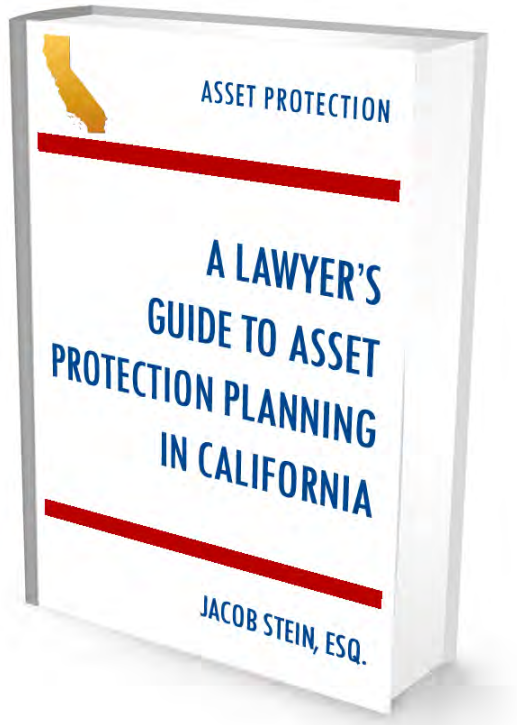
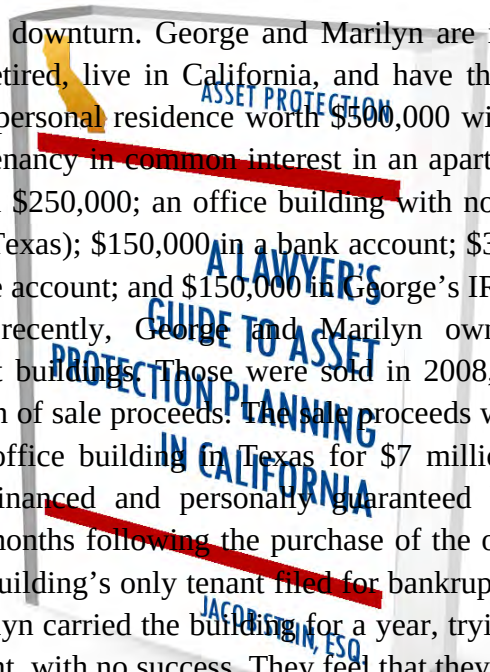


C. Case Study on Last Minute Asset Protection Planning

1. Facts

Our case study will explore the unfortunate situation of George and Marilyn, a fictitious couple that very closely resembles so many of our asset protection clients in this

[79] It should be noted that Section 531of the California Penal Code provides that engaging or assisting in a fraudulent transfer is a misdemeanor. In practice, to the knowledge of this author, this section is never enforced, probably because it may be impossible to prove the required "intent" beyond a reasonable doubt.



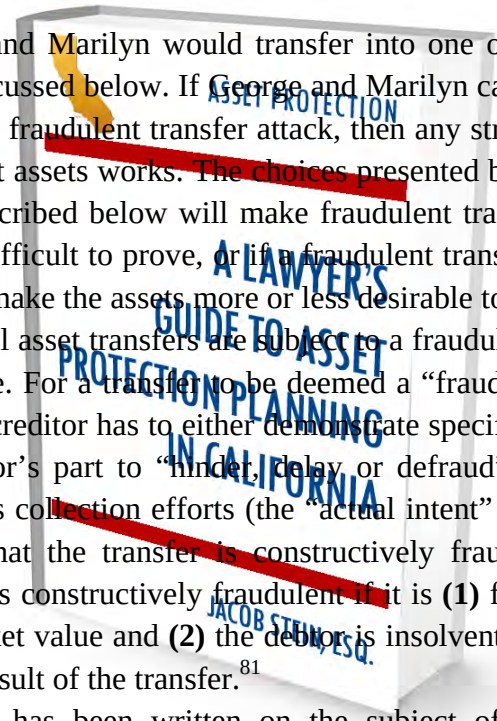
economic downturn. George and Marilyn are in their late sixties, retired, live in California, and have the following assets: a personal residence worth $500,000 with no mortgage; a tenancy in common interest in an apartment building worth $250,000; an office building with no equity (located in Texas); $150,000 in a bank account; $300,000 in a brokerage account; and $150,000 in George's IRA.

Until recently, George and Marilyn owned several apartment buildings. Those were sold in 2008, generating $3 million of sale proceeds. The sale proceeds were used to buy the office building in Texas for $7 million, with $4 million financed and personally guaranteed by George. Several months following the purchase of the office building, the building's only tenant filed for bankruptcy. George and Marilyn carried the building for a year, trying to find a new tenant, with no success. They feel that they cannot sustain carrying the building for much longer and plan on defaulting in three months. The building is now worth $1.5 million.

We will examine whether fraudulent transfer laws prevent George and Marilyn from pursuing asset protection, and, if not, what structures are available to protect each asset, the substantive law behind each structure and their practical implications.

2. Of Ivory Towers and Fraudulent Transfers

There is only one chink in the armor of any asset protection structure—the creditor's ability to challenge the structure as a fraudulent transfer. There are no other legal grounds that would allow the lender to reach the assets that



George and Marilyn would transfer into one of the structures discussed below. If George and Marilyn can escape or survive a fraudulent transfer attack, then any structure used to protect assets works. The choices presented by the structures described below will make fraudulent transfers more or less difficult to prove, or if a fraudulent transfer is proven, will make the assets more or less desirable to pursue.

Not all asset transfers are subject to a fraudulent transfer challenge. For a transfer to be deemed a "fraudulent transfer" the creditor has to either demonstrate specific intent on the debtor's part to "hinder, delay or defraud" a specific creditor's collection efforts (the "actual intent" test), or establish that the transfer is constructively fraudulent.[80] A transfer is constructively fraudulent if it is **(1)** for less than fair market value and **(2)** the debtor is insolvent at the time or as a result of the transfer.[81]

Much has been written on the subject of fraudulent transfers and we will not revisit it here.[82] Instead, the following are a few important legal and practical elements and consequences that are of interest to George and Marilyn.

Under the actual intent test, the lender would have to demonstrate George and Marilyn's intent underlying the transfer of assets. Intent is demonstrated by examining the circumstantial evidence surrounding the transfer, the so-

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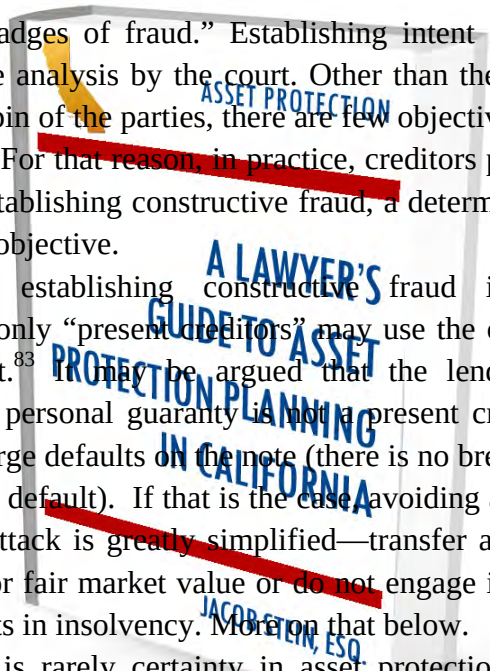
[80] Uniform Fraudulent Transfer Act ("UFTA") §§ 4(a) and 5(a). The UFTA has been codified by each state. The Bankruptcy Code § 548 contains its own version of the UFTA. The UFTA and Bankruptcy Code § 548 are so similar, that either may be used in litigation. *Donell v. Kowell*, 533 F.3d 762, 770 (9th Cir. 2008).

[81] UFTA § 5(a).

[82] See, for example, Stein, Jacob, Asset Protection May Risk Fraudulent Transfer Violations, Estate Planning, August 2010.

called "badges of fraud." Establishing intent is always a subjective analysis by the court. Other than the arguments and the spin of the parties, there are few objective factors to consider. For that reason, in practice, creditors prefer to focus on establishing constructive fraud, a determination that is purely objective.

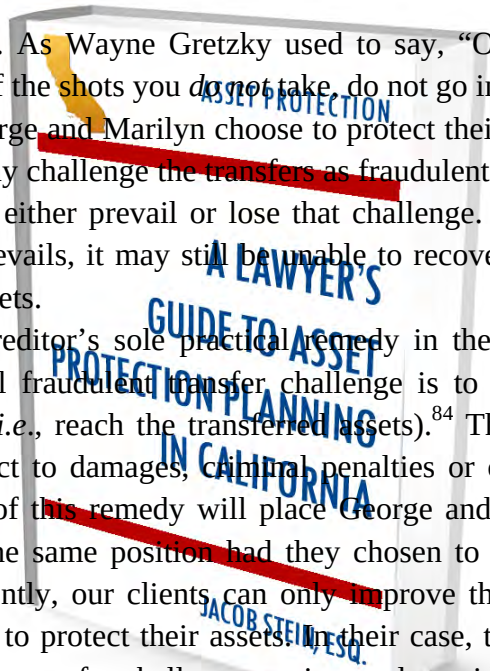


While establishing constructive fraud is straightforward, only "present creditors" may use the constructive fraud test.[83] It may be argued that the lender holding George's personal guaranty is not a present creditor until after George defaults on the note (there is no breach of contract until default). If that is the case, avoiding a fraudulent transfer attack is greatly simplified—transfer assets in exchange for fair market value or do not engage in a transfer that results in insolvency. More on that below.

There is rarely certainty in asset protection planning. Any transfer of assets may be challenged by a creditor as a fraudulent transfer and possibly challenged successfully. How does that hinder the actions that our hypothetical clients will take to protect their assets?

George and Marilyn's decision tree is simple. They can choose to do nothing to protect their assets, either because they are worried about a fraudulent transfer challenge or for any other reason, or they can choose to implement an asset protection plan. Doing nothing is easy to implement and inexpensive, at first, but will result in a close to 100 percent chance of them losing all their assets in the event of a

[83] A present creditor is a creditor whose claim arose before the transfer was made. UFTA § 5(a). Contrast that with a future creditor, a creditor whose claim arises before the transfer is made. UFTA § 4(a).



judgment. As Wayne Gretzky used to say, "One hundred percent of the shots you *do not* take, do not go in."

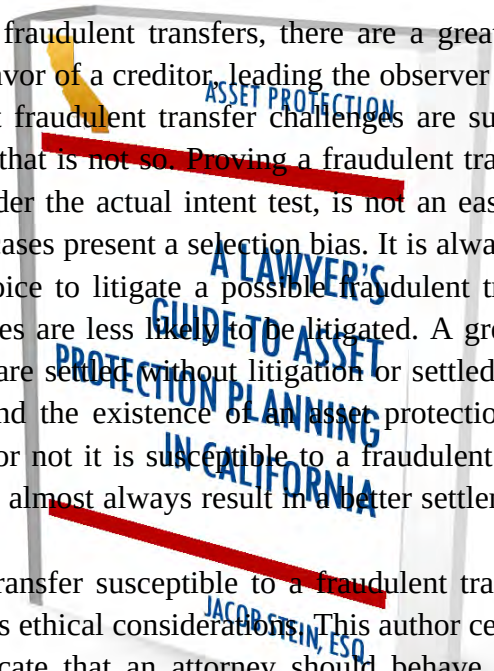
If George and Marilyn choose to protect their assets, the lender may challenge the transfers as fraudulent transfers; it will then either prevail or lose that challenge. Even if the lender prevails, it may still be unable to recover the transferred assets.

The creditor's sole practical remedy in the event of a successful fraudulent transfer challenge is to unwind the transfer (*i.e.*, reach the transferred assets).[84] The debtor is not subject to damages, criminal penalties or caning. The exercise of this remedy will place George and Marilyn in exactly the same position had they chosen to do nothing. Consequently, our clients can only improve their position by trying to protect their assets. In their case, the risk of a fraudulent transfer challenge carries no downside. Even the transaction costs incurred in implementing the asset protection structure are not a consideration, as that money would have been lost to the lender in any case.

The analysis of a fraudulent transfer challenge is therefore an analysis of legal theory as it applies to fraudulent transfers and an analysis of the practical consequences of ignoring such theory. Most attorneys rely purely on theory in making their predictions as to the efficacy of an asset protection plan. If theory leads to prediction, then theory coupled with practical experience leads to an accurate prediction.

A further practical planning point to consider is the available case law. If one peruses the available court deci-

[84] UFTA § 7(a)(1).

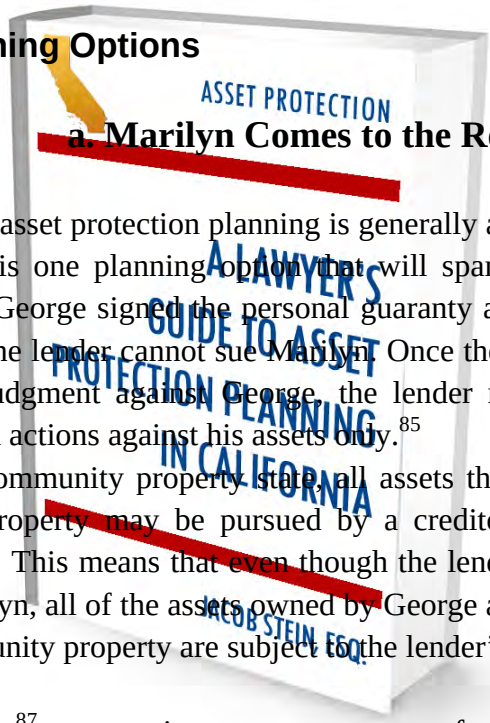


sions on fraudulent transfers, there are a great many that hold in favor of a creditor, leading the observer to conclude that most fraudulent transfer challenges are successful. In practice, that is not so. Proving a fraudulent transfer, especially under the actual intent test, is not an easy task. The decided cases present a selection bias. It is always the creditor's choice to litigate a possible fraudulent transfer, and weak cases are less likely to be litigated. A great majority of cases are settled without litigation or settled during litigation, and the existence of an asset protection structure, whether or not it is susceptible to a fraudulent transfer attack, will almost always result in a better settlement for the debtor.

Any transfer susceptible to a fraudulent transfer attack implicates ethical considerations. This author certainly does not advocate that an attorney should behave unethically. However, this author does believe that the ultimate arbiter of what is right and what is wrong is the client. The client should decide whether an asset protection structure should be implemented. The lawyer's job is to educate and advise, not to make a decision that will so greatly impact the client's life. As an aside, we have learned in our practice that what many deem ethical or unethical will vary greatly depending on whether it is their own assets that are at stake, or a stranger's.

Planning early is always the best defense against a fraudulent transfer challenge. The debtor will either lack the requisite intent or will not have a present creditor. When planning late, allow your client to consider the practical consequences of his choices, and not just legal theory.

3. Planning Options



a. Marilyn Comes to the Rescue

While asset protection planning is generally asset specific, there is one planning option that will span all assets. Because George signed the personal guaranty and Marilyn did not, the lender cannot sue Marilyn. Once the lender obtains a judgment against George, the lender may pursue collection actions against his assets only.[85]

In a community property state, all assets that are community property may be pursued by a creditor of either spouse.[86] This means that even though the lender may not sue Marilyn, all of the assets owned by George and Marilyn as community property are subject to the lender's collection remedies.

In most[87] community property states, a frequently utilized asset protection technique is a transmutation agreement.[88] This is a form of a post-nuptial agreement that is used to convert community property to separate property or vice versa. A typical transmutation agreement will state that the spouses are terminating their community property interests in all or some of their assets and are creating separate property interests in such assets.

This would mean that George and Marilyn can agree that some of their assets will become the separate property

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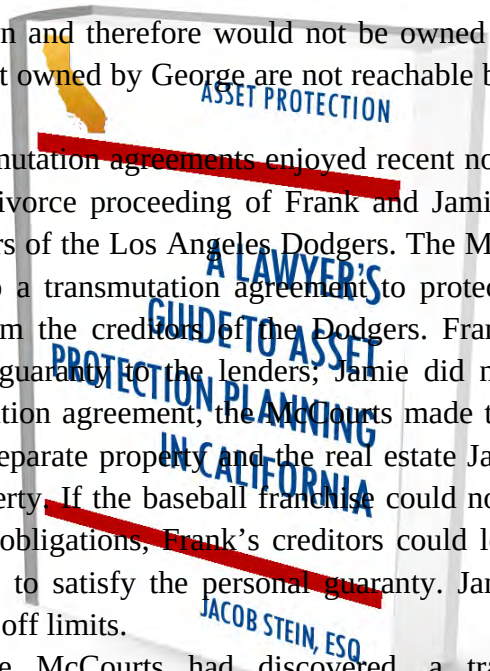
[85] Cal. Code Civ. Proc. § 695.010(a).
[86] Cal. Fam. Code § 910(a).
[87] Nevada, for example, makes transmutations ineffective as to third parties. Nev. Rev. Stat. § 123.220(1).
[88] Cal. Fam. Code § 850.

of Marilyn and therefore would not be owned by George. Assets not owned by George are not reachable by his creditors.[89]



Transmutation agreements enjoyed recent notoriety during the divorce proceeding of Frank and Jamie McCourt, the owners of the Los Angeles Dodgers. The McCourts entered into a transmutation agreement to protect their real estate from the creditors of the Dodgers. Frank signed a personal guaranty to the lenders; Jamie did not. In their transmutation agreement, the McCourts made the Dodgers Frank's separate property and the real estate Jamie's separate property. If the baseball franchise could not satisfy its financial obligations, Frank's creditors could look only to his assets to satisfy the personal guaranty. Jamie's assets would be off limits.

As the McCourts had discovered, a transmutation agreement is a binding legal document for all purposes, including a divorce. That means that George and Marilyn must be advised of that risk and it also means that the possibility of a divorce is a reason to allocate the assets to the two spouses equally, based on fair market value. This way, if one of them files for divorce, there is no downside—community property would have been split equally in a divorce.

Another reason to split the assets equally is to minimize the risk of a successful fraudulent transfer attack. If the assets are split evenly, then George and Marilyn would transfer assets to each other for fair market value.

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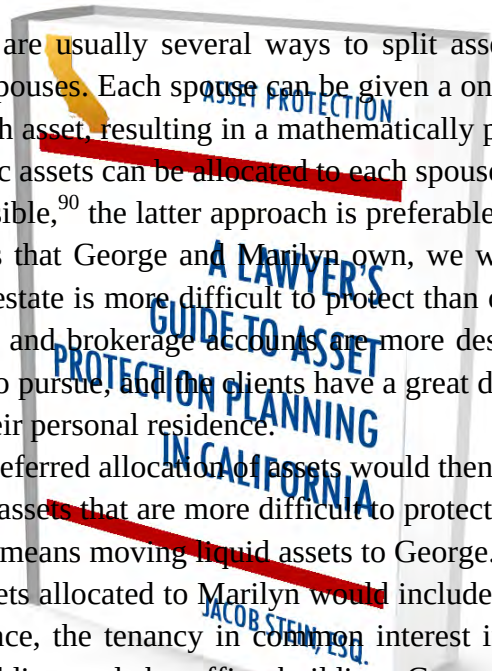
[89] Cal. Code Civ. Proc. § 695.010(a).



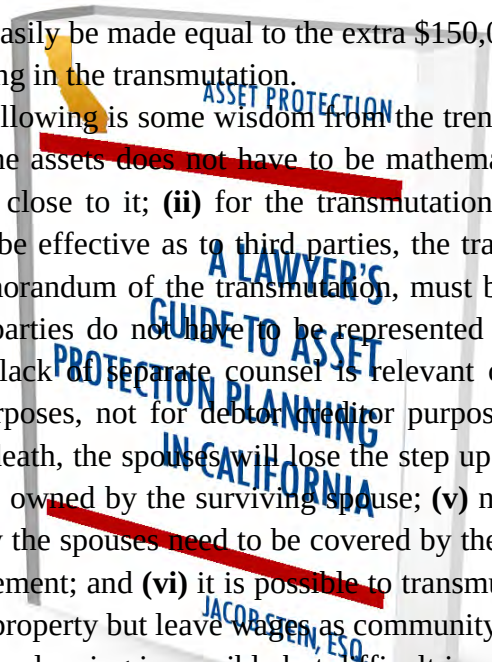
There are usually several ways to split assets between the two spouses. Each spouse can be given a one-half interest in each asset, resulting in a mathematically precise split, or specific assets can be allocated to each spouse.

If possible,[90] the latter approach is preferable. Analyzing the assets that George and Marilyn own, we will discover that real estate is more difficult to protect than other assets, that bank and brokerage accounts are more desirable for a creditor to pursue, and the clients have a great deal of affinity for their personal residence.

The preferred allocation of assets would then be to transfer those assets that are more difficult to protect to Marilyn, even if it means moving liquid assets to George. In our case study assets allocated to Marilyn would include the personal residence, the tenancy in common interest in the apartment building and the office building. George would receive the remaining assets, which include the bank account, the brokerage account and the IRA.

The allocations, by value, are not exactly equal. Marilyn would receive $750,000 worth of assets and George $600,000. There are three ways to deal with this discrepancy: revalue the assets (real estate valuations are often subjective), give George a small tenancy in common interest in real estate, or create an additional benefit for George or a detriment for Marilyn. An example of the third option would be a full or partial waiver of spousal support by Marilyn in the event of a divorce. Such a waiver could be val-

[90] Would not be possible if the spouses owned one asset, or several assets with greatly divergent values, making it mathematically impossible to achieve an equal split overall.



ued and easily be made equal to the extra $150,000 Marilyn is receiving in the transmutation.

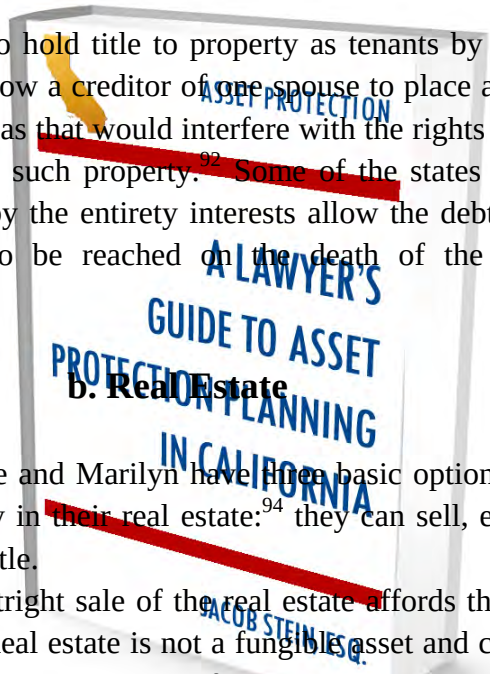
The following is some wisdom from the trenches: **(i)** the split of the assets does not have to be mathematically precise, just close to it; **(ii)** for the transmutation of the real estate to be effective as to third parties, the transmutation, or a memorandum of the transmutation, must be recorded; **(iii)** the parties do not have to be represented by separate counsel (lack of separate counsel is relevant only for divorce purposes, not for debtor-creditor purposes); **(iv)** on the first death, the spouses will lose the step up in basis for the assets owned by the surviving spouse; **(v)** not all assets owned by the spouses need to be covered by the transmutation agreement; and **(vi)** it is possible to transmute assets to separate property but leave wages as community property.

Similar planning is possible but difficult in common law states. For example, if George and Marilyn were living in New York, they would have no community property. George would have his separate property and Marilyn hers.[91] For George to be able to transfer assets to Marilyn in exchange for fair market value, Marilyn would have to transfer some of her assets back to George. This technique may still be useful if George owns difficult to protect assets and Marilyn owns easy to protect assets.

In many states spouses should also consider taking title to property as tenants by the entirety. This is a form of a concurrent estate in real property where each spouse owns an undivided whole of the property. Most states that allow

[91] The concept of marital property is irrelevant for debtor-creditor purposes.

spouses to hold title to property as tenants by the entirety do not allow a creditor of one spouse to place a lien on the property, as that would interfere with the rights of the other spouse in such property.[92] Some of the states that protect tenancy by the entirety interests allow the debtor-spouse's interest to be reached on the death of the non-debtor spouse.[93]



b. Real Estate

George and Marilyn have three basic options to protect the equity in their real estate:[94] they can sell, encumber or transfer title.

An outright sale of the real estate affords the most protection. Real estate is not a fungible asset and can never be protected in a "bulletproof" manner. Once the real estate is converted into a liquid asset, it may be possible to protect such liquid asset with great efficacy. The outright sale of the real estate is a radical approach. George and Marilyn will have to pack up their belongings, find a new place to live and incur capital gains on the sale. However, even with that in mind, the outright sale may be a better option than

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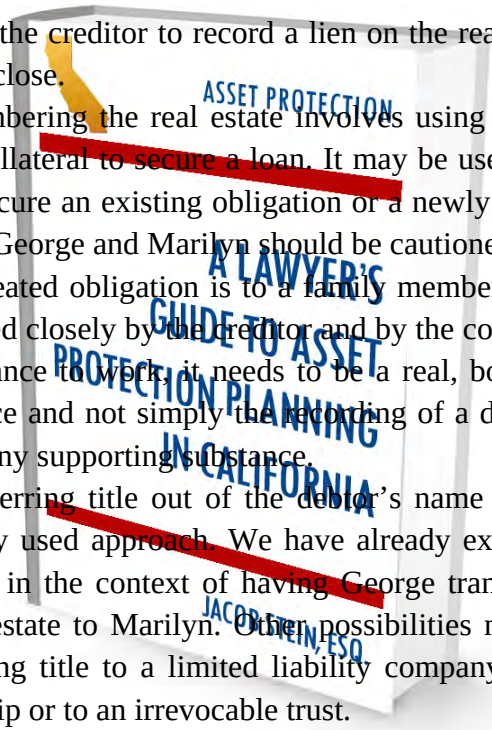
[92] See, e.g., *Citizens' Saving Bank v. Astrin*, 44 Del. 451, 61 A. 2d 419 (1948), *Amadon v. Amadon*, 359 Pa. 434, 59 A. 2d 135 (1948); *Keen v. Keen*, 191 Md. 31, 60 A.2d 200 (1948).

[93] *Sloan v. Sloan*, 182 Tenn. 162, 184 S.W.2d 391 (1945).

[94] With real estate, it is always equity, and not the real estate itself, that is being protected. A creditor's remedy with respect to debtor's real estate is limited to placing a judgment lien on the real estate and then foreclosing on such lien. See, e.g., Cal. Code of Civ. Proc. §§ 697.310(a), 701.510 and 701.810.



allowing the creditor to record a lien on the real estate and then foreclose.

Encumbering the real estate involves using the real estate as collateral to secure a loan. It may be used as collateral to secure an existing obligation or a newly created obligation. George and Marilyn should be cautioned that if the newly created obligation is to a family member, it may be scrutinized closely by the creditor and by the court. For the encumbrance to work, it needs to be a real, bona-fide encumbrance and not simply the recording of a deed of trust without any supporting substance.

Transferring title out of the debtor's name is the most frequently used approach. We have already examined this approach in the context of having George transfer title to the real estate to Marilyn. Other possibilities may include transferring title to a limited liability company or limited partnership or to an irrevocable trust.

c. LLCs and Limited Partnerships

Unlike most assets, a membership interest in a limited liability company or a partnership interest in a limited or general partnership is not subject to attachment by a creditor.[95] The creditor's remedy with respect to these assets is

[95] §§ 503 of the Unif. Ltd. Liab. Co. Act (2006) ("ULLCA"), Rev. Unif. Part. Act (1994) ("RUPA") and Unif. Lim. Part. Act (2001) ("ULPA"). All states have enacted the uniform acts in some way. See, e.g., Alaska Stat., § 32.06.504, Del. Code Ann. 6, § 18-703, Cal. Corp. Code § 17302, Nev. Rev. Stat. § 86.401.

limited to a charging order and/or a foreclosure of the assignable interest.[96]

The charging order is a lien on the debtor's transferable interest in the entity.[97] A "transferable interest" is defined in the uniform acts as a right to receive distributions.[98]

An interest in an LLC or a limited/general partnership commonly consists of two bundles of rights: **(1)** an economic interest (also called assignable, transferable or distributional)—the right to receive distributions of cash and property and the corresponding allocations of income, gain, loss and deduction, and **(2)** management and voting rights.[99] All available creditor remedies (charging order and/or foreclosure) are directed solely at the economic interest; management and voting rights are untouchable. The uniform acts go as far as to provide that: "While in effect, that [charging] order entitles the judgment creditor to whatever distributions would otherwise be due to the partner or transferee whose interest is subject to the order. The creditor has no say in the timing or amount of those distributions. The charging order does not entitle the creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited partnership."[100]

The creditor's inability to vote the charged interest or participate in the management of the entity is at the heart of

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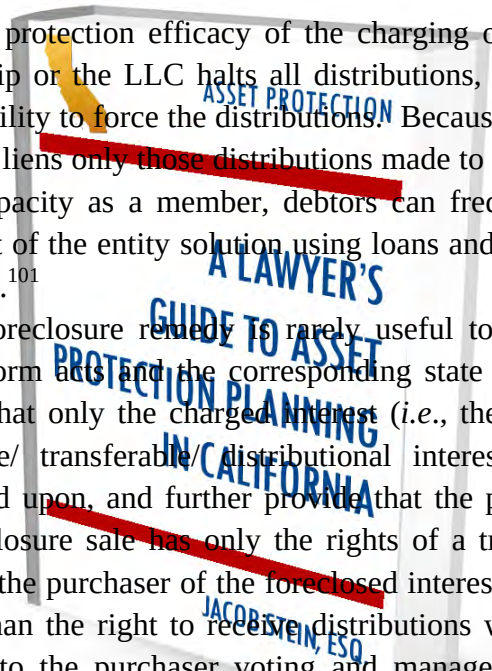
[96] *Id.*
[97] ULLCA, RUPA, ULPA § 504. Notice that ULLCA uses the term "distributional" and state law often uses the term "assignable."
[98] See, e.g., ULLCA § 101(6), ULPA § 102(22).
[99] ULLCA § 101(5), Comments; Cal. Corp. Code § 17001(n).
[100] ULPA § 703, Comments.



the asset protection efficacy of the charging order. If the partnership or the LLC halts all distributions, the creditor has no ability to force the distributions. Because the charging order liens only those distributions made to the member in his capacity as a member, debtors can frequently pull assets out of the entity solution using loans and guaranteed payments.[101]

The foreclosure remedy is rarely useful to a creditor. The uniform acts and the corresponding state acts clearly provide that only the charged interest (*i.e.*, the economic/ assignable/ transferable/ distributional interest) may be foreclosed upon, and further provide that the purchaser at the foreclosure sale has only the rights of a transferee.[102] To grant the purchaser of the foreclosed interest an interest greater than the right to receive distributions would mean granting to the purchaser voting and management rights associated with the debtor's interest in the entity. That would be contrary to the very reason why charging order statutes exist in the first place.[103]

The exclusivity of the charging order appears to be expressly set forth only in the Delaware LLC statute (it is also

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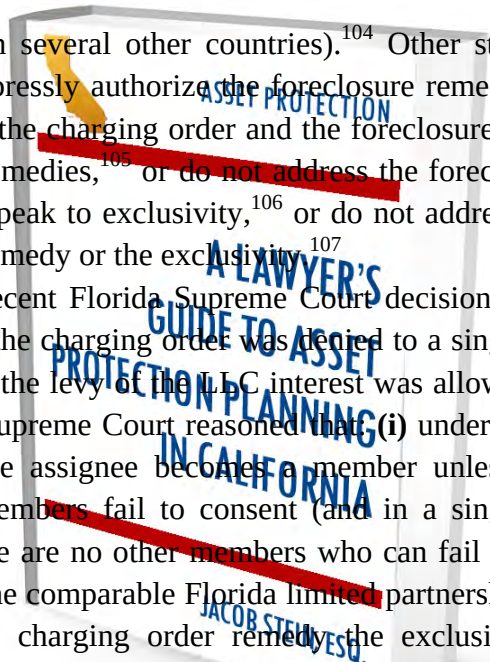
[101] ULLCA § 101(5).

[102] ULLCA § 503(c), "... the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale only obtains the transferable interest, does not thereby become a member..."

[103] For a great state-by-state analysis of charging order statutes and the foreclosure remedy, see Bishop, "Fifty State Series: LLC Charging Order Statutes" table, that may be accessed at http://ssrn.com/abstract=1542244.



present in several other countries).[104] Other state statutes either expressly authorize the foreclosure remedy and provide that the charging order and the foreclosure are the exclusive remedies,[105] or do not address the foreclosure remedy but speak to exclusivity,[106] or do not address the foreclosure remedy or the exclusivity.[107]

In a recent Florida Supreme Court decision, the exclusivity of the charging order was denied to a single-member LLC and the levy of the LLC interest was allowed.[108] The Florida Supreme Court reasoned that, **(i)** under the Florida statute the assignee becomes a member unless the non-debtor members fail to consent (and in a single-member LLC there are no other members who can fail to consent), and **(ii)** the comparable Florida limited partnership act does make the charging order remedy the exclusive remedy. Practitioners establishing LLCs in states lacking the exclusivity language in their charging order statutes should be mindful of the Olmstead ruling and seek to establish multi-member LLCs.

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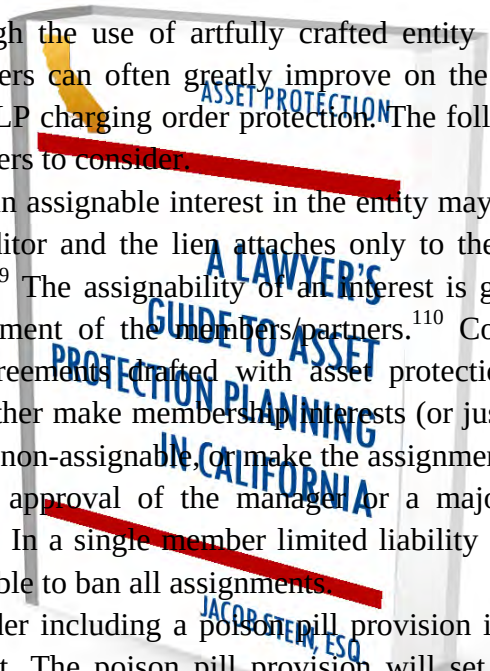
[104] Del. Code Ann. 6, § 18-703(d). " The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest." [Emphasis added.] St. Vincent and the Grenadines LLC Act (2008) §61(3).

[105] See, e.g., Cal. Corp. Code § 17302(b)

[106] See, e.g., Nev. Rev. Stat. § 86.401(2). " This section: (a) Provides the exclusive remedy by which a judgment creditor of a member or an assignee of a member may satisfy a judgment out of the member's interest of the judgment debtor." [Emphasis added.]

[107] See, e.g., Fla. Stat. Ann. § 608.433, Ind. Code Ann. § 23-18-6-7.

[108] *Olmstead v. Federal Trade Commission*, 44 So. 3d 76 (Fla. 2010).



Through the use of artfully crafted entity agreements, practitioners can often greatly improve on the efficacy of the LLC/LP charging order protection. The following are a few pointers to consider.

Only an assignable interest in the entity may be charged by a creditor and the lien attaches only to the assignable interest.[109] The assignability of an interest is governed by the agreement of the members/partners.[110] Consequently, entity agreements drafted with asset protection in mind should either make membership interests (or just economic interests) non-assignable, or make the assignment subject to the prior approval of the manager or a majority of the members. In a single member limited liability company, it is preferable to ban all assignments.

Consider including a poison pill provision in the entity agreement. The poison pill provision will set a predetermined redemption price for a member's interest and is triggered by a collection action against any member. It will help in contentious litigation cases and will prevent a foreclosure sale of the interest.[111]

Take a close look at the distribution clause of the agreement. Most distribution clauses will empower the manager to determine the timing and the amount of the distribution, but when the distribution is made, the manager will have to distribute *pari passu*. A distribution will be *pari passu* only if made to all the members/partners in accordance with their percentage interests, or to none. In the

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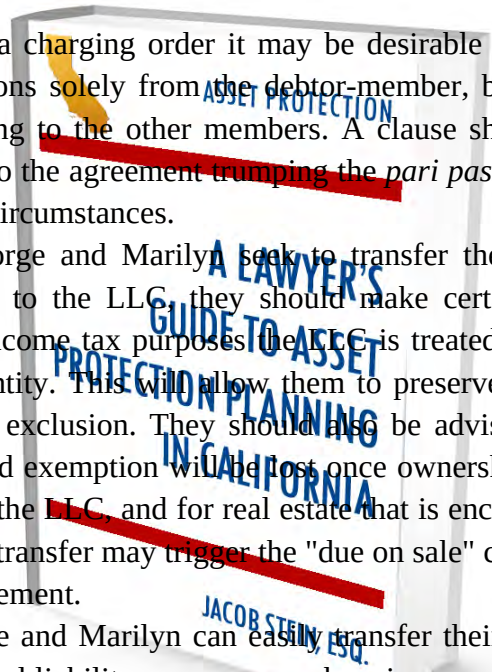
[109] See, e.g., Cal. Corp. Code §§ 17302(a) and (b).
[110] See, e.g., Cal. Corp. Code § 17301(a).
[111] Most state statutes allow redemption of the charged interest prior to foreclosure. See, e.g., Cal. Corp. Code § 17302(a).



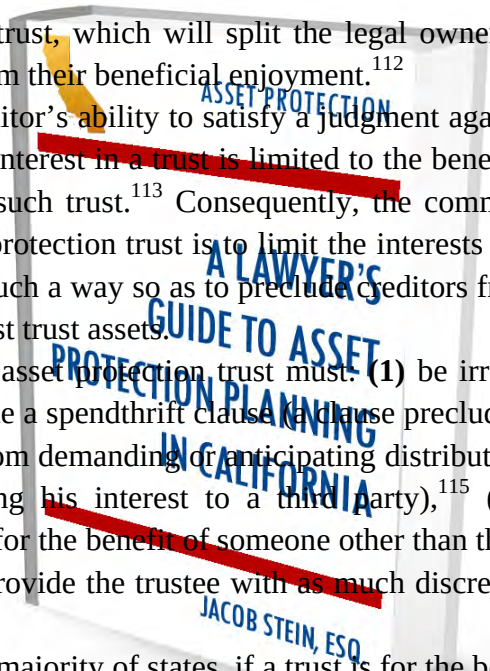
event of a charging order it may be desirable to withhold distributions solely from the debtor-member, but continue distributing to the other members. A clause should be inserted into the agreement trumping the *pari passu* language in those circumstances.

If George and Marilyn seek to transfer their personal residence to the LLC, they should make certain that for federal income tax purposes the LLC is treated as a disregarded entity. This will allow them to preserve the IRC § 121 gain exclusion. They should also be advised that the homestead exemption will be lost once ownership is transferred to the LLC, and for real estate that is encumbered by debt, the transfer may trigger the "due on sale" clause of the loan agreement.

George and Marilyn can easily transfer their real estate to a limited liability company, exchanging unprotected real estate for a membership interest enjoying the limitations of the charging order protection. As with all other transfers, fraudulent transfer consequences must be carefully examined.

d. Trusts

The conceptual goal of all asset protection planning is two-fold: **(1)** remove the debtor's name from the legal title to his assets, but **(2)** in such a way so that he could retain some beneficial enjoyment and a degree of control. These two goals are incompatible, but may be reconciled with the



use of a trust, which will split the legal ownership of the assets from their beneficial enjoyment.[112]

A creditor's ability to satisfy a judgment against a beneficiary's interest in a trust is limited to the beneficiary's interest in such trust.[113] Consequently, the common goal of an asset protection trust is to limit the interests of a beneficiary in such a way so as to preclude creditors from collecting against trust assets.

Every asset protection trust must: **(1)** be irrevocable,[114] **(2)** include a spendthrift clause (a clause precluding a beneficiary from demanding or anticipating distributions, and/or transferring his interest to a third party),[115] **(3)** in most states be for the benefit of someone other than the settlor,[116] and **(4)** provide the trustee with as much discretion as possible.

In the majority of states, if a trust is for the benefit of the settlor, the trust is deemed self-settled, and the beneficial interest retained by the settlor is not protected by the spendthrift clause.[117] Over the past two decades there has been a growing movement by the English common law jurisdic-

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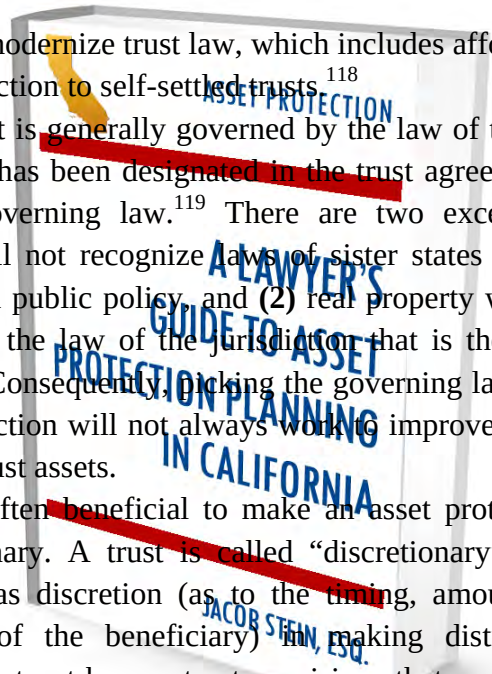
[112] For an in depth discussion of this topic, see, Stein, Jacob, Importance of Trusts in Asset Protection, Cal. Trusts and Est. Quart. (Winter 2007).
[113] See, e.g., *Garcia v. Merlo* (1960) 177 Cal.App.2d 434; *Booge v. First Trust & Sav. Bank* (1944) 64 Cal.App.2d 532-536; *Estate of Bennett* (1939) 13 Cal.2d 354.
[114] See, e.g., Cal Prob. Code § 18200, Fl. Stat. § 736.0505(1)(a), Restatement (Third) of Trusts, § 58 (2003).
[115] See, e.g., Fl. Stat. § 736.0501. For an explanation of the spendthrift clause, see, Unif. Trust Code §§ 501 and 502; Witkin, Summary of Cal. Law (9th ed., 1990), Trusts, § 165.
[116] See, e.g., Cal. Prob. Code § 15304(a), Fl. Stat. § 736.0505 (1)(b), Id. Stat. § 15-7-502(4).
[117] *Id*.



tions to modernize trust law, which includes affording creditor protection to self-settled trusts.[118]

A trust is generally governed by the law of the jurisdiction that has been designated in the trust agreement as the trust's governing law.[119] There are two exceptions: **(1)** states will not recognize laws of sister states that violate their own public policy, and **(2)** real property will be governed by the law of the jurisdiction that is the property's situs.[120] Consequently, picking the governing law of another jurisdiction will not always work to improve the protection of trust assets.

It is often beneficial to make an asset protection trust discretionary. A trust is called "discretionary" when the trustee has discretion (as to the timing, amount and the identity of the beneficiary) in making distributions.[121] There must not be any trust provisions that mandate a distribution, but there may be provisions that set standards for distributions.[122] Because the trustee is not required to make any distribution to any specific beneficiary, or may choose when and how much to distribute, a beneficiary of a discretionary trust may have such a tenuous interest in the trust so as not to constitute a property right at all. If the beneficiary has no property right, there is nothing for a creditor to pur-

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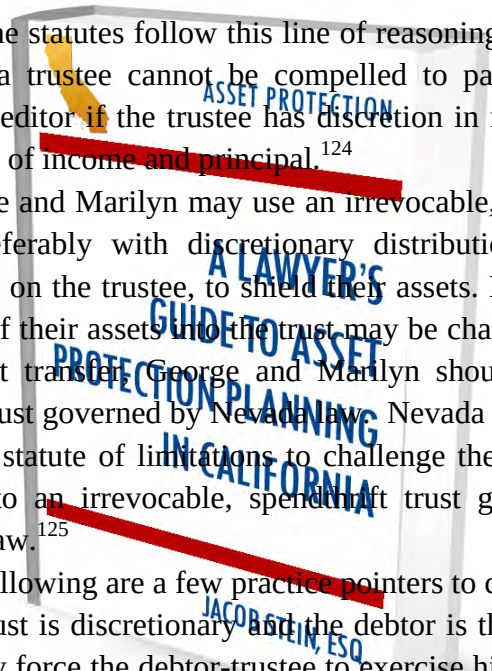
[118] See, e.g., Ala. Stat. § 34.40.110; 12 Del. Code § 3570; Nev. Rev. Stat. § 166.010, et. seq.; Mo. Ann. Stat. § 428.005 *et. seq*.; R.I. Gen. Laws §§ 18-9.2; 31 Okla. Stat. Ann. §§ 13, 16; Nevis Intl. Exempt Trust Ord. (1995) § 6(4), St. Vincent Intl. Trusts Act (1996) § 10(4).
[119] Rest. 2d Conf. of Laws § 273(b); Uniform Trust Law § 107(1).
[120] Rest. 2d Conf. of Laws § 280.
[121] 11 Witkin, *Summary of Cal. Law* (9th ed. 1990) Trusts, § 166, p. 1019.
[122] Unif. Trust Act § 506.

sue.[123] The statutes follow this line of reasoning by providing that a trustee cannot be compelled to pay a beneficiary's creditor if the trustee has discretion in making distributions of income and principal.[124]

George and Marilyn may use an irrevocable, spendthrift trust, preferably with discretionary distributions powers conferred on the trustee, to shield their assets. Because the transfer of their assets into the trust may be challenged as a fraudulent transfer, George and Marilyn should consider using a trust governed by Nevada law. Nevada allows for a two-year statute of limitations to challenge the transfer of assets into an irrevocable, spendthrift trust governed by Nevada law.[125]



The following are a few practice pointers to consider.

If a trust is discretionary and the debtor is the trustee, a court may force the debtor-trustee to exercise his discretion to pull the assets out of the trust. Solve that by appointing a third-party trust protector who would be able to fire the debtor as the trustee of the trust, and/or be able to veto any distribution.

If the debtor does not have any family members who may be appointed as the beneficiaries of the trust (to get around the self-settled trust issue), designate the governing law of the state that affords protection to a self-settled trust, and then create a limited liability company owned by the debtor and designate it as the beneficiary of the trust. An-

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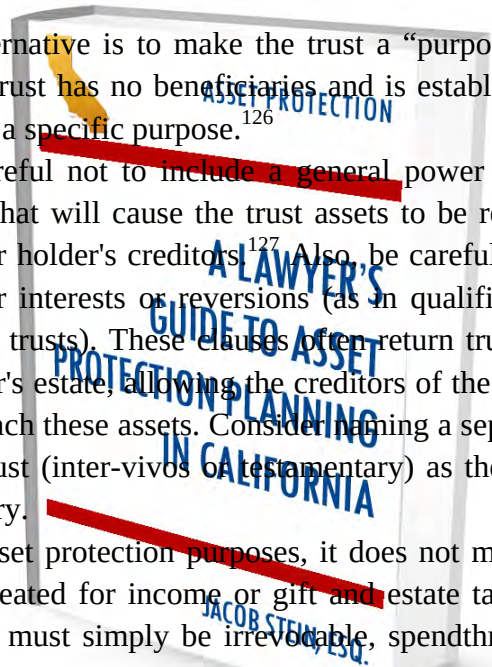
[123] *Magavern v. U.S.*, 550 F.2d 797 (2nd Cir. 1977).
[124] See, e.g., Cal. Prob. Code § 15303(a), Unif. Trust Action § 504(b), Restatement (Second) of Trusts, § 187, Comment E; *U.S. v. O'Shaughnessy*, 517 N.W. 2d 574, 577 (Minn. 1994).
[125] Nev. Rev. Stat. § 166.170.



other alternative is to make the trust a "purpose trust." A purpose trust has no beneficiaries and is established to accomplish a specific purpose.[126]

Be careful not to include a general power of appointment as that will cause the trust assets to be reachable by the power holder's creditors.[127] Also, be careful in drafting remainder interests or reversions (as in qualified personal residence trusts). These clauses often return trust assets to the settlor's estate, allowing the creditors of the settlor's estate to reach these assets. Consider naming a separate irrevocable trust (inter-vivos or testamentary) as the remainder beneficiary.

For asset protection purposes, it does not matter how a trust is treated for income or gift and estate tax purposes. The trust must simply be irrevocable, spendthrift and discretionary. Consequently, in some cases it may be more advantageous to use trusts that are defective for income tax purposes (grantor trusts under IRC § 671) and/or defective for gift and estate tax purposes (transfer to the trust is an incomplete transfer under IRC §§ 2501 and 2036). Commonly used trust clauses to accomplish the above are the power to substitute assets,[128] the power to lend to the settlor without proper security,[129] and a limited power of appointment retained by the settlor.[130]

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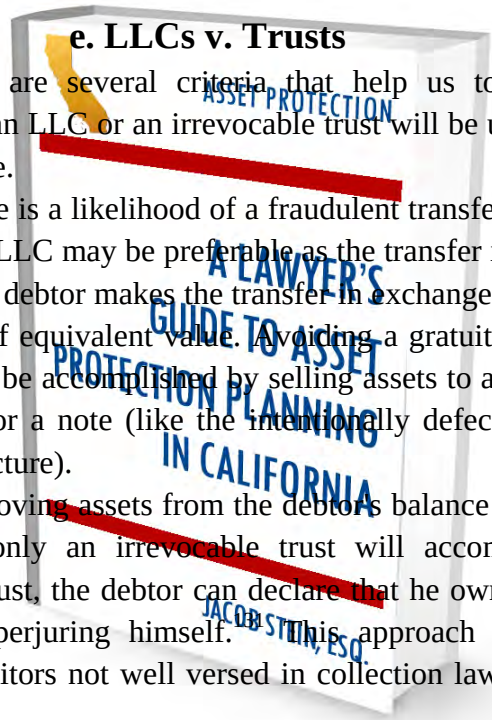
[126] Id. Stat. § 15-7-601; St. Vincent Intl. Trusts Act (1996) § 12(1).
[127] Restatement (Third) of Trusts, § 74, Comment A (PD) (4-2005).
[128] IRC § 675(4).
[129] IRC § 675(2).
[130] Treas. Reg. § 25.2511-2(a), IRC § 2036(a).



e. LLCs v. Trusts

There are several criteria that help us to determine whether an LLC or an irrevocable trust will be used to hold real estate.

If there is a likelihood of a fraudulent transfer challenge, using an LLC may be preferable as the transfer is not gratuitous; the debtor makes the transfer in exchange for an LLC interest of equivalent value. Avoiding a gratuitous transfer may also be accomplished by selling assets to a trust in exchange for a note (like the intentionally defective grantor trust structure).

If removing assets from the debtor's balance sheet is desirable, only an irrevocable trust will accomplish that. With a trust, the debtor can declare that he owns no assets without perjuring himself.[131] This approach works well with creditors not well versed in collection laws and techniques.

When transferring a personal residence using a trust may avoid the due on sale clause.[132]

f. Liquid Assets

Both LLCs and irrevocable trusts may be used to protect George and Marilyn's liquid assets (bank and brokerage accounts). Because liquid assets by definition are fungible, consider setting up the LLC or the trust offshore.

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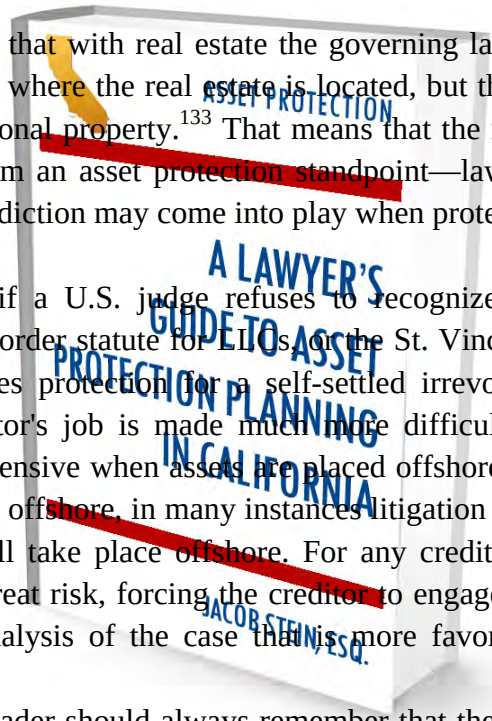
[131] Contrast that with a transfer of assets to an LLC where the debtor changes the asset he owns (*i.e.*, converts real estate into an LLC interest) but still owns some asset.

[132] Garn-St. Germain Depository Institutions Act of 1982 (Pub. L. 97-320).



Recall that with real estate the governing law is the jurisdiction where the real estate is located, but that is not so with personal property.[133] That means that the more favorable—from an asset protection standpoint—laws of a foreign jurisdiction may come into play when protecting liquid assets.

Even if a U.S. judge refuses to recognize the Nevis charging order statute for LLCs, or the St. Vincent and the Grenadines protection for a self-settled irrevocable trust, the creditor's job is made much more difficult and a lot more expensive when assets are placed offshore. When the assets are offshore, in many instances litigation to reach the assets will take place offshore. For any creditor that presents a great risk, forcing the creditor to engage in an economic analysis of the case that is more favorable to the debtor.

The reader should always remember that the goal of asset protection planning is not to set up a structure impervious to creditor claims. Even with an offshore trust holding its assets offshore, the debtor may be directed by the court to return trust assets, and if he fails to do so, hold the debtor in contempt of court.[134] That may happen, but the odds of that happening are very long,[135] and even if it does happen, with the proper structure the debtor will always be able to return the trust assets to the creditor and avoid contempt.

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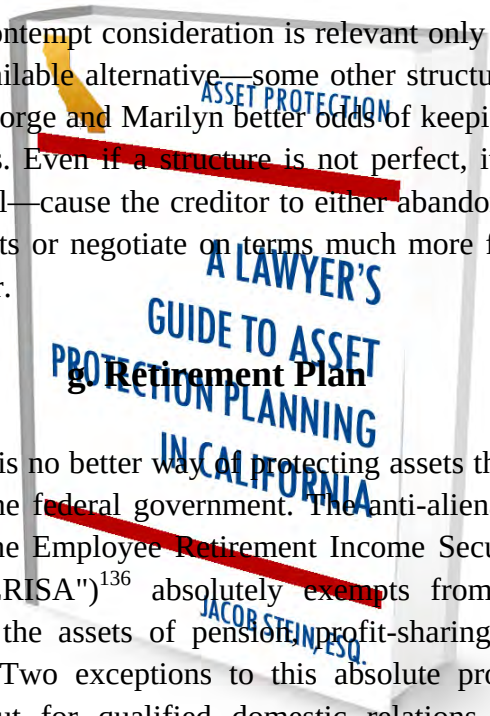
[133] Rest. 2d Conf. of Laws § 280.

[134] See, e.g., *F.T.C. v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999), *In re Lawrence*, 238 B.R. 498 (Bankr. S.D. Fla. 1999).

[135] See this author's analysis of contempt in the context of foreign trust planning in: Stein, Jacob, Importance of Trusts in Asset Protection, Cal. Trusts and Est. Quart. (Winter 2007).

The contempt consideration is relevant only if there is a better available alternative—some other structure that may afford George and Marilyn better odds of keeping their liquid assets. Even if a structure is not perfect, it may—and likely will—cause the creditor to either abandon its collection efforts or negotiate on terms much more favorable to the debtor.



g. Retirement Plan

There is no better way of protecting assets than with the help of the federal government. The anti-alienation provision of the Employee Retirement Income Security Act of 1974 ("ERISA")[136] absolutely exempts from claims of creditors the assets of pension, profit-sharing, or 401(k) plans.[137] Two exceptions to this absolute protection are carved out for qualified domestic relations orders and claims under the Federal Debt Collection Procedure Act.[138]

Because the protection is set forth in a federal statute, it will trump any state fraudulent transfer law.[139]

Protection of ERISA is afforded to employees only and does not cover employers. The owner of a business is treated as an employer, even though he may also be an employee of the same business, as in a closely-held corporation. Accordingly, ERISA protection does not apply to sole proprietors, to one owner businesses, whether incorporated or

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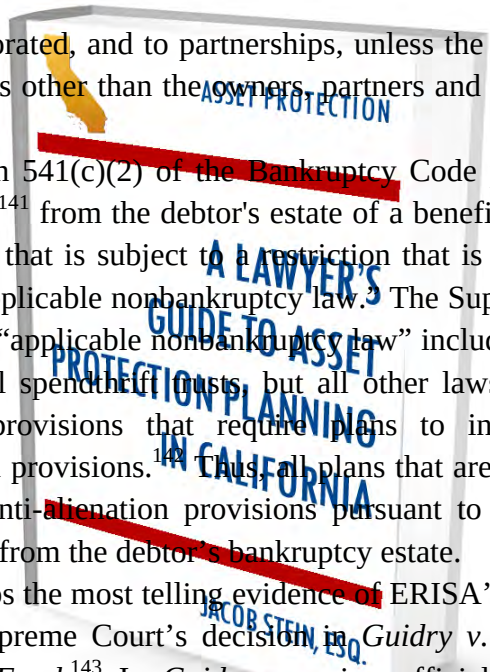
[136] 29 U.S.C. §§1001 *et seq*.
[137] *Raymond B. Yates M.D. P.C. Profit Sharing Plan v. Yates*, 124 S. Ct. 1330 (2004).
[138] 29 U.S.C. §1056(d)(3), 28 U.S.C. §3205.
[139] U.S. Const. art. VI, Par. 2.



unincorporated, and to partnerships, unless the plan covers employees other than the owners, partners and their spouses.[140]

Section 541(c)(2) of the Bankruptcy Code provides an exclusion[141] from the debtor's estate of a beneficial interest in a trust that is subject to a restriction that is enforceable under "applicable nonbankruptcy law." The Supreme Court held that "applicable nonbankruptcy law" includes not only traditional spendthrift trusts, but all other laws, including ERISA provisions that require plans to include anti-alienation provisions.[142] Thus, all plans that are required to include anti-alienation provisions pursuant to ERISA are excluded from the debtor's bankruptcy estate.

Perhaps the most telling evidence of ERISA's protection is the Supreme Court's decision in *Guidry v. Sheetmetal Pension Fund*.[143] In *Guidry*, a union official embezzled money from the union and transferred it to his union pension plan. The union official was convicted of the crime of embezzlement and the union attempted to recover the embezzled proceeds from the pension plan. Other than the fact

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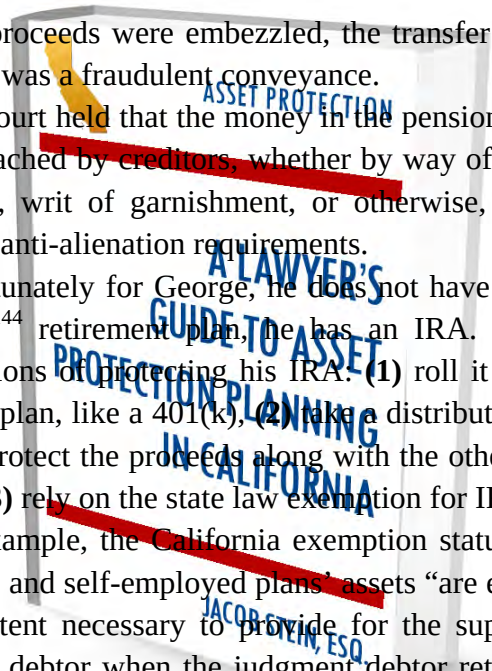
[140] 29 C. F. R. § 2510.3-3(b), 2510.3-3(c); *Giardono v. Jones*, 876 F. 2d 409 (7th Cir. 1989) (sole proprietor denied standing to bring ERISA action); *Pecham v. Board of Trustees, Etc.*, 653 F. 2d 424, 427 (10th Cir. 1981) (sole proprietor is not eligible for protection under ERISA); *In re Witwer*, 148 B. R. 930, 938 (Bankr. C.D. Cal. 1992), aff'd, 163 B. R. 914 (9th Cir. BAP 1993) (debtor's interest in a qualified plan maintained by a corporation of which he was sole shareholder and employee was not protected by ERISA).

[141] An exclusion, as opposed to an exemption, is not limited in amount.

[142] *Patterson v. Shumate*, 112 S. Ct. 2242 (1992).

[143] 493 U. S. 365 (1990).



that the proceeds were embezzled, the transfer to the pension plan was a fraudulent conveyance.

The Court held that the money in the pension plan could not be reached by creditors, whether by way of a constructive trust, writ of garnishment, or otherwise, because of ERISA's anti-alienation requirements.

Unfortunately for George, he does not have an ERISA-qualified[144] retirement plan, he has an IRA. George has three options of protecting his IRA: **(1)** roll it over into a qualified plan, like a 401(k), **(2)** take a distribution, pay the tax and protect the proceeds along with the other liquid assets, or **(3)** rely on the state law exemption for IRAs.

For example, the California exemption statute provides that IRAs and self-employed plans' assets "are exempt only to the extent necessary to provide for the support of the judgment debtor when the judgment debtor retires and for the support of the spouse and dependents of the judgment debtor, taking into account all resources that are likely to be available for the support of the judgment debtor when the judgment debtor retires."[145]

What is reasonably necessary is determined on a case by case basis, and the courts will take into account other funds and income streams available to the beneficiary of the plan.[146] Debtors who are skilled, well-educated, and have

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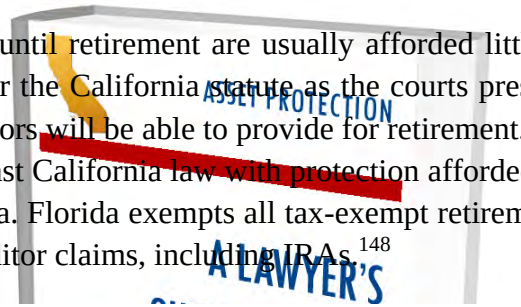
[144] A plan is ERISA-qualified if it contains an anti-alienation provision. IRC § 401(a)(13).

[145] Cal. Code Civ. Proc. § 704.115(e).

[146] *In re Bernard*, 40 F. 3d 1028, 1032–1033 (9th Cir. 1994) (annuity did not meet the reasonably necessary standard for an individual, age 60, who earns in excess of $200,000 a year, where he was also entitled to income from other sources upon retirement, including social security



time left until retirement are usually afforded little protection under the California statute as the courts presume that such debtors will be able to provide for retirement.[147]

Contrast California law with protection afforded to IRAs by Florida. Florida exempts all tax-exempt retirement plans from creditor claims, including IRAs.[148]