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PERSPECTIVE

Bankruptcy's spendthrift trust exception: mandatory or permissive?

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Estate planning attorneys work tirelessly for their clients, taking into account myriad complex issues. Despite these efforts, even the best-laid plans can be adversely affected when a beneficiary files for bankruptcy. As the debtors discovered in *Scott v. King* (*In re Amerson*), 839 F.3d 1290 (10th Cir. 2016), the existence of a valid spendthrift trust does not necessarily prevent the debtor's beneficial interest from being included in his or her bankruptcy estate for the benefit of creditors.

Property of the Estate

The filing of a Chapter 7 bankruptcy case creates an estate that includes "all legal or equitable interest of the debtor" as of the commencement of the case, with certain exemptions or exclusions. One such exclusion is set forth in 11 U.S.C. Section 541(c)(2), which states that "[a] restriction on the transfer of a beneficial interest of the debt in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under [the Bankruptcy Code]." Thus, courts have held that a beneficial interest in a valid spendthrift trust may be excluded from a debtor's bankruptcy estate. *Patterson v. Shumate*, 504 U.S. 753, 757-58 (1992); *In re Moses*, 167 F.3d 470, 473 (9th Cir. 1999).

Scott v. King

One question that arises is whether the "spendthrift trust exclusion" set forth in Section 541(c)(2) is mandatory, and therefore the debtor's beneficial interest is excluded from the bankruptcy estate under that section, or permissive. In *Scott*, the 10th U.S. Circuit Court of Appeals held that the "spendthrift trust exclusion" is permissive and affirmed the bankruptcy court's inclusion of a Chapter 7 debtor's beneficial interest in the bankruptcy estate, despite the existence of a valid spendthrift provision.

In *Scott*, the debtor-wife's father died, leaving a last will. The will was a "pour-over" will that transferred any assets her father held outside of trust to a living trust that contained a spendthrift provision (the spendthrift trust). The debtors later filed a Chapter 7 bankruptcy and failed to disclose on their bankruptcy schedules the debtor-wife's beneficial interest in the spendthrift trust. While their bankruptcy case was still pend-

ing, the debtors filed a lawsuit in Florida state court challenging the father's capacity to enter into the pour-over will. The debtors failed to notify the Chapter 7 trustee about the lawsuit or amend their schedules to disclose the lawsuit as an asset of their estate. The debtors subsequently received a discharge of debts typically received by eligible Chapter 7 debtors.

The existence of a valid spendthrift trust does not necessarily prevent the debtor's beneficial interest from being included in his or her bankruptcy estate for the benefit of creditors.

The debtors later moved to reopen their bankruptcy case to amend their bankruptcy schedule of personal property assets (Schedule B) to list a claim for wrongful foreclosure against their mortgage lender. In doing so, the debtors disclosed the Florida lawsuit for the first time but again failed to mention the debtor-wife's beneficial interest in the spendthrift trust. After the debtors' case was re-opened, the Chapter 7 trustee substituted for the debtors in the Florida lawsuit and reached a settlement of the debtors' state court claims. The bankruptcy court approved the settlement and in doing so expressly found that the debtors "sought to perpetrate a fraud" on the court and creditors by repeatedly failing to disclose the beneficial interest in the spendthrift trust. The bankruptcy court concluded that "in equity and good conscience, [it] could not permit the Debtors' constant and continuing bad faith ... to derail the trustee's efforts on behalf of their creditors."

The debtors appealed the bankruptcy court's order approving the settlement, arguing that the bankruptcy court lacked jurisdiction to administer the debtor-wife's interest in the spendthrift trust because it was mandatorily excluded for the estate pursuant to Section 541(c)(2). The bankruptcy court's order was affirmed by the 10th Circuit Bankruptcy Appellate Panel and the 10th Circuit.

The 10th Circuit held that the spendthrift provision in the father's trust was valid, but determined that the spendthrift exception in Section 541(c)(2) is permissive rather than mandatory. Consequently, "it is a debtor's choice whether or not to include such [a beneficial interest] in his or her bankruptcy estate." The 10th Circuit then held that the spendthrift exclusion did not apply and that the debtors' beneficial interest was

properly included in their bankruptcy estate because: (i) the debtors choose to include the beneficial interest in the trust on their amended Bankruptcy Schedules, and (ii) the debtors failed to argue that they were entitled to the spendthrift exemption during their bankruptcy proceedings.

Practical Considerations

The 10th Circuit's decision in *Scott* demonstrates that estate planning by attorneys for their clients may not have the intended benefits in a subsequent bankruptcy. As demonstrated above, a court's interpretation of Section 541(c)(2) as permissive rather than mandatory may prompt a court to include a debtor's interest in a trust in his or her bankruptcy estate, despite the existence of a valid spendthrift provision. Thus, estate attorneys would be well served to stay current on legal developments and decisions in the bankruptcy arena that may have implications for their practice and remind their clients to take actions consistent with the structures and intentions of their estate plan.

As debtors in bankruptcy have a duty to file complete and accurate schedules of their assets, they should timely disclose any of their contingent or non-contingent interests in trusts on their Bankruptcy Schedule B, and, if applicable, claim such interests exempt in their Bankruptcy Schedule C. *Scott* further suggests that debtors with beneficial interests in spendthrift trusts would be well served to argue in their bankruptcy proceedings that they are entitled to the spendthrift exclusion under Section 541(c)(2). If debtors fail to make such an argument, it is possible that a court will include their entire beneficial interest in their bankruptcy estate, as the debtors in *Scott v. King* discovered.

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