Asset Protection:
Avoiding the Landmines

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Jay is one of the four living honorary members of the California Association of Judgment Professionals, the largest organization of judgment enforcers in that state. Jay has taught courses on busting asset protection plans to the U.S. Department of Justice and Internal Revenue Service. As the creator of the anti-fraud website Quatloos.com, Jay has twice appeared as an expert witness before the U.S. Senate Finance Committee.

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CLIENT EVALUATION

NEW CASE INTAKE

Ready to Reject – "I'm Sorry"

A good planner will reject most of those who are seeking asset protection, as unsuitable on one ground or another. The most common ground is that they have existing creditors, but there are many other grounds for rejecting prospective clients, including numerous or recent bankruptcies, criminal problems, financial problems or a history of stiffing creditors, etc.

It is legally wrong to assist clients with planning who are out to cheat existing creditors, spouses, avoid child support obligations, or seek to protect themselves against federally-backed obligations or tax obligations. Clients desiring to do any of these things should be shown the door as quickly as possible.

Questionnaire

An extensive client questionnaire serves several important purposes, including separating the clients who are seriously interested in asset protection from lookie-loos, and documenting the representations the client has made to the planner about the client's situation.

Affidavits

Some planners require that their clients give them so-called Affidavits of Solvency that state the client's financial current financial condition and thereby protect the planner from negative ramifications if it later turns out that the client intended to cheat a creditor. Note that there are questions about the efficacy of such affidavits, but probably no downside in requiring one.

INSURANCE

Insurance is an important part of asset protection planning. For many clients, having adequate insurance will be enough. Especially for clients who are just starting out, insurance will almost always win the cost-benefit test over asset protection.

Insurance does not compete against asset protection. To the contrary, insurance complements asset protection planning. If an asset is protected by insurance, then it is unlikely that the asset protection plan will ever be tested. Insurance also counts towards solvency in many instances, and can make an otherwise defective asset protection plan work.

Likewise, asset protection planning complements insurance. Asset protection planning can protect the client against risks that are excluded from coverage or are in excess of policy limits.

The bottom line is asset protection planning and insurance planning go hand-in-hand.

Review Existing Coverages

One of the first things that we ask prospective new clients about is their existing insurance coverage. There are several reasons for doing this. First, it tells us something about the client; how the client is currently managing their risks. Second, it allows us look for deficiencies in their coverage where we can suggest that they modify or obtain additional coverages so as to better fit the asset protection planning to be done.

Umbrella Insurance

We always ask our prospective new clients whether or not they have personal umbrella insurance, and if they do not than we immediately suggest it to them. Umbrella insurance will cover most of the types of claims that people want asset protection against. Almost as importantly, umbrella insurance will usually go towards a solvency analysis and thus make it less likely that any planning which is done will cause the client to be rendered insolvent.

Suggest Update with Broker

We usually suggest to our clients that they sit down with their property and casualty insurance broker and review their existing policies and coverages. It is unfortunately common that clients will not increase the amounts of their coverage to reflect either inflationary changes or their own increases in wealth. Clients may also have acquired assets were being engaging in conduct that they do not realize are uncovered.

EXISTING CREDITORS

The existence of creditors poses serious and unique problems in asset protection planning. Many planners will simply not deal with clients who have existing claims in creditors. This is not the worst position to take.

Some types of clients, particularly business organizations, will always have some variety of client stage of resolution. Asset protection planning can still be done for these clients safely and effectively, however, extra precautions will need to be taken.

Risk to Client

The client may run the risk of additional liability and litigation costs if the asset protection planning against an existing claim goes bad. For instance, a client may have to spend hundreds of thousands of dollars defending against a client of fraudulent transfer.

Denial of Discharge

The single greatest risk to a client who attempts asset protection planning in the face of an existing client is the denial of discharge in bankruptcy. This means that all the client's nonexempt assets are wiped out, but all the client's existing debts remain. It is difficult to imagine a worse outcome for client insert than a denial of discharge.

Bankruptcy judges are not shy about handing out orders denying the discharge of those debtors who are believed to have engaged in planning with the intent of defeating the legitimate rights of their creditors in the bankruptcy proceeding.

Distressed at debtors are the ones who want asset protection planning the most; however, they are the ones who run the risk of a denial of discharge should they find themselves in bankruptcy.

Risk to Planner

Depending on the state and the circumstances, planners can find themselves on the hook for liability to the creditor. Various theories abound per creditor to attempt to bring the planner into the lawsuit. If nothing else, the creditor may attempt to leverage the planner into turning on the client. This is a common tactic, and creditors considered to have a high rate of success.

Civil Liability - Conspiracy

Many states recognize that a planner they become liable to a creditor of the civil conspiracy theory. A few states, most notably Florida and New Jersey, have rejected such theories.

This is a good place to point out that the planner cannot foretell which state the debtor will be sued in, or where the planner might be dragged in a civil conspiracy theory.

Professional Sanction

In addition to civil liability, the planner can be subject professional sanction, from private reprimand to disbarment. The question here is, "How much is your license to practice worth?" If you assist the debtor in defeating the rights of an existing creditor, your fee ought to be at least this amount or you are underpricing yourself.

Reserve Against Existing Claims

One way that existing claims can be handled is to have the client set aside a reasonable reserve to pay that claim, which reserve is kept outside of the asset protection planning structure. Typically, a letter from the client's litigation counsel in the case that evaluates the amount of the claim will be used to set the reserve. This is where insurance completed important role, because insurance can count against the claim and dramatically reduce the amount that must be set aside in reserve.

STAMINA

It is a great fiction of the creditors hear the words "asset protection" and they run away in fear. Especially when so much bad asset protection abounds, creditors are skeptical that the debtor has done anything that they cannot eventually get through. The upshot of this is that the client who employs asset protection had better be prepared to aggressively litigate the defense of the plan if necessary.

Asset protection planning is only as good as it is defended.

Emotional

Many clients cannot handle the emotional aspects of litigation. These clients are simply not suitable for asset protection planning. If the client is not going to be able to sit through deposition and rationally explain what they have done, their asset protection plan has little chance of surviving. Other clients cannot handle the idea of going to a bankruptcy proceeding, ever these clients as well as a protection planning may be unsuitable.

Creditors will prey of emotional weaknesses of debtors. If the debtor cannot stand the thought of bankruptcy, the creditor will of course attempt to throw the debtor into an involuntary bankruptcy. If the debtor cannot stomach adverse publicity, the creditor will make sure that they get plenty of that.

Financial

Some clients may not be able to fund the aggressive defense of their asset protection plan. For these clients as well, asset protection planning may be inappropriate. Clients should be advised that the aggressive defense of their asset protection plan may cost many tens or hundreds of thousands of dollars. If they are not prepared to bear such a cost if necessary, then they shall each be warned that their asset protection planning may be ineffective.

Some creditors, especially governmental creditors, will prosecute the enforcement of judgments without regard to any cost benefit analysis. The Federal Trade Commission, for instance, has been known to spend millions of dollars in attempting to collect a fine in the hundreds of thousands. Sometimes private creditors will similarly pursue judgments out of spite, or to make an example for other debtors.

MANAGING EXPECTATIONS

The typical asset protection client has an unreasonable expectation about what asset protection accomplishes. This is not surprising considering the plethora of advertisements promising various silver bullet solutions.

One of the most time-consuming but important tasks of an asset protection planner is to re-educate the client about the realities of asset protection planning, explain its limitations, and manage the expectations of the client.

Pay a Reasonable Settlement

It is unreasonable for clients to expect that all creditors will simply hear of their asset protection plan and decide it is too costly to pursue them. Yet, that is probably the expectation of the average asset protection prospective client.

Client should be advised that one of the primary purposes of asset protection planning is to create the opportunity for an early reasonable settlement. This avoids the cost and expense of litigation in defending the asset protection plan, as well as keeps the plan from being tested on any unknown weaknesses. If such an early settlement can be achieved, the client needs be prepared to pay it.

Beware the perspective client who will not pay a reasonable settlement to get out of a case. Those who take a hard line in litigation are most likely to drag themselves down, and take you with them.

Understand Costs of Defense

Clients must understand the potential cost to aggressively defend their asset protection plan. As stated above, if the client is not willing to defend their plan, then they probably should not implement it the first place.

Understand Risks of Litigation

Clients must also understand the risk of litigation. The most perfect asset protection plan ever created is still subject to the errors of the judge. Unfortunately, by the time the error of the judge has been corrected on appeal, the creditor may have invaded the plan and liquidated assets. While the error may be reversed in the law reporters, the debtor may not have any practical remedies.

While I am not generally in favor of offshore planning, I must admit that one of the benefits of offshore planning is that it tends to avoid the errors of US judges. However, for judges to make bad decisions too.

<u>COLLECTIONS VIEWPOINT</u>

INVESTIGATION

Internet

When receiving a new case, one of the first things that a creditor will do is to run an internet search on the debtor. You would be astonished at the things that a creditor can find on a debtor merely by running a detailed search. Such a search can give a creditor a good idea about the personality and wealth of the debtor. Such searches can also turn up specific assets.

For instance, a debtor could tell the creditor that he has nothing, but his Facebook page could show his sitting in his Ferrari or navigating the harbor on his private yacht. A company phone list that has made its way onto the internet could list the debtor's employer. A newspaper story could talk about the sale of a piece of property.

Property Records

Property records provide a treasure of information for creditors. Not only do property records show what the debtor owns now, if anything, but they also give clues to what the debtor has owned in the past.

Grantor/Grantee Index

The most common type of property search is of the grantor/grantee Index. Here, it is helpful if the debtor has owned property in his own name or the name of the spouse. It is also helpful to the creditor if the client has used the family name for trusts and business entities, such as the Sedgewick family limited partnership.

Because of this, we will avoid using the family name for either trusts or business entities. Instead, our tendency is to pick generic names for trusts and entities based on cities names that we randomly find and which have nothing whatsoever to do with the client's circumstances.

Merlin

Many creditors and judgment collection professionals use a commercial database known as "Merlin" as found at www.merlindata.com The Merlin database provides everything from skip trace services to social security numbers to employment information.

Private Investigator

For often no more than a few hundred dollars, a creditor can hire a private investigator to create a dossier on the debtor and his or her activities. Depending on the fee, private investigators can come up with any information, although caution where you know that the services they use have the potential to cross the line.

INITIAL CONTACT AND DEMAND

The creditor has the first opportunity to initiate contact with the debtor and to set the tone of the collection action.

Demand Letter

Many creditors will send out a form demand letter that requests payment. While demanding payment in full, the letter essentially offers to settle the case for some amount less than the full amount before the creditor starts to incur additional costs.

Hit Assets First, Negotiate Second

Other creditors will announce their presence by simultaneously hitting bank accounts, garnishing wages, setting the debtor for examination, and other actions that seek to tie up assets and overwhelm the debtor before a defense can be mounted. One of the goals of asset protection planning is to keep this from happening.

SETTLEMENT

The goal of asset protection planning is to force a settlement. The goal of an aggressive collection action is to force a settlement. So, everybody wants to settle. Indeed, the vast majority of collection actions are resolved by settlement.

It is on the amount of the settlement that the debtor and the creditor will have a sharp disagreement.

No Financials, No Quick Settlement

Creditors will typically not agree to a quick settlement unless the debtor has given a financial statement and vouched for its accuracy under oath. Among other things, this protects the creditor's attorney from claims that the matter was resolved too cheaply.

Of course, the downside to the debtor is that the debtor has to lay out the entirety of his or her affairs to the creditor in advance, and if no settlement is obtained then the creditor will have a roadmap as to the assets that were disclosed.

One of the goals of asset protection planning is to make such a disclosure to a creditor without the creditor being able to gain a litigation advantage, i.e., assets that are not owned by the debtor (because they were transferred elsewhere before the litigation arose) are not disclosed, and the creditor is left to look at either exempt or illiquid assets.

D-DAY APPROACH

Many creditors approach collections by suddenly taking multiple actions against the debtor on a single day, known as "D-Day". Often, D-Day follows a period of significant investigation by the creditor, sometimes by quiet private investigation and research that is unknown by the debtor, and other times by discovery and examination of the debtor (usually accompanied by a "lulling" that the creditor is doing this investigation in anticipation of "closing the file" on the debtor, which of course is the last thing on the creditor's mind).

Levy

Creditors will levy all bank accounts of the debtor. The idea is that by moving suddenly, the debtor will not have the opportunity to remove the money elsewhere. The first that the debtor may know about a bank account levy is when a utility or retailer calls to complain about a bounced check.

Garnishment

Simultaneously, the creditor will attempt to garnish the wages of the debtor (limited to 25% of net wages under federal law). The idea is to financially strangle the debtor quickly, and also deprive the debtor from having the cash flow to retain quality defense counsel.

DISCOVERY

Post-judgment discovery is very different than pre-trial discovery. The debtor has few, if any, rights and certain evidence that might have been excludable from discovery before – such as tax returns – may be discoverable post-judgment.

Discovery can also be used by a creditor to harass the debtor, such as by taking the examinations of the debtor's spouse, employer, banker, business associates, and others – not so much in hopes of gaining information, but to let them know that the debtor is a deadbeat who can't pay his or her judgment.

Debtor Exam

After some period of private investigation, most creditors will have issued and serve on the debtor an Order to Appear (ORAP) for a debtor's examination. The Order may require the debtor to bring to the examination such things as stock share certificates, bank account statements, cancelled checks, and even jewelry and heirlooms.

Debtors examinations are typically taken at the courthouse, and at the conclusion of the examination the hearing offer may direct the disposition of certain assets. Woe be to the debtor who shows up with car keys, as he will probably be taking the cab home.

A good asset protection plan allows the debtor to get through a debtor's examination without having to tell falsehoods, and without the creditor being able to take the knowledge of how the plan was constructed and do anything about it. Considering the "actual intent" test of the Uniform Fraudulent Transfer Act, such planning is extremely difficult but can be done.

Bank Records

Creditor will give meticulous attention to bank records, not only the current balance but what happened to past balances. A wire-transfer to Bank of Ansbacher in the Cayman Islands will of course elicit interest, but so might payments to a mistress – if the client's spouse is so far unaware.

Phone Records

Phone records can provide a wealth of valuable information to a creditor, from information about where the debtor banks, to the debtor's spending habits and hobbies (frequent calls to golf clubs), to the debtor's bad habits that might result in leverage on the debtor.

Tax Returns If Discoverable

Nearly all states allow the post-judgment discovery of tax returns, which usually give the clearest picture of the debtor's true financial condition.

The discoverability of tax returns is one of the downsides to planning that utilizes grantor trusts and disregarded entities, since their activity appears on the tax return of the debtor.

Third-Party Exams

The creditor may also take the examinations of third-parties if the creditor can demonstrate the reasonable likelihood that such third-parties will have information that will lead to the assets of the debtor. Bank officers, spouses, employers, accountants, financial planners, trustees, and other non-attorney planners all can be made to appear and tell what they know about the debtor.

A particularly aggressive attorney may also compel the debtor's asset protection and estate planning attorneys to appear and testify, if nothing else as to non-privileged information such as what entities were created, what trusts were funded, and other such information.

FILE CABINET APPROACH

Some creditors purchase judgments and intentionally forget about them for a number of years. Then, one day they pull the file and start investigating the debtor who may by then be back on his feet financially and have accumulated assets.

SUING PROFESSIONALS

Attorneys

Aggressive creditors may consider suing the debtor's planning attorney, if for no other reason than to try to drive a wedge between the debtor and the attorney. But there are cases where judgments for monetary damages have been entered against attorneys who engaged in egregious conduct to assist the debtor in cheating legitimate creditors.

Some states impose limits on when an attorney can be sued. California, for instance, requires that a creditor that is seeking to sue an attorney on a fraudulent transfer theory must first seek the permission of the court, and must show that the attorney was involved as an actor in the transaction and not merely a drafter of documents.

CPAs and Financial Planners

Non-attorney planners are the favored game of creditors. Not only can they not assert attorney-client privilege, but often their E&O carrier will not pick up the defense of a lawsuit. Creditors anticipate that non-attorney planners will quickly sell out the debtor and give advice and assistance in getting at the debtor's assets, just to get out of the lawsuit themselves.

APPLICABLE LAW

The difficulty of asset protection planning is that it involves many issues that cross many areas of the law. But fundamentally, asset protection is about creditor-debtor law and bankruptcy law. If you are not well-versed in those areas of the law, then you are flying blind.

COLLECTION LAW

Not Governed by Tax Law

A common mistake by many planners is the notion that tax law controls civil law, i.e., that if an LLC has checked the box to be treated as a corporation then it ipso facto must be a corporation for civil law purposes.

Qualified Plans

There are some areas where civil law looks to tax law for guidance, such as when a plan is a "qualified plan" for tax purposes such that it might be exempt under state law the protects such plans.

Disqualifying Events

Note that this means that certain events that could disqualify the plan as a "qualified plan" for tax purposes could then have the same result for civil law purposes.

TAX LAW

Tax law impacts asset protection in several ways. As mentioned, tax returns can act as a veritable roadmap for creditors to follow, or red-flag certain structures or transfers as in the case of offshore accounts and entities.

Restricts Transfers

A good deal of asset protection planning involves the study of the tax implications of the planning. Taxes can act as a barrier to the efficient transfer of an asset if the transfer is by a sale or gift.

CHOICE OF LAW

Asset protection planning often attempts to exploit issues about which laws apply, such as the laws of some state versus those of an offshore jurisdiction.

State-to-State

It is not a given that a state will apply the laws of some other state in the creditor-debtor context. To the contrary, it should be presumed that a state judge will always apply that state's collection laws to a controversy before that judge, without regard to other facts such as where a trust was formed.

Choice of Law Clauses

Planners will attempt to place choice-of-law clauses in their documents, to attempt to gain the laws of the most favorable jurisdiction. Caution against relying on such clauses since creditors will argue that they are not subject to these clauses because they were not signatories to the controlling document.

EXEMPTIONS

After insurance, the debtor's next best line of defense is to take advantage of the statutory protections given to various assets by the state legislature. These are known as the "exemptions" and the protected assets are known as "exempt assets".

A current list is maintained at www.creditorexemption.com

HOMESTEAD

The statutory homestead exemption varies greatly, from a miserly $5,000 in a few states to unlimited in a few other states.

Limitations

Most states impose significant limits on homestead, whether in the value or size of the parcel that is protected. Even in those states where the value of the homestead is unlimited, there can be significant other restrictions to homestead.

Doesn't Apply to Second Homes

The homestead exemption typically does not apply to second homes, vacation homes, and the like. The typical phrase used by the courts is that a person "can only have one homestead". All the states impose at least some form of residency requirement on the homestead.

Little Protection Against Tax Liabilities

State homestead protections are usually not a defense against federal or state tax liabilities. Occasionally, a patriotic creditor will find a way to use tax liability as an offensive weapon, such as threatening to forgive indebtedness (thus creating tax liability) with the idea that the tax authorities can then execute on the homesteaded property. Thus, even if the creditor cannot get past the exemption, the debtor can be displaced from their home.

40 Month in Bankruptcy

The 2005 revisions to the bankruptcy laws saw the introduction of a new 40-month limitation to the homestead exemption. In essence, accretions to value (whether by market forces or the debtor's payments) exceeding $125,000 within 40 months of the date that the bankruptcy petition was filed are available to creditors.

For judgments based on securities fraud, breach of fiduciary duty, and like torts, the limit is $125,000 without regard to time and regardless of contrary state law.

The 40 month limitation keeps "debt birds" (as Naples attorney David Slenn calls them) from moving to a state such as Texas and Florida to dodge creditors by the use of those states' liberal homestead exemptions. Now, a creditor can defeat such attempts by forcing the debtor into an involuntary bankruptcy.

LIFE INSURANCE AND ANNUITIES

The statutory exemptions for life insurance and annuities are among the most confusion and varied of all the exemptions. No logical pattern can be drawn as to explain why some states protect life insurance and annuities in substantial part while other states do not.

Most States Protect Proceeds on Death

Most states give complete protection to the death-benefit proceeds of life insurance that are paid to the beneficiaries of the policy, from the creditors of the decedent. However, such death benefits are usually fair game for the creditors of the beneficiaries.

Cash Value Exemptions Vary Greatly

The exemptions for the cash value of life insurance and annuities are all over the board, from absolutely no exemptions in some states to total exemptions in others, and quite a few states in between offering exemptions for some set dollar amount.

WAGES

Statutory Limitations

Federal law limits the amount of wage garnishment at 25% of weekly net disposable income; however, some states have greater limitations.

QUALIFIED PLANS

Exemptions Vary Greatly By State

The exemptions for qualified plans also vary greatly from state-to-state, from a miserly $20,000 in Arkansas to an unlimited exemption in a majority of states. In between, a few states, most notably California, impose an amorphous and impossible-to-predict "means test" that looks at how much money a debtor will need in retirement, taking into account all circumstances.

Limited in Bankruptcy

Federal bankruptcy law creates a $1 million exemption for IRAs and qualified plans, 11 U.S.C. § 522(d)(12). There is an open and unresolved issue about how rollovers in excess of $1 million may be treated.

The problem with the federal exemption is that you have to be in bankruptcy, i.e., it has absolutely no application whatsoever outside of bankruptcy.

ERISA

29 U.S.C. § 1056(d)(1), commonly known as the "ERISA Anti-Alienation Provision" states that "[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated." This means that the assets in an ERISA pension plan are not available to creditors.

STRUCTURING

CHOICE OF ENTITY

There is no "best entity" for asset protection – that is a myth, no different than somebody claiming that there is a "best color" or "best temperature". What is best for one, may be a disaster for another.

No amount of marketing makes an entity a "best entity". To the contrary, in asset protection planning probably the less an entity is marketed as an asset protection vehicle the better it will be.

Personal Assets – Trusts

Personal assets are for trusts. Avoid putting liability-producing assets ("hot assets") into trusts.

Business Assets – Business Entities

Business assets are for business entities. Avoid putting personal assets into business entities, as this makes them more likely to be disregarded by the courts for liability purposes on alter ego and similar theories.

Business entities are not created by the legislatures to be family piggy banks, and they must usually have a business purpose to survive challenge.

TRUSTS

Trusts are the classic vehicles that have been created by the legislatures for the specific purpose of holding personal assets outside the reach of creditors. Used as intended they are invulnerable to creditors, but too often they are abused and courts in those circumstances look for ways to circumvent their protections.

Domestic

In asset protection planning as it relates to trust planning, the trend in recent years has been to return to the use of domestic trusts.

Revocable

Revocable trusts provide little if any asset protection against the creditors of the settlor.

Treated as Assets of Settlor

For bankruptcy and most other purposes, the assets of a revocable trust are treated as the assets of the settlor.

Creditors May Directly Levy

Most states have provisions in the collection laws that either allows a creditor of the settlor to levy directly on such assets, or they make it easy for creditors of the settlor to invade such trusts.

Where Revocable Trusts Do Provide Asset Protection

After the settlor has passed, such trusts become irrevocable and thus protection is afforded for the trust assets to the beneficiaries of such trusts from their creditors, assuming the trust has a valid spendthrift provision or spendthrift protection is given by statute, and distributions are not mandatory, etc.

Irrevocable

Irrevocable trusts have been the classic asset protection tool for many centuries. In fact, the first landmark fraudulent transfer case, Twyne's case decided in 1601, involved a transfer to an irrevocable trust that was meant to defeat Twyne's creditors.

Once assets are properly in an irrevocable trust, they are no longer exposed to the creditors of the settlor, nor if drafted properly are they exposed to the creditors of any beneficiary. The assets are then only exposed to creditors of the trust itself – which usually isn't a concern since most trusts do not engage in liability-creating activity.

Not Immune to Fraudulent Transfer Claims

While the assets within an irrevocable trust may be protected from creditors, a transfer to such a trust might still be unwound as a fraudulent transfer if the challenge is made while the Statute of Limitations (usually 4 years) is still open.

Tax Consequences of Transfers to Irrevocable Trusts

Gifts and sales to irrevocable trusts can trigger various taxes. Additionally, irrevocable trusts are normally subject to "compressed" income tax rates where the highest bracket is reached at only $11,150. While the latter can be mitigated through the liberal use of life insurance products, the former often requires that the trust be structured as a grantor trust for tax purposes, a/k/a an "intentionally defective grantor trust" (IDGT).

Indeed, some of the more advanced forms of trusts used for asset protection include trusts that are formed by third-parties for the benefit of the client, who though a beneficiary of the trust is its "tax grantor", a/k/a the "beneficiary-taxed irrevocable trust" (BETIR Trust).

Self-Settled Irrevocable Trusts

The laws of most states provide that if a trust is self-settled, i.e., a person created the trust for their own benefit, then the spendthrift beneficiary protection of such a trust will not be effective.

Domestic Asset Protection Trusts

A few states have eliminated the self-settled trust limitation and protect the assets of such irrevocable trusts from the creditors of the settlor/beneficiary; these are known as "Domestic Asset Protection Trusts" (DAPTs).

A detailed discussion of such trusts is beyond the scope of this paper. Suffice it to say that there are substantial and well-reasoned arguments why such trusts will work, and why such trusts will not work, but that no court opinion has yet (as of the writing of this paper) validated or disproved these arguments.

Note that the 2005 changes to the bankruptcy code created what amounts to a 10-year clawback for "self-settled trusts and like devices", which some have argued effectively increases the fraudulent transfer Statute of Limitations to 10 years for such trusts.

Qualified Personal Residence Trusts

Some planners advocate the use of the Qualified Personal Resident Trust (QPRT) for asset protection planning. If used sufficiently in advance of creditor problems so that no fraudulent transfer argument can be made, the QPRT will be effective against most creditors.

A sophisticated creditor might, however, claim that the debtor's retained interest in the QPRT makes it a self-settled trust to the extent of the term, and thereby foreclose on that interest and lease the house out for the period.

Foreign

A detailed discussion of the Foreign Asset Protection Trust (FAPT), a/k/a "Offshore Trust", is beyond the scope of this paper. Suffice it to say that while such trusts have a powerful deterrent effect against most creditors, against the creditors who have taken aggressive courtroom action the results have at best spotty.

FAPTs are best utilized for the client who has significant family or business activity overseas and can justify the use of such a trust for something other than asset protection, i.e., international estate planning. Thus, an FAPT might not be suitable for the average American-born surgeon having neither family nor commercial interests abroad, but perfect for his Indian-born colleague who still has most of his family in Mumbai.

BUSINESS ENTITIES

Business entities – corporations, partnerships, and limited liability companies – are created by the legislatures for the very purpose of asset protection for the innocent investors against the liabilities creating during the operations of these entities.

Unfortunately, in recent years business entities have been misused and abused to attempt to accomplish purposes for which the legislatures never intended, including serving as the family piggy bank or wealth-transfer vehicle.

Generic Problems

Business entities will usually fail to provide protection where they are not carrying on a bona fide commercial venture.

In certain circumstances, investors can become liable to creditors of the entity, such as where the entity was inadequately capitalized in relation to its activities or where was improperly wound up.

Alter Ego / Veil Piercing

Business entities have proven to be quite susceptible to alter ego claims, i.e., the concept that the entity and its owner are in reality just one and the same.

Alter ego is relatively easy to prove in the case of a wholly-owned corporation or a single-member LLC, which is why such structures are usually to be avoided in asset protection planning. On the other hand, it is nearly impossible to prove alter ego against a minority owner. In between these two extremes, the totality of the facts and circumstances will dictate whether or not the entity stands up.

How much interest in a business entity is too much? 99%? 98%? 95%? 90%? Nobody knows, or can know in advance.

Regardless of the percentage, it is probably more important that the majority interest be a passive interest, i.e., having no voting authority or management rights. A 99.99% non-managing member has little risk of being deemed the alter-ego of the entity; a managing member almost certainly will be.

External Liability - Stakeholder Liability

The assets of an entity are typically not exposed to the claims of creditors of its investors.

Reverse Alter Ego

Recently, the courts of some states have recognized the theory of "reverse alter ego" to make the assets of the entity available to the creditors of the entity's owners. The courts of other states have rejected this theory.

Even where "reverse alter ego" is recognized, the tendency of the courts seem to be get away from the "reverse" analysis and instead say that there is but a single theory of alter ego that swings both ways.

Entity No Shield to Personal Acts

No entity can shield a person from the liability arising for their personal acts. Thus, real estate investors will purchase rental properties in the names of LLCs, but will keep personally managing the properties. If a water heater that they should have replaced explodes they will be personally liable for negligence notwithstanding the ownership of the property by the LLC.

Additionally, the laws of most states prevent professionals from shielding their liability by way of a professional entity.

Illegal Aliens

For an entity to conduct business in a state, including holding title to real property in the state, the corporation should be qualified with the Secretary of State's office to conduct business. An entity that is doing business in a state in which should be qualified to do business, but has not, is known as an "illegal alien".

An unqualified entity can cause unpleasant surprises in planning, such as that title to property held in such entity may be clouded or that in-state shareholders may be exposed to liability until the entity is qualified.

Corporations

Corporations have been the primary business asset protection tool for many hundreds of years. For example, the Swedish mining giant Stora Company issued its first share in 1288 and is still doing business today.

Shares Available to Creditors

For modern asset protection planning, corporations are only rarely used. The problem with corporations is that the debtor's stock shares are subject to – depending on the state – turnover orders, garnishments, and levies, with the end result being that the corporate shares are sold at a sheriff's auction and the proceeds are used to pay creditors.

Charging Order Protected Entities – Partnerships and LLCs

The shareholders of a corporation elect the directors, who elect the officers, who run the company, and thus theoretically there are two layers of distance between a creditor who acquires stock in the corporation and the running of the corporation.

By contrast, the partners directly run a partnership and the members directly run an LLC. Thus, a creditor of a partnership or LLC poses a special problem since the non-debtor partners and members do not want somebody else's creditor to work with them in the business.

The legislatures have thus created a unique remedy for the creditors of partners or members, known as a "charging order". In most states, the charging order is the only remedy available to creditors.

Note here that "exclusive remedy" restriction only means that the charging order must be used in lieu of other remedies such as levy, garnishment, turnover orders, etc. It does not mean that creditors cannot employ other theories, such as fraudulent transfer or alter ego, to get at the assets in the partnership or LLC.

Charging Order Mechanics

A charging order is heard on by way of a noticed motion, and cannot in the vast majority of states simply be issued by an officer of the court.

Creates Lien on Filing

In some states, such as California, the mere filing of the motion for charging order creates a lien on the partnership of membership interest until the motion is heard. This keeps the debtor from assigning the interest elsewhere prior to the hearing.

Permanent Lien When Order Granted

If the charging order motion is granted, then a lien is created on the debtor's partnership or membership interest. More accurately, the lien is on the debtor's economic right to distributions from the partnership or LLC.

Ancillary Provisions

The creditor may be able to have provisions added to the charging order that would prevent loans from being made by the entity to the debtor, fees paid to the debtor, and other provisions to stop the entity from circumventing the charging order. There are no rules here: These provisions are limited only by the creativity of the creditor in thinking them up, and persuasiveness of the creditor in getting the court to add the language.

Who Gets the K-1?

Some asset protection planners claim that the creditor who obtains a charging order on the interest should become liable for the taxes on the debtor's share of any "phantom income" generated by the partnership.

As noted above, the charging order only causes a lien to be placed on the debtor's economic rights to distribution. The debtor remains liable for any tax consequences. If the creditor receives money pursuant to a charging order, the creditor pays tax on that money just like any other money received from a debtor.

Foreclosure

Again, a charging order is a lien, and like any lien can be foreclosed upon (except in the states that expressly prohibit such foreclosure). Note that the foreclosure is of the lien on the debtor's economic right to distributions, i.e., the creditor takes in foreclosure only the right to distributions and not the partnership or membership interest itself, and no voting rights, no rights to participate in management, etc.

Receivers

Some charging order statutes specifically empower the court to appoint a receiver to make sure that the charging order is enforced; the courts of other states will appoint a receiver according to the general receivership statute for the same purpose.

Prevents Upstream to Parent

One effect of a charging order is that a subsidiary of a debtor cannot "upstream" profits to the debtor parent. Thus, an enterprising creditor can use charging orders to choke off the cash flow within a business organization.

Partnerships

LLCs are used in preference to partnerships for the simple reason that LLCs do not require a general partner who is generally liable for the acts of the entity. However, state taxes or local licensing issues sometimes require that partnerships be used instead of LLCs.

General Partner

General partners are of course generally liable for the liabilities of the partnership. If the partnership is merely a passive holder of assets, then it is unlikely to generate any liabilities and this will not be a concern. But if the partnership is actively managing real estate, operating businesses, etc., then it is more of a concern.

Typically, a corporation or LLC is formed to act as the general partner, which entity is usually referred to as the "management company". The best practice is to have this entity owned by a simple irrevocable trust that has no other assets.

The worst practice is to have the management company owned by a revocable trust, which also owns the limited partnership interests. In such a case, a creditor may be able to take control of the general partner and collapse the limited partnership.

Limited Liability Companies

LLCs have the benefit of not needing a general partner that is generally liable for the obligations of the entity. This does not mean, however, that asset protection planning with LLCs is easy.

Personal Liability of Member

An LLC does not shield a person from their personal liability created by their personal acts. Thus, if a person wants the LLC to shield them from many types of liability, they need to be a purely passive investor in the LLC and not involved in its day-to-day operations.

Passive Interest in Bankruptcy - Ehmann

The problem with a passive interest in an LLC that it may give creditors in a bankruptcy proceeding the ability to invade the LLC and take out assets equal to the debtor member's share. See *In re Baldwin*, 2006 WL 2034217 (10th Cir.BAP (Okla.), July 11, 2006); *Movitz v. Fiesta Invs*. (*In re Ehmann*), 319 B.R. 200, 204 (Bankr.D.Ariz.2005) (Opinion withdrawn as condition of settlement in favor of creditor). Thus, a good operating agreement will give every member some duties that must be performed as a precondition to receiving distributions, so as to avoid this potential problem.

Single Member LLC (Albright Problem)

As mentioned, a purpose of charging order protection is to keep the non-debtor members of an LLC from being forced into business with the creditor of the debtor member. Where there is only one member, this protection doesn't make any sense.

So held the court in *In re Albright*, No. 01-11367 (Colo. Bkrpt. April 4, 2003), which allowed a bankruptcy trustee to invade a single-member LLC where the sole member was the debtor.

S-LLC

An LLC may "check the box" to be treated as a corporation, and then having done so may make an S-election like any other corporation for tax purposes. The benefit of an LLC over a tradition S-corporation is that a creditor cannot take the shares of the stock in the LLC like a creditor could with an S-corporation, but is instead restricted to a charging order.

Series LLC

A number of states have enacted legislation providing for the so-called "Series LLC", which allows for different series of membership interests having different rights and creating different liabilities. The Series LLC allows for the LLC to be structured similar to a honeycomb, with each cell having its own assets, and the liabilities of each cell being contained – at least in theory – away from the liabilities of every other cell.

While the Series LLC is conceptually a neat idea having many applications for venture capital funds, hedge funds, and other advanced financing vehicles, it is unfortunately overused and probably abused on the low-end by people to try to save money setting up a single LLC instead of multiple LLCs to own investment real estate.

Problems with the Series LLC include that series legislation has been adopted in relatively few states (though this will change in coming years), and that there no true uniformity between the series acts.

Brave – foolhardy is more like it – is the planner who attempts to use a Series LLC for asset protection in a state that has not yet adopted Series LLC legislation. Even more foolhardy is the planner who attempts to use a Series LLC at all without fully understanding the ramifications of the particular state's act and having a carefully thought-out operating agreement.

TRANSFERS

If structures are the hard nodes that cannot be moved, then transfers are the soft wiring that connects such nodes.

Arguably, transfers are more important than structures. If a transfer is good, then the creditor may not be able to get past it to even be able to challenge a structure. If a transfer is bad, the creditor may be able to reverse it out of the structure as a fraudulent transfer.

Yet, nearly all the academic discussion about asset protection planning is about the latest and greatest structures, and very little discussion is had about the most effective and efficient forms of transfer.

FRAUDULENT TRANSFERS

The creditor's main weapon against an asset protection plan is the Uniform Fraudulent Transfer Act (UFTA).

While many planners have a general idea how the UFTA works, it is fraught with danger for those who have not spent the time to study its intricacies.

Intent to Hinder, Delay or Defraud Creditors

The primary fraudulent transfer test is one of intent, with the presumption being that a distressed debtor will lie about the intent so therefore the transaction should be viewed in light of all pertinent circumstances.

Note that the transfer is not required to be successful in cheating the creditor out of the asset. If the transfer merely delays the creditor in collecting, that is enough for a finding of fraudulent transfer.

Aimed At Existing Creditors

While a few outlier opinions discuss transfers that were fraudulent even though no creditors existed at the time, the vast majority of cases have required that the transfer occur at a time when the transferee had a creditor, even if not necessarily the same one that ultimately complained about the transfer.

Most Common Analysis

The various tests to determine what is a fraudulent transfer is beyond the scope of this paper. Suffice it to say that a fraudulent transfer is one that is intended to defeat or delay the ability of a creditor to collect against the transferred asset, and that intent can be inferred from the circumstances even if vociferously denied by the parties to the transfer.

The vast majority of cases where a fraudulent transfer was found had two elements:

(1) The transfer was "without reasonably equivalent value", usually meaning that it was either a gift, or it was a sale at a silly price; and

(2) The transfer caused the debtor to be insolvent taking into account all debts (unless the debtor was already insolvent, in which case only the first element need be tested).

Statute of Limitations

Most states follow the UFTA's limitations periods and strictly construe that period to start on the date of "transfer".. However, California interprets its UFTA to mean that the Statute of Limitations does not begin to run until there is a judgment, which could of course be long after the transfer. Thus, California has a unique statute that extinguishes UFTA claims made more than seven years after the transfer was made – and some planners would say that this is the effective UFTA limitations period in the Golden State.

4 Years from Date of Transfer

The typical UFTA limitations period is four years from the date of the transfer.

1 Year from Discovery

An alternative UFTA limitations period that is effective in some circumstances is one year from the date the transfer was discovered, or reasonably should have been discovered by the debtor.

GIFTS

While gifts and gifting play an important role in estate and charitable planning, they typically play little role in asset protection planning.

No Reasonable Equivalent Value

The first problem with gifts is that they inherently lack "reasonably equivalent value", which is one of the most important tests for a fraudulent transfer.

Decreases Solvency

The second problem with gifts is that – because the donor is not getting anything back in return – they tend to decrease the solvency of the donor, which is also one of the most important tests for a fraudulent transfer.

Planning with Gifts

One method of making gifts so that it does not negatively affect the asset protection plan is to first sell the asset that will be gifted into an asset-protected structure, and then have that structure make the gift.

SALE

The best method of transferring assets for asset protection purposes is by way of a bona fide sale for value.

Has Reasonable Equivalent Value

Unlike a gift, a sale has reasonably equivalent value thus making it impossible for a creditor to meet this important test under the UFTA.

Replaces, Not Decreases, Value on Balance Sheet

Unlike a gift, a sale does not decrease solvency, but rather replaces on the balance sheet the asset transferred with whatever was paid for it. Thus, a creditor cannot meet this important test under the UFTA either.

Tax Difficulties

The difficulty with a sale is that it could generate potential income or capital gains taxes, depending on a variety of factors.

Tax-Free Exchange

One method of transferring assets from an operating entity to a holding entity is by way of the so-called tax-free exchange, whereby the asset is given in exchange for stock or LLC units.

Sale to Irrevocable Grantor Trust

In recent years, sales to irrevocable trusts that are taxed as grantor trusts have become a popular asset protection tool.

LIENS

Creditors can only take whatever equity is available in an asset. Assuming that a lien is based on a bona fide obligation, the existence of a valid lien could deter or thwart a creditor.

EQUITY STRIPPING

Equity stripping involves placing an asset as collateral for a loan, and allowing the lender to take a security interest against the asset. If the loan balance exceeds the value of the asset, then the asset has no value to creditors.

Sale by Creditor

An aggressive creditor might cause an asset to be levied up and sold at auction, even if all the money goes to the lender, just to deprive the debtor of its use.

Subordination of Lien Priority

There are various ways for creditors to jump into lien ahead of a lender, particularly where the creditor can show collusion between the debtor and the lender to deprive the creditor of his ability to collect on the judgment.

The UCC can provide also cause the lien priorities to be changed much to the lender's surprise, especially in regard to revolving credit facilities and advances.

BOGUS LIENS

Naked UCC-1 Filings

Some (bad) planners advocate the creation of LLCs that are then used to make UCC-1 filings on all the debtor's assets. Liens are only as good, however, as the underlying obligation. Where the holder of the UCC-1 filing cannot show that the underlying obligation was valid, i.e., that money actually changed hands, the lien created will not be enforceable as against the creditor.

Note that the use of this strategy could very well be conduct that would cause a bankruptcy court to deny the debtor's discharge.