and creditors of the debtor which allows the debtor to repay a portion of the debtor's debts over time.

[9] Pub. L. No. 95-598, 92 Stat. 2549 (1978).

Act was the creation of bankruptcy judges pursuant to Congress' authority under Article I of the Constitution, who serve 14-year terms, and the enlargement of bankruptcy court jurisdiction. The 1978 Act provided that the district courts shall have original and exclusive jurisdiction of all cases under title 11, and original but not exclusive jurisdiction of all proceedings arising under title 11, or arising in or related to cases under title 11. Bankruptcy Courts were established as adjuncts of the district courts and given the power to exercise all of the jurisdiction conferred on the district courts with respect to a bankruptcy case. In an attempt to remove bankruptcy judges from administrative duties, the 1978 Act established the United States Trustee program, which is responsible for overseeing the administration of bankruptcy cases and private trustees. The United States Trustee program is a component of the Department of Justice and operates in every state except Alabama and North Carolina. Under the 1978 Act, discharge is self-executing but can be denied for certain specified types of debts, and is subject to complete denial under certain specified grounds. With respect to exemptions, the 1978 Act authorizes the debtor to choose either the exemptions available to the debtor under state law or the federal exemptions set forth in the Bankruptcy Code, but only so long as the state where the debtor resides has not "opted out" of the federal exemptions. Although Texas has not opted out, approximately three-fourths of the states have enacted legislation limiting their resident debtors to state law exemptions.

III. BANKRUPTCY JURISDICTION AND THE PROBATE EXCEPTION

As previously noted, the United States Constitution gives Congress the power to enact a uniform bankruptcy law.[10] In furtherance of that authority, and to address jurisdictional issues raised by the United States Supreme Court in *Northern Pipeline Construction v. Marathon Pipe Line Co.*[11] concerning the broad grant of jurisdiction to bankruptcy courts under the 1978 Act, Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984.[12] After the enactment of this 1984 Act, the Supreme Court has issued three very significant opinions addressing the scope of bankruptcy jurisdiction, including the limitation on this jurisdiction under the probate exception.

A. Bankruptcy Jurisdiction

Under the 1984 Act, the district courts have "original and exclusive jurisdiction" of all bankruptcy cases.[13] With respect to "civil proceedings arising under title 11 [*i.e.*, the Bankruptcy Code], or arising in or related to cases under title 11," district courts have "original but not exclusive jurisdiction."[14] The exclusive jurisdiction of the district court in which a bankruptcy is commenced or is pending specifically includes "all property, wherever located, of the debtor as of the commencement of [the bankruptcy case], and of property of the estate ...."[15] Each district court, however, may provide that all bankruptcy cases and related proceedings shall be referred to the bankruptcy judges for the district.[16] Bankruptcy courts, as "a unit of the district court,"[17] are granted jurisdiction to hear all cases and proceedings under title 11, and all proceedings arising in or related to a case under title 11, pursuant to a reference from the district court.[18] The extent of a bankruptcy court's statutory authority to hear and determine cases under title 11, proceedings arising under title 11, proceedings arising in a case under title 11, or proceedings related to a case under title 11, depends on whether the matter is a "core" proceeding or a "non-core" proceeding.[19] With respect to a core proceeding, the bankruptcy court has the power to hear and determine the core proceeding and "enter appropriate orders and judgments" subject to appellate review by the district court.[20] With respect to a non-core proceeding related to a bankruptcy case, the bankruptcy court may hear the proceeding, but then must submit proposed findings of fact and conclusions of law to the district court, which are reviewable *de novo* by the district court.[21] Notwithstanding the foregoing, the bankruptcy court may hear and determine a non-core proceeding and enter an appropriate order and judgment subject to appellate review by the district court if all of the parties to the proceeding consent.[22]

Congress has identified sixteen nonexclusive types of core proceedings.[23] Generally, a proceeding is core "if it invokes a substantive right provided by title 11 or if it is a proceeding that, by its nature, could arise only in the context of a bankruptcy case."[24] Stated in terms of the statute, core proceedings are those that either "arise under title 11" or "arise in a case under title 11."[25] However, a proceeding may be core even though "its

[10] U.S. Const. art. I, § 8, cl. 4.

[11] 458 U.S. 50 (1982).

[12] Pub. L. No. 98-353, 98 Stat. 333 (1984).

[13] 28 U.S.C. § 1334(a).

[14] *Id*. § 1334(b).

[15] *Id.* § 1334(b), (e)(1).

[16] *Id*. § 157(a).

[17] *Id.* § 151.

[18] *Id.* § 157(a).

[19] *Id.* § 157(b), (c).

[20] *Id*. § 157(b)(1).

[21] *Id*. § 157(c)(1).

[22] *Id*. § 157(c)(2).

[23] *Id*. § 157(b)(3).

[24] *Matter of Wood*, 825 F.2d 90, 97 (5th Cir. 1987).

[25] *Stern v. Marshall*, 564 U.S. 462, 477 (2011).

resolution may be affected by State law."[26] A proceeding is non-core when it relates to a case under title 11 but does not arise under title 11.[27] Or more simply put, a non-core proceeding is one that could exist outside of the bankruptcy case but that nonetheless has some affect on the bankruptcy case.

Specifically excluded from a bankruptcy court's jurisdiction are personal injury and wrongful death claims.[28] This exclusion applies even if when the determination of such claims would otherwise be a core proceeding.[29] If a personal injury or wrongful death claim arises in a bankruptcy case, the claim shall either be tried "in the district court in which the bankruptcy case is pending, or in the district court in the district in which the claim arose, as determined by the district court in which the bankruptcy case is pending."[30]

B. Probate Exception

One noted non-statutory exception to federal jurisdiction is that federal courts may not probate a will or administer a probate estate. This is commonly referred to as the "probate exception." This is a judicially created doctrine with roots originating under the English legal system.[31] The probate exception has been described as "one of the most mysterious and esoteric branches of the law of federal jurisdiction."[32] The scope of the probate exception, particularly to the extent it directly impacts the administration of a case under title 11, was tested in the Supreme Court case of *Marshall v. Marshall*.[33]

1. Marshall (Part I)

This case famously pitted Vickie Lynn Marshall (better known as Anna Nicole Smith) against her late husband's son – E. Pierce Marshall. In this fascinating (yet horrifying) case, Vickie Lynn claimed that her late husband, J. Howard Marshall, intended to transfer all of his assets to a trust for her benefit. However, the transfer of the assets to the trust did not occur prior to J. Howard's death, and she was not a named beneficiary under his will. She claimed this unfortunate occurrence was because Pierce had wrongfully interfered with his father's true intentions. The principal beneficiary under J. Howard's will was Pierce. Vickie Lynn sued Pierce in Texas probate court for tortious interference with a gift. Shortly thereafter, J. Howard passed away and his will was admitted to probate in Harris County, Texas. While the probate proceeding was pending, which included Vickie Lynn's claim against Pierce, Vickie Lynn filed bankruptcy in the Central District of California. Pierce filed a proof of claim in Vickie Lynn's bankruptcy case claiming that she had defamed him by inducing her lawyers to tell the press that he had engaged in fraud in controlling his father's assets. In response, Vickie Lynn objected to Pierce's claim and asserted a counterclaim against Pierce based on her claim of tortious interference with a gift. The bankruptcy court entered an order granting summary judgment in favor of Vickie Lynn on Pierce's defamation claim and it entered a judgment for Vickie Lynn on her tortious interference counterclaim. The bankruptcy court held that both Vickie Lynn's objection to Pierce's defamation claim and her tortious interference counterclaim were core proceedings, thus the court had the authority to enter a final judgment disposing of those claims. Thereafter, the probate court declared that the trust and J. Howard's will were valid, thus creating conflicting rulings.

On review of the bankruptcy court's rulings, the district court determined that Vickie Lynn's counterclaim was not a core proceeding. Instead of reversing the judgment, the district court elected to treat the bankruptcy court's judgment as proposed findings of fact and conclusions of law and it engaged in an independent review of the record. Although the probate court entered its judgment in Pierce's favor before the district court ruled, the district court declined to give the judgment preclusive effect. Like the bankruptcy court, the district court ruled in favor of Vickie Lynn on her tortious interference with a gift counterclaim and awarded her a multi-million dollar award of damages. On appeal, the Ninth Circuit reversed the district court's decision, concluding that the probate exception barred federal court jurisdiction over Vickie Lynn's tortious interference counterclaim and that the district court should have given the probate court judgment preclusive effect.

The Supreme Court, however, disagreed with the Ninth Circuit's application of the probate exception, holding that the probate exception only prevents a federal court from probating or annulling a will, administering a decedent's estate, or exercising *in rem* jurisdiction over probate in the custody of a state probate court.[34] Because Vickie Lynn was not, through her tort claim, seeking to administer a probate estate, probate or annul a will, or reach property in the custody of the probate court, the Supreme Court concluded that the

[26] 28 U.S.C. § 157(b)(3).
[27] *Schuster v. Mims (In re Rupp & Bowman Co.)*, 109 F.2d 237, 239 (5th Cir. 1997).
[28] 28 U.S.C. § 157(b)(5).
[29] *Id*. § 157(b)(2)(B), (O).
[30] *Id*. § 157(b)(5).
[31] James E. Pfander and Michael J.T. Downey, *In Search of the Probate Exception*, 67 Vand. L. Rev. 1533, 1560-62 (2014).
[32] *Dragan v. Miller*, 679 F.2d 712, 713 (7th Cir. 1982) (Posner, J.).
[33] 547 U.S. 293 (2006).
[34] *Id*. at 311-12.

probate exception was not applicable to her claim.[35] Further, because Vickie Lynn's tort claim was "outside the bounds of the probate exception," the Supreme Court avoided the need to consider "whether there exists any uncodified probate exception to federal bankruptcy jurisdiction under § 1334" of title 28.[36] The Supreme Court reversed and remanded the case for determination of which judgment, the probate court judgment or the lower federal court judgment, should be given preclusive effect. Although the Supreme Court did not determine the viability of the probate exception to federal bankruptcy court jurisdiction, the holding in *Marshall* signaled that the scope of the probate exception is narrow.[37]

While the matter was on remand, both Pierce and Vickie Lynn died. Their deaths, however, did not end the litigation and its assault on the jurisdiction of bankruptcy courts. On remand, the Ninth Circuit held that the bankruptcy court lacked the authority to enter final judgment on Vickie Lynn's counterclaim and that the probate court decision should be given preclusive effect. Following this ruling, the Supreme Court agreed to determine the extent of the bankruptcy court's jurisdiction to enter a final judgment on Vickie Lynn's common law tort claim.

C. Stern Claims (Marshall Part II)

In *Stern v. Marshall*,[38] the issue before the Supreme Court was whether the bankruptcy court had the power to adjudicate Vickie Lynn's counterclaim. The Supreme Court noted that, under the plain text of § 157(b)(2)(C), core proceedings specifically include "counterclaims by the estate against persons filing claims against the estate."[39] Notwithstanding, the Supreme Court further noted that § 157 was silent with respect to a category of core proceedings that do not arise under title 11 or arise in a bankruptcy case, which is the category that included Vickie Lynn's counterclaim.[40] With respect to this category of claims, the Supreme Court concluded that Article III of the Constitution prohibited the bankruptcy court, as an Article I court created by Congress (as opposed to an Article III court), from entering final judgment on Vickie Lynn's counterclaim.[41] Because Vickie Lynn's counterclaim was based on state common law and the resolution of the counterclaim was not necessary to resolving the allowance or disallowance of Pierce's claim in the bankruptcy case, the Supreme Court held that the counterclaim could only be decided by an Article III court capable of exercising the judicial power of the United States.[42] Non-Article III judges cannot fully exercise the judicial power established under the Constitution. The Supreme Court further held that the filing of the proof of claim by Pierce did not give the bankruptcy court the constitutional authority to determine the counterclaim because the counterclaim would not necessarily be resolved in the process of ruling on Pierce's claim against the bankruptcy estate.[43] The factual and legal determinations required in order to rule on Vickie Lynn's counterclaim (based on tortious interference) did not overlap with Pierce's proof of claim (based on defamation). Accordingly, the Supreme Court affirmed the judgment of the Ninth Circuit.[44]

D. Consent to Bankruptcy Court Adjudication of Stern Claims

In a follow-up to *Stern*, the Supreme Court, in *Wellness International Network, Ltd. v. Sharif*,[45] provided guidance concerning whether Article III of the Constitution allows bankruptcy judges to adjudicate Stern Claims with the consent of the parties.

Sharif was an individual Chapter 7 debtor. Wellness International Network, one of Sharif's creditors, commenced an adversary proceeding against Sharif in the bankruptcy court in which it, among other things, objected to the discharge of Sharif's debts and sought a declaratory judgment that a trust Sharif administered on behalf of family members was his alter ego and, therefore, the assets of the trust should be included as part of Sharif's bankruptcy estate. After issuing a ruling that Sharif had violated the court's discovery order, the bankruptcy court denied Sharif's discharge and it entered a default judgment declaring that the trust assets were property of the bankruptcy estate.

After Sharif appealed to the district court, the Supreme Court decided *Stern*. Following the closing of briefing, Sharif moved for leave to file a supplemental brief arguing that the alter ego claim was a Stern Claim, which the bankruptcy court did not have the authority to adjudicate, and thus the bankruptcy court's order should only be treated as a report and recommendation to the district court. The district court denied Sharif's motion for supplemental briefing and affirmed the bankruptcy court's ruling. On appeal, the Seventh Circuit affirmed

[35] *Id*. at 312.

[36] *Id*. at 308-09.

[37] Pfander and Downey, *supra* note 31, at 1537.

[38] 564 U.S. 462 (2011). Stern was the executor of Vickie Lynn's estate.

[39] *Id.* at 475.

[40] *Id*. at 476.

[41] *Id*. at 482.

[42] *Id.* at 482-87.

[43] *Id.* at 497-98.

[44] Following *Stern*, claims in a proceeding which a bankruptcy judge lacks constitutional authority to adjudicate even though the proceeding is statutorily core are commonly referred to as "Stern Claims."

[45] *Wellness Int'l Network, Ltd. v. Sharif*, 575 U.S. ___; 135 S.Ct. 1932 (2015).

the rulings on the non-Stern Claims, including the denial of discharge. But with respect to the Stern Claim (*i.e.*, alter ego), the Seventh Circuit determined that the bankruptcy court did not possess the constitutional authority to decide the alter ego claim and that a litigant may not waive a Stern Claim objection because it raises separation of powers issues under Article III of the Constitution.

In reversing the Seventh Circuit, the Supreme Court held that Article III of the Constitution is not violated when a bankruptcy court adjudicates what might be considered Stern Claims if the parties knowingly and voluntarily consent to the bankruptcy court's adjudication of the proceeding.[46] The Supreme Court further held that the consent can be expressed or implied.[47] Although the Supreme Court stated that bankruptcy courts do not have free-floating authority to decide claims traditionally heard by Article III courts, it noted that Stern Claims are a "narrow class of common law claims" that are incident to the bankruptcy court's primary, adjudicative function.[48] Because bankruptcy courts sit as units of the district court and are subject to control by the Article III courts, the Supreme Court concluded that allowing bankruptcy courts to hear Stern Claims did not pose a threat to the separation of powers.[49] In his dissent, Chief Justice Roberts (joined by Justices Scalia and Thomas) argued that the majority had failed to recognize and focus on the narrow issue in the case: whether the assets of the trust were property of the estate (a determination which clearly is within the bankruptcy court's jurisdiction).[50]

The Supreme Court's holding in *Wellness* was a practical solution to addressing, to some extent, Stern Claims.

IV. OVERVIEW OF THE BANKRUPTCY CODE

A. Who Can Be a Debtor

1. <u>Death Prior to Commencement of a Bankruptcy Case</u>

The Bankruptcy Code identifies who may be a debtor under the various chapters.[51] Generally, (i) a "person" may be a debtor under Chapter 7, (ii) an "entity" may be a debtor under Chapter 9, (iii) a railroad, a person and certain financial institutions may be a debtor under Chapter 11, (iv) a family farmer or family fisherman with regular annual income may be a debtor under Chapter 12, and (v) an individual with regular income may be a debtor under Chapter 13.[52] Not specifically excluded from the right to be a debtor is a decedent's estate. Notwithstanding, there appears to be no dispute that a decedent's estate may not be a debtor.[53]

First, the defined term "person" does not specifically include the word estate. The Bankruptcy Code defines the term "person" to include any individual, partnership and corporation, and defines the term "entity" to include person, estate, trust, governmental unit, and United States Trustee.[54] Although Congress used the word "includes" in the definition of "person" and "entity," which means the definitions are not limiting,[55]Congress defined "entity" to specifically include an estate. The inclusion of estate in the defined term "entity" suggests that Congress did not intend the term "person" to include an estate.[56] Secondly, the legislative history of the Bankruptcy Code confirms that Congress did not intend the defined term "person" to include a decedent's estate: "The definition [of person] does not include an estate or a trust, which are included only in the definition of "entity" …."[57]

B. What Happens When a Debtor Dies During the Pendency of a Bankruptcy Case

If a debtor dies after commencing a bankruptcy case, the death does not require the dismissal of the bankruptcy case. If it is a case under Chapter 7 of the Bankruptcy Code, the bankruptcy estate shall continue to be administered until the case is concluded.[58] If it is a case under Chapter 11, Chapter 12, or Chapter 13, the case may be dismissed, or the administration of the case may proceed, if it is possible and in the best interest of the parties.[59] Accordingly, when a debtor dies and the debtor's case is not dismissed, the bankruptcy case and the probate proceeding move forward in tandem but independently.[60] The bankruptcy court and the probate court will have *in rem* jurisdiction over different property, and they will oversee the administration of different claims. Property of the bankruptcy estate will continue to be exclusively administered in the

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[46] *Id*. at 1939.
[47] *Id*. at 1947-48.
[48] *Id*. at 1945.
[49] *Id*. at 1945-46.
[50] *Id*. at 1950-54.
[51] 11 U.S.C. § 109.
[52] *Id*. § 109.
[53] *See, e.g., In re Goerg*, 844 F.2d 1562, 1565-66 (11th Cir. 1988); *Estate of Gray v. McDermott (In re Estate of Gray)*, Nos. 10-14412 & 10-14802, 2011 U.S. Dist. Lexis 100207, at *14 (E.D. Mich. 2011); *In re Estate of Patterson*, 64 B.R. 807, 808 (Bankr. W.D. Tex. 1986).
[54] *Id*. § 101(15), (41).
[55] *Id*. § 102(3).
[56] *In re Goerg*, 844 F.2d at 1565-66.
[57] H.R. REP. NO. 95-595, at 313 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6270; S. REP. NO. 95-989, at 25 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5797, 5811.
[58] FED. R. BANKR. P. 1016.
[59] *Id*.
[60] *In re Lucio*, 251 B.R. 705, 709 (Bankr. W.D. Tex. 2000).

bankruptcy case.[61] The probate estate will just consist of the non-bankruptcy estate property (*i.e.*, exempt property and, generally, property acquired post-commencement of the bankruptcy case).[62] With respect to the decedent's debts, proceeds from the liquidation of property of the bankruptcy estate will be distributed to holders of pre-petition debts and any unpaid amount of such debts will be discharged, if appropriate.[63] The probate estate will only be liable for those debts incurred by decedent after commencing the bankruptcy case as well as any debt found by the bankruptcy court to be non-dischargeable.[64]

C. Types of Bankruptcy Cases

There are six separate types of cases which can be commenced under the Bankruptcy Code: (i) Chapter 7 case; (ii) Chapter 9 case; (iii) Chapter 11 case; (iv) Chapter 12 case; (v) Chapter 13 case; and (vi) Chapter 15 cases. The Bankruptcy Code sets the criteria who may be a debtor under each of the different chapters.

This paper will just summarize Chapter 7, Chapter 11 and Chapter 13 cases, the chapters most commonly used by individual debtors. While some of the concepts discussed below are applicable to the other chapters, we will not focus on them in this paper (Chapter 9 case involves a municipality, Chapter 12 case involves a family farmer or fisherman with regular annual income, and Chapter 15 involves a debtor that is the subject to a foreign proceeding).

1. Chapter 7 – Liquidation

Chapter 7 Bankruptcy — also known as "liquidation bankruptcy" — is the most common form of bankruptcy. Shortly after the filing of the case, a bankruptcy trustee is appointed by the Office of the United States Trustee. The trustee is charged with the general responsibility to gather the debtor's property, liquidate the debtor's nonexempt property, and then distribute the proceeds pursuant to the priority scheme set forth in the Bankruptcy Code. When the trustee believes there may be a distribution to unsecured creditors, creditors are requested to file a proof of claim, and by doing so they may receive a distribution (assuming there is a distribution and the claim is not disallowed) from the trustee. The trustee, among other things, has the authority to recover money or property under the avoidance powers provided in the Bankruptcy Code, file an objection to the debtor's improper scheduling of property as exempt, and file an objection to any improper claim of a creditor. If the debtor is an individual, and absent the entry of an order either denying a discharge to the debtor or finding that a specific debt is non-dischargeable, the debtor will receive a discharge that relieves the debtor from personal liability for certain specified types of debts and prohibits creditors from taking future action against the debtor to collect those debts.

In 2005, Congress amended the Bankruptcy Code[65] in an attempt to reduce the number of filings under Chapter 7 by, among other things, tightening the eligibility of individuals to file Chapter 7. Specifically, Congress added a "means test" which is designed to determine whether a debtor's disposable income is in excess of certain thresholds. If the debtor's income is above the threshold for the geographical area where the debtor resides, the debtor may not be eligible for Chapter 7 relief.

2. Chapter 11 – Reorganization

Chapter 11 is primarily for business debtors that wish to continue operations and repay their creditors, to some degree, over time through a court-approved plan of reorganization. In addition, and with more frequency, Chapter 11 bankruptcy is used to facilitate a going-concern liquidation of assets. Although Chapter 11 is generally used by financially-distressed businesses, individuals may also file under Chapter 11. However, because of the costs associated with filing Chapter 11, including legal and other fees (including, potentially, those of an official committee of unsecured creditors), reporting requirements, and other expenses associated with cases under Chapter 11, usually only individuals with significant assets or income and large liabilities will file under Chapter 11.

One of the primary benefits to proceeding under Chapter 11 is that the debtor can remain in legal control (as debtor in possession) of the debtor's property and, for at least the first 120 days after the case is commenced (unless shortened by the bankruptcy court), has the exclusive right to file a plan of reorganization. The exclusive period to file a plan may be extended by order of the bankruptcy court, but any such extension may not extend beyond a date that is 18 months after the date of the order for relief (which is usually the date the bankruptcy petition was filed in a voluntary case). Generally, before the plan of reorganization can be sent to creditors for approval or rejection, the debtor (or the plan proponent) must file and obtain bankruptcy court approval of a disclosure statement that provides "adequate information" concerning the affairs of the debtor to enable the creditors to make an informed judgment as to whether to vote for or against the plan of

[61] *Id.*

[62] *Moon v. Bauer (In re Bauer)*, 343 B.R. 234, 236-37 (Bankr. W.D. Mo. 2006).

[63] *In re Lucio*, 251 B.R. at 709.

[64] *Id.*

[65] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1007, 119 Stat. 23 (2005).

reorganization. The plan of reorganization must designate one or more classes of claims for treatment under the plan, and only claims that are substantially similar may be placed in a particular class. For the plan of reorganization to be confirmed, the bankruptcy court must find, among other things: (i) the plan and the plan proponent are in compliance with the Bankruptcy Code; (ii) the plan was proposed in good faith and not be any means forbidden by law; (iii) the plan will not likely be followed by the need for further financial reorganization or by the liquidation of the debtor (unless such liquidation or reorganization is proposed in the plan); and (iv) each class of claims voted to accept the plan, which occurs when creditors holding at least two-thirds in amount and more than one-half in number of allowed claims in the class, or at least one class of non-insiders who hold impaired claims (*i.e.*, claims not paid in full or in which some legal, equitable or contractual right is altered) accepts the plan. Among other things, the debtor can use Chapter 11 to reject burdensome contracts and leases and, under a confirmed plan, reduce the aggregate amount of debt owed to creditors. If the Chapter 11 debtor is an individual, the debtor will not receive a discharge, generally, until after all payments required under the plan have been made.

3. Chapter 13 – Individuals with Regular Income

Chapter 13 is designed to allow individuals, with a regular source of income and whose noncontingent and liquidated secured and unsecured debts do not exceed certain threshold amounts (which are adjusted every three years), to gain control of their financial situation via a Chapter 13 plan approved by the bankruptcy court.[66] In most districts, the Office of the United States Trustee has appointed a standing Chapter 13 trustee to administer all Chapter 13 cases in that district. Unlike in Chapter 7, a debtor under Chapter 13 remains in possession of property of the estate, and the debtor may be able to keep certain property if the plan provides that the holder of a valid secured claim will receives at least the value of the collateral. Further, in order for a Chapter 13 plan to be confirmed, it must provide for fixed payments to the Chapter 13 trustee for a set period of time, who then distributes the funds to creditors in accordance with the terms of the court-approved plan. The plan may pay creditors less than the full amount of their claims so long as the debtor is paying all of the debtor's projected "disposable income" over the plan term (which is usually between three to five years) and unsecured creditors receive at least as much under the plan as they would receive under a Chapter 7 case. Importantly, a debtor under Chapter 13 does not have to prepare a disclosure statement or solicit creditor approval of the Chapter 13 plan as a condition to its approval by the bankruptcy court. Subject to certain specified exceptions, a Chapter 13 debtor is entitled to a discharge upon completion of all plan payments.

D. Property of the Estate

When a bankruptcy case is commenced under either Chapter 7 or Chapter 11, an estate is created which consists of, among other things, "all legal or equitable interests" of the debtor in property, "wherever located and by whomever held" as of the commencement of the case, plus any interest in non-exempt property "the debtor acquires or becomes entitled to acquire" within 180 days after the petition is filed (i) by bequest, devise, inheritance, (ii) as a result of property settlement with the debtor's spouse or a divorce decree, or (iii) as a beneficiary of a life insurance policy or a death plan policy.[67] However, for cases commenced under Chapter 13, the scope of property of the estate is even broader. Under Chapter 13, property of the estate includes, in addition to the property mentioned above, (i) all property the "debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of the ... [Bankruptcy Code], whichever occurs first" or (ii) "the earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of the ... [Bankruptcy Code], whichever occurs first."[68] The Bankruptcy Code does not define "property" or "interest in property." The debtor's rights in and to property is determined under applicable state law.[69] Once that interest is determined under state law, the bankruptcy court will determine if the property is included in the bankruptcy estate.[70]

The application of the 180-day rule with respect to property of the estate is not always clear, particularly when the debtor's interest in a decedent's property is acquired by bequest, devise, or inheritance. At what point does the debtor's interest in such property attach? Must the probate proceeding have been commenced prior to the commencement of the bankruptcy case, or at least within 180 days thereafter? In Texas, as in most states, a beneficiary's interest in bequests, devises, and inheritances vests at the moment of the decedent's

[66] As of April 1, 2019, noncontingent, liquidated, unsecured debts had to be less than $419,275 and noncontingent, liquidated, secured debts had to be less than $1,257,850. These amounts are adjusted every three years. *See* 11 U.S.C. § 104.

[67] 11 U.S.C. § 541(a).

[68] *Id.* § 1306(a).

[69] *Butner v. United States*, 440 U.S. 48, 55 (1979).

[70] *Osherow v. Porras (In re Porras)*, 312 B.R. 81, 111 (Bankr. W.D. Tex. 2004).

death.[71] This vested interest, however, is subject to the payment of the debts of the decedent (except as exempted by law) and any court-ordered child support payments that are delinquent on the date of death.[72] Because the interest vests immediately in the devisees or heirs upon the decedent's death, the timing of the commencement of the probate proceeding is not relevant with respect to whether a vested property interest is property of the estate. The debtor's interest in the decedent's property is property of the bankruptcy estate as long as the decedent either dies prior to the commencement of the bankruptcy case or within 180 days after the commencement of the bankruptcy case, even when the probate proceeding is commenced after the 180-day period.[73]

Another issue to consider is what happens if the debtor's interest in a decedent's property is challenged and the decedent's property has yet to be distributed? Does the probate court determine the validity of the debtor's interest? The answer is no. The bankruptcy court is the court with jurisdiction to make this determination. Immediately upon the decedent's death, title to the decedent's property passes to the devisees or heirs.[74] The vested interest, whether vested prior to the commencement of the bankruptcy case or during the 180-day period, is property of the estate and the bankruptcy court has exclusive jurisdiction to adjudicate any dispute involving the validity of the bankruptcy estate's interest in the property.[75] The exercise of federal jurisdiction to adjudicate rights in property that is in the custody of a probate court does not violate the probate exception.[76] Following the final adjudication of such rights by the bankruptcy court, the probate court is bound by the judgment of the bankruptcy court.[77]

Although the determination of the bankruptcy estate's interest in a non-debtor decedent's property is within the exclusive jurisdiction of the bankruptcy court, the bankruptcy court's authority to direct what happens to the property, including ordering the sale or distribution of the property, may depend on the timing of the commencement of the probate proceeding. If the probate proceeding is commenced prior to the commencement of the bankruptcy case, the probate estate will include the decedent's property[78] and such property will be in the custody of the probate court.[79] Under Texas law, the executor or administrator of the probate estate will have superior right to possess the probate estate and dispose of the estate in accordance with the law.[80] The subsequent filing of bankruptcy by an heir or a party claiming an interest in the decedent's property should not divest the probate court of its *in rem* jurisdiction over the decedent's property.[81] To the contrary, the probate exception will likely preclude the bankruptcy court from assuming *in rem* jurisdiction over the property even though the debtor's vested interest in the property is property of the estate.[82] But, if the bankruptcy case is commenced prior to the commencement of the probate proceeding, and the non-debtor decedent died prior to the commencement of the bankruptcy case or during the 180-day period following the commencement of the bankruptcy case, the bankruptcy court, as previously noted, will have exclusive *in rem* jurisdiction with respect to the debtor's vested interest in the decedent's property. The subsequent commencement of the probate proceeding will not divest the bankruptcy court of that jurisdiction.[83]

Notwithstanding the broad definition of property of the estate, the Bankruptcy Code specifically excludes certain property from the bankruptcy estate.[84] Generally, these exclusions are narrow. Among the excluded property are powers the debtor may exercise solely for the benefit of another entity.[85] This has been held to exclude from property of the estate any property that the debtor controls in a fiduciary capacity, including as holder of trust fund taxes,[86] as executrix of a decedent's estate,[87] and as trustee in a testamentary trust.[88] If the debtor reserves the power to confer a benefit on the debtor in addition to another entity, this power is property of the estate.[89] In addition, if a trust agreement includes a restriction on the transfer of the debtor's beneficial interest in the trust, and this

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[71] TEX. ESTATES CODE ANN. § 100.001 (Vernon 2017).

[72] *Id.* § 101.051.

[73] *In re Chenoweth*, 3 F.3d 111, 112-13 (7th Cir. 1993).

[74] *See Welder v. Hitchcock*, 617 S.W.2d 294 (Tex. Civ. App. – Corpus Christi 1981, *writ ref'd n.r.e.*) (noting that "there is no shorter interval of time than between the death of a decedent and the vesting of his estate in his heirs").

[75] *28* U.S.C. § 1334(e).

[76] *Marshall*, 547 U.S. at 311-12; *Markham v. Allen*, 326 U.S. 490, 494 (1946).

[77] *Markham*, 547 U.S. at 494.

[78] TEX. ESTATES CODE ANN. § 22.012 (Vernon 2017).

[79] *See Id.* § 32.001.

[80] *Id.* §101.003.

[81] *Marshall*, 547 U.S. at 311-12.

[82] *Id.*; *Markham*, 326 U.S. at 494 ("a federal court may not exercise its jurisdiction to disturb or affect the possession of property in the custody of a state court ...."); *Rentas v. Gonzalez (In re Garcia)*, 507 B.R. 32, 44 (B.A.P. 1st Cir. 2014).

[83] *See* 28 U.S.C. § 1334(e).

[84] 11 U.S.C. § 541(b).

[85] *Id.* § 541(b)(1).

[86] *Begier v. IRS*, 496 U.S. 53, 67 (1990).

[87] *In re Cherry*, 37 B.R. 893, 894 (Bankr. E.D. Pa. 1984).

[88] *In re Kreiss*, 72 B.R. 933, 939 (Bankr. E.D.N.Y. 1987).

[89] *In re Johnson*, 513 B.R. 333, 343 (Bankr. S.D. Ill. 2014).

restriction is enforceable under applicable non-bankruptcy law, the Bankruptcy Code states that the debtor's beneficial interest will not be property of the estate.[90] Mostly, this provision in the Bankruptcy Code has been applied to spendthrift trusts containing valid limitations on alienation of the beneficiaries' interests.[91] But, it has also been extended to a debtor's interest in an ERISA qualified pension plan containing a valid restriction on transfer of interest.[92] If the spendthrift trust does not have a valid spendthrift clause under applicable non-bankruptcy law, or the debtor has the power to amend or terminate the trust, the debtor's interest in the trust becomes property of the estate.[93] In the event a spendthrift trust is partially self-funded by the debtor, only the extent of the self-funded portion of the trust becomes part of the bankruptcy estate.[94] The balance of the debtor's interest in the trust is excluded from the bankruptcy estate.

E. Automatic Stay

1. Overview

The "automatic stay" is one of the most important protections that the Bankruptcy Code provides to a debtor. The moment a bankruptcy case is filed, the petition operates as a stay to protect the debtor and the debtor's property.[95] Creditors thus cannot take any action to require or obtain payment of a pre-petition debt except by obtaining the requisite authority from the bankruptcy court.

The automatic stay serves several purposes. First, it provides an honest but unfortunate debtor a "fresh start." The stay provides some breathing room, during which the debtor is relieved of the intense pressure from demanding creditors and it gives the debtor the time to pull the debtor's life together and figure out a way to start making payments again.[96] In addition, the automatic stay protects the interests of creditors. As one court puts it, the stay "protects the bankrupt's estate from being eaten away by creditors' lawsuits and seizures of property before the trustee has had a chance to marshal the estate's assets and distribute them equally among the creditors."[97] The stay keeps the estate intact and avoids its piecemeal destruction.

The Bankruptcy Code excepts from the automatic stay a litany of matters, including: (i) the commencement or continuation of a criminal proceedings against the debtor; (ii) the commencement or continuation of a proceeding (a) for the establishment of paternity, (b) for the establishment or modification of an order for domestic support obligations, (c) concerning child custody or visitation, (d) for the dissolution of a marriage, except to the extent such proceeding seeks to determine the division of property of the estate, and (e) regarding domestic violence; (iii) the collection of a domestic support obligation from property that is not property of the estate; (iv) suspension of a driver's license; and (v) the undertaking a tax audit.[98] Generally, actions relating to the government's police or regulatory powers are not stayed.

2. Violations of the Stay

An action taken by a creditor that violates the stay is typically deemed void or voidable, depending on the jurisdiction. It is axiomatic to state, however, that actions which do not affect the debtor or property of the estate do not violate the stay. There are a few basic situations in which a probate practitioner could violate the automatic stay.

First, the Bankruptcy Code prohibits the commencement or continuation of an action against the debtor if it was commenced or "could have been" commenced before the bankruptcy case.[99] Based on this language, courts have held that a proceeding to remove a debtor as a personal representative of a probate estate violates the stay.[100] If a debtor should be removed as the executor of an estate in probate (for example, because the debtor had engaged extensively in fraudulent activities – either before or after the bankruptcy case was commenced), the appropriate course of action is to seek in the bankruptcy case emergency relief from the automatic stay, which would allow for consideration of the requested relief on an expedited basis. Similarly, an action in a probate proceeding to sanction a debtor for pre-petition misconduct would violate the stay.

Second, actions taken against the bankruptcy estate can violate the automatic stay. This can happen when a

[90] 11 U.S.C. § 541(c).

[91] *See, e.g., Ehrenberg v. Southern Cal. Permanente Med. Group (In re Moses)*, 167 F.3d 470, 473 (9th Cir. 1999); *Shurley v. Texas Commerce Bank – Austin, N.A. (In re Shurley)*, 115 F.3d 333 (5th Cir. 1997); *cf. Bass v. Denney (In re Bass)*, 171 F.3d. 1016, 1029-30 (5th Cir. 1999) (debtor's interest in a valid spendthrift trust are immune from claims of the debtor's creditors).

[92] *Patterson v. Shumate*, 504 U.S. 753, 757-60 (1992).

[93] *In re Shurley*, 115 F.3d at 335 (5th Cir. 1997); *In re Orkin*, 170 B.R. 751 (Bankr. D. Mass. 1994).

[94] *In re Shurley*, 115 F.3d. at 338-42.

[95] 11 U.S.C. § 362.

[96] *See* William Bassin, *Why Courts Should Refuse to Enforce Pre-Petition Agreements That Waive Bankruptcy's Automatic Stay Provision*, 28 Ind. L. Rev. 1, 4 (1994).

[97] *Martin-Trigona v. Champion Fed. Sav. & Loan Ass'n.*, 892 F.2d 575, 577 (7th Cir. 1989).

[98] 11 U.S.C. § 362(b)(1)-(28).

[99] *Id*. § 362(a)(1).

[100] *In re Steward*, 338 B.R. 654, 659-60 (Bankr. D.N.J. 2006); *In re Panayotoff*, 140 B.R. 509, 511-12 (Bankr. D. Minn. 1992).

debtor is a beneficiary of a probate estate (assuming the decedent died before or within 180 days of the commencement of the bankruptcy case). In these situations, commencing an action that affects the debtor or the debtor's interest in the probate estate would violate the stay.[101] By way of further example, commencing a probate proceeding after a debtor dies would not violate the stay because the probate proceeding would not include property of the bankruptcy estate.

It is important to remember that the bankruptcy court can grant relief from the automatic stay. The requested relief can be quickly and easily obtained by filing an appropriate motion (be sure and check the requirements for doing so in the court's Local Rules or, even better, associate a bankruptcy lawyer with knowledge of the local practice) and pay the requisite filing fee. If sufficient cause exists, or the debtor has no equity in the property and it is not necessary to an effective reorganization, chances are good that the bankruptcy court will grant the requested relief.[102]

V. OTHER BANKRUPTCY/PROBATE ISSUES

There are a host of miscellaneous issues that can affect both estate planning and probate practice. It is important to remember that the sections above—dealing with the bankruptcy estate, the automatic stay, etc.—still apply when dealing with these specific issues.

A. Disclaimers

In Texas, as in other states, beneficiaries can disclaim inherited property.[103] If disclaimed, this property is treated as if it never passed into the hands of the beneficiary.[104] This "relation back" doctrine makes disclaimers a powerful estate planning tool. For example, if an individual is being aggressively pursued or constantly hounded by creditors, he or she may wish to simply disclaim his or her inheritance to avoid having it ultimately be distributed into those creditors' hands.

This raises an interesting and important question: does the act of disclaiming soon-to-be inherited property constitute a fraudulent transfer? And, if it does, at what point is it triggered? Under the Bankruptcy Code, a fraudulent transfer is any transfer made by the debtor up to two years before the commencement of the bankruptcy case and (i) the transfer was made "with actual intent to hinder, delay, or defraud any entity" to which the debtor owes money, or (ii) the debtor "received less than a reasonably equivalent value in exchange for such transfer" and the debtor (a) was insolvent on the date of the transfer, (b) engaged in business with an unreasonably small amount of capital, (c) intended to incur debt beyond the debtor's ability to pay as such debts mature, or (d) made the transfer to or for the benefit of an insider.[105] In addition to the foregoing, the Bankruptcy Code also permits a bankruptcy trustee to use any applicable non-bankruptcy law to avoid a transfer.[106] The bankruptcy trustee can "avoid" such transfers and bring the transferred assets into possession of the bankruptcy estate.

Federal courts agree that a valid pre-petition disclaimer (*i.e.*, not a fraudulent transfer) cannot be avoided by the bankruptcy court.[107] This makes perfect sense when considering that disclaimers and the relation-back doctrine are well-accepted state property law concepts, not newly-conjured legal schemes or artifices. Certain states, however, have passed laws which limit a beneficiary's right to disclaim property in certain situations.[108] As a consequence, although disclaimers which are in place long before bankruptcy is ever an issue or consideration will likely be upheld, it is important to double check individual state law to make sure the situation which you are facing has not been curtailed by the use of disclaimers.

When advising a client in Texas, it may be reasonable to remind the client that disclaiming inherited property would likely place the affected property beyond the reach of the client's potential future creditors. But, in order for a disclaimer to be safe and effective, a client cannot have participated in a scheme, planned for or otherwise have any knowledge of an impending filing of a bankruptcy case – or, for that matter, possess knowledge of actual, existing or future creditors. The more knowledge a client has of imminent financial issues or difficulty, the more likely the disclaimer will be held to be fraudulent and the less likely it will be enforced.

A post-petition disclaimer of property raises even more questions. If the decedent dies before the bankruptcy case is commenced, but the debtor disclaims after the bankruptcy case is commenced, the transfer is essentially fraudulent by default. The minute that the bankruptcy case is commenced, the right to inherit (or disclaim) the property belongs to the bankruptcy trustee, not the debtor personally.[109] But, what if the decedent dies after the bankruptcy case is commenced? Although there has been a significant amount of litigation

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[101] *See, e.g., Nickless v. Kessler (In re Berman)*, 352 B.R. 533, 539-41 (Bankr. D. Mass. 2006).

[102] *Id.*

[103] TEX. ESTATES CODE ANN. § 122.002 (Vernon 2017).

[104] TEX. PROP. CODE ANN. § 240.051 (Vernon 2018).

[105] 11 U.S.C. § 548(a)(1).

[106] *Id.* § 544(b)(1).

[107] *See, e.g., Simpson v. Penner (In re Simpson)*, 36 F.3d 450, 452-53 (5th Cir. 1994) (per curiam).

[108] *See, e.g.,* N.J. Stat. Ann. § 3B:9-9(a)(6).

[109] *Lowe v. Sanflippo (In re Schmidt)*, 362 B.R. 318, 324-25 (Bankr. W.D. Tex. 2007).

addressing this question, the answer remains the same. The debtor is not allowed to utilize the debtor's right to disclaim the inheritance once a bankruptcy case has been commenced; in other words, the Supremacy Clause strikes again and (federal) bankruptcy law trumps the relation-back doctrine (created by state law).

B. Post-Petition Testamentary Changes

Unlike disclaimers, testamentary changes made post-petition by non-debtors are virtually untouchable by the bankruptcy court. There is nothing to stop a testator from changing the testator's will the second that the testator's child, grandchild, niece, nephew, or lover files for bankruptcy. This is because an expectancy is not an "interest of the debtor in property" that is includable in a bankruptcy estate.[110] Accordingly, it is not only advisable for counsel to advise an aging testator to change the testator's will in this situation, it may actually be malpractice *not* to do so.

C. Asset Protection Trusts

Another question for estate planners is whether bankruptcy courts will respect the integrity of a spendthrift trust—and the answer to this question is not necessarily uniform. As stated above, a debtor's beneficial interest in a spendthrift trust will not be property of the estate if the restriction on the transfer of the debtor's beneficial interest is enforceable under applicable non-bankruptcy law.[111] Protecting this beneficial interest is one of the principal benefits of spendthrift trusts.

Self-settled spendthrift trusts, or "domestic asset protection trusts," are truly a different breed of cat and will only be protected if the controlling state law allows for them. For example, Delaware allows for the creation of such trusts.[112] These types of trusts, though created by the debtor, can provide protection against creditor claims in bankruptcy. Notwithstanding, in states (including Delaware) that allow these self-settled spendthrift trusts, there is a useful list of exceptions that, if satisfied, allow creditors the opportunity to access the assets within the trust to satisfy their claims.[113]

Texas has a statute addressing spendthrift trusts.[114] Subject to certain specified exceptions, the statute provides that a settlor's beneficial interest in the spendthrift trust estate will not prevent the settlor's creditors from satisfying claims from the settlor's interest in the trust estate.[115]

D. Trust Income

As shown above, certain types of trusts can successfully protect a debtor's assets from creditor claims. But, what about trust income that is distributed within 180 days of filing the petition? The answer to this question turns on the type of trust that is under scrutiny. The Bankruptcy Code states that the trustee may collect post-petition property that the debtor "acquires or becomes entitled to acquire … by bequest, devise, or inheritance."[116] Based on this express language, most bankruptcy courts have concluded that creditors can only reach distributions made by testamentary trusts, as these satisfy the "bequest, devise, or inheritance" language rubric.[117] Distributions made from *inter vivos* trusts are more similar to lifetime gifts, and thus are not generally available to satisfy creditor claims, even if made within 180 days of the petition.

E. Marital Property Agreements

Estate planners have often utilized the tools of marital property agreements as "arrows in their quivers." Accordingly, it is not unusual for spouses in Texas to execute pre-nuptial (or post-nuptial) agreements – with the effect being to attempt to separate – or combine – their property for a variety of legitimate and entirely appropriate reasons. Under Texas law, these types of agreements are valid and because their usage is so common, lawyers may sometimes overlook the required initial "smell test": a pre-marital agreement is void if its purpose is to defraud creditors. The Texas Family Code provides as follows: "(a) A provision of a partition or exchange agreement made under this subchapter is void with respect to the rights of a pre-existing creditor whose rights are intended to be defrauded by it."[118] Further, the Family Code states: "(a) A conversion of separate property to community property does not affect the rights of a pre-existing creditor of the spouse whose separate property is being converted."[119] While the Texas Family Code allows for recordation of such marital or exchange agreements to be signed, acknowledged and filed in the deed records in order to provide constructive notice to third parties, it is clear that the mere filing of these types of agreements will not provide validity or legitimacy to an agreement

[110] *See In re Trautman*, 296 B.R. 651, 655 (Bankr. W.D.N.Y. 2003).

[111] 11 U.S.C. § 541(c)(2).

[112] Del. Code Ann. tit. 12, §§ 3570 to 3576.

[113] In Delaware, creditors can breach a self-settled spendthrift trust if they can demonstrate fraudulent intent. In addition, alimony payments, child support, and certain tort liabilities can all ignore the trust's protection.

[114] TEX. PROP. CODE ANN. § 112.035 (Vernon 2018).

[115] *Id.* § 112.035(d).

[116] 11 U.S.C. § 541(a)(5)(A).

[117] *See, e.g., In re Kragness*, 58 B.R. 939 (Bankr. D. Or. 1986).

[118] TEX. FAM. CODE ANN. § 4.106 (Vernon 2019).

[119] *Id. §* 4.206.

with an otherwise unlawful intent to defraud pre-existing creditors. Accordingly, counsel would be well-advised to suggest that existing creditors search appropriate county deed records to determine whether a marital or exchange agreement has been filed of record to which the debtor is a party and review whether any form of intentional fraud is intended or being perpetrated.

In the bankruptcy context, these same marital property agreements can be set aside, but on different bases. In bankruptcy court, assuming the transfer(s) satisfy the statutory predicate, the marital property agreement may be set aside as being either a preferential transfer or a fraudulent conveyance.

F. Homestead

With an unlimited homestead exemption, Texas (along with other states, like Florida) has been historically considered a refuge where a debtor could move, buy an expensive house (or 200 acres of land if the debtor is married and lives in a rural area) and claim it as homestead. In doing so, a debtor could essentially convert otherwise non-exempt property into an exempt property, thereby placing the property beyond the reach of creditor claims. In an attempt to limit perceived abuses of the generous homestead laws in certain states, Congress in the 2005 amendments to the Bankruptcy Code put certain limitations on the right to utilize state exemption laws. If a debtor elects state law exemptions, the value of the homestead will be limited to $170,350[120] if the debtor acquired the homestead during the 1215-day period preceding the date of the filing of the bankruptcy petition.[121] This limitation does not apply to any amount rolled over from the debtor's prior residence if the prior residence was acquired by the debtor outside the 1215-day period and both the previous and current residences are located in the same state.[122] The value of the homestead will also be limited to $170,350 if the debtor (i) was convicted of a felony and the filing of the bankruptcy case was an abuse of the Bankruptcy Code, or (ii) owes a debt arising from (a) a violation of federal or state securities laws, or any regulation or order issued under such laws, (b) fraud, deceit or manipulation in a fiduciary capacity or in connection with the purchase or sale of any registered security, (c) any civil remedy for engaging in racketeering activities under 18 U.S.C. § 1964, or (d) any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another person in the preceding five years.[123] The foregoing limitation is not applicable to the extent the interest in property is "reasonably necessary for the support of the debtor and any dependent of the debtor.[124]

A recent case provides an interesting (albeit unique) set of circumstances involving a homestead tied up in a bankruptcy case which illustrates the old adage: "Bad facts make bad law."[125] In this case, the debtor and his non-debtor spouse (from whom he was separated and pursuing divorce) owned a large, lakeside home on the banks of Lake Austin, valued at approximately $3 million. The debtor scheduled the property as exempt under state law. The homestead property was encumbered by first and second lien mortgages aggregating $2 million in addition to a $650,000 federal tax lien. The debtor and his estranged spouse both acknowledged in open court and ultimately agreed to sell the homestead property, but she subsequently backed out of the agreement. She also attempted to terminate the services of the court-approved real estate broker and initiated other obstacles designed to interfere with or frustrate the closing of the proposed sale. Although the property was exempt, the bankruptcy court intervened and ordered the sale of the homestead. In a twist of irony, after satisfying the various lien balances, including the federal tax lien, the bulk of the remaining equity never found its way into the hands of either the debtor or his estranged spouse; instead, the proceeds were used to pay the fees of the parties' divorce lawyers.

VI. CONCLUSION

The purpose of this paper was to explore some issues of bankruptcy law as it impacts probate law. If any conclusion can be easily drawn from this discussion, clearly it is that the intersection of bankruptcy and probate law is complicated and the issues are much more than simply theoretical or academic. As legislative bodies continue to enact laws and statutes, and courts continue to render decisions respecting the validity and efficacy of those enactments, the law will continue to evolve and develop. From defining what constitutes property of the bankruptcy estate to determining which set of laws provide the most appropriate structure for decision-making, a continuing review and analysis of both bankruptcy and probate laws is necessary to appreciate, recognize and effectively deal with the similarities and the differences in both arenas, and craft solutions to problems that seem, at least at the outset, as complicated as a Gordian knot.

[120] This amount is adjusted every three years. *See* 11 U.S.C. § 104.
[121] 11 U.S.C. § 522(p)(1).
[122] *Id.* § 522(p)(2)(B).
[123] *Id.* § 522(q)(1).
[124] *Id.* § 522(q)(2).
[125] *In re Phillips,* Case No. 17-10068 (Bankr. W.D. Tex.).

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