

Protecting Assets from Creditors Legally, Ethically, and Morally (Part 1)

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All section references are to the Internal Revenue Code (“IRC”) unless otherwise indicated. “APP” refers to asset protection planning; “APT,” to asset protection trust; “OAPT,” to offshore asset-protection trust; “FLP,” to family limited partnership; “IRA,” to individual retirement account; “IRS,” to the Internal Revenue Service; “LLC,” to limited liability company; “UFCA,” to the Uniform Fraudulent Conveyance Act; and “UFTA,” to the Uniform Fraudulent Transfer Act.

A. Introduction

1. Some people think of APP as little more than the hiding of assets from existing creditors. They picture secret offshore trusts and morally challenged settlers. And they think of the estate planner’s participation as unethical and foolhardy...maybe even criminal.
2. There is some basis for such thinking.

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- a. Like most things in life, APP can be abused. See, e.g., Hahn, "The Offshore Solution: Worried about investor suits? Just transfer your asset abroad," *Investment Dealers Digest*, 2002 WL 8039179 (August 19, 2002) ("The corporate scandals that have investment bankers, analysts, asset managers, corporate executives and directors facing a seemingly never-ending stream of lawsuits may provide new clients for attorneys who specialize in creating offshore trusts."); "Fraudulent Tax Schemes," Congressional Testimony, 2002 WL 2012567 (April 11, 2002) ("a siren song to independent business owners and intelligent professionals, especially physicians"); *IRS Nabs Fugitive Wanted in Offshore Trust Scheme*, Highlights & Documents Vol. 62, No. 36, p. 1779 (August 21, 2001); David C. Lee, *Offshore Asset Protection Trusts: Testing the Limits of Judicial Tolerance in Estate Planning*, 15 *Bank. Dev. J.* 451 (1999); David L. Lupi-Sher, *The IRS's Fight Against Abusive Offshore Trusts*, 88 *Tax Notes* 162-166 (July 10, 2000); *Couple Sentenced in Crackdown on Abusive Trusts*, 60 *Tax Analysts' Daily Tax Highlight & Documents* 2587 (February 26, 2001) (wife got 11 years, husband 62; both must serve at least 85 percent of sentence, plus three years supervised release); *Six Individuals Changed in Illegal Offshore Trust Scheme*, 60 *Tax Analysts' Daily Tax Highlight & Documents*, No. 41, 2748 (March 1, 2001) (use of offshore trusts to hide assets described as significant law enforcement problem in the United States and targeted for crackdown).
- b. A common definition of APP ("planning to protect a client's assets from potential creditor claims") is remarkably similar to the definition of a fraudulent transfer ("any transaction by means of which the owner of property has sought to place such property beyond the reach of creditors"). Allan J. Claypool, *Asset Protection Overview*, ACTEC Notes (<http://www.actec.org>) (May 2001).
- c. Lawyers (and others) involved in an effort to delay, hinder, or defraud a client's existing or foreseeable creditors are asking for trouble, especially if dishonesty is involved. *In re Kenyon and Lusk*, 491 S.E.2d 252, 254 (S.C. 1997) (lawyer suspended indefinitely for his role in an attempt to protect property from creditors: "We do not have to find fraudulent conveyances—only fraudulent or dishonest conduct"); *In re Hockett*, 734 P.2d 877 (Or. 1987) (attorney suspended for 63 days in part for helping clients protect assets from creditors via connived divorce settlements); *Townsend v. State Bar*, 197 P.2d 326 (Cal. 1948) (attorney suspended from practice of law for three years for his role in APP that included a back-dated deed).

- i. The ABA Model Rules of Professional Conduct state that a lawyer shall not counsel a client to engage, or assist a client, in conduct that a lawyer knows is criminal or fraudulent. Model Rule 1.2(d).
 - ii. The ABA Model Code of Professional Responsibility states that a lawyer shall not counsel or assist a client in conduct that the lawyer knows to be illegal or fraudulent. Model Code DR 7-102(A)(7).
 - iii. A lawyer also may not knowingly make false statements of material fact or law to third persons. Model Rule 4.1.
 - iv. The term “fraudulent” should be broadly construed in this context and may require disclosure of client confidences to the court. *See, e.g., In re Grand Jury Subpoena Duces Tecum Dated September 15, 1983*, 731 F.2d 1032, 1038 (2nd Cir. 1984); *see also, Fellerman v. Bradley*, 493 A.2d 1239, 1245-48 (N.J. 1985).
 - v. Attorney-client communications are not always privileged. Creditors should be expected to argue the crime-fraud exception. *In re Campbell*, 248 B.R. 435 (Bankr. M.D. Fla. 2000); *First Union National Bank v. Turney*, 2002 Fla. App. LEXIS 1373 (Fla. Dist. Ct. App. Feb. 13, 2002).
 - vi. A county ethics committee has stated that a lawyer cannot ethically assist a client who wants to use a trust and family limited partnership, or similar techniques, to put assets beyond the reach of existing and identifiable creditors. *San Diego Co. Bar Assn. Ethics Comm.*, Op. 1993-1 (1994).
- d. Some states have recognized a theory of recovery known as conspiracy to fraudulently convey property, and have allowed creditors to assert it against a debtor’s lawyer. *See e.g., Summers v. Hagen*, 852 P.2d 1165 (Alaska 1993); *Van Royen v. Lacey*, 277 A.2d 13 (Md. 1971); *Joel v. Weber*, 602 N.Y.S.2d 383 (N.Y. App. Div. 1993); *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992, 999 (S.D. N.Y. 1991); *McElhanon v. Hing*, 728 P.2d 256 (Arizona Ct. App. 1985), *aff’d in part, vacated in part*, 728 P.2d 273 (Ariz. 1986), *cert. denied*, 481 U.S. 1030 (1987); *Dalton v. Meister*, 239 N.W.2d 9 (Wisconsin 1976); *see also, Milton Roberts, Annot., Right of Creditor to Recover Damages for Conspiracy to Defraud Him of Claim*, 11 A.L.R.4th 345, 350, 359-81.
- e. Arguing that common APP techniques offend public policy, one commentator has called for new laws that impose “criminal penalties.” Randall J. Gingiss, *Putting a Stop to “Asset Protection” Trusts*, 51 Baylor L.

Rev. 987 (Fall 1999). Any such laws would simply add to the ones already on the books. See, e.g., RICO 18 U.S.C. 1962, criminal mail and wire fraud 18 U.S.C. §§1341; 1343, transfers with intent to evade tax collection (§ 7206(4)), actions that impede the administration of tax laws (§7212(a)), criminal money laundering (18 U.S.C. §§1956; 1957), and bankruptcy crimes (18 U.S.C. §§152; 157). Not too long ago, APP in the form of Medicaid planning could be “honest,” yet criminal. See, e.g., Patricia L. Harrison, *Granny’s in the Clink and Her Lawyer’s There Too*, 11 Prob. and Prop. at 7 (May/June 1997).

3. You should not overreact to all the potential problems. Approached responsibly and done right, APP is an ethically and legally sound component of comprehensive estate planning. In fact, estate planners risk much by *not* discussing APP in appropriate circumstances. A growing number of commentators suggest that an estate planner “who fails to counsel his clients as to opportunities to structure their planning in a manner which maximizes asset protection has committed malpractice.” Gideon Rothchild, *Asset Protection Trusts*, Trusts in Prime Jurisdictions (Kluwer International Law Publishing, November 2000).
4. APP is not new: “There is absolutely nothing new about debtors’ trying to avoid paying their debts, or seeking to favor some creditors over others—or even about their seeking to achieve these ends through sophisticated...strategies.” *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund*, 527 U.S. 308, 322 (1999). Even so, it seems to be more popular than ever before as a topic at estate planning conferences.
5. “Asset protection planning is, by its very nature, designed to give a client a crucial ‘head start’ over everyone, in the maximum amount legally permissible. For a potential future creditor, almost anything absent outright fraud is available as a planning tool. For a current creditor, however, or for the creditor whose claim is pending, threatened, or expected, both a ‘pure heart’ (lack of actual fraudulent intent to hinder, delay or defraud creditor) and solvency or reasonable equivalent consideration are necessary to defeat a later claim which might either unwind the transaction or lead to a claim being non-dischargeable in bankruptcy.” Ronald G. Neiwirth and Eric Lund, *U.S. Bankruptcy Principles Meet Trust Planning*, So. Calif. Tax & Est. Plg. Forum (September 5-8, 2001); see also Lund, *Ethical, Civil & Criminal Liability Issues Arising in Asset Protection Planning: Important Considerations for Planning Team Members*, S. Calif. Tax & Est. Plan. Forum (September 5-8, 2001).

B. View APP as a Form of Risk Management

1. Risks are inevitable, but they usually can be minimized or shifted.
 - a. Getting out of bed in the morning can be risky to your health.
 - i. A person can reduce the risk of being hurt in a plane crash by not flying; a car crash by not riding in a car; a drive-by shooting by not venturing into high-crime areas.
 - ii. Also, safety devices such as parachutes, seatbelts, and bulletproof vests are available to further reduce risks.
 - iii. Health and life insurance products can be used to shift financial risks associated with injuries or premature death.
 - b. Marriage can be financially risky. Prenuptial agreements are one way to reduce the inherent danger.
 - c. Investment risks generally can be reduced through strategies such as diversification and creative use of derivatives.
 - d. People who worry a lot about lawsuits can reduce that risk by being competent, careful, and nice. They also can buy various forms of liability insurance.
 - e. Intelligent risk management requires cost-benefit analysis. How bad is the disease? How certain is the cure? How expensive is the treatment?
2. Like other forms of risk management, APP should be done as a precaution against future uncertainty, not in desperate response to an immediate crisis. Fire insurance should be bought, if at all, well before the building is on fire.
3. Estate planners must be familiar with basic APP concepts and strategies.
 - a. The incorporation of a business is a time-honored, feel-good, form of APP.
 - i. Like most other forms of APP, the incorporation of a business does not protect all assets from all creditors, and it is not foolproof—it won't protect the incorporator's personal assets from existing or future personal creditors, or even from corporate creditors in all cases. The planning or

implementation might be flawed (e.g., “thin incorporation”). The follow-up might be deficient (e.g., formalities not observed).

- ii. Of course, corporations are not the only entities that offer some degree of asset protection. LLCs and FLPs and similar creatures of statutory law are increasingly common.
- b. Creditors may not have the legal ability to “step into the debtor’s shoes.” What they can actually get might be relatively unattractive to them. An equity holder might not have control of or access to assets and activities of the entity, and his equity interest might not be readily marketable. If the creditor of a partner manages to get that debtor’s interest in the partnership in satisfaction of a debt, the creditor will not automatically gain control of the partnership. In fact, he will not automatically become a partner. All such a creditor could get in most jurisdictions is a charging order against the partner’s interest in the partnership (i.e., an assignment of the debtor’s right to receive distributions, but not the power to force such distributions). *See, e.g., In re Stocks*, 110 B.R. 65 (Bankr. N.D. Fla. 1989) (creditor treated as mere assignee who could not force any action by the remaining partners), *but see, Hellman v. Anderson*, 284 Cal. Rptr. 830 (Cal. Ct. App. 1991) (creditor could foreclose upon debtor’s interest in a general partnership and sell it, even if the other partners did not agree, as long as it did not unduly interfere with the partnership’s business) and *Schiller v. Schiller*, 625 So. 2d 856 (Fla. Dist. Ct. App. 1993) (creditor could foreclose on general partnership interest and then sell the assignee interest to a third party who could apply for dissolution of the partnership). Despite being “a mere assignee,” that creditor would from that point forward be taxed on his or her share of partnership income each year, whether or not distributed. Rev. Rul. 77-137, 1977-1 C.B. 178.
- i. Accordingly, a client interested in asset protection might be well advised to put assets into an entity such as a FLP. Do you think creditors would rather get someone’s readily marketable assets, or become mere assignees in a partnership controlled by the debtor’s family? Because APP frequently involves an inquiry into a person’s motives (i.e., was something done to delay, hinder or defraud?), it is important that all non-APP purposes be documented clearly and completely whenever assets are transferred to an entity. There are many reasons, other than asset protection, why a client might want to form and fund an FLP. *See generally*, S. Stacy Eastland, *The Art of Making Uncle Sam Your Assignee Instead of Your Senior*

Partner: The Use of Partnerships in Estate Planning, ALI-ABA Course of Study on Advanced Est. Plan. Techniques, pp. 19-239 (Feb 2001).

- c. Asset protection planning doesn't necessarily have to be complicated. A simple gift to one's spouse can be an effective way to protect assets as long as it is done when the donor is solvent and is not under imminent threat of some kind. More on this below in the section on fraudulent transfers.
- d. State exemption laws protect some assets even when owned outright by debtors. *See generally*, Lowell P. Bottrell, *Comfortable beds, a church pew, a cemetery lot, one hog, one pig, six sheep, one cow, a yolk of oxen or a horse, and your notary seal: some Thoughts about exemptions*, 72 N. Dak. L. Rev. 83 (1996); Wells M. Engledow, *Cleaning Up the Pigsty: Approaching a Consensus on Exemption Laws*, 74 Am. Bankr. L.J. 275 (Summer 2000).
 - i. In Kansas, Florida, and Texas, a person's principal residence is fully protected from the claims of creditors. These exemptions typically are unlimited for improvements on real property and quite substantial for investments in acreage located outside municipalities. All that is generally required is that the debtor actually resides in the residence. Kan. Stat. Ann. §60-2301; Fla. Const. art. X, §4; Tex. Prop. Code Ann. §§41.001, 41.002.
 - ii. Details can vary considerably from state to state. For example, a married couple living in separate residences apparently gets two unlimited homestead exemptions in Florida *In re Russell*, 60 B.R. 190 (Bankr. M.D. Fla. 1986); *Colwell v. Royal Int'l Trading Corp.*, 196 F.3d 1225 (11th Cir. Fla. 1999), but the homestead exemption in that state might not work against the IRS *In re McFadyen*, 216 B.R. 1006, 1008 (Bankr. M.D. Fla. 1998).
 - iii. Former major league baseball commissioner Bowie Kuhn reportedly became a Florida domiciliary and acquired a million-dollar residence there just weeks before his attorneys filed for bankruptcy. Rosalind Resnick, *The Deadbeat State*, *Forbes* at 62 (July 8, 1991).
 - iv. Shifting from non-exempt to exempt assets in anticipation of bankruptcy can result in a denial of discharge. The case law is mixed. *See e.g.*, *In re Coplan*, 156 Bankr. M.D. Fla. 1993), *aff'd*, 101 B.R. 997 (D. Minn. 1988); *In re Levine*, 166 B.R. 967 (Bankr. M.D. Fla. 1994); *In re Johnson*, 80 B.R. 953 (Bankr. D. Minn. 1987), *Norwest Bank v. Tveten*, 848 F.2d 871 (8th Cir. 1988) and *Armstrong v. Henningford*, 931 F.2d 1233 (8th Cir. 1991); *see also*, Lawrence Ponoroff and F. Stephen Knippenberg, *Debtors Who Convert*

Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start? 70 N.Y.U. L. Rev. 235 (1995). Some states allow non-exempt funds to be converted into exempt property and thereby put beyond the reach of creditors, even if done with the specific intent of hindering, delaying or defrauding creditors in violation of local fraudulent transfer law. *Havoco of America, Ltd. v. Hill*, 197 F.3d 1135 (11th Cir. 1999). For example, a physician sold non-exempt property (a Jaguar automobile) and used the proceeds to buy exempt property (a cash-value life insurance policy) shortly after being involved in a car accident. Noting that the guy had a history of asset-protection planning and that he had done this before liability for the accident had been judicially determined, the bankruptcy judge held that the conversion could not be avoided as a fraudulent transfer. *In re Kimmel*, 131 B.R. 223 (Bankr. S.D. Fla. 1991) But again, the case law is mixed. See, e.g., *In re Davidson*, 178 B.R. 544 (Bankr. S.D. Fla. 1995); *In re Mackey*, 158 B.R. 509 (Bankr. M.D. Fla. 1993).

v. In bankruptcy, the debtor currently is entitled to exemptions under the laws of the state in which he or she has been domiciled for 180 days before filing the petition. 11 U.S.C. §552(b)(2)(A).

vi. Domicile generally is the place where a person has a permanent residence to which he or she intends to return, and where political rights are exercised. Other factors might include whether the debtor had prior contacts with the new state, and whether the move was solely motivated by a desire to secure the benefits of generous exemptions. Compare *In re Coplan*, 156 B.R. 88, 91-92 (Bankr. M.D. Fla. 1993) (move apparently motivated by desire to secure generous exemptions did not work) with *In re Hill*, 163 B.R. 598, 601 (Bankr. N.D. Fla. 1994) (debtor successfully claimed homestead exemption where he had long planned to retire in Florida and did so at normal retirement age).

vii. Such moves may not work if done with intent to hinder, delay, or defraud. See, e.g., Fla. Stat. Ann. §222.30 and Tex. Prop. Code Ann. §42.004; But see also *In re Fracasso*, 222 B.R. 400,401 (B.A.P. 1st Cir. 1998), *aff'd without opinion*, 187 F.3d 621 (1st Cir. 1999) (state restrictions on pre-bankruptcy planning might be preempted by rules granting exemptions as a federal right).

viii. Many states provide an exemption for assets held in IRAs and qualified retirement plans. Hawaii law is typical. It exempts "the right of a

debtor to a pension, annuity, retirement or disability allowance, death benefit, any optional benefit, or any other right accrued or accruing under any retirement plan or arrangement described in section 401(a), 403(a), 403(b), 408, 409...414(d), or 414(e) of the Internal Revenue Code....” Haw. Rev. Stat. §651-124; *see also* §88-91 Notice that it does not yet include Roth IRAs in the list of protected arrangements. Florida is one of many states that do include Roth IRAs. Florida Stat. Ann. §222.21 (2) (a) reads as follows: “Except as provided in paragraph (b), any money or other assets payable to a participant or beneficiary from, or any interest of any participant or beneficiary in, a retirement or profit-sharing plan that is qualified under 401(a), 402(a), 403(b), 408, 408A, or 409 of the Internal Revenue Code of 1986, as amended, is exempt from all claims of creditors of the beneficiary or participant.” Notice that it does not include 403(b) annuities. Missouri law exempts “[a]ny payment under a stock bonus plan, pension plan, disability or death benefit plan, profit-sharing plan, nonpublic retirement plan or any similar plan described, defined, or established pursuant to section 456.072...annuity or similar plan or contract on account of illness, disability, death, age or length of service, to the extent reasonably necessary for the support of such person and any dependent of such person unless...such plan or contract does not qualify under Section 401(a), 403(a), 403(b), 408, 408A or 409 of the Internal Revenue Code....” Mo. Ann. Stat. §513.430 (10)(e) (1999). Kansas law protects not just the participant, but also any beneficiary of such a plan. It provides that “any money or other assets payable to a participant or beneficiary from, or any interest of any participant or beneficiary in, a retirement plan which is qualified under sections 401(a), 403(a), 403(b), 408, 408A or 409...shall be exempt from any and all claims of creditors of the beneficiary or participant.” Kan. Stat. Ann. §60-2308(b). For a state-by-state comparison *see*, <http://www.lawyersweekly.com/featira2.html>. Courts are split over whether section 522(d)(10)(E) of the Bankruptcy Code is applicable to IRAs. That provision exempts retirement funds “reasonably necessary for the support of the debtor and any dependent of the debtor.” *Cf.*, *Carmichael v. Osherow*, 100 F.3d 375 (5th Cir. 1996) (IRAs protected), and *In re Moss*, 143 Bankr. 465 (Bankr. W.D. Mich. 1992) (IRAs not protected).

ix. Life-insurance products may be protected from the claims of creditors in some states, though statutory wording often leaves some degree of doubt about its application while the insured is still alive. This can be especially important for life insurance products that look a lot like investments (e.g., single-premium variable life). *See, e.g.*, Haw. Rev. Stat. §431:

10-232(a): “the aggregate cash value of any and all life and endowment policies and annuity contracts payable to a spouse...child, parent or other person dependent upon the insured.” New York and Florida reportedly provide particularly broad protection. William L. Zabel and Kim E. Baptiste, *Asset Protection and Estate Planning: Three Scenarios*, 134 *Trusts & Estates*, at 47 (Dec 1995). New York protects from creditors “proceeds and avails,” including “cash surrender and loan values.” New York Insurance Law Section 3212(a)(1) and (b)(5) Florida law is even more clear. For example, Fla. Stat. 222.14 provides that “The cash surrender values of life insurance policies issued upon the lives of citizens or of residents of the state and the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such annuity contract....” There appears to be no dollar limit in either of these states. See, e.g., *In re Kern*, 8 F. Supp. 246 (S. D. N. Y. 1934). It may be possible for nonresidents to acquire a policy in New York that will be subject to New York law. See e.g., *Annis v. Pilkewitz*, 282 N.W. 905 (Mich. 1938). Of course, a policy may be protected as a practical matter in any event if it is owned by an irrevocable life insurance trust or family limited partnership.

x. Exemptions for annuities also vary considerably from state to state, and it often is not clear exactly what is an annuity for this purpose. See e.g., *LeCroy v. McCollam*, 612 So. 2d 572 (Fla. 1993) (divided Florida Supreme Court held annuity to be exempt even though paid in lieu of lump sum, and maybe even if created by the debtor) and *In re Mart*, 88 B.R. 436 (Bankr. S.D. Fla. 1988) (private annuity seemingly found to be within the exemption). The term interest in typical split-interest trusts such as GRATs and CRUTs might be “annuities” for APP purposes. “If trust assets can be liquidated to satisfy the creditor’s claim, then the respective interests of the settlor (who holds the term interest) and the remainder beneficiary could easily be determined actuarially. Of course, the value of the term interest diminishes while any litigation progresses, which is some jurisdictions can take several years.” Spero, “Using Life Insurance and Annuities for Asset Protection,” 28 *Est. Plan.* 12 (Jan. 2001). The same author discusses use of a private annuity in conjunction with a foreign variable life insurance policy: “The policy would form and fund a corporation which in turn enters into the private annuity arrangement with the annuitant, i.e., the annuitant transfers property to the corporation in

exchange for an unsecured promise to pay the annuity.” A recent case out of Florida involved a doctor who was sued by a patient for negligently performing a gall bladder surgery. The jury found for the plaintiff and awarded approximately \$4 million in damages. The doctor filed for bankruptcy, listing assets of \$3.75 consisting almost entirely of an IRA and single-payment annuity. In response to a certified question, the Florida Supreme Court held unanimously that the proceeds of an annuity contract are exempt where there is a surrender penalty, as there was here. *In re Goldenberg*, 253 F.3d 1271 (11th Cir. 2001); *Goldenberg v. Sawczak*, 791 So. 2d 1078 (Fla. 2001); see also, *Windsor-Thomas Group, Inc. v. Parker*, 782 So. 2d 478 (Fla. Dist. Ct. App. 2001).

- xi. State exemption laws generally are construed liberally. In some cases, a “plain meaning” approach has benefited debtors. A debtor took advantage of a Virginia exemption of “one horse” by acquiring Boogie-woogie Man, a \$640,000 thoroughbred. The judge cited a previous case in which a mink coat was found to be “necessary wearing apparel.” *In re Freedlander*, 93 B.R. 446 (Bankr. E.D. Va. 1988). In a more recent case, a Virginia court decided that an exemption for “wedding and engagement rings” included not just the wedding bands and engagement rings that the debtors had given each other when they got married, but also valuable rings that had belonged to ancestors. *In re McNeal*, 1998 Bankr. Lexis 1751 (E.D. Va. Dec. 29, 1998).
- xii. Pending bankruptcy law reform would limit some exemptions. Both the House and the Senate passed reform bills in 2001 but differences in the two bills had not been resolved by the conference committee at the time this outline was prepared. Bankruptcy Reform Act of 2001. The domiciliary requirement to claim a state’s exemptions, other than the homestead, would be increased from 180 to 730 days. The Senate bill limits the state homestead exemption to \$125,000, except for the principal residence of a family farmer. The House version limit is only \$100,000, but it also has an exception for a homestead owned two years before the bankruptcy. The exemption available to certain IRAs would be limited to \$1 million.
- e. Federal law generally protects money invested as part of a qualified retirement plan in any event. See *Patterson v. Shumate*, 504 U.S. 753 (1992) (upholding the anti-alienation clause in ERISA plans); and *Guidry v. Sheet Metal Workers Nat’l Pension Fund*, 493 U.S. 365 (1990) (labor union could not

impose constructive trust on pension of former union official who had embezzled funds); *See also*, Bankr. Code 541(c) (2).

- i. Exceptions might include improperly administered (sham) plans and those with but one participant. U.S. Dept. of Lab. Reg. 2510.3-3(b) and (c); *In re Fernandez*, 236 B.R. 483 (Bankr. M.D. Fla. 1999). Self-employed individuals in states that protect IRAs, might consider terminating their currently tax-qualified retirement plan and rolling over the assets into an IRA. *See generally*, Marcia E. Levine (co-author), *Qualified Plans May Not Be Protected in Bankruptcy*, 23 ACTEC Notes 75 (Summer 1997). *See also*, Alan P. Woodruff, *ERISA's Hidden Traps for Owner-Employees*, 66 Fla. B. J. 30 (December 1992).
 - ii. Plan anti-alienation provisions also do not preclude enforcement of Federal tax levies or collection of a judgment resulting from an unpaid assessment of federal taxes. §1.401(a)-13(b)(1) and (2); *Deming v. IRS*, 1994 Bankr. LEXIS 1129 (Bankr. E.D. Pa. 1994).
 - iii. It is not clear whether plans must be tax-qualified also to be protected. Compare, *In re Hall*, 151 Bankr. 412 (Bankr. W.D. Mich. 1993) (plan must be subject to 206(d)(1) of ERISA and also be tax-qualified), and *In re Hanes*, 162 Bankr. 733 (E.D. Va. 1994) (plan need not be tax-qualified as long as it is subject to ERISA anti-alienation provision).
- f. Twenty-one states extend substantial protection to property owned by married couples as tenants by the entirety. *See generally*, Oval E. Phipps, *Tenancy by the Entireties*, 25 Temple L.Q. 24 (1951); *In re Planas*, 1998 U.S. Dist. LEXIS 20524 (S.D. Fla. 1998).
- i. “A tenancy by the entirety is a unique form of ownership in which both spouses are jointly seized of property such that neither spouse can convey an interest alone nor can one spouse’s creditor attach the property to satisfy a debt.” *Traders Travel International, Inc. v. Howser*, 753 P.2d 244 (Haw. 1988).
 - ii. In some states, this tenancy can exist in more than just real estate. *See, e.g., Missouri v. Morganstein*, 588 S.W.2d 472 (Mo. 1989) (“whether a tenancy by the entirety follows every exchange of the joint proceeds depends primarily on the intent of the parties”); *Sawada v. Endo*, 561 P.2d 1291 (1977); *In re Estate of Au*, 59 Haw. 474 (1978) New York is different. It recognizes tenancy by the entirety only in real estate.

- iii. Again, timing is very important. A transfer from one spouse to both spouses as tenants by the entirety can be a fraudulent transfer. *In re Oliver*, 44 B.R. 989 (Mass. 1984).
 - iv. A bankruptcy trustee can sell the entire interest with respect to which the bankruptcy estate owns “an undivided interest as...tenants by the entirety,” provided that certain conditions are met. Bankr. Code §363(h).
 - v. Tenancy by the entirety property cannot be attached when a federal tax lien is against only one of the spouses. *Foust v. Foust*, 98-1 U.S.T.C. 50,202.
- g. Because asset-protection issues are inherent in the use of trusts, partnerships, limited liability companies, corporations, retirement plans, life insurance products, and the like, this is not a question of whether an estate planner should do APP. The questions that really need to be asked are, which planning strategies should be considered, when should they be discussed, and *where* is “the line” that never should be crossed?
4. Pre-bankruptcy planning is common. See e.g., Peter Spero, *Prebankruptcy Planning*, 5 J. Asset Prot. Protection 73 (Nov./Dec. 1999); *Fraudulent Conveyance Law*, ABA 9th Annual Spring CLE Meeting (May 1998).
 - a. “It is almost alarming what the courts do permit in relation to federal fraudulent transfer law applied in a bankruptcy context.” Osborne & Schurig, *What ACTEC Fellows Should Know About Asset Protection Planning*, 25 ACTEC Notes at 368 (Spring 2000).
 - b. Ditto for pre-divorce planning. “Attorneys are often approached by one member of a married couple who discloses that he or she is contemplating a divorce. What measures, the unhappy client asks, are available to protect his or her assets if the marriage does not survive? The attorney can suggest numerous measures, from outright gifts to irrevocable trusts, many of which look innocent enough but which are designed to produce the desired result with respect to the property settlement.” Peter R. Brown and George L. Cushing, *The Impaired Matrimonial Client: Asset Protection or Fraudulent Conveyance*, 16 J. Am. Acad. Matrimonial Law. 347 (2000).
 5. APP has certainly caught the eye of plaintiffs’ lawyers. “The system by which money judgments are enforced is beginning to fail....Tort and statutory liability are at the risk of death.” Lynn M. LoPucki, *The Death of Liability*, 106 Yale

L.J. 1 (1996); See also, Bacon & Terrill, *Domestic Asset Protection Trusts Work But Should They?*, ACTEC Annual Meeting, March 2000.

C. Duty To Do APP?

1. A growing number of commentators are saying that estate planners can have a duty to consider APP possibilities when doing conventional estate planning. Nenno, *Perpetual Dynasty Trust & Domestic Asset Protection Trust*, Southern Calif. Tax & Est. Plg. Forum (Sept. 2001); Gideon Rothchild, *Asset Protection Trusts*, Trusts in Prime Jurisdictions (Kluwer International Law Publishing: November 2000); R. Christopher Hunter, "An Impassioned Argument for Offshore Advocacy as an Ethical Duty," 3 J. Asset Protect. No. 2, p. 48 (Nov./Dec. 1997); Peter Spero, *Search and Rescue Missions*, 85 A.B.A. J. 70 (Oct 1999); Samuel L. Braunstein & Carol F. Burger, *Protecting the Wealth*, 85 A.B.A. J. 58 (Nov 1999); Allan J. Claypool, *Asset Protection Overview*, ACTEC Notes (<http://www.actec.org>) (May 2001); Patricia Donlevy-Rosen, *Asset Protection Planning*, RIA Tax Advisors Planning Series, 3.00 at 12 (July 1996); Howard D. Rosen, *Asset Protection Planning*, 810 T.M., I.C.3., A-3; *Domestic Asset Protection Trusts: The "Estate Planning Tool of the Decade" or a Charlatan?*, 13 BYU J. Pub. L. 163 (1998); Osborne & Schurig, *What ACTEC Fellows Should Know About Asset Protection Planning*, 25 ACTEC Notes 367 (Spring 2000).
2. Clients who might be good candidates for APP should be so informed, whether or not the estate planner "does" asset protection: "Lawyers probably have a duty to engage in asset protection planning for their clients, but if they do not, then to protect themselves from potential malpractice liability, they should clearly communicate to their clients that their representation does not involve any advice regarding asset protection." Osborne & Schurig, *What ACTEC Fellows Should Know About Asset Protection*, 25 ACTEC Notes 367 (Spring 2000).
3. Estate planning involves the gratuitous transfer of wealth. Transferors easily can use trusts to protect property from the creditors of donees/devisees, including, for example, the donee/devisee's ex-spouse in a divorce. In many cases, the donees/devisees also like the concept.
 - a. Some lawyers reportedly will not assist in the gratuitous transfer of substantial wealth if it is outright rather than in trust. Jonathan G. Blattmachr, *Fundamental Rules, Pitfalls & Planning Opportunities of Grantor Trusts*, S. Cal. Tax & Est. Plan. Forum (Oct 2000).

- b. It just makes sense to build in flexibility. For example, trust funds can be used to purchase assets for the use of the beneficiary, or to make loans. Al W. King, *The Modern Dynasty Trust: Flexibility is More Important than Ever*, 137 Tr. & Est. 32 (Jan. 1998).
 - c. Trusts can be used to provide many non-tax benefits over and above asset protection. Randall W. Roth, "A Critical and Practical Analysis of the Effect of Time on the Efficacy of Trusts in Wealth Transfer Planning: Helping Clients Make Informed Decisions," ACTEC Annual Meeting Program Outlines (1999).
 - d. Of course, trusts are commonly used to save income and transfer taxes. See, e.g., Randall W. Roth, "The Intentional Use of Tax-defective Trusts," 15th Annual U.M.K.C. Federal Est. Plan. Symposium (May 1996); Randall W. Roth, "Advanced Estate Planning: Proven Techniques, Recent Developments and Cutting-edge Ideas," Minn. St. Bar C.L.E. Adv'd Est. Plan. Series (Feb. 2001); Roth, "Estate Planning in a Changing World," 18th Annual West. Colo. Est. Plan. Inst. (Oct 2000).
4. Some clients worry about future creditors and don't find total comfort in insurance protection.
 - a. Many don't like the idea of being viewed by plaintiff lawyers as a "deep pocket." See, Gideon Rothchild, "Asset Protection Trusts," *Trusts in Prime Jurisdictions*, Kluwer Law International (2000) ("real estate developers, corporate directors, doctors, lawyers, and others"); see also, Ritchie W. Taylor, *Domestic Asset Protection Trusts: The 'Estate Planning Tool of the Decade,' or a Charlatan?*, 13 BYU J. Pub. L. 163 (1998).
 - b. Liability insurance helps some clients sleep well, but others worry that insurance might *attract* future creditors: "Many people are of the view that a large insurance policy serves as a magnet for litigation." Barry S. Engel, "Asset Protection Planning, Integrated Estate Planning, and the Current State of the Art," S. Cal. Tax & Est. Plan. Forum (1999) Others worry about exclusions and exceptions from coverage, not to mention the possibility that the carrier will not be around when claims need to be paid.
 5. In theory, a prenuptial agreement is a wonderful asset protection device. The reality is that many clients consider the potential damage to the relationship too high a price to pay, so they never broach the subject.

- a. Some clients like the idea of a family trust that benefits his or her “spouse.” If a person ceases to be the settlor’s spouse, he or she ceases to be a beneficiary. *See e.g., Riechers v. Riechers*, 679 N.Y.S.2d 233 (N.Y. Sup. Ct. 1998).
 - b. What’s good for the goose, is good for the gander. But that raises the issue of reciprocal trusts. As long as the issue is recognized and dealt with carefully, this is a relatively low hurdle. *See, e.g., Cheryl E. Hader, Planning to Avoid the Reciprocal Trust Doctrine*, 26 Est. Plan. 358 (Oct 1999).
 - c. Lifetime QTIPs offer interesting possibilities in stable marriages: “Suppose that a husband creates a...QTIP trust for the benefit of his wife, giving her a limited power of appointment over the remainder at her death, with the property to pass to their children if the power of appointment is not exercised. Assume a bank is appointed trustee, and given the power to invade the trust for the wife’s benefit unlimited by any standard. In effect, the entire trust property is still available to the marital unit. However, the trust principal should not be subject to the claims of either the wife’s or the husband’s creditors....” Blattmachr, Rivlin and Morgan, “Selected Aspects of Creditors’ Rights in the Context of Estate Planning,” *The Chase Review* at 8 (April 1992).
6. In many cases, APP segregates wealth into separate “pockets” so that not all assets are subject to the claims of all creditors. For example, it might make little sense to leave marketable securities or other passive investment assets in an entity that is conducting an active business. Perhaps the general partner of a FLP that owns both a ranch and marketable securities should consider dropping the ranch into a “subsidiary” entity. This can enhance the discount-planning features of the arrangement while accomplishing additional APP. Tax planning can be the “good” motivation for APP-analysis purposes, while asset protection is the “good” motivation for tax-analysis purposes.
 7. Protecting assets from a client’s current and foreseeable creditors is difficult, to say the least. It may or may not be doable. Extreme caution is advised.
 - a. “Does the transferor/settlor have anything to lose? Many debtors facing a creditor problem see no downside to transferring assets to a trusted friend, relative, or maybe even an offshore asset protection trust. The debtor may make the transfer hoping that it will withstand an attack as a fraudulent conveyance.” Alan R. Jahde and Michael P. Franzmann, *What Are Creditors’ Rights Against Asset Protection Trusts?* 26 Estate Planning 410 (Nov 1999).

- b. Can more be lost? Let me count the ways.
 - i. Although fraudulent transfer laws tend to be remedial in nature, most states provide other civil remedies and some states have criminal statutes that can apply. See, e.g., *U.S. v Mathewson*, 93-1 U.S.T.C. 50,152 (S.D. Fla. 1993) (debtor placed under “house arrest” to prevent him from moving additional assets and himself offshore); See also, Barry S. Engel, *Big Nets Catch Small Fish*, 1 *Trusts & Trustees Intern’l Asset Managm’t* (No. 3, 1995).
 - ii. There may also be Federal criminal implications.
 - iii. It’s always possible that the assets will be gone forever—a “trusted friend,” for example, might not behave as anticipated.
 - iv. The debtor might lose the ability to obtain a discharge in bankruptcy if a fraudulent transfer occurred. *In re Portnoy*, 201 B.R. 685 (Bankr. S.D. N.Y. 1996).
 - c. The debtor’s lawyer might be inviting disciplinary, civil, or even criminal proceedings. “Estate planners who are considering any form of asset protection for a client (whether offshore or onshore and whether in trust, partnership or other form) must confront the issue whether their assistance will subject them to ethical, civil or criminal exposure.” Adams, Kurlander and Holt, *Creditor Protection: Offshore-Onshore Options*, Estate Planning Teleconference Series 2 (2001).
8. Extreme caution also is advised whenever the subject of asset protection is first raised by the client, especially if there appears to be a sense of urgency. As a general rule in such cases, the estate planner should do an in-depth analysis of the client’s specific concerns and net worth. If the client is new, it might also be appropriate to make discreet inquiries about reputation.
- a. Many planners will not assist clients who want to put most of their wealth beyond the reach of their own creditors, even if it leaves them solvent. Duncan E. Osborne & Schurig, *What ACTEC Fellows Should Know About Asset Protection Planning*, 25 *ACTEC Notes* 370 (Spring 2000).
 - b. “It would be prudent...to undertake the following when helping to set up a creditor-protection trust: the settlor of the trust should be carefully screened, and due diligence should be undertaken to ensure that the settlor is highly solvent, that none of his creditors would be prejudiced by the

conveyance of property to the trust....” The well-documented good faith effort to prevent wrongdoing and the genuine attempt to avoid harm to the settlor’s existing and potential creditors provide the bases for shielding the fiduciary and advisor from a successful prosecution...” Advantages and Problems of Foreign Trusts,” PLI International Tax & Estate Planning, Chapter 7 (2000).

- c. “Many asset protection attorneys typically require clients to provide an affidavit of solvency.” Allan J. Claypool, “Asset Protection Overview,” ACTEC Notes (<http://www.actec.org>) (May 2001).
- d. Just say no: “If a client is already insolvent, faced with an impoverishing claim, or only threatened with an impoverishing claim, the attorney should undoubtedly decline any work in connection with transferring assets offshore.” Duncan E. Osborne, *New Age Estate Planning: Offshore Trusts*, 27 Inst. On Est. Plan. ¶1701.4 (1993).
- e. Last-minute attempts to protect the bulk of a person’s estate from his own current or soon-to-be creditors give APP a bad name.
 - i. Contempt findings were upheld against a Nevada couple, the Andersons, for “refusing” to retrieve assets held in a Cook Islands asset-protection trust. The settlor/debtors started out as co-trustees of their own trust as well as trust protectors, but they were bumped out by a duress clause, leaving just a foreign co-trustee who predictably ignored their instructions (given under duress) to repatriate the assets. Inability to comply with an order is normally a defense to civil contempt, but according to the court, trust provisions had been “intended by the Andersons to frustrate the operation of domestic courts...by preventing the trustee from repatriating any of the trust assets to the U.S. if a so-called >event of duress’ occurred...It is readily apparent that the Andersons’ inability to comply...is the intended result of their own conduct.” The court noted that the Andersons somehow managed to get the trustee to repatriate \$1 million at about the time of their contempt hearing. It added in a footnote that, although the 9th Circuit opinion concentrated on the fact that the Andersons had been trust protectors, other facts not considered might have further supported the argument that the Andersons had control over the trust. The court clearly did not like the idea of asset protection planning, at least not when done to protect the \$6 million plunder from a telemarketing Ponzi scheme that defrauded thousands of investors. *FTC v.*

Affordable Media LLC, 179 F.3d 1228 (9th Cir. 1999), cert. denied 122 S. Ct. 620 (2001); See generally, Gideon Rothschild and Daniel S. Rubin, "Asset Protection After Anderson," 26 Estate Plan. 466 (Dec. 1999).

ii. The debtor's motions for summary judgment and discharge in bankruptcy were denied where he had established a self-settled spendthrift trust in the Jersey Channel Islands "at a time when he knew his personal guarantee...was about to be called." Virtually all of his assets had been put in the trust, yet he failed to disclose to the court his retained interest in the trust as an asset of the bankruptcy estate. The court held under these egregious circumstances that New York had the greater interest in the issue and that applying foreign substantive law would offend New York and federal bankruptcy policies. *In re Portnoy*, 201 B.R. 685 (Bankr. S.D. N.Y. 1996).

iii. The Bankruptcy Court did not believe the debtor's claim to have created self-settled spendthrift trusts in Bermuda and the Jersey Channel Island as part of a long-term estate planning strategy. It was actually his wife who had set up the trusts, with assets given to her days earlier by the debtor. All this was done with fraudulent intent and only slightly more than one year before the filing of an involuntary bankruptcy petition against the debtor. To no one's surprise, the court held that self-settled trusts were contrary to Connecticut public policy and therefore the assets had to be included in the bankruptcy estate. *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998).

iv. The debtor created a self-settled spendthrift trust in the Jersey Channel Island 66 days before an arbitrator determined that he owed \$20 million to Bear, Stern & Company. The arbitration had begun more than three years before the transfer. Shortly after the initial transfer, the debtor changed the situs of the trust to the Republic of Mauritius, and amended the terms of the trust by inserting a duress provision that stripped him of any powers and interests in the trust if he became bankrupt. Shortly after the arbitrator rendered the decision, the debtor filed a voluntary petition for bankruptcy discharge, claiming that he no longer owned, and could not control, the millions that he had just recently put in trust. The Bankruptcy Court held him in contempt for not producing the assets, and imposed a \$10,000 per day fine until he purged his contempt. Finding his attempts at compliance to be "entirely unacceptable," the court then ordered him incarcerated until he complied fully with the earlier order. The District Court noted the strong public policy against allowing self-set-

tled spendthrift trusts and concluded that it could only be inferred from the timing of the trust's creation that the debtor had been motivated by a design to protect these assets from an anticipated creditor. It also held that the document in which he purported to exclude himself as a beneficiary of the trust was not controlling since it did not specifically say that it was irrevocable. The debtor's attempts to comply, according to the District Court, were "half-hearted, last minute...plainly insufficient and...did not demonstrate that compliance was impossible." *In re Lawrence*, 251 B.R. 630 (Bankr. S.D. Florida 2000), *aff'd*, 279 F.2d 1294 (11th Cir. 2002). As of late 2001, Lawrence reportedly was still in jail. According to Bankruptcy Judge Cristol, Lawrence holds "the key to the dungeon door." One is reminded of the line from the movie Jerry Maguire: "Show me the money!"

v. Debtors seemingly engaged in the fraudulent transfer of property to a preexisting Cook Islands trust that severed no lawful purpose (according to the court) other than to protect that property from creditors of the creditors. These transfers were made within days of a predictable arbitration award in favor of the creditor, leaving the debtors insolvent. Maryland court asserted jurisdiction over the trust because it owned Maryland real estate (the debtor's home) and had a business address in the state. The debtors had personally guaranteed a \$16 million corporate line of credit. The wife/debtor was trust protector and her father was a co-trustee of the trust. There was some question about whether they had been effectively removed, but the court held that the debtors had "substantial control over the trust," even if the removals were effective. The court had "the clear impression that if the debtors ask the trustee for moneys, such will be provided." The creditor also got a Mareva Injunction in the Cook Islands, freezing the assets of the trust and requiring the transfer of assets in a Swiss bank to a Cook Islands bank. *Bank of America, N.A. v. Weese*, Case No. 03-C-01-001892 (Cir. Ct. Baltimore Co. Aug. 3, 2001).

vi. The debtors lost a lawsuit and were ordered to pay damages. Rather than comply, they filed for bankruptcy protection, claiming that assets they used to own were now beyond their reach in an offshore, self-settled spendthrift trust. The offshore trustee refused to turn over the funds, despite "pleas" from the debtors. The bankruptcy court found that their efforts to comply were "at best minimal," and that the defense of impossibility was unavailable in any event since the impossibility was self-created. They were found in civil contempt. *In re Coker*, 251 B.R. 902 (Bankr. M.D. Fla. 2000).

vii. Assets obtained through fraud were reached despite having been put into offshore trusts. Under longstanding principles of English common law, spendthrift protection is not available to illegally obtained assets. *Grupo Torras, S.A. v. Chemical Bank & Trust (Bahamas)*, Sup. Ct. of the Bahamas (1995).

viii. Assets of revocable offshore trust were available to creditors where transfers had been made while the settlor was under a restraining order not to make such transfers, and in arrears on child support and other court-ordered payments. *Papson v. Papson*, (Queens County Supreme court, N.Y. 1998); *see also*, New York Law Journal, August 25, 1998, p. 29.

ix. Bankruptcy Court ignores law of trust situs (Belize) since the trust was administered as a “mere alter ego” of the settlors. This was a so-called common law business trust, and the debtors were president and secretary of “the trust.” They had complete control over trust assets. The court called it “a sham,” and cited the settlors’ continuing control as the “primary reason” for finding the transfers to be fraudulent. *In re Brown*, 4 Ak. Br. Rpt. 279 (Bankr. D. Ak. 1995).

x. A debtor who had established a trust in Bermuda was denied a discharge in bankruptcy, in part because he lied on bankruptcy schedules. *In re Colburn*, 145 B.R. 851 (Bankr. E.D. Va. 1992).

xi. The president of Bre-X Minerals in Indonesia made \$15 million from stock sales before a gold mine discovery was found to be a fraud. He had implemented an asset protection plan that included transfer of assets to various entities in the Bahamas. The Canadian trustee in bankruptcy, however, obtained a court order from the supreme court of the Bahamas freezing assets and enjoining the debtor from transferring assets. *Wall Street Journal* at A18 (May 5, 1998).

xii. Note that the above cases appear to involve debtors who tried to evade existing or foreseeable creditors, were dishonest, took action “late in the game,” or implemented their plan poorly. An adage, “bad facts make bad law,” comes to mind.

xiii. Timing can be critical. Consider the doctor who created a Cook Islands trust in 1992 to protect assets in the event of future malpractice judgments. He and the members of his immediate family (including his “spouse”) were beneficiaries, but his wife automatically ceased to be a beneficiary in 1996 when she ceased to be his spouse. A New York court

determined that marital property had been used to fund the trust, but left the matter to the Cook Islands court since the trust had been established for a legitimate purpose: "Assuming, arguendo, that this court had jurisdiction over the corpus of the Riechers Family Trust, which it does not, a cause of action would not lie to set aside the trust since the trust was established for the legitimate purpose of protecting family assets for the benefit of the Riechers family members." *Riechers v. Riechers*, 679 N.Y.S.2d 233 (N.Y. Sup. Ct. 1998).

xiv. Looks can be deceiving. It is worth noting that debtors even in egregious situations sometimes achieve a form of success. I take no pleasure in pointing out that the debtor in Lawrence reportedly spent all of two days in jail, and that while the Andersons did spend five months in jail, at last report their creditors were still trying to work their way through the Cook Islands legal maze. According to reliable sources, the creditors in *Brooks* settled for roughly 50 cents on the dollar, and the creditor in *Portnoy* went away for about 20 cents on the dollar. I've been told of numerous controversies that got settled before judgment. In none of them did creditors get anything close to a dollar on the dollar. APP apparently works better than it should, even under egregious circumstances. See, generally, Barry S. Engel, *Does Asset Protection Planning Really Work?* 1 Journal of Asset Protection 18 (Sept./Oct. 1998).

9. APP typically relies on the general rule that creditors cannot reach property that is no longer owned by the debtor. Attacks typically fall into one or more of these categories.
 - a. The debtor made a fraudulent transfer/conveyance;
 - b. The debtor retained too much control over transferred property;
 - c. The debtor retained too much of an interest in transferred property;
 - d. The debtor engaged in a sham transaction;
 - e. The debtor lacked "another" purpose for a transfer to an entity;
 - f. The debtor elevated form over substance; or
 - g. The transferee assumed the debt, is subject to transferee liability, or should be made to pay the transferor's debt as a matter of public policy.

(To be continued)

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 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 it 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 unassailable 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. Transfers 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 principle 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 (New York).
 - 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 transferee 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 discre-

- tionary 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 be increased under the pending 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.
 - v. 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 when 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 provision 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. 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 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.” 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 be 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 build-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 Adjustment 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 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 Fed 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 understand-

ing” 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 McMenamain, *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.