Bankruptcy as an Estate Planning Tool: An Overlooked Strategy for Preserving Family Wealth

By most measures, bankruptcy and estate planning appear to occupy opposite ends of the legal spectrum. Estate planning is associated with preserving and transferring wealth, while bankruptcy is often viewed as a remedy for financial distress. As a result, investment advisers, wealth managers, accountants, and estate planning attorneys rarely consider whether a bankruptcy filing by an intended beneficiary could actually enhance the effectiveness of an estate plan.

In many circumstances, however, bankruptcy should be viewed not as a failure, but as a legitimate financial planning tool that can preserve family wealth and ensure that gifts and inheritances accomplish their intended purpose.

Looking Beyond the Donor

Estate planning traditionally focuses on the person making the gift or bequest. Considerable attention is devoted to minimizing estate taxes, protecting assets from creditors, selecting fiduciaries, and implementing tax-efficient transfer strategies. Yet one critical question is frequently overlooked:

What is the financial condition of the intended beneficiary?

A gift that immediately becomes available to satisfy credit card debt, deficiency judgments, collection actions, or other unsecured obligations may do little to improve the beneficiary's long-term financial security. Instead of providing an opportunity to build wealth or achieve financial stability, the inheritance simply replenishes assets that creditors may quickly reach.

Accordingly, prudent estate planning should evaluate not only the assets being transferred, but also the financial circumstances of those who will receive them.

A Common Family Dynamic

Throughout my years representing bankruptcy clients, I have repeatedly encountered affluent parents and grandparents who continually subsidize the financial obligations of adult children. Monthly assistance frequently includes payment of:

- Credit card obligations;
- Automobile loans;
- Personal loans;
- Utility bills;
- Mortgage or rent payments; and
- Ordinary living expenses.

The underlying causes vary. Divorce, illness, unexpected unemployment, business reversals, or simply poor financial judgment may all contribute to chronic financial instability.

Although these recurring payments often arise from understandable parental concern, they frequently fail to solve the underlying problem. Instead, they merely postpone the inevitable while allowing unsecured debt to continue consuming resources that could otherwise be used to build financial security.

Bankruptcy as a Financial Planning Strategy

Chapter 7 bankruptcy exists to provide the "honest but unfortunate debtor" with a fresh start—a principle repeatedly recognized by the United States Supreme Court. See *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (describing the Bankruptcy Act as giving the honest debtor "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt"); *Grogan v. Garner*, 498 U.S. 279, 286–87 (1991).

Congress likewise codified the bankruptcy discharge to relieve debtors from personal liability for dischargeable debts. 11 U.S.C. § 727. Once a discharge is entered, the discharge injunction permanently prohibits creditors from attempting to collect discharged debts. 11 U.S.C. § 524(a).

From an estate planning perspective, these provisions can substantially improve the effectiveness of future gifts or inheritances.

Rather than allowing future family wealth to be diverted toward servicing historical unsecured debt, a properly timed Chapter 7 filing enables the beneficiary to receive future financial assistance with significantly fewer creditor claims competing for those assets.

The Economics Are Often Compelling

Consider a parent who routinely pays an adult child's credit card obligations and other monthly expenses.

If those payments total several hundred—or even several thousand—dollars each month, the parent may spend tens of thousands of dollars over several years merely maintaining the status quo.

In contrast, the cost of a straightforward Chapter 7 bankruptcy filing—including attorney's fees and filing costs—is frequently only a fraction of that amount. A one-time expenditure of approximately $3,000 to $4,000 may eliminate substantial unsecured debt and terminate the cycle of continual financial assistance.

Instead of making endless payments that principally benefit creditors, the parent is investing in the child's financial rehabilitation.

Integrating Bankruptcy Into Estate Planning

This approach does not suggest that bankruptcy should be recommended indiscriminately. Rather, bankruptcy should be evaluated alongside more traditional estate planning tools, including discretionary trusts, spendthrift trusts, lifetime gifting strategies, and asset protection planning.

When a financially distressed beneficiary is expected to receive a significant gift or inheritance, advisers should consider several questions:

- Would a Chapter 7 discharge substantially improve the beneficiary's financial condition?
- Will existing creditors effectively consume a future inheritance?
- Should the bankruptcy occur before substantial gifts or inheritances are received?
- Would trust planning or spendthrift provisions provide additional protection?
- Is the anticipated inheritance exempt under applicable federal or state bankruptcy law, and how might the timing of the transfer affect the bankruptcy estate? See 11 U.S.C. § 541(a)(5).

Each of these issues requires careful coordination among the bankruptcy attorney, estate planning counsel, financial adviser, and tax professionals.

Conclusion

Bankruptcy should not be viewed solely as a remedy of last resort. Properly employed, it can function as an effective component of a comprehensive estate planning strategy.

Where parents or grandparents are repeatedly paying the debts of financially struggling adult children, a carefully planned Chapter 7 bankruptcy may represent the most efficient use of family resources. Rather than allowing future gifts and inheritances to disappear into the hands of existing creditors, bankruptcy can restore the beneficiary's financial foundation and allow future transfers of wealth to achieve their intended purpose.

Estate planning is ultimately about preserving wealth for future generations. In appropriate cases, one of the most effective ways to preserve that wealth is to ensure that the beneficiary receives it free from the burden of overwhelming preexisting debt.