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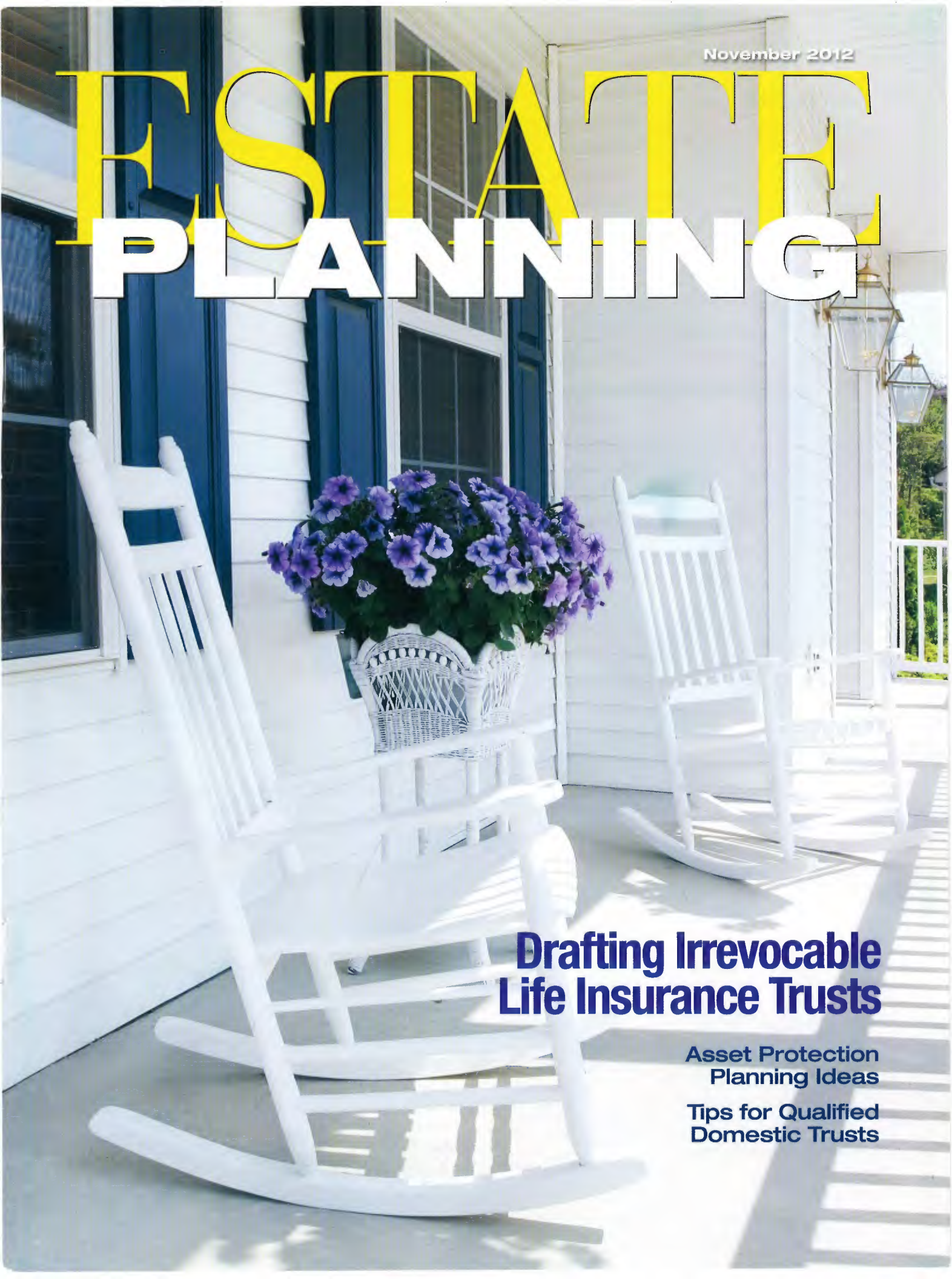
ESTATE PLANNING



Drafting Irrevocable Life Insurance Trusts

Asset Protection Planning Ideas

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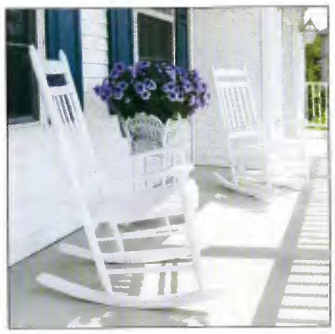

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Practical Asset Protection Planning Concepts and Ideas

Asset protection arrangements should be personalized to the needs of the client and entered into before a claim arises to avoid questions of fraudulent conveyance.

WILLIAM E. RUSSELL, EILEEN B. TROST, AND ELIZABETH L. JANCZAK, ATTORNEYS

In the current litigious environment, individuals with substantial wealth should consider asset protection planning, as they may become the "deep pocket" defendants in many unanticipated situations. Yet, most clients do not recognize the need to undertake asset protection planning until after a claim has been made against their personal assets. Such "after the fact" planning, however, has very limited effectiveness. Instead of waiting until a claim arises, business owners; professionals such as doctors, accountants, attorneys, and architects; and executives of public companies should routinely consider undertaking some type of asset protection plan, even if it is only to be aware of which assets are exempt from attachment.

From a practitioner's point of view, the question is how to provide protection that is both effective and practical. Asset protection may take many forms, from the simple (e.g., a residence in tenancy by the entirety) to the exotic (e.g., offshore asset protection trusts). In many cases, it is impossible to provide absolute protection of assets against every conceivable claim. Asset protection planning should be viewed as a means to maximize exemptions and to provide a high barrier to creditor attachment, putting the client in a stronger position to negotiate settlement. Appropriate asset protection planning must balance legitimate planning against overzealous steps that, when placed under the spotlight of litigation, may be evidence of intent to avoid creditors.

Regardless of what level of asset protection is undertaken, the planning must be completed prior to the occurrence that would give rise to a claim. Understanding the various asset protection techniques that are typically used and the "fraudulent transfer" rules that may undermine any asset protection structure is critical to examining what level of asset protection is best suited for a particular client.

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Fraudulent conveyances

To be effective, asset protection planning generally must be done in advance of the event giving rise to the claim. Otherwise, a creditor may claim that the transfer to protect an asset is a "fraudulent conveyance." This is not a criminal concept, but rather a civil action to

void a transfer. The essence of asset protection planning is preventing transfers of assets from being deemed fraudulent transfers by a court. However, asset protection planning cannot be used to illegally evade U.S. income taxes or to hide assets from legitimate creditors who have an existing claim prior to the transfer of assets.

The two primary sources of fraudulent transfer law are:

1. The Uniform Fraudulent Transfer Act (UFTA), which is applied by most states.
2. Title 11 of the United States Code (the Bankruptcy Code).

The UFTA. The vast majority of state fraudulent transfer laws are governed by the UFTA. Since its promulgation in 1984, the UFTA has been adopted in 43 states.[1] Under the UFTA, there are two types of fraudulent transfers. The first is an actual fraudulent transfer. An actual fraudulent transfer is one that is made "with actual intent to hinder, delay, or defraud any creditor of the debtor[.]"[2] The UFTA provides a list of factors, typically referred to as "badges of fraud," to consider in determining whether actual intent exists, including whether:

1. The transfer or obligation was to an insider.
2. The debtor retained possession or control of the property transferred after the transfer.
3. The transfer or obligation was disclosed or concealed.
4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with a lawsuit.
5. The transfer was of substantially all the debtor's assets.
6. The debtor absconded.
7. The debtor removed or concealed assets.
8. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.
9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
10. The transfer occurred shortly before or shortly after a substantial debt was incurred.
11. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.[3]

The essence of asset protection planning is preventing transfers of assets from being deemed fraudulent transfers by a court.

Each of the factors is relevant evidence as to the debtor's actual intent, but does not create a presumption that the debtor has made a fraudulent transfer or incurred a fraudulent obligation.[4] An action for actual fraudulent transfer must be brought within four years after the transfer was made, or, if later, within one year after the transfer could reasonably have been discovered by the creditor.[5]

The second type of fraudulent transfer contemplated by the UFTA is a constructive fraudulent transfer. A transfer is constructively fraudulent if the debtor (1) did not receive reasonably equivalent value for the transfer, and (2) either (a) the debtor had unreasonably small assets in relation to its business or the transaction in which it was engaging or was about to engage, or (b) the debtor intended, believed, or reasonably should have believed that it would incur debts beyond its ability to pay as they came due.[6] The first element looks at the value of what the debtor received in exchange for the transfer, while the second element, in essence, looks at whether the debtor was insolvent at the time of the transfer. A creditor is barred from bringing an action for constructive fraudulent transfer if it is not commenced within four years after the transfer was made.[7]

If a court determines that a transfer is fraudulent under the UFTA, the creditor may avoid and recover the transfer to the extent necessary to satisfy that creditor's claim.[8] The creditor may recover against the transferee or the party for whose benefit the transfer was made.

The Bankruptcy Code. In bankruptcy, a trustee may bring a fraudulent transfer action either under the applicable state law, which typically has adopted the UFTA, or under the fraudulent transfer laws unique to the Bankruptcy Code. Bankruptcy Code section 548 governs fraudulent transfers and obligations. Section 548(a) largely tracks the UFTA, but contains a look-back period of two years prior to the bankruptcy filing instead of the UFTA's four years after the transfer.[9] Therefore, it is sometimes more advantageous for a bankruptcy trustee to bring an action

1 Kettering, "Codifying a Choice of Law Rule for Fraudulent Transfer: A Memorandum to the Uniform Law Commission," 19 Am. Bankr. Inst. L. Rev. 319 (2011).
2 Unif. Fraudulent Transfer Act § 4(a)(1) (1984).
3 *Id.* § 4(b).
4 *Id.* § 4 cmt. 5.
5 *Id.* § 9(a).
6 *Id.* § 4(a)(2).
7 *Id.* § 9(b).
8 *Id.* § 7(a)(1).
9 See 11 U.S.C. section 548(a)(1).

under the UFTA, rather than Bankruptcy Code section 548.

The major difference between a transfer avoided in state court and a transfer avoided in bankruptcy is that in bankruptcy, the transfer is avoided by the bankruptcy trustee for the benefit of all creditors, instead of to the extent of a single creditor's debt.[10] Therefore, the entire transfer may be avoided in bankruptcy, as opposed to only that portion of the transfer required to repay the creditor who brought the action.

Basic techniques

The following are basic asset protection techniques that are readily available to most people.

Liability insurance. Asset protection structures are not a substitute for adequate liability insurance. The first defense against a tortious claim (e.g., a car accident) is liability insurance. Such insurance will cover the cost of the initial litigation defense of such claims, and that is often half the battle. Additional coverage through "umbrella" excess liability policies should be considered to defend against large claims. Excess liability coverage should be carefully reviewed not just for cost, deductibles, and dollar limits on coverage, but for covered risks, exceptions and exclusions to coverage, the existence and extent of coverage for costs of defense, and the solvency and credit rating of the insurer.

Many types of claims, however, are not insurable as a practical matter, or simply exceed coverage. The techniques discussed below may provide additional protection.

In many states, life insurance and, in some instances, annuities are exempt from attachment by creditors.

Business limited liability entities. Any operating business or real estate (other than one's home) should be titled in a corporation or a limited liability company (LLC) to limit the liability arising to the owner *from the operation of the business or real estate.* Single-member LLCs are a common and simple way to limit liability with respect to rental real estate. These entities, however, must be specially structured to protect assets from judgments against the owner personally. For example, titling real estate in an LLC protects the individual who owns the property from a slip and fall claim on that property.

In contrast, a judgment against the owner caused by an unrelated claim (e.g., a car accident or a medical malpractice claim, in which the creditor is attaching personal assets, including ownership in the business) is a different matter. If an individual personally guarantees a debt incurred on behalf of a corporation, LLC, or partnership, for instance, that creditor will be able to reach the individual's personal assets. Entities can be structured to resist such lateral attacks, as is illustrated below in the discussion of family partnerships.

It should also be noted that certain types of claims can penetrate limited liability entities (e.g., environmental claims and tax law liabilities).[11]

Life insurance. In many states, life insurance and, in some instances, annuities are exempt from attachment by creditors.[12] This exemption carries over to bankruptcy. For Illinois residents, all proceeds on death, and the cash value of life and annuity policies payable to a spouse, child, parent, or dependent, are exempt from judgment by creditors even if the insured can change the beneficiary.[13] The exemption does not apply, however, with respect to a life insurance policy payable to a trust, rather than a spouse, child, parent, or dependent.[14]

IRA and qualified retirement accounts. Qualified retirement benefits are fully exempt from creditor claims under ERISA.[15] A debtor's interest in an IRA may also be exempt from judgment by creditors. Federal bankruptcy law limits the IRA exemption to approximately $1 million plus all qualified plan rollovers, including growth of those rollovers.[16] Because rollovers and rollover growth have no cap, IRAs remain substantially exempt as a practical matter. In addition, many states (e.g., Illinois and Florida) exempt the full value of an IRA from attachment.[17] This state exemption carries over to a bankruptcy.

[10] See *id.*; 11 U.S.C. section 550.

[11] See, e.g., McNamee v. Dep't of Treasury, 488 F.3d 100 (CA-2, 2007) (holding that a single member of a disregarded LLC was personally liable for employment taxes); BEC Corp. v. Dep't of Env't Protection, 775 A.2d 928 (Conn., 2001) (holding corporate officers personally liable for environmental violations).

[12] Colo. Rev. Stat. § 10-7-106 (2012); Fla. Stat. § 222.13 (2012).

[13] 735 Ill. Comp. Stat. 5/12-1001(f) (2012).

[14] Dowling v. Chicago Options Assoc., 875 N.E.2d 1012 (Ill., 2007).

[15] See 29 U.S.C. section 1056(d)(1); 26 U.S.C. section 403(b); Patterson v. Shumate, 504 U.S. 753 (1992) (holding that a debtor's interest in an ERISA-qualified plan is not property of the bankruptcy estate and, thus, not subject to the claims of creditors).

[16] 11 U.S.C. section 522(n).

[17] 735 Ill. Comp. Stat 5/12-1006(a); Fla. Stat. § 222.21(2)(a).

A surviving spouse of a deceased participant in an IRA has been allowed to "roll over" his or her beneficiary distribution into an IRA established in the spouse's own name since the inception of IRAs in 1976, and later this rule was extended to all qualified retirement plans. Since 2006, all beneficiaries of qualified retirement plans and IRAs have been permitted to create "beneficiary IRAs" with benefits otherwise payable to them under these plans. Nationwide, the courts (including Bankruptcy Courts) have reached inconsistent results as to whether beneficiary IRAs and spousal rollover IRAs are eligible for either state law or bankruptcy law protection from creditors.[18]

Section 529 college savings plans. These income tax-exempt accounts are savings accounts for one's family to pay for college education costs. There are both federal[19] and state exemptions for 529 accounts. State exemptions for 529 accounts are not universal, and vary as to the creditor protection offered. Some states limit exemptions to the state's own program, or exempt certain obligations (such as child support or alimony).

Tenancy by the entirety. Tenancy by the entirety property is property held in the name of both spouses. Upon death, the property passes to the survivor, as it would in joint tenancy. However, tenancy by the entirety protects property titled in that manner because a creditor cannot cause the division and liquidation of the asset until the death of a spouse or divorce. The tenancy by the entirety exemption varies from state to state. In Florida, for example, a state resident may also treat personal property as tenancy by entirety property, allowing investment accounts to be exempt from certain creditors.[20]

The law of one's state of residence must be consulted. In Illinois, tenancy by the entirety applies to only the primary residence of a married couple residing in Illinois.[21] Tenancy by the entirety does not protect a person from a mortgagee if both spouses have consented to that lien. Further, a creditor of both tenants may seize the tenancy by entirety property of the debtors.

Bankruptcy trustees have limited power to cause the sale of tenancy by entirety property to satisfy debts of the bankrupt tenant except under certain conditions, including whether the benefit to the bankruptcy estate outweighs the detriment to the non-debtor spouse.[22] In particular, 11 U.S.C. section 363(h) states that the trustee may sell the interest of a debtor and a non-debtor in certain property only if:

1. Partition of the property is impracticable.
2. Sale of the estate's interest would realize significantly less than sale free of the interest of such co-owners.
3. The benefit to the estate of a sale outweighs to the detriment to the co-owners.
4. The property is not used in the production, transmission, distribution, or sale of certain types of energy.

Conversion of a house to a tenancy by the entirety may be a fraudulent conveyance. In *LaSalle Bank, N.A. v. DeCarlo*,[23] for instance, the debtor's transfer of title to a home, which he had owned with his wife as joint tenants, into tenancy by the entirety was deemed a fraudulent transfer because the evidence supported the circuit court's finding that his sole intent in making the transfer was to avoid paying debts existing at the time of the transfer. In short, advance planning is key.

Homestead. Some states include within their exemptions from creditor claims generous provisions for homesteads. In Illinois, the homestead exemption is limited to $15,000 for a single person and $30,000 for a married person.[24] Florida, on the other hand, has no limitation on value in connection with its homestead exemption for up to a one-half acre plot within a municipality, or 160 acres elsewhere. Texas also has an unlimited homestead exemption on ten acres within a municipality, or 100 acres elsewhere (200 acres for a family).[25]

The Bankruptcy Abuse and Consumer Protection Act of 2005 (BAPCPA) tried to curb some of these overly generous homestead exemptions by limiting the homestead exemption in the bankruptcy context to $146,450[26] ($292,900 for a married couple filing jointly) if the homestead was acquired within 40 months of the bankruptcy filing (not including any

[18] No creditor protection was found in In re Sims, 241 B.R. 467 (Bkrptcy. DC Okla., 1999); In re Kirchen, 344 B.R. 908 (DC Wis., 2006); Robertson v. Deeb, 16 So. 3d 936 (Fla. Dist. Ct. App., 2009). Creditor protection was found to exist in Chilton v. Moser, 444 B.R. 548 (DC Tex., 2011); In re Nessa, 426 B.R. 312 (B.A.P. CA-8, 2010); In re Kuchta, 434 B.R. 837 (Bkrptcy. DC, Ohio 2010); In re Clark, 10-18035, 2011 WL 1814209 (Bkrptcy. DC Wis., 2011).

[19] Funds contributed to a Section 529 account within 365 days of filing bankruptcy are considered property of the estate, but funds contributed more than a year prior to filing bankruptcy are not and are, therefore, exempt from creditors' claims. 11 U.S.C. section 541(b)(6).

[20] See e.g. Beal Bank, SSB v. Almand and Assocs., 780 So. 2d 45 (Fla., 2004) (bank account may be held in tenancy by the entireties); Berlin v. Pecora, 968 So. 2d 47 (Fla. Dist. Ct. App., 2007) (stock and partnership interests held in tenancy by the entireties).

[21] See 735 Ill. Comp. Stat. 1005/1–4 (providing for tenancy by the entirety for real property, but not personal property); *Id.* 1005/1c (providing that a tenancy by the entirety "shall exist only if, and as long as, the tenants are and remain married to each other[.]").

[22] See In re Persky, 893 F.2d 15 (CA-2, 1989).

[23] 783 N.E.2d 211 (Ill. App., 2003).

[24] 735 Ill.Comp. Stat. 5/12-901.

[25] Fla. Const. of 1885 art. X, § 4 (amended 1968); Tex. Prop. Code Ann. § 41.001(a) (West 2010).

[26] This is an inflation adjusted amount; see 11 U.S.C. section 522(p).

amount transferred from a previous residence in the same state acquired prior to the 40 month period).[27] Some states, such as Arizona[28] and Illinois,[29] have "opted out" of the federal exemption scheme, and debtors are left with the exemptions provided under only state law, while debtors living in other states may choose either the state or federal exemptions.[30]

Estate planning. Transfers to family members should have a purpose other than creditor avoidance. Estate planning is such a purpose as long as the debtor is solvent at the time of the transfer. Several basic planning techniques to consider are:

1. *Gifts to spouse.* If the spouse is not also a debtor, the transfer of assets free of gift tax to the spouse is a comon way to shelter those assets from claims against the debtor spouse. Without proper justification and support, such spousal transfers are also very vulnerable to fraudulent conveyance claims. Furthermore, there is the risk that the non-debtor spouse might claim that the transferred assets are not part of the marital estate.
2. *Annual exclusion gifts.* As of 2012, individuals may give $13,000 per year to each donee.[31] For minors, this may be accomplished through a Uniform Gifts or Transfers to Minors account. The donor should not be the custodian. Other options include trusts for minors and 529 accounts (discussed below). Donors may effectively shift more of their assets by making a "split-gift" election with their spouse, which applies the spouse's annual exclusion to the donor's gift. This allows tax-free gifts by a consenting married couple of $26,000 per donee.

The family partnership actually allows individuals who are trying to protect their assets to retain an indirect ownership interest in the assets transferred.

3. *529 college savings accounts.* Contributions to these income tax-exempt accounts to pay for college education costs are another way to make annual exclusion gifts. For asset protection purposes, the donor should not be the "account owner," meaning the person with power to control distributions from the account. As with any annual exclusion gifts, the donor may give $13,000 per year to a 529 plan for education. A donor may also "pre-pay" up to five years of annual exclusion ($65,000).[32]
4. *Transfer to fund exemption amount.* As of 2012, each person currently has a $5,120,000 exemption from estate and gift tax.[33] A valid estate planning goal would be to transfer assets to one's spouse in order to fully fund this exemption for the spouse, or to make irrevocable lifetime gifts to use one's exemption currently, particularly as future tax legislation may reduce it.

Estate planning trusts are very effective asset protection devices for the beneficiary. For example, a properly drafted "spendthrift trust"[34] created for the grantor's child (i.e., a trust interest that by its terms cannot be transferred or subject to claims against the child) protects the trust assets from most of the child's creditors. So long as the child does not have the power to withdraw the trust funds unilaterally, a creditor of the child has a limited ability to attach those funds. The ability of the creditor to reach the trust assets depends on the nature of the claim (e.g., courts often will permit child support, and occasionally alimony, to be paid out of an otherwise valid spendthrift trust) and applicable state law. Also, if the assets have been transferred into the trust by gift, the assets no longer belong to the donor and are protected from the donor's creditors as well (absent a fraudulent conveyance).

Advanced planning

Advanced planning techniques also take a variety of forms.

Family partnerships and LLCs. The protection afforded by a family partnership (or family LLC) is illustrated in the following example. Investment assets are placed into a limited partnership by husband and wife (H and W). Each spouse is both a 1% general partner and a 49% limited partner. Together, the general partners control the partnership, and the consent of both general partners is required to liquidate the partner-

[27] There are other limitations on the homestead exemption under the Bankruptcy Code, as well as questions regarding its applicability in states that do not allow an election opt out of the federal exemptions. See In re McNabb, 2-05-07495, 2005 WL 1525101 (DC Bkrptcy. Ariz, 2005).

[28] Ariz. Rev. Stat. Ann. § 33-1133.

[29] 735 Ill. Comp. Stat. 5/12/1201.

[30] 11 U.S.C. section 522(b).

[31] Section 2503(b).

[32] Section 529(c)(2)(B).

[33] Section 2505.

[34] That is, a trust interest that by its terms cannot be transferred or subject to claims against the child.

ship. A creditor seeking to attach the assets of W cannot attach the underlying investment assets of the family partnership, but only the partnership interest of W. H, as the other general partner, will not consent to a liquidation of the partnership. The partnership interest of W is non-transferable.

The creditor is left with only a "charging order" against the future distributions to W from the partnership. Of course, distributions are unlikely to occur as long as the creditor is pursuing W.

A family partnership is typically combined with gifts of limited partnership interests to family members. Because the limited partnership interests are illiquid, a family partnership also affords significant valuation discounts on any gift. Transfers may be on a small scale (i.e., $13,000 per donee annual exclusion gifts) or on a large scale, using advanced planning trusts (e.g., GRATs) to further reduce the taxable gift. Execution of a valid estate planning structure bolsters the legitimacy of the partnership. Tax minimization is considered a proper and common purpose for creating a family partnership.

The weakness of the family partnership is that a creditor may attack the transfer of assets into the partnership as a fraudulent conveyance, thereby avoiding the partnership altogether. All gifts or transfers of partnership interests to family members also may be subject to such an attack. On the plus side, the family partnership actually allows individuals who are trying to protect their assets to retain an indirect ownership interest in the assets transferred, as opposed to outright gifts to others. Because a creditor steps into the shoes of the debtor partner or LLC member, it is important that partnership and LLC operating agreements limit the rights of individual partners to liquidate the partnership or assign partnership interests.

Not all states provide for charging orders as the exclusive remedy for creditor claims against a partnership or LLC interest. Additional remedies may include foreclosure on a charging order or judicial dissolution of the partnership, making partnership or LLC interests more vulnerable under the law of those states.[35] Among the states that are considered to have the most creditor protection embedded in their partnership and LLC statutes are Alaska,[36] Delaware,[37] and South Dakota.[38] Furthermore, although single-member LLCs are commonplace, they are easier for the courts to pierce, because of the lack of other economic interests to consider.[39]

Domestic spendthrift trusts. This option, also known as a domestic asset protection trust, is as yet unproven. Under Illinois law, and the laws of most other states, an irrevocable "spendthrift trust" created for one's own benefit may be set aside by creditors. A growing number of states[40] have passed statutes granting some level of protection from creditors for these types of self-settled spendthrift trusts. These statutes differ in material respects, but all of the statutes have fraudulent conveyance provisions of some kind. Most of the statutes also specify what rights can be retained by the grantor of the trust while still qualifying for the creditor protection offered by the statute. Creditors may attempt to apply the law of the debtor's residence as opposed to the law of the jurisdiction where the trust is situated, as well as federal bankruptcy law, to penetrate such trusts. Federal bankruptcy law imposes a ten-year fraudulent conveyance look-back with respect to such trusts.[41]

Under the current state of the law, the effectiveness of these domestic spendthrift trusts to protect assets is unclear. The case of *Battley v. Mortensen (In re Mortensen)*[42] examined this very issue. In *Mortensen*, the debtor placed certain land into an Alaska Asset Preservation Trust for the benefit of himself and his descendants "to maximize the protection of the trust estate or estates from creditors' claims of the Grantor or any beneficiary and to minimize all wealth transfer taxes." In exchange for the transfer, the debtor's mother gave him $100,000, stating that it was payment for the transfer that would benefit her grandchildren.

Prior to placing the land in trust, the debtor had experienced several years of lower-than-average income, and his financial condition continued to deteriorate after the establishment of the trust. Four years after placing the land into trust, the debtor filed for chapter 7 bankruptcy relief. The chapter 7 trustee sought to set aside the transfer of

[35] 805 Ill. Comp. Stat. 180/30-20.

[36] Alaska Uniform Partnership Act, Alaska Stat. § 32.06.504; Alaska Rev. Limited Liability Company Act, Alaska Stat. § 10.50.380.

[37] Delaware Revised Uniform Partnership Act, Del. Code. Ann. tit. 6, § 15-504; Delaware Limited Liability Company Act; Del. Code. Ann. tit. 6, § 18-703.

[38] South Dakota Uniform Partnership Act, S.D Codified Laws § 48-7A-504; South Dakota Uniform Limited Liability Company Act, S.D Codified Laws § 47-34A-504.

[39] See e.g. FTC v. Olmstead, 528 F.3d 1311 (CA-11, 2008).

[40] As of 8/1/2012, Alaska (Alaska Stat. § 34.40.110); Colorado (Colo. Rev. Stat.§ 38-10-111); Delaware (Del. Code Ann. tit. 12, §§ 3570-3576); Hawaii (Haw. Rev. Stat. § 554G); Missouri (Mo. Rev. Stat. §§ 456.5-505.3); Nevada (Nev. Rev. Stat. §§ 166.010-166.170); New Hampshire (N.H. Rev. Stat. Ann. § 564-D:1-18); Oklahoma (Okla. Stat. tit. 31 § 10, *et seq*); Rhode Island (R.I. Gen. Laws §§ 18-9.2-1 - 18-9.2-7); South Dakota (S.D. Codified Laws §§ 55-16-1 to 55-16-16); Tennessee (Tenn. Code Ann. § 35-16-101); Utah (Utah Code Ann. § 25-6-14); Virginia (Va. Code Ann. §§ 55-545.03:2 – 545.03:3, and 55.545.05); and Wyoming (Wyo. Stat. Ann. §§ 4-10-505 and 4-10-510 – 523); with further legislation pending in other states.

[41] 11 U.S.C. section 548(e)(1).

[42] A09-90036-DMD, 2011 WL 5025249 (Bkrptcy. D.C., Alaska, 2011).

the land into the trust on an actual fraudulent conveyance theory under Bankruptcy Code section 548(e), which provides that a bankruptcy trustee may avoid a transfer of the debtor's property if (1) it was made to a self-settled trust; (2) by the debtor; (3) the debtor is a beneficiary of the trust; and (4) the debtor made the transfer with the actual intent to hinder, delay, or defraud any of the debtor's creditors.

At issue in determining whether the debtor had actual fraudulent intent was the introduction of the trust language itself. The debtor argued that under Alaska law, a trust settlor's expressed intention to protect assets from potential future creditors is not evidence of an intent to defraud. The Bankruptcy Court acknowledged that the trustee's action was brought under the Bankruptcy Code, not under state law, and that the applicable Bankruptcy Code section was a response to state legislators diverging from the common law rule that self-settled spendthrift trusts may be reached by creditors.

The Bankruptcy Court declined to apply the state law, stating that "[i]t would be a very odd result for a court interpreting a federal statute aimed at closing a loophole to apply the state law that permits it. I conclude that a settlor's expressed intention to protect assets placed in a self-settled trust from a beneficiary's potential future creditors can be evidence of an intent to defraud." The Bankruptcy Court concluded that the debtor had the actual intent to hinder, delay, or defraud creditors in transferring the land to the trust because the debtor had been experiencing a significant deterioration of his financial state, he accumulated substantial credit card debt at the time the trust was created, and instead of paying his creditors with the $100,000 he received from his mother, he transferred $80,000 to the trust and began speculating in the stock market.

Certainly, including a statement that the purpose of the trust is to protect the estate from the claims of creditors is a mistake.

The important lesson to take away from *Mortensen* is that the Bankruptcy Court determined that the Bankruptcy Code may trump state law, in some circumstances, as to the ability of the bankruptcy trustee to recover assets transferred to self-settled domestic spendthrift trusts. Certainly, including a statement that the purpose of the trust is to protect the estate from the claims of creditors is a mistake.

Offshore trusts. Offshore trusts are foreign spendthrift trusts, i.e., an irrevocable trust created for one's own benefit that are governed by the laws of a foreign jurisdiction. They are located in certain offshore banking jurisdictions that have statutes protecting these types of trusts from creditors. These jurisdictions include the Cook Islands,[43] Bahamas,[44] Bermuda,[45] the Cayman Islands,[46] and the Island of Man,[47] as well as others in the Caribbean, the Mediterranean (Gibraltar), the Pacific, and elsewhere.

Offshore trusts are the ultimate protection device because a U.S. creditor must obtain a U.S. judgment and then seek to have the judgment enforced in a foreign court. Those considering the offshore trust as an asset protection device should be aware of the following:

1. One may still have the investments managed in the U.S., although to maximize difficulty of attachment, locating those assets offshore is advised.
2. The law and procedure in these jurisdictions makes it difficult to enforce foreign judgments.
3. Most have a very short period of limitations (as little as two years) on fraudulent conveyance.
4. They are expensive to set up (over $50,000) and maintain (annual expenses usually exceed $5,000 per year).
5. They do not avoid U.S. income, estate, or gift tax (although the offshore jurisdiction is generally tax free).
6. There will be additional tax compliance costs. Ownership of foreign trusts must be reported to the U.S. government, which frequently triggers audits.
7. Control over the assets held in the trust must be relinquished to the foreign trustee. The more control retained, the greater the possibility that a U.S. court will find the trust to be a sham, and disregard it in its entirety.

The primary advantage of offshore trusts is that a U.S. judgment creditor must obtain an attachment of the trust assets in the court having jurisdiction of the foreign trust. A U.S. judgment that might be enforceable against a domestic asset protection trust (due to a fraudulent conveyance or otherwise)

[43] See International Trust Act of 1984, as amended in 1985, 1989, 1991, 1995-96, & 1999 (Cook Islands), §§ 13B(5); 13C, 13F.

[44] See Bahamas Trusts Act, 1989, and Bahamas Fraudulent Dispositions Act of 1991.

[45] See Bermuda Trusts (Special Provisions) Act of 1989 (as amended) § 11(1)(B).

[46] See The Trusts (Foreign Element) Law, 1987 (Cayman Islands) § 6.

[47] See Trusts Act of 1995 § 5 (Isle of Man).

might not be recognized at all in the offshore jurisdiction, particularly if it is at variance with the applicable laws of the foreign jurisdiction where the trust is administered. Additionally, the practical costs of posting bond or attempting to enforce the judgment in an offshore jurisdiction may scare a creditor away.

The primary disadvantages of an offshore trust are:

1. The cost of establishing and maintaining the trust.
2. The heightened U.S. income tax compliance and scrutiny.
3. The general optics that a conveyance to an offshore trust will be used as evidence in itself that the debtor was primarily attempting to avoid creditors in funding the offshore trust.

For example, in bankruptcy the creation of an offshore trust can be a sign of fraud which could lead to a denial of the debtor's discharge,[48] and if the offshore trust is created within the relevant period, fraudulent intent may be inferred[49] which could lead a bankruptcy court to find that deposits into the offshore trust were fraudulent transfers.

Additionally, U.S. courts have taken a dim view of such transfers and take other draconian actions against a debtor when the offshore trust cannot be reached. In the case of *F.T.C. vs. Affordable Media, LLC*,[50] the grantors established an offshore trust of which they were co-trustees. The U.S. court issued a temporary restraining order (TRO) requiring that the trust assets be frozen and repatriated to the U.S. Although the offshore trustee received a repatriation demand from the grantors, the trust instrument included a (not uncommon) provision that, if given a direction that the offshore trustee considers to have been made while under duress, the offshore trustee is not required to comply. The offshore trustee, viewing the TRO as an event of duress, refused to repatriate the trust assets. The U.S. court held the grantors in contempt, for which they were jailed.

Offshore trusts can easily create a "Catch 22" for the grantor of the offshore trust when a U.S. court, which has jurisdiction over the person of the grantor, orders the grantor to take an action with which the offshore trustee will not comply because it does not conform to the terms of the trust instrument.

The grantors in the *F.T.C.* case were released from the contempt order when they relinquished to the F.T.C. all of their control over and beneficial interests in the trust. This did not resolve the issue, however. When the F.T.C. tried to obtain actual possession of the trust assets in the offshore jurisdiction (the Cook Islands, in this case), the Cook Islands High Court rejected the F.T.C.'s claim that it was now the trust beneficiary and/or trustee, or that any fraudulent conveyance was involved, in two separate suits. These decisions were subsequently affirmed on appeal.

This is not an isolated case. The tighter the offshore trust is drafted with respect to protection from creditor's claims, the more likely it is that in some circumstances it may protect too well, even in cases where the grantor no longer wants the protection, or needs to relinquish it to prevent incarceration or other harm.

There are many subtle issues in selecting the jurisdiction in which to establish an offshore trust, as well as complex U.S. income, gift, estate, and generation-skipping transfer tax issues and tax reporting obligations. The IRS' longstanding campaign to collect income taxes on assets held overseas has created significant compliance issues for both beneficiaries and trustees of offshore trusts, and foreign partnerships and corporations.

Conclusion

Wealth may be structured either to protect assets or make them harder to reach by creditors. While fraudulent conveyances with respect to existing claims is an unavoidable risk, steps should be taken sooner rather than later for asset protection purposes. Each individual's asset structure should have a personalized solution. One option may fit the needs of one person, but not another.

When engaging in asset protection on behalf of clients, advisors need to conduct sufficient due diligence regarding their clients' financial condition, the existence of current claims, creditor exposure, solvency, need for protection (e.g., officer and director liability, environmental liability, professional malpractice, tort claims, and contract claims), motives and potential criminal activity, to properly advise them and to avoid becoming embroiled in situations that violate U.S. law or create new legal issues for their clients, and for themselves. ■

[48] See e.g. Peterson v. Hazen (In re Hazen), 37 B.R. 329 (Bkrptcy. DC Fla., 1983) (assets transferred to trust with a retained life estate resulted in denial of discharge where it occurred within one year of filing bankruptcy).

[49] See e.g. Pavy v. Chastant (In re Chastout), 873 F.2d 89 (CA-5, 1989) (inferring fraudulent intent where settlor created a trust in which he retained the income interest, which would cease when he filed for bankruptcy or a judgment of $20,000 or more was entered against him, at which point his wife would become the beneficiary).

[50] 179 F. 3d 1228 (CA-9, 1999).