

Protecting Assets from Creditors Legally, Ethically, and Morally (Part 2)

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Part 1 of this outline, which appeared in the October 2002 issue, discussed how asset protection planning (“APP”) can be an ethically and legally sound component of estate planning. It then explained how APP is actually a form of risk management. Finally, part 1 of this outline described the growing sentiment that estate planners have the duty to consider APP in their estate planning.

D. Fraudulent Transfer Laws

1. Fraudulent transfer laws often are a creditor’s most effective weapon. If an individual makes a transfer for less than reasonably equivalent value, and his remaining assets are unreasonably small in relation to his debts, a creditor is likely to challenge the transfer as fraudulent.
2. The word fraudulent, as used here, is misleading. Literal fraud (i.e., deliberate deception for unlawful gain) is not necessarily required. A fraudulent conveyance or transfer is generally defined as any transaction by means of which

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the owner of property has sought to place such property beyond the reach of creditors (i.e., asset protection planning). 37 Am. Jur.2d *Fraudulent Conveyances* §1 (2001).

3. Six states have a version of the UFCA; 37 have a version of the UFTA; and the remaining seven have statutory or common law derived from the 16th century Statute of Elizabeth. These laws provide equitable remedies; punitive damages generally are not available. Costs of the action generally must be borne by the creditor. See Duncan S. Osborne, *Asset Protection: Domestic and International Law and Tactics*, 2:01-2:06 (1999).
 - a. The Statute of Elizabeth was first enacted in 1571. Basically, it provides that transfers made with the intent to hinder, delay, or defraud creditors of the transferor are voidable. It requires that the debtor's actual intent be proved, but such proof can be derived from "badges of fraud."
 - b. There is no limitations period under the Statute of Elizabeth. This is the biggest difference between it and the UFCA/UFTA, both of which generally provide for a limitations period of four years, or one year from discovery, whichever is greater.
4. The Bankruptcy Code also has fraudulent transfer rules, and generally gives the trustee a power to avoid transfers that would be voidable under local law by an unsecured creditor. Sections 544(b) and 548. It also can result in the debtor being denied a discharge in bankruptcy. Bankruptcy Code §727(a)(2).
5. The word "transfer" generally refers to any means of ridding oneself of property. So, for example, the incurrence of debt can be a basis for a fraudulent transfer avoidance action. The existence of consideration doesn't necessarily ensure that a transaction will not be a fraudulent transfer.
6. It is important to distinguish between present creditors and future creditors, as determined at the time of the alleged fraudulent transfer or conveyance. This distinction is important because a present creditor does not need to establish that the debtor subjectively intended the transfer to be fraudulent. Instead, he must only objectively demonstrate that the debtor engaged in a constructive fraud by transferring assets without receiving a reasonably equivalent value in exchange, and that the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer.

- a. Present creditors include anyone with “a claim” against the debtor at the time of the transfer. This term is defined by UFTA as “a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” UFTA §1.
- b. To be voidable by future creditors, the transfer generally must have been made with actual intent to hinder, delay, or defraud creditors, but, as mentioned above, this typically is determined by reference to “badges of fraud.”
 - i. A transfer to an “insider,” such as a relative, is a badge of fraud.
 - ii. So, too, is one in which the transferor retains possession or control of the transferred property.
 - iii. Concealment is a badge, as is a transfer made after the transferor has been sued or threatened with a suit.
 - iv. Others include transferring all assets, absconding (i.e., leaving the state or country permanently), removal of assets from the jurisdiction, hiding them, being left insolvent, close proximity in time to incurrence of debt, and use of straw persons.
 - v. “The well-advised settlor...would leave significant non-exempt assets remaining in his name post-transfer, will not conceal the existence of the trust structure or its assets, and will pay or resolve all his debts, claims, and causes of action outstanding at the time of the conveyance.” Alan R. Jahde and Michel P. Franzmann, “What Are Creditors’ Rights Against Asset Protection Trusts?” 26 Est. Plan. 410 (Nov. 1999).
 - vi. A debtor might be well advised to explicitly provide in the governing instrument that assets will continue to be available to satisfy valid claims of existing creditors. In many situations, this will have no “cost,” yet will offer a significant potential benefit.
- c. Although on its face these laws appear to protect even future creditors who are remote in time and circumstances, the reality generally is that they do not. Duncan E. Osborne, *Asset Protection: Domestic and International Law and Tactics*, §§2:01-2:06 (1999), at §20:02.

- i. The law does not directly require that an individual preserve his or her assets for the benefit of future creditors.
 - ii. There are, however, a handful of cases where future creditors have successfully attacked APP. See, e.g., *Mandolini Co. v. Chicago Produce Suppliers*, 540 N.E.2d 505 (Ill. App. Ct. 1989); *Bandas v. Emperor*, 467 N.Y.S.2d 749 (N.Y. Sup. Ct. 1983); *U.S. Nat'l Bank of Omaha v. Rupe*, 296 N.W.2d 474 (Neb. 1980); *Dept. of Public Welfare v. Thibert*, 279 N.W.2d 53 (Minn. 1979); *Stauffer v. Stauffer*, 351 A.2d 236 (Pa. 1976); see also, Howard J. Alperin, Annot., "Conveyance as Fraudulent where Made in Contemplation of Possible Liability for Future Tort," 38 ALR 3d 597 (1971).
 - iii. Much depends on the situation. Does it look like APP was done because of a specific concern, or for general peace of mind? "If the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the discharge. If the debtor is merely looking to his future well-being, the discharge will be granted." *In re Oberst*, 91 B.R. 97, 101 (Bankr. C.D. Cal. 1988); see also, *Klein v. Klein*, 112 N.Y.S.2d 546 (N.Y. Sup. Ct. 1952) and *Wantulak v. Wantulak*, 214 P.2d 477 (Wyo. 1950).
7. Because most states have a statute of limitations, APP generally will be unsalable under the UFCA/UFTA after four years.
8. Much can depend on the specific facts of a case.
 - a. APP worked just fine in this case despite being done just 13 months before a bankruptcy. It had been suggested by an estate planning attorney at a time when the debtor was solvent and involved a transfer to an irrevocable trust of only 10 percent of the debtor's assets. *In re Mart*, 88 B.R. 436 (Bankr. S.D. Fla. 1988).
 - b. Another court set aside transfers that had been made during litigation over tax deficiencies, despite the transferor's claims to have been motivated primarily by a desire to plan his estate. *U.S. v. Bryant*, 15 F.3d 756, 758 (8th Cir. 1994).
 - c. For a spouse to qualify as a creditor, divorce must be imminent. *Yacobian v. Yacobian*, 508 N.E.2d 1389 (Mass. App. Ct. 1987).

- d. A transfer to an irrevocable trust was held to be a fraudulent transfer where it was done one month after filing for divorce without telling the spouse about it and the husband had a potential interest under the terms of the trust. *Aronson v. Aronson*, 516 N.E.2d 184 (Mass. App. Ct. 1987).
9. If the transfer is not fraudulent, trust assets might be unavailable to creditors even if the transferor retained an interest in, or a power to revoke, the trust. See, e.g., *In re Baum*, 22 F.3d 1014 (10th Cir. 1994) (six years before bankruptcy, settlor put his home into an irrevocable trust for his children but retained a right to live there); *Van Stewart v. Townsend*, 28 P.2d 999 (Wash. 1934) (settlor of children's trust retained power to direct trust investments and a power to revoke the trust); *Schofield v. Cleveland Trust Co.*, 21 N.E.2d 119, 122 (Ohio 1939) ("The mere fact that there is a benefit for the settlor is not conclusive of fraudulent intent, even when the trust for the settlor is secret....A power of revocation...does not necessarily render the trust fraudulent, and creditors of the settlor cannot compel its exercise for their benefit").
- a. But the clear trend is to allow creditors access to trust assets if the settlor/debtor retains control. See, e.g., *Matter of Estate of Kovalyshyn*, 343 A.2d 852 (N.J. Super. Ct. 1975) (assets in revocable trust were available to settlor's creditors after his death); *State Street Bank & Trust Co. v. Reiser*, 389 N.E.2d 768 (Mass. App. 1979) (trust assets were available to creditors of deceased settlor since he had retained right to amend and revoke, and to direct disposition of principal and income); *Johnson v. Commercial Bank*, 588 P.2d 1096 (Or. 1978) (power to revoke deemed equivalent to general power of appointment and so creditors could reach trust assets).
 - b. Most states have enacted laws that make available to creditors the assets of a revocable trust. See, e.g., Cal. Prob. Code §18200; N.Y. Est. Powers & Trusts §10-10.6.
 - c. And a trustee in bankruptcy can exercise powers that the bankrupt could exercise for his or her own benefit, including a power of revocation and general power of appointment. 11 U.S.C. §541.
 - d. Although spendthrift and discretionary trusts have long been effective in protecting trust assets from the claims of a beneficiary's creditors, that protection generally is not available to the settlor.
 - i. "Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interests, his trans-

feree or creditors can reach his interest.” *Restatement (Second) of Trusts* §156(1) (1959).

ii. “Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.” *Restatement (Second) of Trusts* §156(2)(1959).

10. It is relatively easy to protect assets from a donee’s present and future creditors by making gifts in trust, specifically a spendthrift or discretionary trust.
11. This is true in some jurisdictions even if the beneficiary is the sole trustee and holds a combination of interests and powers that provide the functional equivalent of ownership. See, e.g., *Morrison v. Doyle*, 582 N.W.2d 237 (Minn. 1998).
 - a. A beneficiary arguably can be given a right to income and corpus as needed, or at the unfettered discretion of another person, plus:
 - i. A right to use trust property (e.g., live in a residence rent-free or borrow money interest-free);
 - ii. A power to manage trust property; and
 - iii. A power to appoint trust property to others.
 - b. Kansas is typical: a beneficiary can be a trustee of a discretionary or spendthrift trust without necessarily subjecting trust assets to creditor claims as long as there are restrictions on the beneficiary’s power to benefit himself. *In re Pechanec*, 59 B.R. 899 (Bankr. Kan. 1986); See also, David B. Young, *The Pro Tanto Invalidity of Protective Trusts: Partial Self-Settlement and Beneficiary Control*, 78 Marq. L. Rev. 807 (1995).
 - c. Federal bankruptcy law recognizes the validity of spendthrift and discretionary trusts. See, e.g., §541.
 - d. Most states have limited exceptions that apply to spendthrift trusts in any event, such as for child support and the provision of necessities. Protections for such creditors would have been increased under the recently defeated Bankruptcy Abuse Prevention and Consumer Protection Act of 2002.

- e. *Restatement (Second) of Trusts* §157 (1959) identifies four specific exceptions.
 - i. Child support or alimony.
 - ii. Necessary goods or services supplied to the beneficiary.
 - iii. Services rendered that preserve or benefit the interest of the beneficiary in the trust.
 - iv. Amounts owed to the U.S. government, or to a state. There also is a comment that suggests the possibility of other exceptions when public policy requires it.
- f. Mississippi has held that a spendthrift trust is not protected from creditor claims arising from the beneficiary's gross negligence or intentional torts. The case involved a beneficiary of two spendthrift trusts who was involved in a car accident while intoxicated, leaving the plaintiff paralyzed. *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997).
 - i. Interestingly, the Mississippi legislature passed a law in 1998 effectively reversing the rule in *Sligh*. The statute provides that the trustee of a spendthrift trust may not be required to pay creditors of the beneficiary.
 - ii. Georgia and Louisiana have statutes that permit victims of a beneficiary's torts to reach trust assets, and the California probate code allows a court to order a trustee to satisfy a judgment against the beneficiary when it is for restitution or damages resulting from the beneficiary's felony crime.
 - iii. Delaware has refused to permit a creditor of a trust beneficiary to reach an interest in a spendthrift trust even though that beneficiary committed a willful tort against the creditor. *Gibson v. Speegle*, 1984 Del. Ch. LEXIS 475 (May 30, 1984).
 - iv. The New Hampshire Supreme Court recently upheld a spendthrift provision in a case where the beneficiary had been found criminally and civilly liable for sexual assault. His grandmother had set up the trust and provided that until he was 50 year old (he currently was 35), he could request income but the trustee could make distributions of income or corpus only for maintenance, support, or education. *Scheffel v. Krueger*, 782 A.2d 410 (N.H. 2001).

- v. The Supreme Court in Nebraska similarly has upheld a spendthrift provision, in this case against the claims for child support brought by the beneficiary's ex-spouse. *Doksansky v. Norwest Bank, N.A.*, 615 N.W.2d 104 (Neb. 2000).
- g. The presence of a typical Crummey-power clause might have an adverse effect for APP purposes.
 - i. "The lapse or affirmative refusal likely causes the trust to be self-settled to that extent. To avoid this result, in most states a disclaimer...would have to be filed..." Peter Spero, *Using Life Insurance and Annuities for Asset Protection*, 28 Est. Plan. 12 (Jan 2001).
 - ii. At least one state has tried to eliminate this potential problem by statute. Tex. Prop. Code Ann. 112.035(e) ("A beneficiary of the trust may not be considered a settlor merely because of a lapse...if the value...does not exceed...the greater of the amount specified in (1) Section 2041(b)(2) or 2514(e)...or (2) Section 2503(b), the Internal Revenue Code").
- 12. For many years, no state allowed self-settled spendthrift trusts, and discretionary trusts could not be used to protect assets from the creditors of a settlor who was a beneficiary. Assets put into trust could be reached by the settlor's creditors to the extent that they could be distributed to the settlor without breaching a fiduciary duty to any other beneficiary. This was true whether or not the transfer to the trust was a fraudulent transfer and whether or not the settlor/beneficiary's interest was vested.
 - a. One commentator explains it this way: "Although courts and legislatures have had some sympathy for property owners seeking to protect their imprudent or profligate children, the notion that property owners ought to be able to protect themselves against their own profligacy, at the expense of their creditors, has been much harder to swallow." Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 Cornell L. Rev. 1035, 1044 (2000).
 - b. It is counterintuitive to many that a person would be able to protect his or her wealth from creditors without necessarily giving up all beneficial interests in that wealth.

E. Domestic Asset-Protection Trusts

1. Domestic asset-protection trusts are relatively new and untested, but the possibilities are enormous. Missouri, Alaska, Delaware, Nevada and Rhode Island, have enacted legislation making it possible for residents and nonresidents alike to settle APTs in their respective jurisdictions. Mo. Rev. Stat. §456.080; Alaska Trust Act, Alaska Stat. §§13.36.105-220 (1997); Qualified Dispositions in Trust Act, Del. Code Ann. tit. 12, §§3570-3575 (1998); Spendthrift Trust Act, 1999 Nev. Stat. 299; Qualified Dispositions in Trust Act, 1999 R.I. Pub. Laws 402.
2. A trust consisting of personal property will usually be construed in accordance with the rules of construction of the jurisdiction designated in the trust instrument. This is generally true with respect to questions of trust administration as well. *Restatement (Second) Conflict of Laws* §§224, 268, and 271.
 - a. But a “local” court might refuse to recognize such a designation if the named jurisdiction does not have a substantial relation to the trust, or if the application of its laws violates a strong public policy of the other jurisdiction. *Restatement (Second) Conflict of Laws* §270.
 - b. In determining which jurisdiction has the most significant relationship with the trust, the court generally will consider the justified expectation of creditors, basic policies underlying debtor-creditor law, and the ease in the determination and application of the law to be applied. *Restatement (Second) Conflict of Laws* §6.
 - c. Domestic APTs are increasingly being used, but thus far they have not been fully tested. Beyond doubt, there will be creditors who question them when the settlor is not a resident of the state where the trust has its situs. The battlefield might be in a state, bankruptcy, or other federal court, in or outside the situs state. Much will depend upon the facts of each case and perhaps the judge’s attitude about asset protection as well.
3. Missouri adopted a provision in 1986 that seemingly authorized self-settled APTs, but odd wording, a lack of legislative history, and some disquieting language in subsequent cases leave some people uncomfortable.
 - a. The statute in question is entitled, “Spendthrift trusts—certain provisions not applicable to trusts for benefit of employees.” The reason for the reference to employees is not apparent from a reading of the statute.

- b. The letter of this law seems clear enough: "A provision restraining the voluntary or involuntary transfer of beneficial interests in a trust will prevent the settlor's creditors from satisfying claims from the trust assets except: (1) [w]here the conveyance of assets to the trust was intended to hinder, delay, or defraud creditors or purchasers...or (2) [t]o the extent of the settlor's beneficial interest in the trust assets, if at the time the trust was established or amended: (a) [t]he settlor was the sole beneficiary of either the income or principal of the trust or retained the power to revoke or amend the trust; or (b) [t]he settlor was one of a class of beneficiaries and retained a right to receive a specific portion of the income or principal of the trust that was determinable solely from the provisions of the trust instrument." Mo. Rev. Ch. 456, §456.080.
- c. Consider an irrevocable spendthrift trust in which a trustee other than the settlor has discretion to accumulate or distribute income and principal to the settlor or members of the settlor's family. The settlor's "beneficial interest" in such a trust seemingly will not be available to his or her creditors since the settlor is not "the sole beneficiary of either the income or principal," did not retain "the power to revoke or amend the trust," and does not have "a right to receive a specific portion of the income or principal of the trust." According to the letter of the law in Missouri, this trust would protect assets from the claims of all the settlor's creditors (existing as well as future) as long as it was not "intended to hinder delay, or defraud creditors or purchasers."
- d. But one wonders if the retention of a special power of appointment (perhaps to prevent gift taxation) or a power to hire and fire independent trustees (perhaps to calm the settlor's nerves) will be treated as retention of the power to amend or revoke the trust?
- e. Another concern is that various courts have sounded less than supportive of self-settled spendthrift trusts in Missouri.
- i. The Eighth Circuit had this to say in 1995, nine years after enactment of the current Missouri statute: "[W]e note that the common-law rule against self-settled spendthrift trusts is apparently still valid in Missouri to the extent it permits creditors to reach a beneficiary's income interest. See *Citizens Nat'l Bank of Maryville v. Cook*, 857 S.W.2d 502, 506 (Mo. Ct. App. 1993). Furthermore, spendthrift provisions will only be upheld if they contravene 'neither a statute nor public policy.' *Electrical Workers Local No. 1*

Credit Union v. IBEW-NECA Holiday Trust Fund, 583 S.W.2d 157 (Mo. 1979). The public policy of Missouri is that one may not settle their own spendthrift trust and avoid their creditors. See *id.* at 162; see also 2A Austin W. Scott & William F. Fratcher, *The Law of Trusts* §156 (4th ed. 1989).” *Markmueller v. Case*, 51 F.3d 775, 776 (8th Cir. 1995).

ii. The Bankruptcy Court seems to have read a great deal into the Missouri statute: “The traditional common law recognition of spendthrift trusts has been committed to statute. Mo. Rev. Stat. Section 456.080....That provision simply codifies the traditional prohibition against extending spendthrift protection to a trust beneficiary who is also the settlor of the trust. Certainly, it is inequitable to allow an individual to put his assets beyond reach of creditors through the simple expedient of creating a spendthrift trust.” *In re Enfield*, 133 B.R. 515, 519 (Bankr. W.D. Mo. 1991).

iii. I have been told of a self-settled Missouri trust that was respected in a resolution-trust matter. Unfortunately, it did not result in a written opinion.

4. Alaska and Delaware in 1997 were the first states to explicitly and unequivocally embrace the concept of a self-settled spendthrift trust. Nevada in 1998 and Rhode Island in 1999 quickly followed suit. There are many common features. Alaska Stat. §34.40.110 (Michie 1998); Del. Code Ann. Title 12, §§3570-3576 (1998); 1999 Nev. Stat. Ch. 299; 1999 R.I. Pub. Laws 402 (1999).
 - a. After a “tail” or “reach-back” period, virtually all claims of future creditors are barred even though discretionary distributions can be made to or for the benefit of the settlor.
 - b. Keep in mind, however, that these statutes vary at least slightly in a number of areas and key questions remain to be answered.
 - c. Delaware, for example, bars actions by existing creditors if they do not bring their action within four years of the transfer or, if later, within one-year after the transfer could reasonably have been discovered. Del. Code Ann., tit. 12, §3572. But there are specific exceptions for alimony and child support and tort claims arising before the transfer. 12 Del. Ann. §3573. Alaska is similar but its exceptions are much more narrow. Alaska Stat. §34.40.110.

- i. Delaware expressly protects the trustee, trust advisor, and anyone else involved in “counseling, drafting, preparation, execution, or funding...” Del. Code Ann. tit. 12, §3572(d). Alaska has a similar provision. Alaska Stat. §34.40.110(f).
 - ii. Delaware and Rhode Island bar “actions,” including actions to enforce judgments of other jurisdictions, after expiration of the four-year tail. Del. Code Ann. tit 12, §3572(a); R.I. Public Laws 402.
- d. The Alaska statute, for example, carves out four exceptions where trust assets will *not* be protected from creditors:
 - i. Settlor retains power to revoke or terminate all or part of the trust without the consent of an adverse party;
 - ii. Trust income and/or corpus must be paid to the settlor;
 - iii. The settlor was in default by 30 days or more on child support payments at the time of the transfer; and
 - iv. The transfer was intended to hinder, delay, or defraud creditors (but this is generally subject to a four-year statute of limitations). Alaska Stat. §34.40.110.
- e. In Nevada, the transfer cannot be with the intent to hinder, delay, or defraud creditors, but this applies only to existing creditors, and such creditors have only two years (or six months after the transfer reasonably could have been discovered) to bring an action. Interestingly, there is no specific requirement that some of the trust assets be in the state. One or more trustees generally must be a resident individual or local trust company but some states permit others to serve as co-trustees. Because the presence of a nonresident trustee can complicate jurisdictional issues, some planners limit nonresidents to advisory roles or a power to change trustees.
- f. In Alaska there is a conclusive presumption that Alaska law controls the trust if the instrument so recites and if the following statutory conditions are met:
 - i. Some of the assets are deposited in Alaska and administered by a “qualified person” (an Alaska domiciliary or Alaska trust company or bank);

- ii. The Alaska trustee's duties include maintaining records and preparing or arranging for the preparation of the trust's income tax returns; and
 - iii. Part of the administration of the trust occurs in Alaska. Alaska Stat. §13.36.035.
- g. In Delaware:
- i. All trustees must be Delaware individuals or entities;
 - ii. The instrument must contain a spendthrift clause and state that the trust is irrevocable and that the trust's validity, construction, and administration are governed by Delaware law; and
 - iii. Certain administrative functions must occur in Delaware (e.g., custody of at least some assets, maintenance of trust records, preparation or arrangement for preparation of the trust's tax returns, and "other material participation in the administration of the trust"). Del. Code Ann. tit. 12, §123570.
 - iv. Most courts resolve conflict-of-law issues in bankruptcy using principles found at Restatement (Second) Conflict of Laws. The "most-significant-relationship" test is the touchstone of this analysis. The governing instrument can dictate governing law only if the designated state has a substantial relation to the trust, and then only if that law does not violate a strong public policy of the state that has the most significant relationship regarding the issue in controversy. Restatement (Second) Conflicts of Law §270; *See also, In re Livingston*, 186 B.R. 841, 863 (D. N.J. 1995); *Securities and Exchange Commission v. The Infinity Group*, 27 F. Supp.2d 559, 564-65 (E.D. Pa. 1998); *In re Kaiser Steel Corp.*, 87 B.R. 154, 160 (Bankr. D. Colo. 1988); *In re Morse Tools Inc.*, 108 B.R. 384, 385-86 (Bankr. D. Mass. 1989).
 - v. Several recent cases have addressed the "most significant relationship" test in the context of self-settled offshore trusts, but to date I have found none that have done so with respect to domestic varieties of such trusts. *See, In re Brooks*, 217 B.R. 98, 101 (Bankr. D. Conn. 1998); *In re Lawrence*, 227 B.R. 907, 916 (Bankr. S.D. Fla. 1998); *In re Portnoy*, 201 B.R. 685, 700 (Bankr. S.D.N.Y. 1996); *See also*, Daniel S. Rubin and Jonathan G. Blattmachr, *Self-settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?* 32 Vand. J. Transn'l L. 763 (1999).

- vi. “When the debtor does not have significant contacts with the state in which he established the trust, a panel trustee or creditor may be able to reach the trust through Bankruptcy Code §541(a).” Thomas L. Flynn and Matthew T. Cronin, *Self-settled Spendthrift Trusts Move Close to Home*, 2000 ABI Jnl. Lexis 70, at *12 (Sept 2000).
- vii. Debtors who had already defaulted on a bank loan set up a trust in the Cook Islands. A local court found that it had jurisdiction over a Cook Islands trust that had been funded after the settlors defaulted on a bank loan, noting that the trust owned realty in the state and a co-trustee resided therein. *Bank of America v. Weese*, *supra*.
- h. What the trust looks like it depends primarily on what the settlor is trying to accomplish. For example, some settlors want the funding of the trust to be a completed gift for gift tax purposes, many others do not. The most common means of avoiding a completed gift is to retain a special power of appointment. Treas. Reg. §25.2511-1.
 - i. Arguably, the value of a domestic asset protection trust is not includible in the settlor’s gross estate simply because the trustee had discretion to make distributions to the settlor, or for his benefit (if local law does not make trust assets in such cases available to the settlor’s creditors). Accordingly, such a trust might be used by someone wanting to “use up” his exemption while continuing to qualify for trust distributions (i.e., retain a security blanket).
 - ii. The existence of tax-minimization motives arguably helps in the asset protection front. Imagine a trust with two “pots,” where the settlor has a special power of appointment over pot A, but not pot B. A formula provides that pot B will be funded with the maximum amount that will not result in a gift tax liability; the rest goes to pot A. In the alternative, pot A could get a fraction of the amount put into trust, the numerator of which would be \$1 million (the current exemption amount) and the denominator of which would be the finally determined value of the property put into trust. If the trust is funded with hard-to-value property, such as FLP interests, there arguably is built-in protection against an unexpected gift tax liability. Perhaps more importantly from a practical standpoint, the IRS now has little incentive to question the value reported on the 709. See, e.g., Carlyn S. McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33 U. Miami Inst. Est. Plan. Ch. 4 (1999); Trapp, *Thinking About Valuation Ad-*

justment Clauses, 1999 ACTEC Annual Meeting Materials, Hot Topics, p. HTII-9-JMT.

iii. See generally, Jeffrey T. Getty, *Federal Estate and Gift Tax Issues With Domestic Asset Protection Trusts*, 140 Tr. & Est. 45 (June 2001) and p. 64 (September 2001).

i. Domestic asset protection legislation has not yet had to stand up to a full frontal, policy-based assault. That undoubtedly will come in time.

i. A major concern is that a creditor will obtain a judgment from another state and ask the local court to honor it (the “full faith and credit issue”). Alaska law, for example, does not explicitly preclude enforcement of foreign judgments. On the other hand, what good will an out-of-state judgment against the settlor do if the trustee was not a party to the litigation?

ii. There also is a “contract clause question” under the U.S. Constitution (no state shall pass any law impairing the obligation of contracts). Leslie C. Giordani & Duncan E. Osborne, *Will the Alaska Trusts Work?* Journal of Asset Protection 13 (Sept./Oct. 1997); Duncan E. Osborne, Leslie C. Giordani & Arthur T. Catterall, *Asset Protection and Jurisdiction Selection*, U. Miami Est. Plan. Inst. 14-27 (1999).

5. In theory at least, domestic trusts don’t offer the level of protection offered by foreign trusts. Accordingly, some commentators remain skeptical. See, e.g., King, *The Modern Dynasty Trust: Flexibility is More Important than Ever*, 136 Trusts & Estates, 32, 34 (1998); Engle, *A False Sense of Security?* Shore to Shore at 86-87 (Oct 1997), Giordani and Osborne, *Will the Alaska Trusts Work?* 3 Journal of Asset Protection (Sept./Oct. 1997).

a. Differences typically include a shorter tail period, a refusal to enforce the judgment of a U.S. state or Federal court (i.e., no comity), high burdens of proof, an obligation to hire local counsel and to pay attorneys’ fees under the English rule, and a prohibition of contingent fee arrangements.

b. But offshore trusts face increased regulation and scrutiny. Clients also worry about the foreign country’s political stability and respect for rule of law.

F. OAPTs

1. As tax reform diminished the attractiveness of offshore tax havens, many of the affected jurisdictions passed asset-protection legislation and then aggressively marketed OAPTs to U.S. persons wanting protection from creditors. It's been estimated that such trusts now hold assets worth more than \$1 trillion. Adams, Kurlander and Holt, *Creditor Protection: Offshore-Onshore Options*, Estate Planning Teleconference Series 2 (Feb 2001); Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It too*, 47 Rutgers L. Rev. 11, 14 (1994); Lowell, *Dealing With Client Interest in Offshore Trust Structures*, Duke Univ. Estate Planning Conf. (Oct 2001) That estimate strikes me as high, but conceivable. I have discounted completely another commentator's estimate of \$5 trillion. Stacy K. Lee, *Piercing Offshore Asset Protection Trusts in the Cayman Islands: The Creditors' View*, 11 Transnat'l Law. 463 (2000).
 - a. A settlor of an OAPT is subject to the fraudulent transfer laws of his own jurisdiction, but repatriation of assets can be quite difficult. The typical settlor hopes that his creditors will factor that into their initial decision to sue or to pursue a claim. See generally, *Advantages and Problems of Foreign Trusts*, 7 PLI International Tax & Estate Planning Ch. 7 (2000).
 - b. A typical OAPT involves the transfer of all or most of the interests in a closely held entity (e.g., family limited partnership) to one foreign trustee and maybe one or two U.S. trustees. The OAPT generally is irrevocable and provides for discretionary distributions. The settlor is usually a permissible distributee and may even be the only current beneficiary. Often, the OAPT has an additional party—a protector, who holds the power to veto distributions and trust investments, and also to hire and fire trustees. It is not uncommon for the settlor to serve as protector, or at least to retain the power to hire and fire trustees. It also is not uncommon that a “duress clause” will provide for certain changes if and when things start to heat up (e.g., trust becomes irrevocable; settlor gives up power to hire and fire trustees; jurisdiction of trust is moved; settlor ceases to be permissible distributee). See, e.g., *Riechers v. Riechers*, 679 N.Y.S.2d 233 (N.Y. Sup. Ct. 1998) (New York physician who put marital property into a Cook Islands trust); See also, Stewart K. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom*, 85 Cornell L. Rev. 1035 (2000).
 - c. Offshore jurisdictions that seem to be particularly active in the marketing of OAPTs include Bahamas, Barbados, Belize, Cayman Islands, Cook

Islands, Cyprus, Gibraltar, Mauritius, Turks, Caicos, Nevis, the Jersey Channel Islands, and the Isle of Man.

- i. The mere fact that trust assets can be distributed to the settlor does not enable creditors to reach assets in these jurisdictions.
 - ii. The general rule in these jurisdictions is that transfers to the trust become “unassailable” after the passage of a time period specified in a statute (typically two years; sometimes one).
 - iii. In some of these jurisdictions, the statute of limitations starts to run when the trust is funded even if creditors have no way of knowing of the trust’s existence.
 - iv. Some of these jurisdictions assume a good intent on the part of the settlor and impose on the creditor the duty to prove beyond a reasonable doubt that the trust was established for fraudulent purposes.
 - v. Even if a creditor is able to prove in a local court that the debtor made a fraudulent transfer, he typically will have to relitigate the claim in the off-shore jurisdiction. *See, e.g., Cook Islands International Trusts Act (1984) (amended).*
2. An OAPT created by a U.S. settlor, and having U.S. beneficiaries, will almost always be a grantor trust and the trust usually is structured in a way that makes transfers to it “incomplete” for estate and gift tax purposes.
- a. Things a client might want to consider when thinking about setting up a foreign trust:
 - i. Nonrecognition of foreign judgments (i.e., no comity);
 - ii. Local courts will apply only local law to trusts domiciled there;
 - iii. Clear rules as to what powers and benefits settlors can safely retain;
 - iv. Clear fraudulent conveyance laws that are relatively pro-debtor;
 - v. Clear statute of limitations that is relatively pro-debtor (i.e., starts early and runs soon);
 - vi. Stable economic, political, and social environment;

- vii. Non-burdensome local tax structure;
 - viii. Minimal language or customs barriers;
 - ix. Availability of reputable professional services;
 - x. Modern telecommunications facilities. *See generally*, Gideon Rothschild, *Establishing and Drafting Offshore Asset Protection Trusts*, 23 Est. Plan. 65 (1996) and Barry S. Engel, *Using Foreign Situs Trusts for Asset Protection Planning*, 20 Est. Plan. 212 (1993).
- b. Although foreign trusts are not for the timid (and are sometimes used by bad people for bad reasons), they're not inherently abusive.
- i. Compared to domestic trusts, they provide "a much greater daunting effect." Barry S. Engel, *Asset Protection Planning, Integrated Estate Planning, and the Current State of the Art*, S. Cal. Tax & Est. Plan. Forum (1999).
 - ii. There is no "full faith and credit" issue.
- c. Assets do not necessarily have to be transferred to the country in question; distributable solely in the foreign trustee's discretion; or even be placed in the name of the foreign trustee.
- i. It may be possible to make the fund manager a co-trustee, and have it alone take title to trust property.
 - ii. Another possibility is to name as co-trustee a family member or trusted friend/advisor and stipulate that key decisions (e.g., distributions to or on behalf of the settlor) are to be made solely by that trustee.
 - iii. Yet another is to require more than just the foreign trustee's signature to do anything. Another party (possibly the settlor) could be given the power to prevent any unwanted action by withholding his signature. In the event the foreign trustee refused to go along with a desired action, the settlor (or, better yet, a trusted friend/advisor/relative) could fire the trustee.
 - iv. In addition to a power to remove and replace trustees held personally or by a trusted party, many settlors will want to retain a limited power of appointment. But it may be necessary to suspend such powers during any period when the assets are under attack (i.e., duress clause).

- v. Such provisions may be counterproductive. If a U.S. court gets involved, having them in the trust document might be like waving a red flag at a bull.
- d. A settlor wanting maximum protection will select a trustee who is not connected with the U.S. in any way. The simple reason is that some level of contact might subject the trustee, and therefore the trust, to the jurisdiction of a U.S. court. *Restatement (Third) of Foreign Relations* §421 (1987); *See also, Securities and Exchange Commission v. Levine*, 1986 U.S. Dist. Lexis 24576 (S.D.N.Y. June 5, 1986); *Hercules Inc. v. Leu Trust and Banking Ltd.*, 611 A.2d 476 (Del. 1992), *cert. dismissed*, 507 U.S. 1025 (1993); *Litton Industries, Inc. v. Lehman Bros.*, 767 F. Supp. 1220 (S.D.N.Y. 1991), *rev'd*, 967 F.2d 742 (2d Cir. 1992).
- e. It may be best to select a foreign fund manager that doesn't have an affiliate in the United States. There are many such entities with stellar reputations and solid investment track records. *U.S. v. Bank of Nova Scotia*, 740 F.2d 817 (11th Cir. 1984), *cert. denied*, 469 U.S. 1106 (1985) (faced with daily fines of \$25,000 pending receipt of information from the Bahamian branch, the Miami branch chose to cooperate with the creditors).
- f. You sometimes hear of outrageous claims of possible tax savings. Promoters sometimes claim that OAPTs can be used to eliminate all U.S. taxes. This is nonsense.
 - i. The vast majority of foreign trusts reportedly are established by people who want to protect assets from future creditors, but don't want to incur gift taxes.
 - ii. Those few that want transfer tax consequences (i.e., gift-tax treatment now rather than estate-tax inclusion at death) may be hard pressed to convince the IRS that sections 2036 and 2038 do not apply to typical OAPTs. Courts and the IRS have taken the position that if the settlor's creditors could get to the assets of a self-settled discretionary trust, such trust is "defective" for transfer tax purposes. *Paolozzi v. Comm.*, 23 T.C. 182 (1954); *Outwin v. Comm.*, 76 T.C. 153 (1981); Rev. Rul. 76-103, 1976-1 C.B. 293; Rev. Rul. 77-378, 1977-2 C.B. 347. Depending on the particulars of any given situation, the IRS might be expected to argue that "an understanding" existed between the settlor and trustee, and that such understanding amounted to a section 2036 or section 2038 retention. *See, e.g., Estate of Paxton v. Comm.*, 86 T.C. 785 (1986) (§2036 applied because the settlor's

creditors could have reached trust assets under Washington law *and* because the assets had been placed in trust subject to “an understanding, express or implied, that he would receive the trust income or corpus or both when requested”).

- g. If estate taxes are not repealed, it will continue to make great sense to leverage and utilize one’s applicable exclusion using strategies such as formation of FLPs, and transfer of partnership interests to defective trusts. Tax and asset-protection planning can go hand-in-hand.
 - h. OAPTs reportedly are feeling the initial impact of a forthcoming “tidal wave” of litigation. Norman, *The Uncertain Future of Offshore Trusts for Effective Asset Protection Purposes*, 4th Annual ABA/IBA International Wealth Transfer Techniques at 16-18 (1998).
3. According to Forbes magazine, “offshore judges are beginning to balk at protecting deadbeats and crooks, too.” And, a well-know asset-protection lawyer has reportedly left the practice of law, and for pennies on the dollar is buying up claims against people who have offshore trusts. Evidently, he thinks OAPTs are not impenetrable. Brigid McMenamin, *Your Trust Has a Hole*, Forbes at 240 (June 15, 1998).

G. Summary of Basic Concepts.

- 1. Asset protection planning is an essential element of estate planning. Estate planners cannot simply refrain from doing it. But there are lines that never should be crossed.
- 2. You know for sure that you are beyond a line if creditors already are circling, or any form of dishonesty is involved in the planning.
- 3. APP is best viewed as a form of risk management. The goal should be peace of mind, and the assumption should be that present creditors cannot be avoided.
- 4. Some assets in some jurisdictions are surrounded by a magical force field that protects them from creditors (e.g., homesteads, life insurance, IRAs).
- 5. Trusts make it possible to protect a donor’s property from the claims of a donee’s creditors, perhaps even if the donee is given the functional equivalent

of ownership over that property. Lifetime marital and credit shelter (i.e., A&B) trusts are potential examples.

6. If a client is willing to give away property completely (i.e., not retain a beneficial interest in, or control over, the gifted property), and can do so without thereby making a fraudulent transfer, the property can be placed beyond the reach of the donor's creditors.
7. A settlor's creditors generally can reach any trust assets that the trustee could distribute to the settlor, but up to five states and dozens of offshore jurisdictions provide otherwise.
8. A creditor who has the legal ability to "devour" a debtor, might not do so if the taste is bitter (e.g., a creditor who successfully reaches a debtor's partnership interest will not necessarily gain control of the partnership, but will be taxed on a share of partnership income, whether or not distributed).
9. APP strategies usually are built on a foundation of changed legal relationships. If a client does not respect the changes, he or she should not be surprised if creditors and courts don't either.
10. Timing can be critical—fire insurance should be sought, if at all, before the building is on fire.
11. Advisors have a personal stake in making sure there is no fraud (civil or criminal), and in being able to document good intentions.
12. APP tends to work better in practice than in theory. However, when it comes to asset protection planning, there's no such thing as a sure thing and caution is advised.