Estate Planning

Through an

Asset Protection Lens

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ASSET PROTECTION PLANNING

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I. INTRODUCTION

A. The Current Litigation Environment Creates Greater Exposure to Risk of Loss Than Ever Before:

1. Expanded theories of liability

2. Higher and higher jury awards

3. Unpredictable judges and juries

B. Traditional Forms of Protection Have Become Inadequate

1. Insurance

a. Exclusions

b. Policy limits

c. Solvency of insurer

d. Policy lapses

2. Incorporation

a. Piercing the corporate veil

b. New theories of shareholder/officer liability

C. Candidates for Asset Protection Planning

1. Professionals

2. Corporate officers and directors

3. Fiduciaries

4. Real estate owners

5. Individuals exposed to lawsuits arising from claims alleging negligent acts, intentional torts (i.e., discrimination, harassment, libel, etc.), or contractual liability

6. Individuals seeking a prenuptial alternative

D. Asset Protection Is Not New

1. Incorporation of business activities

2. Formation of LLC's, LLP's, LP's

3. Offshore trusts have been long used to avoid forced heirship and expropriation

4. Exemption and pre-bankruptcy planning

E. Asset protection is part of an overall wealth preservation process including:

1. Financial planning

2. Insurance planning

3. Income tax planning

4. Estate tax planning

II. FRAUDULENT TRANSFER ISSUES

A. Every asset protection plan must account, in the very first instance, for the law of fraudulent transfers. In general, the law of fraudulent transfers, which dates back to the enactment of the Statute of Elizabeth in England in 1571, provides that the transfer of assets in anticipation of a creditor problem will be disregarded by the courts and the creditor will be allowed to enforce its judgment against the transferee of the property.

B. Although minor variations exist, fraudulent transfer statutes can be found under the law of every state and almost all foreign jurisdictions, as well.

C. A fraudulent transfer is often deemed to be a transfer of property that was made with the intent to "hinder, delay or defraud" either existing or reasonably anticipated future creditors. Common law usually divides creditors into three categories:

1. Present creditors - those persons of whom the transferor has notice when making transfers.

2. Subsequent creditors - those persons against whom the transferor harbored an actual fraudulent intent when transferring assets, including creditors whose rights arose after the transfer if the transferor intended to proceed with his or her affairs in a fraudulent manner or with reckless disregard for the rights of others.

3. Potential future creditors - those nameless, faceless persons of whom the transferor had no awareness when the transfer was made.

D. In addition, a transfer which has the effect of rendering the transferor insolvent will automatically be held a fraudulent transfer.

E. Moreover, in certain jurisdictions, the mere fact that one has been named as a defendant in a lawsuit can render all transfers made without sufficient return consideration as *per se* fraudulent transfers irrespective of the transferor's actual intent in making the transfer.

F. Under all other circumstances, however, the issue remains the transferor's intent in effecting the transfer, which generally boils down to how close in time the transfer of property was to the subsequent creditor claim.

1. It is notable that, except as specified hereinabove, it is unimportant whether or not a creditor's claim has yet coalesced into a lawsuit (which, of course, might be months or years later).

G. It is, therefore, absolutely imperative that asset protection planning be undertaken as far in advance of a potential creditor claim as possible in order to ensure that any transfer of property incident to such plan is not later undone as a fraudulent transfer.

III. TRADITIONAL FORMS OF ASSET PROTECTION

A. Transfers to spouse - "Poor man's" asset protection

1. Potentially effective (assuming it is not later deemed a fraudulent transfer).

2. Numerous problems exist, however, in connection with transfers to a spouse, including:

a. Possibility of divorce

b. Spouse's potential exposure to creditors

c. Loss of control over assets

d. Potential gift tax consequences where spouse is not a U.S. citizen

e. Estate tax issues (i.e., transferor spouse should retain in his/her own name assets at least equal to exemption amount).

B. Corporate ownership

1. In the usual case (absent a personal guarantee of corporate obligations), a shareholder will not be personally liable for the debts of the corporation and thus, the shareholder's personal assets are protected from the creditors of the corporation.

   a. This type of protection is referred to as "inside out" protection because the shareholder's personal assets (which are outside of the corporation) are protected from the corporation's creditors (whose claims arose inside of the corporation's business dealings).

   b. The inside out protection is not absolute.

      - In the case of a closely held corporation, a plaintiff's attorney is likely to join the shareholder (in the shareholder's capacity as a corporate officer or director) in the action.

      - The protection may also be breached via statutory and/or common-law arguments including an argument to "pierce" the "corporate veil" due to a failure to consistently observe the formalities of the corporate form.

2. The reverse, however, is not also true, and if the shareholder is sued personally, the shareholder's interest in the corporation (in the form of his or her shares) will be reachable by the judgment creditor and, in the case of a sole or even a majority shareholder, a personal creditor would be able to reach the assets of the corporation in satisfaction of a judgment through the liquidation of the corporation following execution on the shares of the shareholder.

C. Limited Partnerships and Limited Liability Companies

1. The asset protection afforded by the limited partnership or limited liability company structure is based upon what is commonly known as a "charging order" protection.

   a. Under the law of every state it is arguably the case that if the limited partner or limited liability company member is successfully sued his or her creditor would only be entitled to a lien on the limited partnership interest or limited liability company membership interest, and would not be entitled to enforce its claim directly against the underlying assets of the limited partnership or limited liability company.

b. In addition, the creditor's charging order may not necessarily entitle the creditor to become a limited partner in the limited partnership, or a member in the limited liability company, entitle the creditor to vote on limited partnership or limited liability company matters, entitle the creditor to inspect or copy limited partnership or limited liability company records, or entitle the creditor to obtain the business and tax information of the limited partnership or limited liability company (which is usually available to limited partners and limited liability company members as a matter of law).

c. The sole entitlement of a creditor with a charging order is, arguably, the right to receive the distributions that are allocable to the debtor limited partner from the limited partnership, or the debtor member from the limited liability company, if and when distributions might be made.

- The creditor's "remedy" of being able to receive distributions from the limited partnership or limited liability company if and when distributions might be made may ultimately prove hollow in a "family" limited partnership, or "family" limited liability company situation, since it is unlikely that the general partner or manager will distributions while a charging order is outstanding.

- A limited partnership agreement or limited liability company agreement drafted for asset protection purposes will provide the general partner, manager or managing member with broad discretion to make, or to refrain from making, distributions from the limited partnership or limited liability company.

2. Under the tax law there is some authority to the effect that the taxable income of the limited partnership or limited liability company will be chargeable to the creditor who has obtained a charging order notwithstanding the fact that no distributions may ever actually be made to the creditor.

a. Therefore, the effect of a charging order might be that the creditor will be forced to realize "phantom" income on which the creditor would have to pay income tax on a current basis.

b. There is substantial doubt, however, as to whether the creditor will, in fact, actually be charged under the tax law with phantom income by reason of the charging order. In fact, it is at least as likely that, notwithstanding the charging order, the limited partner or limited liability company member will be liable to report the

c. Even if phantom income were realized by the judgment creditor, all of the remaining non-debtor partners would at the same time also be realizing phantom income with respect to their own limited partnership or limited liability company interests and, therefore, they might force a distribution to be made, thereby negating any leverage that the debtor might otherwise have *viz a viz* his or her creditor.

3. There is substantial uncertainty in most states as to whether or not the courts will consider a charging order as the sole and exclusive remedy available to a creditor.

4. Even where the charging order might be held to be an exclusive remedy to the creditor, a sale of the limited partnership interest or limited liability company membership interest may still be allowed where the creditor can demonstrate to the court that monies that might be collected pursuant to the charging order (if in fact, any are ever collected), will likely be insufficient to satisfy the creditor's judgment in a reasonably timely manner.

5. Alternatively, it might be argued by the creditor that the limited partnership or limited liability company should be deemed to be an "alter ego" of the debtor. Such an argument might be made, for example, where:

   a. The limited partnership or limited liability company lacks any real business purpose.

   b. The limited partnership or limited liability company is funded with an excess of personal use assets.

   c. There has been a pattern of non-adherence to the legal formalities attendant to the limited partnership form or limited liability company form.

   d. The interests of the other limited partners or limited liability company members in the limited partnership or limited liability company are inconsequential relative to the debtor's limited partnership or limited liability company interest.

D. Joint ownership of property - Tenancy by the Entireties

1. A tenancy by the entireties is a special form of joint ownership of property that can only exist between a husband and wife. In some states, only real estate can be held in a tenancy by the entireties form. In other states, personal property may also be held as tenants by the entirety.

2. A tenancy by the entireties is characterized by five coincident unities: unity of possession (joint ownership and control); unity of interest (the interests must be the same); unity of title (the interests must originate in the same instrument); unity of time (the interests must commence simultaneously); and the unity of marriage.

   a. The unity of possession has the effect of requiring a husband and wife to act together to convey title to tenancy by the entireties property, thereby generally precluding a unilateral severance.

   b. As a result, in those states that follow the common law rule, the creditor of only one spouse cannot execute upon property held as a tenancy by the entireties.

   c. Property which is exempt from creditors by reason of a tenancy by the entireties under state law will also be exempted from an estate in bankruptcy.

3. No asset protection is afforded by a tenancy by the entirety, however, where:

   a. There is a divorce.

   b. In the event of death of the non-debtor spouse.

   c. The creditor is a joint creditor of the two spouses.

   d. The real property is sold and the governing state law provides that only real estate can be held as a tenancy by the entireties.

4. In addition, the asset protection afforded by husband and wife holding title to property as tenants by the entirety is frequently at odds with the couple's estate tax planning, since proper estate tax planning often requires that the joint estate be divided between the spouses for purposes of estate equalization or so as to ensure that each spouse's estate can make maximum use of the applicable exclusion amount.

E. Exemption planning

1. Homestead

   a. One asset that is frequently granted an exemption from creditors' claims is an individual's principal residence. This exemption is most often referred to as a "homestead exemption."

b. The fairly obvious legislative purpose behind the enactment of a statutory homestead exemption is the preservation of that asset most necessary for the subsistence of an individual and his or her dependents – their home.

- In fact, so significant is the family homestead deemed to be to one's subsistence that forty-eight of the fifty states provide at least some level of exemption for an individual's principal residence. Only New Jersey and Pennsylvania provide no exemption.

- Only Florida, Iowa, Kansas, Oklahoma, South Dakota and Texas, plus the District of Columbia, provide for a so-called "unlimited" homestead exemption.

  - Even where the homestead exemption is unlimited, this does not necessarily also mean that the exemption is unqualified – for example, certain specially protected classes of creditors (i.e., the Internal Revenue Service or an ex-spouse), might be permitted to avoid this exemption and enforce a judgment against the home.

c. In order to maximize use of the homestead exemption, one might consider moving, subject to the time requirement of the Bankruptcy Code for establishing residency in that jurisdiction, to a jurisdiction that allows a more generous or even an unlimited homestead exemption.

- The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act imposed restrictions upon the homestead exemption in a Bankruptcy case. Most significantly, §522 of the Bankruptcy Code now imposes an aggregate monetary limitation of $125,000 (subject to adjustment for inflation and currently $146,450), on the value of property that the debtor may claim as exempt under state or local law under certain circumstances - most significantly, where the debtor acquired such property within the 1,215-day period preceding the filing of the petition.

d. Alternatively, where one is already domiciled in such a jurisdiction, or even where one wants to make the best use of the limited homestead exemption available in one's current jurisdiction, one might pay down one's mortgage, improve one's home, or purchase a larger, more expensive home, in furtherance of one's asset protection plan.

2. Retirement Plans and IRAs

a. A retirement plan that is "qualified" under the Employee Retirement Income Security Act of 1974 (ERISA) is protected from the plan participant's creditors pursuant to the 1992 decision of the U.S. Supreme Court in *Patterson v. Shumate*.

- In that case, the Supreme Court ruled on the issue of whether the legally required anti-alienation provision contained in every ERISA qualified pension plan caused the participant's interest therein to fall within the exclusion from the bankruptcy estate provided under § 541(c)(2) of the Bankruptcy Code.

    - Section 541(c)(2) of the Bankruptcy Code excludes from the bankruptcy estate all property subject to a restriction on transfer which is enforceable under "applicable nonbankruptcy law." Although the trustee contended that the term "applicable nonbankruptcy law" was limited to state law, the Supreme Court, resolving a conflict among the circuits, held that the term "applicable nonbankruptcy law" as used in that section of the Bankruptcy Code, in fact, encompassed any relevant nonbankruptcy law including federal nonbankruptcy law such as ERISA.

b. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, amended the Bankruptcy Code to provide protection for IRAs.

- Prior to the effective date of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, IRAs established under § 408 of the Internal Revenue Code were not necessarily deemed the equivalent of an ERISA-qualified plan and, as a consequence, were not automatically afforded any creditor protection under the Supreme Court's holding in *Patterson v. Shumate*.

c. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, amended § 522 of the Bankruptcy Code to permit a debtor to exempt certain retirement funds to the extent those monies are in a fund or account that is exempt from taxation under §408 or §408A. The exemption is subject to a $1 million cap (subject to adjustment for inflation and currently $1,171,650), however, on the value of the debtor's interest in an IRA established under either §408 or §408A.

- This limit applies without regard to amounts attributable to rollover contributions and earnings thereon.

- The cap may be increased if required in the interests of justice.

d. Inherited IRAs, however, may well be treated differently.

- With one exception, the authority that exists on this point has generally held that an inherited IRA is not protected from creditor claims under *state* exemption law. The courts so holding have cited to the following factors in favoring a rule whereby an inherited IRA is available to the beneficiary's creditors:

  - The IRA exemption is based upon a public policy intending that retired persons should be assured their support.

  - The beneficiary of an inherited IRA has an unrestricted right to withdraw the assets of the account without penalty, which is not the case with an original IRA.

  - The inherited IRA is substantially different from an original IRA under the tax law.

- Texas and Florida have enacted legislation to provide that inherited IRAs are protected from creditors.

- In the Bankruptcy context, however, the authority is mixed and the legal issue centers on whether or not an inherited IRA contains "retirement funds" within the meaning of § 522(b)(2), (3)(C) and (d)(12) of the Bankruptcy Code which exempt from a debtor's bankruptcy estate "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, or 501(a) of the [Code]." In re Clark _______ B.R. ______ (Bankr. E.D. Wis. 2011).

- OH, FL, WA, CA, MN, AZ (being appealed to the Ninth Cir. and PA (being appealed to the Third Circuit) exempt inherited IRAs in Bankruptcy.

ii. Consider designating either a conduit or accumulation trust as a beneficiary of an IRA to protect the inherited IRA from a beneficiary's creditors.

3. Life Insurance

a. The federal bankruptcy exemptions for life insurance policies owned by the debtor are found at 11 U.S.C. §§ 522(d)(7) and (8) and provide that unmatured policies owned by the debtor and up to $8,625 of the debtor's aggregate interest in any accrued dividend or interest under, or loan value of, an unmatured life insurance contract, is exempt provided that the insured is either the debtor or an individual of whom the debtor is a dependent.

- Federal bankruptcy law, 11 U.S.C. § 522(d)(7), broadly defines a dependent as including a spouse, regardless of whether the debtor's spouse is actually dependent on the debtor.

b. Since the federal exemption scheme for life insurance that is owned by the debtor is so parsimonious, if an exemption under an alternative state scheme is provided, its use in lieu of the federal exemption scheme should be carefully considered.

- New York's scheme for the exemption of life insurance, Insurance Law § 3212; Civil Practice Law and Rules § 5205(i), distinguishes between the several permutations which can result depending on whether the debtor is the owner of the policy (referred to under the New York statute as the person "effecting the policy," and need not be the person who actually purchased the policy), the insured, the beneficiary, or some combination thereof. More specifically, the New York State exemption scheme for life insurance provides that:

  - If the owner of a life insurance policy insures his or her own life for the benefit of another (*i.e.*, a beneficiary other than the owner's estate), that other person shall be entitled to the proceeds and avails of the policy as against the creditors of the owner. (In other words, the beneficiary's interest in a life insurance policy owned by another is protected from claims of the policy owner's creditors, notwithstanding the fact that a power to change the beneficiaries of the life insurance policy has been reserved by the owner).

  - If the owner of a life insurance policy insures the life of another for the owner's own benefit, the owner is entitled to the proceeds and avails of the policy as against the creditors of the insured. (In other words, the interest of an owner of life

- If the owner of a life insurance policy insures the life of his or her spouse for the owner's own benefit, the owner is also entitled to the proceeds and avails of the policy as against his or her own creditors. (In other words, the interest of an owner/beneficiary of life insurance in the policy is protected from the owner/beneficiary's own creditors if the insured is the owner's spouse).

- If the owner of a life insurance policy insures the life of another person for the benefit of a third party, the third party is entitled to the proceeds and avails of the policy as against the creditors of both the owner and the insured. (In other words, the beneficiary's interest in a life insurance policy is protected from claims of the creditors of both the owner of the policy and the insured).

- The owner of a life insurance policy, regardless of the identity of the insured, is entitled to accelerated payment of the death benefit or accelerated payment of a special surrender value permitted under such policy as against the creditors of the owner. (In other words, the owner's interest in the cash surrender value of a life insurance policy is protected from claims of the owner's own creditors).

- In the New York statute, Insurance Law § 3212(a)(2), the phrase "proceeds and avails" is defined to include "...death benefits, cash surrender and loan values, premiums waived, and dividends, whether used in reduction of premiums or in whatever manner used or applied, except where the debtor has, after issuance of the policy, elected to receive the dividends in cash."

4. Annuities

a. The federal bankruptcy exemption for annuity payments is located at 11 U.S.C. § 522(d)(10)(E) and, like many federal exemptions, the exemption for the right to receive an annuity is neither overly generous nor does it lend itself to asset protection or pre-bankruptcy planning.

b. Specifically, the federal exemption for the right to receive an annuity provides that payments may be exempted only if payable by reason of "…illness, disability, death, age, or length of service…" and even then, only to the extent that such payments are "reasonably necessary" for the support of the debtor and any dependent of the debtor.

- While the "reasonably necessary" standard should arguably be sensitive to the debtor's particular situation, the courts have not necessarily applied the exemption in this manner. Moreover, the courts have generally proven extremely spare in applying such standard in any event.

c. State law exemptions for the right to receive an annuity vary broadly from one state to another.

- New York's exemption for annuities, Insurance Law § 3212(d)(1), initially provides that "[t]he benefits, rights, privileges and options which, under any annuity contract are due or prospectively due the annuitant, who paid the consideration for the annuity contract, shall not be subject to execution." Unfortunately, the New York exemption statute goes on to provide that: "…the court may order the annuitant to pay to a judgment creditor or apply on the judgment in installments, a portion of such benefits that appears just and proper to the court, with due regard for the reasonable requirements of the judgment debtor and his family, if dependent upon him…"

- The New York exemption for the right to receive an annuity is further qualified by New York Debtor and Creditor Law § 283(1), which generally provides that the exemption for annuity contracts initially purchased by the debtor within six months of the debtor's bankruptcy filing are capped at five thousand dollars irrespective of the reasonable income requirements of the debtor and his or her dependents.

    - The intent of this section of the statute, according to the Bankruptcy Court, is to "…limit the debtor's ability to deliberately 'load up' on exempt property." *See, In re Moore*, 177 B.R. 437 (Bkrtcy. N.D.N.Y. 1994).

IV. A BRIEF (AND SELECTIVE) HISTORY OF SPENDTHRIFT (AND DISCRETIONARY) TRUST PROTECTIONS

A. Spendthrift Trusts

1. "Trusts in which a beneficiary cannot assign the interest, or that provide that creditors cannot reach it, are known as 'spendthrift trusts.'" SCOTT AND ASCHER ON TRUSTS § 15.2, Vol. 3 at 898 (5th ed. 2007).

2. "The term 'spendthrift trust' refers to a trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests." RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

B. Discretionary Trusts

1. A "discretionary" trust is a trust in which distributions to the beneficiary are left wholly within the discretion of the trustee, generally without regard to any ascertainable standard. RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

C. Combined Discretionary and Spendthrift Trusts

1. "A spendthrift trust is to be distinguished from a discretionary trust but may or may not also contain discretionary interests…" RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

2. A discretionary spendthrift trust has the potential to afford a beneficiary a significant amount of creditor protection. A trio of cases is instructive in this regard; they are (i) *Nichols v. Eaton*, 91 U.S. 716 (1875), (ii) *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997), and (iii) *Scheffel v. Krueger*, 782 A.2d 410 (N.H. 2001).

D. *Nichols v. Eaton*, 91 U.S. 716 (1875)

1. It was actually not until 1875, with the Supreme Court decision in *Nichols v. Eaton*, that a break with the English common law on spendthrift trusts was affected, and their validity became generally accepted throughout the United States.

2. The theoretical basis underlying the general acceptance of the validity of spendthrift trusts in the United States, as demonstrated by the Supreme Court in *Nichols*, is the idea that an individual should be able to transfer property subject to certain limiting conditions upon which the property will be available to the beneficiary. In this regard, the maxim "*cujus est dare, ejus est disponere*," or "[w]hose it is to give, his it is to dispose" is frequently cited in connection with references to the validity of spendthrift trust restrictions.

3. In *Nichols*, the trust in question was a testamentary trust established by a mother for her son, who had failed in business and who had assigned all of his property for the benefit of his creditors and then later filed for bankruptcy. The mother's will included a provision that stated that if any of her sons should "alienate or dispose of the income to which they were entitled under the trusts of the will, or if, by reason of bankruptcy or insolvency, or any other means whatsoever, said income could no longer be personally enjoyed by them respectively, but the same would become vested in or payable to some other person, then the trust expressed in said will concerning so much thereof as would so vest should immediately cease and determine. In that case, during the residue of the life of such son, that part of the income of the trust fund was to be paid to the wife and children, or wife or child, as the case might be, of such son, and in default of any objects of the last-mentioned trust, the income was to accumulate in augmentation of the principal fund." *Nichols* at 718.

4. In establishing the modern rule with regard to spendthrift trusts, the Supreme Court in *Nichols* stated that:

> "[w]e concede that there are limitations which public policy or general statutes impose upon all dispositions of property, such as those designed to prevent perpetuities and accumulations of real estate...We also admit that there is a just and sound policy...to protect creditors against frauds upon their rights...But the doctrine, that the owner of property...cannot so dispose of it, but that the object of his bounty...must hold it subject to the debts due his creditors...is one which we are not prepared to announce as the doctrine of this court." *Nichols* at 725.

E. *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997)

1. The defendant in *Sligh v. First National Bank of Holmes County* was a beneficiary of two spendthrift trusts which had been established by his mother. The defendant was operating a vehicle while intoxicated and was involved in a motor vehicle accident which left the plaintiff paralyzed with the loss of the use of both legs, loss of all sexual functions and loss of the ability to control bowel and urinary functions. The plaintiff won a $5 Million civil judgment against the defendant for compensatory and punitive damages and tried to collect against the trusts alleging that the defendant's mother had actual knowledge that the defendant was an alcoholic and had created the trusts to shield his interest from the likely claims of involuntary tort creditors. The defendant had no other assets aside from his beneficial interests in the trusts.

2. The plaintiff alleged that it was a violation of public policy to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against the beneficiary, and urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor

3. Most significant, however, is the fact that the Mississippi legislature promptly negated the import of *Sligh* in future cases through enactment of the "Family Trust Preservation Act of 1998." Miss. Code Ann. §§ 91-9-501, *et seq.* (1998). That act provides that except in the case of a self-settled trust, a beneficiary's interest in a spendthrift trust may not be transferred nor subjected to a money judgment until paid to the beneficiary.

F. *Scheffel v. Krueger*, 782 A.2d 410 (N.H. 2001)

1. In *Scheffel v. Krueger*, the defendant was a convicted child molester who was the beneficiary of a discretionary spendthrift trust established by his grandmother in 1985. The plaintiff filed suit in 1998 asserting tort claims against the defendant in connection with the molestation charges and seeking an attachment of the defendant's beneficial interest in the discretionary spendthrift trust. Under the terms of the trust, all income was to be distributed to the defendant annually and distributions of principal were to be made in the Trustee's discretion. The defendant had the power to invade the principal of the trust only following his fiftieth birthday on April 6, 2016.

2. The court found no basis for relief for the plaintiff and held that nothing in the language of the relevant statute suggested that the legislature intended to exempt a tort creditor from a spendthrift provision.

3. The court also found that the defendant's ability to direct trust income and principal after attaining age fifty did not in and of itself disqualify the trust as a spendthrift trust.

G. Uniform Trust Code

1. Article 5 of the Uniform Trust Code addresses the validity of spendthrift provisions and the rights of creditors against a beneficiary's interest in a spendthrift trust. Some form of the Uniform Trust Code has been adopted by the following twenty two states (as well as the District of Columbia): Alabama, Arizona, Arkansas, Florida, Kansas, Maine, Missouri, Michigan, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia and Wyoming. A number of other states have either introduced bills or are reviewing bills to adopt the Uniform Trust Code.

2. Uniform Trust Code § 502(a) provides that a spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest. Accordingly, the settlor may not permit a beneficiary to assign trust assets while prohibiting a beneficiary's creditors from collecting on an involuntary basis. Pursuant to Uniform Trust Code § 502(b), a statement that the beneficiary's interest is held subject to a "spendthrift trust" is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.

3. Uniform Trust Code § 504(b), provides that whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion even if the discretion has been expressed in the form of a standard of distribution or the trustee has abused the discretion; however, in certain cases a court may compel a distribution. For example, under Uniform Trust Code § 504(c)(1), in specified circumstances the court may order discretionary distributions that the beneficiary's child, spouse, or former spouse can reach.

4. Uniform Trust Code § 503 sets forth exceptions to the spendthrift provision, which are discussed in detail below.

H. Exception Creditors

1. Exception creditors are creditors whose claims are "excepted" from spendthrift trust protections under certain circumstances.

2. Exception creditors sometimes include:

   a. creditors with claims for necessaries provided to the beneficiary

   b. creditors with claims for services to protect the beneficiary's interest in the trust

   c. claims by a governmental entity

   d. spouses with support claims

   e. children with child support claims

   f. (very rarely) involuntary tort creditors

3. Exception creditors vary based on the applicable law

   a. Uniform Trust Code § 503 provides for the following exception creditors:

i. The beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance.

ii. A judgment creditor who has provided services for the protection of a beneficiary's interest in the trust.

iii. The state or the United States to the extent a statute of the state or federal law so provide.

4. The exception for spousal support claims and the claims of dependent children is recognized in both the Restatement of the Law of Trusts and, to a significantly lesser extent, the Uniform Trust Code

a. Section 59, Paragraph (a) of the Restatement (Third) of Trusts (2003), provides that "[t]he interest of a beneficiary in a valid spendthrift trust can be reached in satisfaction of an enforceable claim against the beneficiary for support of a child, spouse, or former spouse." This Section is carried forward from § 157 of the Restatement (Second) of Trusts (1959), which provided that "[a]lthough a trust is a spendthrift trust or a trust for support, the interest of the beneficiary can be reached in satisfaction of an enforceable claim against the beneficiary by the wife or child of the beneficiary for support, or by the wife for alimony."

b. Uniform Trust Code § 503(b) provides that "[e]ven if a trust contains a spendthrift provision, a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance...may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary."

i. The comment to this section of the Uniform Trust Code notes, however, that the quoted subsection "does not authorize the spousal or child claimant to force a sale of the beneficiary's interest." Instead, Uniform Trust Code § 504(c) (which deals with discretionary trusts as opposed to spendthrift trusts), provides that "[t]o the extent a trustee has not complied with a standard of distribution or has abused a discretion: (1) a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse; and (2) the court shall direct the trustee to pay to the child, spouse, or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the

V. DOMESTIC ASSET PROTECTION (SELF-SETTLED TRUSTS

A. Although every state recognizes the validity of spendthrift clauses to protect a third party beneficiary's interest from creditor claims, as a matter of public policy such clauses have historically not been enforceable with respect to a settlor who is also a beneficiary to the extent of such settlor's interest. In this regard, many states have statutes or common law prohibiting such so-called "self-settled trusts" and provide that a settlor cannot create such a trust to protect him or herself from creditors.

1. *See e.g.,* New York's EPTL 7-3.1, which provides that "[a] disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator."

B. However, since 1997 twelve states have enacted legislation extending spendthrift protections to a settlor-beneficiary of a discretionary trust (provided that the funding of the trust is not a fraudulent transfer). Those states are:

1. Alaska
2. Delaware
3. Hawaii
4. Missouri
5. Nevada
6. New Hampshire
7. Rhode Island
8. South Dakota
9. Tennessee
10. Utah
11. Virginia
12. Wyoming

C. In addition, Oklahoma, pursuant to the Family Wealth Preservation Trust Act of June 9, 2004 (O.S. § 10,Title 31), permits an individual to create a trust with a bank or trust company located in Oklahoma (but not an individual resident of

D. Alaska

1. The Alaska Trust Act (effective April 2, 1997), modified Alaska's previously undistinguished common law body of trust law in an effort generally touted as making Alaska a domestic alternative to foreign situs asset protection trusts.

2. Alaska Statutes § 34.40.110 permits a settlor to create a trust for his or her own benefit which will be protected from the settlor's future creditors so long as:

   a. The settlor does not retain the right to revoke or terminate the trust.

   b. The settlor was not in default by thirty (30) days or more in making a child support payment.

   c. The settlor's ability to receive distributions from the trust is within the discretion of the trustees rather than mandatory. However, the trustee may permit a beneficiary the use of trust property and the settlor may retain an annuity or unitrust interest in a charitable remainder trust. The settlor may also retain the right to receive a percentage of the trust each year not to exceed the unitrust amount provided under Internal Revenue Code § 643(b).

   d. The transfer of property to the trust was not intended to defraud creditors (*i.e.*, a "fraudulent transfer" generally subject to a four year statute of limitations under Alaska law).

      i. Under Alaska Statutes § 34.40.110, a creditor existing at the time the trust is created must bring suit within the later of:

- Four years after the transfer is made; or

- One year after the transfer is or reasonably could have been discovered by the creditor if the creditor can demonstrate, by a preponderance of the evidence, that the creditor asserted a specific claim against the settlor before the transfer to the trust or the creditor files an action against the settlor within four years after the transfer asserting a claim based on the settlor's pre-transfer act or omission.

ii. For a creditor that comes into being as such subsequent to the creation of a self-settled spendthrift trust, a cause of action claiming a fraudulent conveyance must be brought within four years after the transfer is made.

3. Alaska Statutes § 13.36.310 prohibits a challenge to a trust on the grounds "...that the trust or transfer avoids or defeats a right, claim, or interest conferred by law on any person by reason of a personal or business relationship with the settlor or by way of a marital or similar right."

4. A mere choice of law clause, however, will not be sufficient to establish a trust as an "Alaska" trust. Alaska Statutes § 13.36.035 sets forth definitive statutory requirements for establishing a trust as a trust subject to Alaska's trust law, as follows:

   a. At least one trustee must be a "qualified person" under Alaska Statutes § 13.36.390(1), meaning that at least one trustee must be either a trust company or a bank with trust powers with its principal place of business in Alaska, or an individual resident of Alaska;

   b. Some of the trust assets must be deposited in Alaska, either in a checking or brokerage account or other similar account located in Alaska;

   c. The Alaska trustee's duties must include both the obligation to maintain the trust's records and to prepare or arrange for the preparation of the trust's income tax returns, although neither of these requirements must be exclusive to the Alaska trustee; and

   d. Part or all of the trust's administration must occur in Alaska, including the physical maintenance of the trust's records in Alaska.

5. Consistent with the foregoing requirements, an Alaska trust may be settled by any person, regardless of whether or not he or she is domiciled in Alaska.

6. Alaska Statutes §§ 13.35.70 and 13.36.375 provide for the appointment of third party trust protectors and trustee advisors without imposing fiduciary liability.

7. The settlor must provide an affidavit of solvency in connection with his or her funding of the trust.

8. Alaska Statutes § 34.40.110(e) precludes a claim against a "…trustee of the trust or against others involved in the preparation or funding of the trust for conspiracy to commit fraudulent conveyance, aiding or abetting a fraudulent conveyance, or participation in the trust transaction." It further provides that "[p]reparation or funding of the trust includes the preparation and funding of a limited partnership or a limited liability company if interests in the limited partnership or limited liability company are subsequently transferred to the trust. The creditor and other person prevented from asserting a cause of action or claim for relief are limited to recourse against the trust assets and the settlor to the extent allowed under [Alaska's fraudulent conveyance statute]."

E. Delaware

1. The synopsis of the Delaware Qualified Dispositions in Trust Act notes that the purpose of the legislation is to allow settlors to reduce estate tax by excluding creditors' claims against self-settled trusts. The Act noted recent legislation in Alaska and provided that the Act "…is intended to maintain Delaware's role as the most favored jurisdiction for the establishment of trusts."

2. Delaware law (12 Del. C. § 3570, *et seq.*) applies to "qualified dispositions" made on or after July 1, 1997. A "qualified disposition" is a disposition by or from a transferor to a trustee who is (i) a Delaware resident, bank or institution authorized by Delaware law to act as a trustee, and (ii) who maintains or arranges for custody in Delaware of some or all of the trust corpus, maintains records (on an exclusive or nonexclusive basis), prepares or arranges for the preparation of fiduciary tax returns or otherwise materially participates in the trust's administration.

3. A trust must be irrevocable but can include one or more of the following provisions:

   a. The settlor may retain power to veto distributions;

   b. The settlor may retain a special power of appointment;

c. The settlor may retain the right to receive:

- Current income distributions;
- Payments from a charitable remainder trust;
- Annual payments of up to five percent of the initial value of the trust, or of its value as determined from time to time; or
- Principal distributions under an ascertainable standard (*i.e.*, health, maintenance, education, or support);

d. The settlor may receive income, principal or both in the sole discretion of a trustee;

e. The settlor may remove a trustee or adviser and appoint a new trustee or adviser (other than a person who is a related or subordinate party with respect to the transferor within the meaning of Internal Revenue Code § 672(c) and any successor provision thereto); and

f. The settlor may retain use of a residence held in a qualified personal residence trust.

4. Provided that the transfer of property to the trust was not intended to hinder, delay or defraud creditors, no action to enforce a judgment can be brought for attachment against such qualified disposition.

a. Under 12 Del. C. §3572(b) a creditor existing at the time a transfer to a trust is made must commence an action to enforce a judgment within the later of four years or, if later, within one year after the transfer was or could reasonably have been discovered by the creditor.

b. If the creditor's claim arose after the transfer the action must be brought within four years of the transfer.

- Furthermore, subsection (a) of 12 Del. C. § 3572 provides that a creditor whose claim arose after a qualified disposition can set the transfer aside only if that creditor proves that the transfer was made with actual intent to defraud (not merely to hinder or delay).

5. The Delaware Qualified Dispositions in Trust Act provides that no action of any kind shall be brought against the trustee or against "…any person involved in the counseling, drafting, preparation, execution or funding" of a trust that is the subject of a "qualified disposition."

6. Certain creditors may, however, avoid qualified dispositions:

   a. "…any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt." Del. Code Ann. tit. 12, § 3573(1).

      - For purposes of this rule, however, a "spouse" or "former spouse" includes "…only persons to whom the transferor was married at, or before, the time the qualified disposition is made." Del. Code Ann. tit. 12, § 3570(9).

      - Therefore, if the transferor creates a Delaware asset protection trust prior to the marriage, he or she will be protected.

   b. Any person who suffers death, personal injury or property damage on or before the qualified disposition, which, death, personal injury or property damage was caused by the transferor or another person for whom transferor is liable.

7. In 2003, 12 Del. C. § 3572 was amended by the addition of a new subsection which has the effect of immediately terminating a trustee's authority upon the occurrence of another state court's attempt to exercise jurisdiction over a trustee if the court declines to apply Delaware's law with respect to the validity, construction or administration of the trust. If the trust instrument does not provide for a successor trustee, the Delaware Court of Chancery would appoint a successor trustee (and presumably one that would be subject only to the Delaware court's jurisdiction).

8. On June 30, 2005 the Delaware Qualified Dispositions in Trust Act was amended to (i) permit the settlor to retain the right to receive annual payments of a fixed dollar amount not to exceed five percent of the initial value of the trust corpus; (ii) clarify that a qualified personal residence trust may include provisions requiring conversion to an annuity trust in the event the residence is sold; (iii) permit the settlor to receive reimbursement for income taxes paid on trust income provided such payments are in the discretion of the trustee or trust advisor; (iv) permit a trust being redomiciled to Delaware to tack on the time during which it was located elsewhere for purposes of the statute of limitations regarding creditor claims (provided, however, that any general power of appointment that the settlor retained in the original trust is curtailed to a limited testamentary power); and (v) clarify that a creditor seeking to recover distributions made to a beneficiary, or to prevent a trustee from paying its fees and costs out of the trust, must prove by clear and

F. Hawaii

1. Hawaii enacted the "Permitted Transfers in Trust Act" on June 30, 2010 to "…increase the assets under management by Hawaii's private financial sector, increase state tax revenues, and position the State as a world-class financial management jurisdiction." Section 1, Hawaii Act 182 (10).

2. The Permitted Transfers in Trust Act provides for enforceability of a spendthrift provision in a trust, including with respect to a beneficiary who is also the transferor of the trust, if the transfer to the trust was a "permitted transfer."

3. A "permitted transfer" is a transfer to a "permitted trustee" of property pursuant to a trust instrument.

   a. A permitted trustee is a person, other than the transferor, who is a resident of Hawaii, or a bank or trust company authorized to do business in Hawaii that possesses and exercises trust powers and has its principal place of business in Hawaii, and:

      - Maintains or arranges for custody of some or all of the property that is the subject of the permitted transfer;

      - Maintains records for the trust on an exclusive or nonexclusive basis;

      - Prepares or arranges for the preparation of fiduciary income tax returns; or

      - Otherwise materially participates in the administration of the trust."

   b. A transfer is effective upon completion of:

      - The delivery and acceptance of the property.

      - The delivery to a permitted trustee of the transferor's signed and notarized certificate of solvency.

4. To be a permitted transfer, the trust instrument must be:

   a. Irrevocable.

b. Expressly incorporate the laws of the State of Hawaii as governing the validity, construction, and administration of the trust.

5. A trust will not be deemed to be revocable, however, on account of the inclusion of:

   a. The transferor's power to veto distributions from the trust.

   b. The transferor's testamentary power of appointment, provided that the transferor cannot appoint the trust property to himself, his creditors, his estate, or the creditors of his estate.

   c. The transferor's potential or actual receipt of income, including rights to income retained in the trust instrument.

   d. The transferor's annual receipt of a percentage not to exceed five per cent of the initial value of the trust assets or its value determined from time to time pursuant to the trust instrument or of a fixed amount that on an annual basis does not exceed five per cent of the initial value of the trust assets.

   e. The transferor's potential or actual receipt or use of the trust's principal due to the trustee acting in the trustee's discretion, or pursuant to a provision in the trust instrument that governs the distribution of principal that does not confer upon the transferor a substantially unfettered right to the receipt or use of the principal, or at the direction of an advisor who is acting in the advisor's discretion, or pursuant to a provision in the trust instrument that governs the distribution of principal that does not confer upon the transferor a substantially unfettered right to the receipt or use of the principal.

   f. The transferor's right to remove a trustee or advisor and to appoint a new trustee or advisor.

   g. The transferor's potential or actual receipt of income or principal to pay income taxes due on income of the trust if the trust instrument includes a provision allowing or directing the use of trust funds to pay income taxes due, or if the trustee acts in the trustee's discretion to allow payment of income taxes due on the trust income.

   h. A trustee's authority pursuant to discretion, direction, or the transferor's exercise of a testamentary power of appointment to pay all or any part of the transferor's debts outstanding at the time of the transferor's death, the expenses of administering the

i. The transferor's potential or actual receipt of income or principal from a charitable remainder trust, and the transferor's right to release the transferor's retained interest in the trust in favor of one or more charitable organizations with a succeeding beneficial interest in the trust.

j. The transferor's potential or actual receipt of income or principal from a grantor-retained annuity trust or a grantor-retained unitrust, or the transferor's receipt each year of a percentage specified in the governing instrument of the initial value of the trust assets or their value determined from time to time; provided that the percentage received does not exceed five per cent.

k. The transferor's potential or actual use of real property held under a qualified personal residence trust, or the transferor's possession and enjoyment of a qualified annuity interest.

6. No claim, including an action to enforce a judgment or avoid a permitted transfer, is allowed unless:

   a. The creditor proves that the transfer was made with actual intent to defraud, hinder, or delay; and

   b. The claim arose before the permitted transfer and the action is brought before the permitted transfer; or

   c. The claim arose concurrent with or subsequent to the permitted transfer and the action is brought within two years thereafter.

7. Exception creditors include:

   a. "…any person to whom the transferor is indebted on account of a family court-supervised agreement or family court order for the payment of support or alimony to the transferor's spouse, former spouse, or children, or for a division or distribution of property to the transferor's spouse or former spouse, but not for any claim for forced heirship, legitime, or elective share".

      - However, under Hawaii law, for this purpose, "…'[s]pouse' means a person to whom the transferor is married at the time of the permitted transfer…" and '…[f]ormer spouse' means a person to whom the transferor was married where the marriage was dissolved before the time of the permitted transfer.

b. Tort creditors with claims arising on or before the date of the permitted transfer.

c. Lenders secured by the transferred property.

d. Hawaii, in connection with tax liabilities.

G. Missouri

1. Missouri law provides that where the settlor is not the sole beneficiary of a trust, and does not retain the power to revoke or amend the trust, or the right to a portion of the income or principal of the trust, the trust will be protected from the settlor's creditors.

2. Section 456.5-505.3 provides that with respect to an irrevocable trust with a spendthrift provision, a spendthrift provision will prevent the settlor's creditors from satisfying their claims from the trust assets except:

a. Where the conveyance of assets to the trust was fraudulent as to creditors; or

b. To the extent of the settlor's beneficial interest in the trust assets, if at the time the trust became irrevocable:

- The settlor was the sole beneficiary of either the income or principal of the trust or retained the power to amend the trust; or

- The settlor was one of a class of beneficiaries and retained a right to receive a specific portion of the income or principal of the trust that was determinable solely from the provisions of the trust instrument.

3. In addition, Section 456.5-504.1 provides as follows:

"Except as otherwise provided in section 456.5-503, whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if:

(1) the discretion is expressed in the form of a standard of distribution; or

(2) the trustee has abused the discretion.

4. The referenced exception under section 456.5-503 provides that, "[e]ven if a trust contains a spendthrift provision, a beneficiary's child, spouse, or former spouse who has a judgment against the beneficiary for support or maintenance, or a judgment creditor who has provided services for the

H. Nevada

1. Effective October 1, 1999, Nevada began allowing spendthrift protection for self-settled trusts, provided that they meet the following requirements as set forth in Nevada Revised Statutes § 166:

   a. The trust must be irrevocable;

   b. The settlor is only a discretionary beneficiary;

   c. The transfer was not intended to hinder, delay or defraud known creditors;

   d. The settlor may retain a veto power over distributions or hold a testamentary special power of appointment;

   e. All or part of the property is located in Nevada;

   f. All or part of the administration of the trust is performed in Nevada; and

   g. At least one Nevada resident is a trustee and has powers that include maintaining records and preparing tax returns for the trust.

2. A creditor may not bring an action with respect to property transferred to a spendthrift trust unless the action is brought within two years after the transfer or six months after the creditor discovers or reasonably should have discovered the transfer, whichever is later. If a person becomes a creditor after the transfer is made, he or she must bring the action with two years after the transfer.

I. New Hampshire

1. New Hampshire's "asset protection trust" legislation, entitled the Qualified Dispositions in Trusts Act, applies to qualified dispositions and dispositions by transferors who are trustees made after January 1, 2009.

2. A qualified disposition is defined as a disposition by or from a transferor to a qualified trustee or qualified trustees, with or without consideration, by means of a trust instrument.

3. A qualified trustee is defined as any person, other than the transferor, who in the case of a natural person, is a resident of the state of New Hampshire or who, in all other cases, is a state or federally chartered bank or trust company having a place of business in New Hampshire, is

a. Not all trustees must be qualified trustees.

4. A trust instrument must meet the following requirements in order for the disposition to be qualified:

   a. The trust instrument must be irrevocable;

   b. The trust instrument must provide that the interest of the transferor or other beneficiary in the trust property or the income thereof may not be transferred, assigned, pledged, or mortgaged, whether voluntarily or involuntarily, before the qualified trustee or qualified trustees actually distribute the property or income therefrom to the beneficiary.

5. The legislation specifically provides that the trust instrument shall not be deemed revocable on account of the inclusion in the trust instrument of any one or more of the following rights, powers, and interests:

   a. The transferor's power to veto a distribution from the trust;

   b. A power of appointment, other than a power to appoint to the transferor, the transferor's creditors, the transferor's estate, or the creditors of the transferor's estate, exercisable by will or other written instrument of the transferor effective only upon the transferor's death;

   c. The transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument;

   d. The transferor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust;

   e. The transferor's receipt each year of a percentage, not to exceed 5 percent, specified in the trust instrument of the initial value of the trust assets or their value determined from time to time pursuant to the trust instrument;

f. The transferor's potential or actual receipt or use of principal if such potential or actual receipt or use of principal would be the result of a qualified trustee or qualified trustees, including a qualified trustee or qualified trustees acting at the direction of a trust advisor, acting either in such qualified trustee's or qualified trustees' sole discretion or pursuant to an ascertainable standard in the trust instrument;

g. The transferor's right to remove a trustee or trust advisor and to appoint a new trustee or trust advisor, other than a related or subordinate party with respect to the transferor within the meaning of section 672(c) of the Internal Revenue Code;

h. The transferor's potential or actual receipt or use of real property held under a personal residence trust;

i. The transferor's potential or actual receipt or use of a qualified annuity interest;

j. The ability, whether pursuant to discretion or direction, of a qualified trustee to pay, after the transferor's death, all or any part of the transferor's debts outstanding at the time of the transferor's death, the expenses of administering the transferor's estate, or any estate inheritance tax imposed on or with respect to the transferor's estate.

6. Neither shall the trust instrument be deemed revocable on account of the transferor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on trust income if such receipt of income or principal is pursuant to a provision in the trust instrument that expressly provides for the payment of such taxes and such receipt of income or principal results from (i) the qualified trustee's acting in such qualified trustee's discretion or (ii) the qualified trustee acting at the direction of a trust advisor who is acting in such trust advisor's discretion.

7. The transferor may appoint one or more trust advisors (whether or not such trust advisors would meet the definition of a "qualified trustee"), with authority under the trust instrument to:

a. Remove and appoint qualified trustees or trust advisors;

b. Direct, consent to, or disapprove distribution from the trust.

8. The transferor may serve as a trust advisor; provided, however, that in such case his or her rights and powers as a trust advisor must be limited to the right to disapprove distribution from the trust and the right to consent to a trustee's action or inaction in relation to the investment of trust assets.

9. A creditor's claim against property which was the subject of a qualified disposition in trust is extinguished unless the creditor's claim arose before the qualified disposition was made and the action is brought within the limitations period under the New Hampshire version of the Uniform Fraudulent Transfer Act, or if the creditor's claim arose on or after the date of the qualified disposition, the action is brought within four years after such date.

10. However, the qualified dispositions in trusts law does not apply:

    a. To any person to whom the transferor is indebted on account of an antenuptial agreement or an agreement or order of court for the payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt.

        - However, this exception "…shall not apply to any claim for forced heirship or legitime or the elective share of the transferor's surviving spouse, unless the transferor made the qualified disposition for the purpose of defeating the surviving spouse's elective share rights." New Hampshire Statutes § 564-D:15(II).

        - In addition, "…'spouse' and 'former spouse' means only persons to whom the transferor was married at, or before, the time the qualified disposition is made." New Hampshire Statutes § 564-D:1(VIII).

    b. To any person who suffers death, personal injury, or property damage on or before the date of qualified disposition by a transferor.

11. No creditor has any claim or cause of action against the trustee, or an advisor, of a trust that is the subject of a qualified disposition, or against any person involved in the counseling, drafting, preparation, execution, or funding of a trust that is the subject of a qualified disposition.

J. Rhode Island

1. Rhode Island Statutes § 18-9.2 applies to "qualified dispositions" made after June 30, 1999. A qualified disposition is a transfer to a trust which is:

    a. Irrevocable;

    b. Incorporates the laws of Rhode Island to govern the validity, construction and administration of the trust;

c. Contains a restriction on assignment of income or property; and

d. Wherein the transferor retains only:

- The power to veto distributions;
- A testamentary special power of appointment; and
- The right to receive distributions in the sole discretion of a trustee who is neither related or subordinate to the transferor.

2. The trustee must be a resident of Rhode Island (in the case of an individual), or authorized by Rhode Island law to act as a trustee (in the case of a non-individual).

3. A creditor may not bring an action to avoid a qualified disposition if:

a. The creditor's claim arose before the transfer was made unless the action is brought within four years after the transfer or, if later, within one year after the transfer was or could reasonably have been discovered by the creditor; or

b. The creditor's claim arose after the transfer, unless the action is brought within four years after the transfer is made.

4. In Rhode Island, a transfer can be avoided by "[a]ny person to whom the transferor is indebted on or before the date of a qualified disposition on account of an agreement or order of court for the payment of support or alimony in favor of the transferor's spouse, former spouse or children, or for a division or distribution of property in favor of the transferor's spouse or former spouse, but only to the extent of the debt…". R.I. Gen. Laws § 18-9.2-5(a).

a. "…'spouse' and 'former spouse' means only persons to whom the transferor was married at, or before the time the qualified disposition is made." R.I. Gen. Laws § 18-9.2-2(7).

K. South Dakota

1. The "Act to Authorize Qualified Dispositions" is effective for trusts settled on or after July 1, 2005.

2. The trust must meet the following requirements:

a. The governing law must be South Dakota;

b. The trust must be irrevocable;

c. The trust must prohibit voluntary or involuntary assignment;

d. The settlor may retain the following:

- A power to veto trust distributions;
- A limited testamentary power of appointment;
- The right to current income distributions;
- Payments from a charitable remainder trust;
- Annual payments of up to five percent of the initial value of the trust or of its value as determined from time to time;
- Principal distributions under an ascertainable standard (*i.e.*, health, maintenance, education, or support);
- The settlor may receive income, principal or both in the sole discretion of a trustee who is neither the settlor nor a related or subordinated party of the settlor;
- A power to remove and appoint trustees; and
- The retained use of a residence in a Qualified Personal Residence Trust.

3. The trustee must be a resident of the state of South Dakota, or a trust company, or a bank or savings association that exercises trust powers, that has its principal place of business in South Dakota, which maintains or arranges for custody in the state of South Dakota of some or all of the property, maintains records on an exclusive or nonexclusive basis, prepares or arranges for the preparation of the tax returns, or otherwise materially participates in the administration of the trust.

4. The Act to Authorize Qualified Dispositions permits the appointment of a nonresident trust advisor, including a trust protector, who may hold one or more trust powers. The settlor may be designated as a trust advisor.

5. The Act to Authorize Qualified Dispositions provides protection to trustees and any person involved in "counseling, drafting, preparation, execution or funding of a trust" from claims of creditors.

6. Transfers are subject to provisions of the Uniform Fraudulent Transfer Act.

a. Certain creditors may, however, avoid qualified dispositions:

- Any person to whom the settlor is indebted on account of an agreement or court order for support, alimony or property distribution in favor of a spouse, former spouse or children;

    - "…'spouse' and 'former spouse,' mean only persons to whom the transferor was married at, or before, the time the qualified disposition is made." S.D. Code § 55-16-1(7).

- Any person who suffers death, personal injury or property damage on or before the qualified disposition, which death, personal injury or property damage was caused by the transferor or another person for whom the transferor is liable.

L. Tennessee

1. Effective July 1, 2007, the "Tennessee Investment Services Act of 2007," began permitting the creation of self-settled spendthrift trusts under Tennessee law (called an "Investment Services Trust" in Tennessee).

2. An Investment Services Trust means an instrument appointing a qualified trustee or qualified trustees for the property that is the subject of a disposition, which instrument:

    a. Expressly incorporates the law of Tennessee as governing its validity, construction and administration;

    b. Is irrevocable; and

    c. Provides that the interest of the transferor in trust property or the income from trust property may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily.

3. A "qualified trustee" is a natural person who is a resident of Tennessee (other than the settlor), or a person authorized by the law of Tennessee to act as a trustee, and who maintains or arranges for custody in Tennessee for the property of the trust, maintains records for the trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation of required income tax returns for the trust, or otherwise materially participates in the administration of the trust.

4. The settlor is permitted to retain one or more of the following rights in an Investment Services Trust:

a. To direct the investment of the Investment Services Trust's assets;

b. To receive trust income;

c. To request up to five percent of the trust principal annually;

d. To receive additional distributions of principal based upon the discretion of the trustee or another appointed advisor;

e. To live in a home owned by the trust;

f. To veto distributions to any other permissible beneficiary;

g. To direct the distribution of the trust assets upon the settlor's death to any one or more persons other than the settlor's creditors, the settlor's estate or the creditors of the settlor's estate; and

h. To remove the trustee and other trust advisors and to appoint their successors provided they are not related or subordinate to the settlor.

5. At the creation of the Investment Services Trust, the settlor is required to provide an affidavit under oath which must include, among other things, a statement that by creating the trust the settlor does not intend to defraud a creditor and that the settler does not have any pending or threatened court action against him or her other than those identified in the affidavit.

6. An Investment Services Trust will not provide asset protection for assets transferred to it until four years after the transfer. At that time, the settlor's creditors are prevented from seizing the assets of the Investment Services Trust to satisfy claims against the settlor

7. A transfer can be avoided by a creditor to whom "…the transferor is indebted on account of an agreement, judgment or order of a court for the payment of…(A) Past due child support; (B) Past due alimony in solido of a spouse or former spouse; (C) Past due alimony or support of a spouse or former spouse; or (D) A written agreement, judgment or order of a court for division of marital property of a spouse or former spouse, but only to the extent of such debt, legally mandated interest and the reasonable cost of collection. Tenn. Code Ann. § 35-16-104(i).

   a. "…'spouse' or 'former spouse' means only persons to whom the transferor was legally married at, or before, the time the qualified disposition is made…" Tenn. Code Ann. § 35-16-102(13).

M. Utah

1. The Utah legislation, which is effective for trusts created after May 5, 2003, is set forth in UCA § 25-6-14, *et seq*. It applies only to transfers of personal property or interests therein.

2. The trust must meet the following requirements:

   a. At least one trustee must be a trust company resident in Utah;

   b. The settlor does not retain the right to revoke the trust;

   c. The settlor may only receive income or principal at the discretion of the trustee; and

   d. The settlor was not in default by thirty (30) days or more under a child support order.

3. A creditor existing at the time the trust is settled must bring suit within the later of three years after the transfer is made or one year after the transfer is or reasonably could have been discovered. A creditor arising after a transfer has two years from the transfer date to bring a suit.

4. A transfer can be avoided if "…the claim is by a spouse or former spouse of the settlor on account of an agreement or order for the payment of support or alimony or for a division or distribution of property…" Utah Code Ann. § 25-6-14(2)(c)(ix).

5. The Act provides protection from a claim against a trustee or advisor for conspiracy to commit a fraudulent conveyance or aiding and abetting a fraudulent conveyance.

6. A trust will be subject to Utah's governing law if:

   a. Some or all of the assets are deposited in the state in a bank, brokerage or trust company;

   b. The trust has at least one resident trustee; and

   c. Some administration (*i.e.*, maintaining of trust records or arranging for tax return preparation) occurs in the state.

7. The Act also modifies the state's Rule Against Perpetuities to provide for a 1,000 year period.

N. Virginia

1. Virginia enacted legislation to be effective for trusts settled after July 1, 2012.

2. An exception has been grafted into § 55-545.05 of the Virginia Code that permits the creation of self-settled spendthrift trusts, which protect

3. To be a qualified self-settled spendthrift trust, it must satisfy the following criteria:

    a. irrevocable (further confirmed by subsection A.1. of § 55-545.05);

    b. created during the settlor's lifetime;

    c. has at least one beneficiary other than the settlor, (i) to whom income may be paid, if settlor is eligible to receive income, (ii) to whom principal may be paid, if settlor is eligible to receive principal, or (iii) to whom income and principal may be paid, if settlor is eligible to receive both;

    d. has at least one "qualified trustee;"

    e. expressly incorporates the law of the Commonwealth of Virginia to govern the validity, construction and administration of the trust;

    f. contains a spendthrift provision that restrains both voluntary and involuntary transfer of the settlor's "qualified interest;" and

    g. the settlor <u>does not</u> retain the right to disapprove distributions (i.e., a veto power).

O. Wyoming

1. Wyoming Statues § 4-10-510 provides for the creation of a "qualified spendthrift trust" (*i.e.*, a self-settled spendthrift trust) with a "qualified trustee" for "qualified trust property."

2. A "qualified spendthrift trust" requires:

    a. The trust instrument to state that the trust is a qualified spendthrift trust under Wyoming Statutes § 4-10-510;

    b. The trust instrument to expressly incorporate the law of Wyoming to govern the validity, construction and administration of the trust;

    c. The trust instrument to provide that the interest of the settlor in the trust income or principal, or both, is held subject to a spendthrift provision;

d. The trust to be irrevocable, but a trust instrument will not be deemed to be revocable because of the inclusion of one or more of the following:

- The settlor's power to veto trust distributions;

- An inter vivos or testamentary limited or general power of appointment held by the settlor;

- The settlor's potential or actual receipt of income;

- The settlor's potential or actual receipt of income or principal from a charitable remainder trust;

- The settlor's receipt each year of up to five percent of the initial value of the trust or of its value as determined from time to time;

- The settlor's potential or actual receipt or use of principal under an ascertainable standard (e.g., health, maintenance, education, or support);

- The settlor's right to add or remove a trustee, trust protector or trust advisor, and to appoint a new trustee, trust protector or trust advisor, other than the settlor;

- The settlor's potential or actual use of real property held under a Qualified Personal Residence Trust;

- A trust protector has the power to add beneficiaries to the trust who are not the trust protector, the estate of the trust protector, the creditors of the trust protector or the heirs of the trust protector; or

- The settlor's service as an investment advisor to the trust.

3. "Qualified trust property" is real property, personal property and interests in real or personal property and all gains, appreciation and income thereon which are the subject of a "qualified transfer" or are acquired with the proceeds of property of a qualified transfer.

4. Qualified trust property is not protected under the following circumstances:

a. Against any claim by any person to whom the settlor is indebted on account of an agreement or order of court for the payment of child support;

b. If the qualified trust property is listed upon an application or financial statement used to obtain or maintain credit other than for the benefit of the qualified spendthrift trust; or

c. Property of a qualified spendthrift trust that was transferred by a settlor who received the property by a fraudulent transfer.

5. Transfers are also subject to provisions of the Uniform Fraudulent Transfer Act.

6. A "qualified trustee" is a natural person (other than the settlor) who is a resident of Wyoming, or a person authorized by the law of Wyoming to act as a trustee, who maintains or arranges for custody in Wyoming of some or all of the qualified trust property, maintains records for the qualified spendthrift trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation of fiduciary income tax returns for the qualified spendthrift trust, or otherwise materially participates in the administration of the qualified spendthrift trust.

7. A creditor can not make any claim or bring any cause of action against the trustee, trust protector, trust advisor or other fiduciary of the trust, or against any person involved in the counseling, drafting, administration, preparation, execution or funding of the trust.

8. The settlor must provide an affidavit of solvency containing the statements set forth in Wyoming Statutes § 4-10-523.

P. Constitutional Issues

1. Notwithstanding the enactment of self-settled spendthrift trust protections under the laws of a significant minority of the states over the course of the past fourteen years, foreign trusts will likely offer a more substantial barrier to creditors because of certain issues under the United States Constitution.

a. Full Faith and Credit Clause

- Under the Full Faith and Credit Clause of the United States Constitution, "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State." U.S. Const., Art. IV, § 1.

- Full faith and credit principles are so broadly construed that they generally require the judgment of another state to be recognized and enforced even though the original claim is illegal in, or contrary to the strong public policy of, the second state. *See, e.g.*, *United Nat'l Bank v. Lamb*,

- In addition, the Full Faith and Credit Clause is also usually thought to require the enforcement of another state's judgments, even where the second state disallows by statute jurisdiction over the action. *Hughes v. Ferter*, 341 U.S. at 611 fn. 4 (1951); *Brodderick v. Rosner*, 294 U.S. 629, 639-642 (1935); *Kenny v. Supreme Lodge of the World*, 252 U.S. 411, 415 (1920).

- In fact, assuming that in personam jurisdiction is obtained over the trustee, there are only two apparent limitations upon the application of the Full Faith and Credit Clause.

    - The first limitation upon application of the Full Faith and Credit Clause is that "for a State's substantive law to be selected in a constitutionally permissible manner, that State must have a significant contact or significant aggregation of contacts, creating state interests, such that choice of its law is neither arbitrary nor fundamentally unfair." *Allstate Ins. Co. v. Hague*, 449 U.S. 302, 312-13 (1981).

    - The second limitation upon application of the Full Faith and Credit Clause is that the issue has been fully and fairly litigated and finally decided in the court rendering the original judgment. *Durfee v. Duke*, 375 U.S. 106, 111 (1963).

- Arguments are sometimes raised that the Full Faith and Credit Clause does not affect the protection afforded by domestic asset protection trusts. Such arguments rely upon the fact that the trustee is not the same person as the settlor, and that, therefore, a judgment obtained against the settlor in one state would not be enforceable against the trustee in another state. However, such arguments obviously ignore the possibility that the trust might be held to be a "sham" trust in the courts of the forum state (most likely being a state that does not itself provide for the validity of self-settled spendthrift trusts), or should

- By contrast, a creditor holding a judgment from a United States court cannot hope to have the courts of a properly selected offshore jurisdiction enforce the United States judgment. Instead, the creditor must commence a new action in the offshore jurisdiction.

b. Supremacy Clause

- Under the Supremacy Clause of the United States Constitution, the "…Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." U.S. Const., Art. VI, §2.

- Thus, federal law overrides state laws to the extent that federal and state law conflict.

- In the asset protection trust context there is concern that the Supremacy Clause might apply, for example, where a federal bankruptcy court issues an order directing the trustee of a domestic self-settled spendthrift trust to distribute assets to a creditor.

- This concern has been mitigated somewhat, however, since the enactment of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, which amended § 548(e) of the Bankruptcy Code so as to limit the power of the trustee of the bankruptcy estate to avoid transfers to a "self-settled trust or similar device" to situations where the transfer is a fraudulent transfer, and then only if made within ten years before the date of the filing of the bankruptcy petition.

- In re Mortensen (*Battley v. Mortensen*, Adv. D. Alaska, No. A09-90036-DMD, May 26, 2011), is the first and only case yet to deal with a domestic asset protection trust. In that case, Mortensen, a resident of Alaska, without the aid of counsel, drafted a trust document in 2005 called the "Mortensen Seldovia Trust (An Alaska Asset Preservation Trust)" intending for the Trust to qualify as an asset protection trust under Alaska law. Following his creation and funding of the Trust, Mortensen's financial condition deteriorated, his income became "sporadic," and he ultimately filed for bankruptcy. Although the Bankruptcy Court concluded that Mortensen was not insolvent when he established and funded the Trust, due to the specific circumstances of the case it held that his funding of the trust nevertheless fell under Section 548(e) of the Bankruptcy Code as a fraudulent transfer to a self-settled trust made within ten years prior his bankruptcy filing.

c. Contract Clause

- Under the Contract Clause of the United States Constitution, "[n]o State shall…pass any…Law impairing the Obligation of Contracts…" U.S. Const. Art. I, § 10.

- In the asset protection context, the concern over the Contract Clause, albeit somewhat ill defined, is that domestic asset protection trust legislation potentially infringes upon the ability of persons to contract with each other by allowing a contracting party to avoid the effect of certain contracts by protecting his or her assets from claims made under the contract through the use of an asset protection trust.

Q. Inter-vivos QTIP Trusts and Creditors

1. A basic tenet of estate planning is that each spouse own assets in their own name to utilize their exemption. However, due to concerns that a wealthy spouse may have about outright transfers (loss of control, testamentary disposition, asset protection), an alternative is the QTIP trust.

2. If the settlor-spouse survives the donee spouse the trust may continue for the settlor's benefit. Technically, this might result in a self-settled trust which would then be available to the settlor's creditors.

a. While Treas. Reg. Section 25.2523(f)-1(f), Ex. 11 provides that assets held in an inter-vivos QTIP for the settlor's benefit after the donee spouse's death will not be includable in the settlor's estate under Sections 2036 and 2038, Section 2041 is not addressed.

b. Four states have recently enacted legislation to provide that such trusts will not be treated as self-settled trusts. AZ, DE, MI, FL

c. Alternatively, one might consider utilizing a testamentary power of appointment in favor of the settlor but the "relation back doctrine" may result in inclusion and potential for creditor exposure.

VI. FOREIGN ASSET PROTECTION TRUSTS

A. Overview

1. Historically such trusts were used to avoid forced heirship and government expropriation in non-United States jurisdictions, but in the asset protection context such trusts are now used to place assets out of the reach of the United States courts since many foreign jurisdictions do not honor United States judgments in the asset protection trust context.

2. Such trusts, if properly funded, will require a creditor to litigate its claim in a foreign jurisdiction under that jurisdiction's laws and system (which are likely to be much more debtor friendly than would be the case in a domestic jurisdiction). Such trusts provide procedural, substantive and psychological barriers to creditors. Such trusts do not rely on secrecy or concealment to be effective.

B. Selecting a Jurisdiction

1. The following jurisdictions have enacted favorable asset protection trust legislation, some offering greater protection than others:

    a. Anguilla
    b. Antigua
    c. Bahamas
    d. Barbados
    e. Belize
    f. Bermuda
    g Cayman Islands
    h Cook Islands
    i. Cyprus
    j. Gibraltar
    k. Labuan
    l. Marshall Islands
    m. Mauritius
    n. Nevis
    o. Niue
    p. St. Vincent
    q. St. Lucia
    r. Seychelles
    s. Turks and Caicos

2. Perhaps the most critical aspect in selecting a jurisdiction is the fraudulent transfer law of that jurisdiction. Until recently, most common law jurisdictions followed the Statute of Elizabeth, passed in 1571, which provided no limitations period within which a creditor must bring a fraudulent transfer claim or be thereafter barred from asserting its claim.

3. Other factors to consider in selecting a jurisdiction:

    a. Need for a professional and responsible institutional trustee in a stable country;

    b. Effect of tax laws;

    c. Existing language barriers;

d. Solidity of reputation in the global financial community;

e. Statutory trust law framework, including a short statute of limitations period for challenging a trust pursuant to a fraudulent transfer claim;

f. Whether and to what extent a settlor can be a beneficiary and protector;

g. Whether foreign judgments are recognized;

h. The standard of proof required to succeed in a fraudulent conveyance action; and

i. Issues relating to access to the legal system (*i.e.*, court costs, legal fees and the like).

C. Overview of Cook Islands

1. General Characteristics

a. The Cook Islands are located in the south Pacific Ocean east of Australia and south of Hawaii.

b. The capital is Rarotonga, with a modern international airport and regular air service to Los Angeles, Hawaii, Tahiti, Fiji and Auckland, New Zealand.

c. The islands are remote from the world's major financial centers but have modern communications systems and are in a time zone only three hours behind Pacific Standard Time.

d. The Cook Islands are self-governing. Their closest link is with New Zealand, and they use New Zealand currency. They have been independent since 1965.

e. English is the official language, and there is a common law legal system. Appeals of court decisions are brought before the Privy Council in England.

2. Confidentiality -The Cook Islands banking laws mandate secrecy of client information, with a year's imprisonment being the punishment for a violation.

3. Taxes - The Cook Islands are a "no-tax" jurisdiction.

4. Fraudulent Disposition Law

a. The Cook Islands enacted comprehensive asset protection trust legislation with the enactment of the International Trusts Act 1984, and its amendment pursuant to the International Trusts Amendment Act 1989. There have been several smaller amendments since 1989.

b. The legislation addresses "International Trusts" and the effect thereon of fraudulent dispositions and bankruptcy.

c. With respect to fraudulent dispositions, a creditor seeking to set aside a disposition to an International Trust must prove beyond a reasonable doubt that:

- The disposition was made with an intent to defraud that particular creditor; and

- The transferor was rendered insolvent by the transfer; if the fair market value of the settlor's assets after the transfer to the International Trust exceeds the value of the creditor's claim at the time of the transfer, there can be found no intent to defraud.

d. If the creditor meets this burden of proving a fraudulent disposition, the transfer to the International Trust is not void or voidable. Instead, the creditor's claim must be paid from property that would have been subject to its claim but for the transfer. Furthermore, any punitive damage award which is part of the creditor's claim is disregarded.

e. An International Trust will not be deemed void simply by reason of the settlor's bankruptcy.

f. Recent amendments (in 1997 and 1999) contain limitations provisions:

- If a creditor's cause of action accrues more than two years before a transfer to an International Trust, the transfer will be deemed not to be fraudulent unless proceedings in respect of that cause of action had been commenced at the date of the transfer.

- Also, if a creditor fails to bring an action within one year from the date the transfer to an International Trust occurs, the action is barred.

- Furthermore, if the transfer (whether initial or subsequent) to an International Trust occurs before a creditor's cause of action accrues, such a disposition will

- For redomiciled trusts, the limitations period is deemed to have commenced at the time of original transfer, even when the transfer was to a trust located in a jurisdiction other than the Cook Islands.

g. The Cook Island International Trusts Act also defines certain circumstances that will not be deemed badges of fraud. Specifically, fraudulent intent cannot be imputed from the fact that:

- A transfer to an International Trust was made within two years of the accrual of a creditor's cause of action;

- The retention of powers or benefits by the settlor; or

- The designation of the settlor as a beneficiary, trustee or protector.

5. Trusts

a. Retained powers and benefits are explicitly addressed by statute. An International Trust cannot be "declared void or be affected in any way" because the settlor:

- Has the power to revoke or amend the trust, to dispose of trust property, or to remove or appoint a trustee or protector;

- Retains, possesses or acquires any benefit, interest, or property from the International Trust; or

- Is a beneficiary, trustee or protector of the International Trust.

b. The rule against perpetuities has been repealed in the Cook Islands.

c. Selection of the law of the Cook Islands is binding and conclusive.

d. An International Trust is not subject to the forced heirship laws of other countries.

e. Foreign judgments against an International Trust, its settlor, trustee and protector, cannot be recognized in the Cook Islands.

f. The Act also provides that community property transferred to an International Trust retains its character as community property.

D. Choice of Law Clause

1. The general rule is that the settlor's designation of controlling law will govern the administration of a trust, including the efficacy of a trust's spendthrift provision.

a. If the settlor creates a trust to be administered in a state other than that of his domicile, the law of the state of the place of administration, rather than that of his domicile, ordinarily is applicable. Thus a settlor domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state. In that case the law of that state will be applicable as to the rights of creditors to reach the beneficiary's interest. This permits a person who is domiciled in a state in which restraints on alienation are not permitted, to create an inter vivos trust in another state where they are permitted and thereby take advantage of the law of the latter state. 5A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *THE LAW OF TRUSTS* § 626, at 419 (4th ed. 1989).

2. In addition, Restatement (Second) of Conflicts of Laws § 273 provides that:

> "[w]hether the interest of a beneficiary of [an inter vivos] trust of movables is assignable by him and can be reached by his creditor is determined…by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered and otherwise by the local law of the state to which the administration of the trust is most substantially related."

3. In some jurisdictions a settlor's ability to designate the law of a particular jurisdiction as the governing law of the trust is expressly provided for by statute.

a. For example, Section 7-1.10 of the New York Estates, Powers and Trusts Law provides that:

> "[w]henever a person, not domiciled in this state, creates a trust which provides that it shall be governed by the

> laws of this state, such provision shall be given effect in determining the validity, effect and interpretation of the disposition in such trust..."

4. There are also a number of cases that have applied conflicts of law principles to spendthrift trusts.

   a. In *Togut v. Hecht*, 54 B.R. 379, Bankr. L. Rep. (CCH) ¶ 70821 (Bankr. S.D.N.Y. 1985), decision aff'd, 69 B.R. 290 (S.D.N.Y. 1987), a case involving a non-self settled spendthrift trust, the issue was "...whether the laws of the State of Maryland or New York are applicable in determining the validity of the spendthrift trust provisions... " The debtor argued for the application of Maryland law, because it would preclude the bankruptcy trustee from claiming any portion of the spendthrift trust's undistributed income and principal as a part of the bankruptcy estate. The bankruptcy trustee argued that the law of the forum state of New York should apply, because under the law of New York, the bankruptcy trustee would be entitled to ten percent of the trust's undistributed income as well as any portion of the remaining ninety percent of such income that might be in excess of the debtor's reasonable living requirements. The bankruptcy court's determination that the law of Maryland was the "applicable non-bankruptcy law" for purposes of determining the Bankruptcy Code section 541(c)(2) exemption was based solely upon the trust settlor's designation of Maryland law as the law governing "all questions pertaining to [the trust's] validity, construction and administration."

   b. In *The National Shawmut Bank of Boston v. Cumming*, 325 Mass. 457, 91 N.E.2d 337 (1950), the settlor, a domiciliary of Vermont, created a trust of "the greater part of his property," which trust the settlor designated to be "construed and the provisions thereof interpreted under and in accordance with the laws of the Commonwealth of Massachusetts." As recognized by the lower court's opinion, the *Shawmut* settlor's clearly implied intent in designating Massachusetts law as controlling, was to defeat his surviving spouse's significantly greater inheritance rights under Vermont law. According to the *Shawmut* court:

      > [i]f the settlor had been domiciled in this Commonwealth and had transferred here personal property here to a trustee here for administration here, the transfer would have been valid even if his sole purpose had been to deprive his wife of any portion of it. The Vermont law we understand to be otherwise and to invalidate a

transfer made there by one domiciled there of personal property there, if made with an actual, as distinguished from an implied, fraudulent intent to disinherit his spouse.

In holding that Massachusetts law should apply, thereby depriving the surviving spouse of the greater part of her inheritance rights, the *Shawmut* court stated that "[t]he general tendency of authorities elsewhere is away from the adoption of the law of the settlor's domicile where the property, the domicile and place of business of the trustee, and the place of administration intended by the settlor are in another State."

5. For a detailed analysis of the conflict of law rules as they relate to self-settled trusts see Rothschild, Rubin and Blattmachr, "*Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch*", Vanderbilt Journal of Transnational Law, Vol. 32, No. 3, May 1999.

E. Tax and Reporting Issues

1. Income Taxation and Related Reporting Requirements

a. Residence of Trust

- Internal Revenue Code §§ 7701(a)(30) and (31)(B), and the Treasury Regulations thereunder, provide that a trust is a foreign trust unless two criteria are met:

  - A court within the United States must be able to exercise primary supervision over the administration of the trust; and

  - One or more United States persons have the authority to control all substantial decisions of the trust.

- Note that, under these rules, a trust can be structured to meet the requirements of a domestic trust for United States tax reporting purposes, but can nevertheless be governed by foreign law. Such a trust, commonly referred to as a "hybrid trust," will provide that a United States person shall control all substantial decisions of the trust (even though there will also be a foreign co-trustee), and that a United States court will have primary supervision over the administration of the trust even though it may be directed to apply foreign law in so doing.

b. A properly structured foreign trust should not be taxed any differently than a domestic trust. The only distinction, in the end, will be that additional information reporting requirements will be triggered if the trust is a foreign trust. This is because the trust would be treated as a grantor trust for federal income tax purposes (even if not otherwise structured as a grantor trust), by dint of:

- Being self-settled since Internal Revenue Code § 677 provides that "[t]he grantor shall be treated as the owner of any portion of a trust…whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be – (1) distributed to the grantor…; [or] (2) held or accumulated for future distribution to the grantor…"

- Being a foreign trust since Internal Revenue Code § 679 provides that "[a] United States person who directly or indirectly transfer property to a foreign trust…shall be treated as the owner…of the portion of such trust attributable to such property if…there is a United States beneficiary of any portion of the trust."

c. Since the trust is a grantor trust, a Form 1041, *United States Income Tax Return for Estates and Trusts* (or, alternatively, a Form 1040NR, *U.S. Nonresident Alien Income Tax Return*), must be filed annually.

d. If the trust is a foreign trust, line 8 on Form 1040,*United States Individual Income Tax Return*, Schedule B, *Interest and Ordinary Dividends*, Part III, *Foreign Accounts and Trusts*, which asks "…were you the grantor of, or transferor to, a foreign trust?" must be answered in the affirmative.

e. If the trust is a foreign trust, a Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, will need to be filed by the settlor on an annual basis for the purpose of reporting any transfers to the foreign trust that occurred during the preceding taxable year. After having made the initial transfer, the settlor must continue to file Form 3520 for every succeeding year - even those years when no additional transfer is made.

f. For taxable years beginning January 1, 2011, taxpayers with foreign financial assets are required to file Form 8938, *Statement of Foreign Financial Assets* pursuant to FATCA legislation.

g. In addition, a Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*, must be filed on an annual basis by the trustee of the foreign trust to provide sufficient information to the United States owners of the foreign trust, as well as the trust beneficiaries, so that they can satisfy their obligation to report transactions with the foreign trust on Form 3520.

h. Internal Revenue Code § 684, *Recognition of gain on certain transfers to certain foreign trusts and estates*, provides "…in the case of any transfer of property by a United States person to a foreign estate or trust…such transfer shall be treated as a sale or exchange for an amount equal to the fair market value of the property transferred, and the transferor shall recognize as gain the excess of…the fair market value of the property so transferred, over…the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor." However, Internal Revenue Code § 684 also provides that this rule shall not apply "…to a transfer to a trust by a United States person to the extent that any person is treated as the owner of such trust under section 671."

- Normally, gain would be recognized upon the death of the grantor, when the foreign trust is necessarily no longer a grantor trust. However, Treas. Reg. § 1.684-3(c), provides that "…[gain] recognition…shall not apply to any transfer of property by reason of death of the U.S. transferor if the basis of the property in the hands of the foreign trust is determined under section 1014(a)."

2. Gift and Estate Taxation

i. Generally, the settler will retain a testamentary limited power of appointment over the trust fund and a veto power over distributions in order to render the transfers to the trust as incomplete gifts. *See ILM 201208026.*

F. Foreign trustee

1. Trust can have one or more trustees with at least one trustee resident in the foreign jurisdiction.

2. Duties of offshore trustee may be nominal initially, but trust would usually provide that foreign trustee has power to remove domestic trustee(s) in event threat to assets or against trust were to develop.

3. Trust generally allows trustees to invest trust assets anywhere in the world, so trustee can direct that the assets be transferred to a financial

4. Foreign trustee should have no presence in the United States to avoid jurisdiction by U.S. court.

G. "Protectors" who act as watchdogs over the trustees

1. A protector has veto powers over a trustee and can discharge a trustee

2. In some jurisdictions the settler may be a protector and may have certain veto powers over the trustees, including power to remove and replace trustees and veto investment and distribution decisions without such powers affecting creditor protection status. But vesting the settler with such powers may expose the settlor to contempt. See *FTC v. Affordable Media, et al.*, infra.

3. Since protector's power to veto certain trustee decisions is a negative power (as opposed to an affirmative power to initiate action), protector cannot be compelled by a court to submit the assets to its control.

H. Non-asset Protection Reasons for Offshore Trusts

1. A client may wish to create a long term dynasty trust not limited by Rule Against Perpetuities. Some jurisdictions permit trusts to last 100 years or more.

2. Although the trust is tax neutral during the settlor's lifetime under the grantor trust rules, it becomes a non-grantor foreign trust at the settlor's death. This can present tax opportunities not available to domestic trusts.

3. Avoidance of forced heirship rules (i.e., right of election provisions).

4. Properly structured foreign situs trust can invest in companies that for one reason or another do not wish to comply with SEC filing requirements (and therefore are otherwise off limits to U.S. investors).

   a. Offshore hedge funds

   b. Foreign variable life insurance

5. Foreign trusts are also used to diversify risk, avoid exchange controls, avoid government expropriation and maintain privacy

I. Trust Structure

1. Irrevocable to avoid possibility a creditor could have the settlor compelled to revoke it. May provide for reversion to the settlor after a period of time provided no creditor claims exist provide for reversion

2. Settlor's interest as beneficiary should be discretionary

3. Settlor should retain a limited power of appointment if a completed gift is to be avoided.

4. Provision should be made for a protector and the powers of protector.

5. Give power to remove trustees located in jurisdictions where certain events occur (i.e. any threat to trust or trustees).

J. Combining Foreign Trust with Limited Liability Company

1. Maximizes both flexibility and protection.

2. When first established, transferor conveys assets to LLC in exchange for LLC interest, which is then transferred to the trust, allowing the manager/settlor to maintain control over LLC's assets.

3. Once threat appears, foreign trustee has power to remove manager (to protect manager from any potential court order) and, as sole member of the LLC, move LLC assets offshore

4. A member of the LLC can make election to be a disregarded entity by filing Form 8832. Single member LLC's electing to be disregarded entities must file annually on Form 8858.

K. Asset Transfer Considerations

1. Generally, liquid assets are best and least complicated to transfer offshore

2. If client wishes to protect illiquid assets (i.e., real estate, business interests, etc.) it may be possible to borrow out most of the equity using the property as collateral and moving the loan proceeds offshore.

3. Pension assets, including IRAs, would generally not be transferred since doing so would result in immediate income taxation and possible penalties for premature withdrawals. But ERISA qualified plans and IRA's are protected, and in many states, non-ERISA plans (i.e. Keoghs with only one participant) are protected under state exemption statutes.

4. Statutory provisions restrict transfers of professional corporation stock. However, to strip the equity out of the corporation, the grantor can borrow against corporate assets and transfer the proceeds to the partnership or trust.

5. "Nest egg" transfer for business person who must retain adequate assets to obtain bank loans versus other clients who might transfer all their property

6. Creation of several partnerships or LLC's so that inherent liabilities of certain assets do not taint other assets, e.g. real estate.

7. Subchapter S corporate stock should not be transferred to a foreign trust as it will terminate S status.

L. Export the Assets v. Import the Law

1. Exporting assets to foreign jurisdiction under control of foreign trustee.

2. Importing the law

a. Assets transferred to settlor-controlled LLC or FLP remain in United States until threat arises

b. May subject settlor to civil contempt. See Section V, *infra*.

c. U.S. court may have jurisdiction over foreign trust due to situs of assets remaining in United States. See *Nastro v. D'Onofrio*, 263 F. Supp 2d. 448 (2003).

M. Foreign vs. Domestic

1. Foreign trusts offer more substantive barriers to creditors since a U.S. judgment may not be enforceable offshore, whereas U.S. Constitution generally requires state courts to enforce other state's judgments. See e.g. *In re Mortenson*, supra p. 44.

2. Will settlor's designation of what state or foreign country's laws govern the trust be respected? Or will a creditor's rights be determined by the state's governmental interest or "significant relationship" with the settlor? See e.g., *In re Portnoy*, 201 B.R. 685 (S.D.N.Y. 1996) *infra*. and *B.V. Brooks* 1998 Bankr. Lexis 60 (D.CT., 1998)

3. Consider appointment of a domestic trustee resident in a state which recognizes self-settled trusts to act with a foreign trustee.

N. How Much Protection Is Necessary?

1. Some client situations warrant greater sophistication and complexity resulting in higher costs.

2. Continuum beginning with transferring assets to a spouse (at minimum cost) and proceeding through a series of alternatives offering more certainty and flexibility until you reach offshore trust/foreign LLC contribution (at the greatest cost).

O. Costs

1. In addition to legal fees, client will incur annual fees to offshore trustee of $3,500 to $5,000 depending on jurisdiction. Once trust is created only other ongoing costs are those for preparing the trust income tax returns

2. Fees paid to establish asset protection trust and administrative fees paid to operate it should, if reasonable, be deductible under IRC Code § 212 as "ordinary and necessary expenses paid or incurred... (1) for the production or collection of income or (2) for the management, conservation, or maintenance of property held for the production of income"

3. Client should assess level of protection desired and consider annual cost to be similar to that of a single premium liability policy

    a. A cost/benefit analysis

    b. Typical client has at least $1,000,000 in assets to protect

    c. Clients who place great value on peace of mind will be better able to justify more sophisticated techniques.

    d. Offshore trust on a stand alone basis, where settlor is neither a protector nor a beneficiary; but client must give up control which, as a practical matter, most clients would prefer not to do.

    e. Nature and location of assets owned by LLC or trust. If client utilizes the LLC/trust technique generally there is no need, initially, to transfer assets offshore.

    f. In authors' experience, less than 5% of clients creating such vehicles have been targeted by creditors and therefore these structures merely serve a similar purpose to that of insurance policies

    g. When a creditor attack is imminent, however, a decision will have to be made to remove assets from danger of being seized. At this time assets can be liquidated and moved to another jurisdiction.

P. Other Practical Concerns

1. Possibility that a creditor may bring legal action against planner under various theories; possibility exists that a client may have misrepresented his or her liabilities or that an aggressive creditor may name planner as a co-conspirator to gain some leverage in litigation. See, e.g., *Morganroth & Morganroth v. Norris McLauglin*, 2003 U.S. App. Lexis 10808 (3rd Cir, May 30, 2003). Planner must protect himself or herself by

2. Since asset protection planning must be implemented when there are no legal claims on the horizon, the planner has the difficult task of motivating a client to take action before a fear becomes a nightmare.

3. How will the filing of bankruptcy affect the creditor protection of self-settled trusts?

   a. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added a provision that will deem a transfer to a self-settled trust to be a fraudulent transfer if made within 10 years of filing a bankruptcy petition, if the transfer is made with fraudulent intent to hinder, delay or defraud existing or future creditors.

   b. Should the settlor's interest as a beneficiary "spring" up only after 10 years? Alternatively, should the trust be settled offshore for the first 10 years and then be redomiciled onshore?

   c. Does the Act legitimize self-settled trusts that have been existent for more than 10 years? Or will the forum state still apply its own laws?

VII. EFFECTIVENESS OF AND CHALLENGES TO OFFSHORE TRUSTS.

A. The effectiveness of any asset protection plan is determined by the results ultimately achieved. That is, in the final analysis, to what extent has the client protected the assets from loss.

B. In the real world plaintiffs must weigh the heavy costs of litigation against the likelihood of successful recovery. If, as a result of availing oneself of certain techniques, the client is in a better position to settle the dispute at considerably less cost, then the benefits of asset protection are realized.

C. The few reported decisions which involve offshore trusts offer insight into how the courts, both in the United States and abroad, view these structures.

1. *Re: 515 South Orange Grove Owners v. Orange Grove Partners*, brought in the Cook Islands in 1994, involved a California real estate developer against whom suit was brought in California in 1992 and a judgment of $5 million was awarded in California in 1994. During 1993 and 1994 the defendant settled a trust in the Cook Islands and transferred assets thereto. The creditors obtained a *Mareva* injunction (similar to a TRO) *ex parte*. The author has been advised that this case settled. It may not

2. In *Brown v. Higashi*, U.S. Bankruptcy Court 95-3072 (D. Alaska 1996), the District Court determined that the Belize trust created by the debtor was a sham and therefore the assets of the trust were includable in the debtor's bankruptcy estate. The Court's decision was based on several factors including, importantly, the debtor's absolute failure to execute any trust documents and complete retention of control over the trust assets.

3. In *Marine Midland v. Portnoy*, 201 Bankr. 685 (SDNY 1996), the debtor transferred over $1 million to a Jersey, Channel Islands, trust at a time "when he knew his personal guarantee was about to be called." In addition, the District Court noted that the debtor misrepresented, during settlement discussions (prior to the bankruptcy filing), that the debtor had incurred large expenses for cancer treatments because of which the debtor had no assets remaining to satisfy his debt. Finally, the District Court also noted that debtor's salary was being deposited into the debtor's wife's account. The District Court denied the debtor a discharge holding that the debtor's actions demonstrated intent to defraud creditors. There are reports that this matter settled.

4. In the case of *In re B.V. Brooks*, 217 B.R. 98 (D. Conn., 1998), the issue before the court was whether to apply domestic (in this case, Connecticut) law, or foreign law to the spendthrift trust exemption under the Bankruptcy Code. Citing *Portnoy* as precedent, the court found the assets of the debtor's two trusts includable in the debtor's bankruptcy estate notwithstanding the fact that the trusts were valid spendthrift trusts under the laws of Bermuda and Jersey, Channel Islands. Although very little of the case's factual background was actually reported, the Bankruptcy Court did note that the debtor/settlor was the primary beneficiary of each of the trusts and had the right to receive all of the income. In addition, the unreported facts apparently caused the court to perceive the funding of the trusts as fraudulent since the Court twice characterized the debtor's acts in creating the trusts as a "scheme". This perception was likely buttressed by the timing of the case since the trusts were funded in 1990 and an involuntary bankruptcy petition was filed against the debtor the following year.

5. In the matter of *In re Stephan Jay Lawrence*, 227 B.R. 907 (S.D. FL 1998), following a forty-two month arbitration and just sixty-six days before an award in excess of US $20 million was entered against him, the debtor funded an off-shore trust citing first the law of Jersey, Channel Islands, and about a month later, the law of Mauritius, as governing. Citing both *Portnoy* and *B.V. Brooks* the Bankruptcy Court found that the sole purpose of the trust was to shield the debtor's assets from a creditor

- Subsequently, the bankruptcy trustee moved to hold the debtor in contempt if he did not repatriate the funds. In September, 1999, having failed to repatriate the funds, the debtor was held in contempt. *In re Lawrence*, 238 B.R. 498, 500 (S.D.Fla. Bankr., 1999), which finding was affirmed by the U.S. District Court in a *de novo* review. *In re Lawrence*, 251 B.R. 630 (S.D.Fla. 2000).

    - Generally, impossibility of performance is a complete defense to a charge of coercive civil contempt. *United States v. Rylander*, 460 U.S. 752 (1983). However, certain lower courts have suggested that an exception exists where the impossibility is self-created within a nexus of time of the anticipated judgment.

6. *FTC v. Affordable Media LLC, et al.*, 179 F.3d. 1228 (9th Cir. 1999). Although the facts in this case (colloquially known as the "Anderson" case after its individual defendants), were as bad as, if not worse than, those in any of the foregoing cases, the court never reached any issues of trust validity or conflict of laws. Instead, the Court tangled with the settlors' alleged contempt of court in failing, pursuant to a preliminary injunction, to repatriate trust assets which had been invested in trust name offshore. Specifically, the settlors, who were also co-trustees of their own trust, as well as the trust protectors, were ordered to instruct their foreign co-trustee to repatriate more than $6 million in profits collected under an alleged Ponzi-type investment scheme. The "anti-duress" clause in the trust agreement resulted in their removal as trustees and ensured that the assets would not be repatriated pursuant to the Court's order. When the assets were not timely repatriated, the settlors were held in civil contempt for failing to comply with the court order and jailed pending repatriation of the assets. After the FTC lost several rounds in the Cook Islands, the case was ultimately settled for $1.2 million.

    - In finding the Andersons in civil contempt, the district court rejected the Andersons' impossibility defense, specifically finding that the Andersons, in the judgment of the Court, were in control of the trust since the trust instrument provided them, as the protectors, with the exclusive power to determine what constituted an event of duress (which would negate their power to instruct to the trustee to repatriate the trust fund).

7. *United States v. Grant*, No. 00-8986, 2005 U.S. Dist. LEXIS 22440 (S.D. Fl. Sept. 2, 2005). In 1983 and 1984, Raymond Grant created a Bermuda trust and a Jersey, Channel Islands, trust. Raymond was the beneficiary of the Bermuda trust, and his wife, Arline Grant, was the beneficiary of the Jersey, Channel Islands, trust. In 1991 and 1993, the IRS assessed millions of dollars in back taxes against the Grants for the years 1977 through 1982, and 1984 through 1987. In 2003, judgment was entered against the Grants for more than $36 million, and a motion was made to order Arline to repatriate the trust funds because Arline had the power to remove and replace any acting Trustee. The court set forth its query in simple terms: "[I]s this a trust over which the beneficiary lacks any control, such that the beneficiary is simply that and nothing more, and regardless of what she does or says, she lacks the power to repatriate these assets to the United States? – or, does the beneficiary retain such control that she has the power vested in her in some way by the terms of the trust to repatriate the corpus? If she has such power, then this asset is no different from any other asset."

   - Arline took steps to have the trustees remit the funds or resign in favor of a US trustee, which were unsuccessful. Therefore, the Court denied the government's motion to hold Arline in contempt as her demonstrated impossibility to comply was a complete defense to contempt. See, *U.S. vs. Raymond Grant and Arline Grant,* 2008 U.S. Dist. LEXIS 51332, U.S. District Ct., S.D. Florida, May 27, 2008.

8. *Federal Trade Commission v. Ameridebt, Inc.*, 373 F. Supp. 2d 558 (D. Md. 2005). In this case, the defendants allegedly operated a "non-profit" credit counseling service, but defrauded consumers with debt problems by offering to fashion debt payment plans for them and then deducting fees from payments the consumers made under the plans without disclosing those deductions to the consumers. The Federal Trade Commission sought a preliminary injunction appointing a receiver, freezing the defendants' assets, requiring an accounting and directing the defendants to repatriate to the receiver assets that had been transferred offshore. The FTC alleged that since the time when the defendants became aware of the investigation that led to the lawsuit the defendants had been actively dissipating their assets by making transfers to close friends and relatives, to trusts (both domestic and offshore), and by living a lavish lifestyle. In particular, less than two months after the FTC served two of the defendant companies with Civil Investigative Demands, one of the individual defendants set up domestic and offshore asset protection trusts. Presented with this set of egregious circumstances, the District Court granted the motion for preliminary injunction appointing a receiver, freezing the defendants' assets, requiring an accounting of assets and directing the defendants to repatriate to the receiver assets that were transferred offshore. With regard to the latter

9. *Nastro v. D'Onofrio*, et. al., 263 F. Supp. 2d 446 (D. Ct. 2003). The plaintiff obtained a $2.1 million judgment against the defendant for misappropriation of their formerly co-owned company's funds. Two weeks later, the defendant transferred $650,000 worth of stock and membership interests in Connecticut companies of which he was either the 100% owner or 50% owner to an irrevocable spendthrift trust in Jersey, Channel Islands, for the benefit of his wife and children. The plaintiff asserted, *inter alia*, that the transfer was fraudulent under Connecticut's Uniform Fraudulent Transfer Act. The Court dismissed the claims against the Jersey, Channel Islands, trustee, holding that there was no basis to exercise personal jurisdiction over it because the Jersey, Channel Islands, trustee had insufficient contacts with Connecticut. Further, the Court ruled that there was no basis to exercise jurisdiction over the trust assets since they consisted of "certificated" securities and, under Connecticut's version of the Uniform Commercial Code, the situs of a certificated security is the place where the certificate is located (*i.e.*, Jersey, Channel Islands). This is the case "[e]ven though the companies and, presumably, the companies' assets are located in Connecticut." However, the Court granted plaintiff's preliminary injunction enjoining the Connecticut companies from registering any further transfers of stock held by the trust and from transferring any assets to the defendant, his family or the trust during the pendency of the litigation. The Court found that the plaintiff satisfied his twin burdens of showing that he will suffer irreparable harm and that there are sufficiently serious questions on the merits. The first prong was satisfied since there was the possibility that the defendant could take further action to place the assets beyond the reach of the Court. The second prong was satisfied since there was evidence that the defendant transferred his interests in the Connecticut companies without consideration and was thereby rendered insolvent (which, under Connecticut's Uniform Fraudulent Conveyance Act, would render the transfers fraudulent).

10. *SEC vs. Jamie Solow*, 682 F. Supp. 2d 1312 (S.D. Fla., 2010). In this case, the defendant's spouse had settled a Cook Islands Trust shortly after the defendant was found liable for securities fraud and a judgment of $6 million was entered against him, including $3 million for disgorgement. The defendant had made several asset transfers to his wife during the investigation of the fraud and after numerous arbitration proceedings were commenced. Among other assets transferred to the foreign trust, the defendant's wife had stripped the equity in their homes by obtaining a mortgage and transferring the proceeds to the foreign trust. After the

11. As many of these cases illustrate "bad facts make bad law." Based on the facts presented, the trusts were created after the debt was incurred and accordingly the Court, in each instance, reached the right decision. Notwithstanding the results obtained (and without condoning such transfers), in many cases the debtors apparently even benefited by their wrongful transfers.

12. In the end, the best results will be obtained where trusts are settled sufficiently in advance and properly structured and administered.

- A decision recognizing the validity of a foreign trust arose in the context of a divorce proceeding. In *Reichers v. Reichers* (NY Supreme Court, Westchester County), (New York Law Journal July 1, 1998), the defendant husband settled an irrevocable trust in the Cook Islands in 1992 following the successful conclusion of three medical malpractice lawsuits that had been filed against him. Ironically, his wife then sued for divorce in 1994. The Court in its decision, wrote:

> "Assuming arguendo, that this Court had jurisdiction over the corpus of the Reichers Family Trust, which it does not, a cause of action would not lie to set aside the trust since the trust was established for the legitimate purpose of protecting family assets for the benefit of the Reichers family members."

13. At the end of the day, however, the offshore trust's effectiveness as a tool to thwart future creditors will most likely not depend on whether a United States court gives credence to the application of foreign trust law when adjudicating a claim against the settlor. Provided that the trust's assets are located offshore (whether that be in the jurisdiction of the trust's governing law or an established financial center such as Switzerland or Luxembourg), a creditor with a United States judgment will still be faced with significant hurdles before actually being able to levy on any of the trust's assets. In fact, since some jurisdictions will not recognize foreign judgments, the creditor may be forced to re-litigate its entire case against the trust. Moreover, in some jurisdictions the statute of limitations on fraudulent transfer claims may have already expired by the time suit is brought in that jurisdiction). Finally, aside from the United States, most common law jurisdictions (*i.e.*, those jurisdictions which recognize the trust concept), (i) do not allow attorneys to take matters based on a contingency fee, and (ii) provide that the losing party to a lawsuit must

VIII. NEW TRENDS IN ASSET PROTECTION WITH AN EMPHASIS ON ESTATE PLANNING.

A. Tax Planning vs. Asset Protection

1. Many of the structures that are used to maximize planning with the lifetime gift tax exemption also provide potentially significant asset protection benefits by (i) divesting the settlor of an asset, or (ii) converting the settlor's outright ownership of an asset into either (a) a less attractive retained interest, or (b) an entirely different type of property which is less attractive to creditors.

2. Moreover, the asset protection benefit of such structures is enhanced by the fact that since these structures are ubiquitous as estate planning vehicles, they are much less controversial and prone to scrutiny than so-called "asset protection trusts."

3. Finally, since these structures provide undisputedly significant estate and gift tax savings, they can help to counter potential creditor claims to the effect that transfers in connection with the structures were made with the intent to hinder, delay or defraud creditors (*i.e.*, a fraudulent transfer).

B. Dynasty Trusts

1. A "dynasty trust" might be defined as a trust which is intended to be generation-skipping transfer ("GST") tax exempt and which will continue, at a minimum, for a period beyond the lifetime of the settlor's children.

2. The term of a dynasty trust can be the maximum term allowed under the applicable Rule Against Perpetuities; in a jurisdiction which has abolished the Rule Against Perpetuities, a dynasty trust can last forever.

    a. The Rule Against Perpetuities period is most states provides, generally, that a trust cannot continue beyond twenty-one years after the death of an individual living at the time of the trust's creation.

b. In order to attract trust business, more than one half of the states have either repealed or substantially modified the Rule Against Perpetuities, thereby encouraging dynasty trusts. Of those states, Alaska, Arizona, Delaware, Florida, Ohio and South Dakota also do not impose a state income tax on trust income.

3. A dynasty trust can be created by inter vivos or testamentary transfer. The advantage of an inter vivos dynasty trust is that it allows any appreciation between the date of the transfer and the date of the settlor's death to avoid estate taxation, thereby leveraging the settlor's "unified credit" and the settlor's GST tax exemption. Also, it is obviously only with an inter vivos dynasty trust that the assets used to fund the dynasty trust will avoid creditor claims against the settlor (assuming, of course, that the funding of the dynasty trust is not later found to have been a fraudulent transfer).

4. The trustees of a dynasty trust are usually given discretion to distribute income and/or principal to a class of beneficiaries which includes the descendants of the settlor and can also include the settlor's spouse. One of the benefits inherent in naming the settlor's spouse as a discretionary beneficiary of the dynasty trust is to enable the settlor to indirectly benefit from the trust fund, within the trustees' discretion, if the settlor should so require (*i.e.*, a distribution can be made to the settlor's spouse within the trustees' discretion, and the settlor's spouse might then use the distribution for the settlor's benefit, if the settlor's spouse is so inclined).

a. In order to facilitate cooperation by the trustees, the settlor may act as the "protector" of the dynasty trust and, in that capacity, hold the power to remove and replace the trustees.

b. Obviously, in the event of a divorce, or in the event that the settlor's spouse should predecease the settlor, this avenue of accessing the trust fund would become unavailable to the settlor.

i. This problem can be ameliorated, however, by naming "the Settlor's Wife" or "the Settlor's Husband" as the beneficiary, rather than including the actual name of the settlor's spouse as a beneficiary of the dynasty trust. This is sometimes called a "floating spouse" clause and it obviously defines the beneficiary, in effect, as the person to whom the settlor is married at the time reference might be made. Therefore, in the event that the settlor is no longer married to the person he or she was married to at the time of the creation of the dynasty trust, whether by reason of the spouse's untimely death or by reason of a divorce, the settlor can again have indirect access to the dynasty trust by remarrying.

c. In addition, the dynasty trust can also include a "revisions of interests" provision that would provide the trustees with discretion, during the settlor's lifetime, to add or remove individuals as beneficiaries of the dynasty trust. Therefore, in the event of the settlor's spouse's untimely death or a divorce, and if the settlor should require access to the dynasty trust, the trustees would have the discretion to add the settlor as an additional beneficiary of the dynasty trust.

i. This should not cause estate tax inclusion if the dynasty trust is created in a state, such as Alaska, Delaware, Nevada or South Dakota, or in one of the other states that permits so-called "self-settled" trusts.

5. Advantages of Dynasty Trusts:

a. Trust assets are not generally available to the beneficiaries' creditors under state spendthrift trust law.

b. Property is made available for successive generations of descendants without the imposition of estate taxation.

c. The lifetime use of the settlor's GST tax exemption amount will avoid the imposition of generation-skipping transfer taxation on any future appreciation for so long as the property remains in trust.

C. Leveraging the Lifetime Gift Tax Exemption to Enhance Trust Benefits

1. Discounting

a. After years of challenging discounts in the family transfer context, in 1993 the Internal Revenue Service issued Rev. Rul. 93-12, IRB 1993-7 recognizing (at least in theory), the applicability of such discounts.

b. Upon the transfer of a limited partnership interest or limited liability company membership interest, the transferor may be entitled to certain discounts off of a proportionate share of the value of the company's underlying assets. The two most important such discounts are (i) a discount for a lack of marketability, and (ii) a minority interest discount.

c. A lack of marketability discount is based on the inability to convert an interest into cash quickly with minimum transactional costs. For example, a closely-held business will generally have a smaller pool or buyers than an interest in a publicly traded

d. A minority interest discount is based on the lack of control that accompanies the ownership of a minority interest (*i.e.*, fifty percent or less of the voting interest in the business). Typically only a majority interest owner in a business will have the authority to make decisions relating to distributions, liquidation, management, etc. Accordingly, the owner of a minority interest has no control over the flow of distributions out of the business (amongst other things), and consequently has a less valuable interest in the company than the majority interest holder who can make these decisions without the consent of the minority interest holders.

2. Installment Sales

a. Another commonly utilized estate planning technique that offers asset protection benefits is the sale of property on credit to a "defective" or "grantor" type trust (including a dynasty trust).

b. Such a sale provides a potentially significant asset protection benefit by converting the settlor's outright ownership of one type of property (*i.e.*, marketable securities), into an entirely different type of property which is likely less attractive to creditors (*i.e.*, an unsecured note receivable from the purchasing trust).

c. The trust's promissory note is likely to be less attractive to a creditor than the property sold for various reasons:

i. In order to leverage the estate planning benefits of the sale, the promissory note likely provides only for the payment of interest for a term of years with a balloon payment of capital due at the end of the term.

ii. In addition, the differential between the applicable federal rate and the actual return on the transferred assets can be captured free of tax and protected from creditors in the trust. With the current federal "hurdle" rates at their lowest level since the 1960's, the additional amount "transferred" in a loan or credit sale transaction can be quite significant.

D. Analysis of IRS Rulings and Court Decisions

1. Estate Tax Inclusion

a. IRC § 2036 provides that a transferor's gross estate includes the value of any transferred property over which the transferor retained the right to possession, enjoyment or income for a period not ascertainable without reference to his life.

b. A gift is incomplete in every instance in which "the donor reserves any power over its disposition." Treas. Reg. §25.2511-2.

c. Since, under Restatement (Second) of Trusts §156(2), a settlor's creditors can reach trust property to the maximum extent that the trustees may distribute the property to the settlor, the settlor is deemed to have retained rights to the property within the meaning of IRC §2036 and §2511. (See, e.g., *Paxton v. Comm'r*, 86 T.C. 785 (1986), *Outwin v. Comm'r*, 76 T.C. 153 (1981), and *Paolozzi v. Comm'r*, 22 T.C. 182 (1954)).

2. Completed Gifts

a. "If and when the [settlor's] dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a state where the [settlor's] creditors cannot reach the trust's assets, then the gift is complete for federal gift tax purposes under the rules set forth in §25.2511-2 of the Regulations." Rev. Rul. 76-103, 1976-1 C.B. 293.

b. Where "...the [settlor] cannot require that the trust's assets be distributed to the [settlor] nor can the creditors of the [settlor] reach any of the trust's assets..." the settlor has parted with dominion and control so as to have made a completed gift of the assets transferred to the trust. Rev. Rul. 77-378, 1977-2 C.B. 347.

c. Private Letter Ruling 9332006 (which is not precedential) applies the foregoing rules to a foreign situs asset protection trust of which the settlor and the settlor's family were discretionary beneficiaries. The settlor's transfer to the foreign situs trust was deemed by the IRS to be a completed gift and, therefore, outside of the settlor's taxable estate because under the laws governing the trust the settlor's creditors could not attach the trust assets.

d. Private Letter Ruling 9837007 (not precedential) applies to an Alaska trust in which the settlor was among the class of beneficiaries. The Service held the transfer to be a completed gift but refused to rule on whether the assets in the trust would be includable in the Settlor's estate at death because of the possibility of an implied agreement with the trustee to make distribution upon the settlor's demand.

e. Private Letter Ruling 200944002 (not precedential) also applies to an Alaska Trust settled by an Alaska resident and concluded that the transfer was a completed gift and, barring other facts existing at death, should not be includable in the settlor's estate citing Rev,. Ruling 2004-64.

E. Using Self-Settled Trusts for Estate Planning Benefits.

1. Introduction

a. Basic objective of estate planning is to minimize estate, gift and generation-skipping transfer taxes to the greatest extent possible while remaining true to the client's dispositive wishes.

b. An estate planner's ability to minimize transfer taxes may be frustrated by the client's desire to retain control over and/or access to his assets during lifetime.

c. A properly structured, self-settled, spendthrift trust ("APT") provides a viable solution to a client's desire to be able to minimize transfer taxes without putting his assets forever out of reach in the event of an emergency need.

d. As an added benefit, property held in trust will avoid the delay, expense and publicity involved in transferring property at death pursuant to a probate proceeding

e. Since assets held in the trust will enjoy a greater degree of creditor protection than assets retained in the settlor's individual name, a transfer to an APT will actually enhance the likelihood that the assets will be available to the settlor in case of some future emergency need

2. Minimizing Estate and Generation-Skipping Transfer Taxes

a. A settlor can make an inter-vivos transfer of the gift tax annual exclusion amount to an APT in order to gradually reduce the size of his taxable estate without incurring any transfer tax or reducing his unified credit.

- In order to have a transfer to an APT come under the IRC §2503 gift tax exclusion the transfer must be of a "present interest" under IRC §2503(b). This can be accomplished by the inclusion of "Crummey" powers in the trust agreement.

b. A settlor could make an inter-vivos gift of his remaining IRC §2010 applicable exemption amount

i. No current transfer tax liability

ii. Removal of subsequent appreciation from settlor's estate

iii. The loss of the IRC §1015 "stepped-up" basis is more than compensated for by the overall tax savings inherent in the differential between the maximum 45% estate (and generation-skipping transfer) tax rate and the maximum 15% capital gains tax rate

c. Gifts in excess of the applicable exemption amount (in particular, gifts aggregating the IRC § 2631 generation-skipping transfer tax exemption amount of $2 million) are advisable if the settlor can afford to pay the current gift tax since inter-vivos gifts are, in effect, one-third more tax advantageous than testamentary bequests

d. Any gift tax paid will further reduce the settlor's taxable estate (provided the settlor lives 3 years)

e. An allocation of the settlor's generation-skipping transfer tax exemption to a transfer to trust will exempt the entire transfer of property and all future appreciation thereon from generation-skipping transfer tax

3. Drafting Considerations

a. Trustee selection - trust must have at least a resident trustee but settlor could appoint others (e.g. advisory committee) to make investment or distribution decisions. Trustee should not be related or subservient to settlor

b. Trust protector - Protector can have power to discharge trustees, make certain trust amendments if necessary, etc.

c. Change of situs provision allows for subsequent changes if laws or circumstances change

d. Other asset protection provisions such as anti-duress clauses and flee clauses can be incorporated into trust

e. Distribution Guidelines - Consider incentive provisions conditioned on earned income and distributions to beneficiary's spouse while married

f. Termination powers given to trustee if continuation not in beneficiary's best interests

g. Spendthrift provision to protect from beneficiary's creditors/former spouses

4. Advanced Considerations.

a. An APT can be combined with a limited partnership or limited liability company in order to permit investment management and control of the trust assets to continue in settlor without jeopardizing the nature of the transfer as a completed gift.

i. Structure may provide lack of marketability and lack of control discounts on the transfer of limited partnership/membership interests to the trust, thereby permitting the transfer of real value in excess of the amount subject to taxation.

ii. Structure will provide an additional layer of protection between third party creditors and the trust.

iii. In the unlikely event of trust creditors, enforcement of a judgment will be limited to a charging order against the trust's limited partnership or limited liability company interest

iv. Use of an Alaska or Delaware limited partnership or limited liability company will increase the settlor's contacts with that state, further justifying the application of that state's law to the claims of any creditor of the settlor

b. An APT can be combined with any split-interest gift in trust (*i.e.*, a QPRT, GRAT, or CLT), in order that the settlor may continue to have discretionary access to the transferred property after the initial term of the trust has expired.

c. An APT can be used to own the settlor's life insurance policies in the same manner as an irrevocable life insurance trust. So long as the settlor does not retain incidents of ownership in the transferred policies he can be a discretionary beneficiary, thereby permitting distributions of cash value to the settlor. (*See*, PLR 9434028).

5. Domestic vs. Offshore?

a. Introduction

i. Although highly touted as an asset protection vehicle, domestic trusts are generally inferior to foreign-situs asset

ii. Selected foreign asset protection jurisdictions will not honor judgments rendered by courts in the United States, thereby requiring a creditor to re-litigate its claims offshore. In contrast, a U.S. court is required by the Full Faith and Credit Clause of the United States Constitution to honor the validly rendered judgments of its sister states (United States Constitution, Article IV, Section 1).

iii. The Statute of Limitations for fraudulent conveyances in selected foreign asset protection jurisdictions may be as short as one year from transfer.

iv. The standard of proof for a creditor on a fraudulent conveyance claim in selected foreign asset protection jurisdictions can be as high as "beyond a reasonable doubt" (a standard normally used exclusively for criminal matters in the United States).

b. The issue of which is better, domestic or offshore, should, therefore, focus on a settlor's primary use of the structure as an estate planning, rather than as an asset protection, vehicle.

c. Considerations in Favor of Offshore

i. Statutory framework and case law in foreign jurisdiction may provide greater certainty to the result of a settlor's transfer (*i.e*. whether the transfer is a completed gift despite the trustees' discretionary power to return the trust assets to the settlor).

ii. Cook Islands first enacted comprehensive asset protection trust legislation in 1984.

iii. Ten year fraudulent transfer statute under U.S. Bankruptcy Code not likely enforceable.

d. Considerations in Favor of Domestic Trusts

i. Although a properly structured foreign situs asset protection trust should not be taxed any differently than a domestic trust substantial reporting requirements are imposed on foreign trusts with U.S. beneficiaries.

ii. Many offshore asset protection trusts are designed with either automatic or discretionary "flee" clauses to cause the trust to "migrate" abroad when creditor problems arise. At that point the trust will be deemed "foreign" under the IRC and may become subject to additional tax reporting requirements.

iii. Prospective settlors of offshore asset protection trusts must concern themselves with the economic stability and political security of the jurisdiction whose laws they are entrusting their assets to compared with the economic stability and political security in the United States.

- Even offshore jurisdictions with extensive histories of political and economic stability may probably not provide the same level of comfort as a domestic trust.

iv. United States federal and state courts and the IRS may regard domestic trusts as a more legitimate creditor protection and estate planning device than offshore trusts

- A domestic court may resent transfers outside of the jurisdiction of United States courts and reason that there is no "legitimate" reason for using an offshore trust (rather than a domestic trust) other than thwarting the domestic legal system. See e.g. *In Re: Portnoy*, 201 Bkrtcy 685 (S.D. N.Y.1996) and *B.V. Brooks*, 1998 Bankr. Lexis 60 (D.Conn.1998)

v. Domestic trusts should, both in its creation and in its maintenance, be less expensive than an offshore asset protection trust with comparable assets.

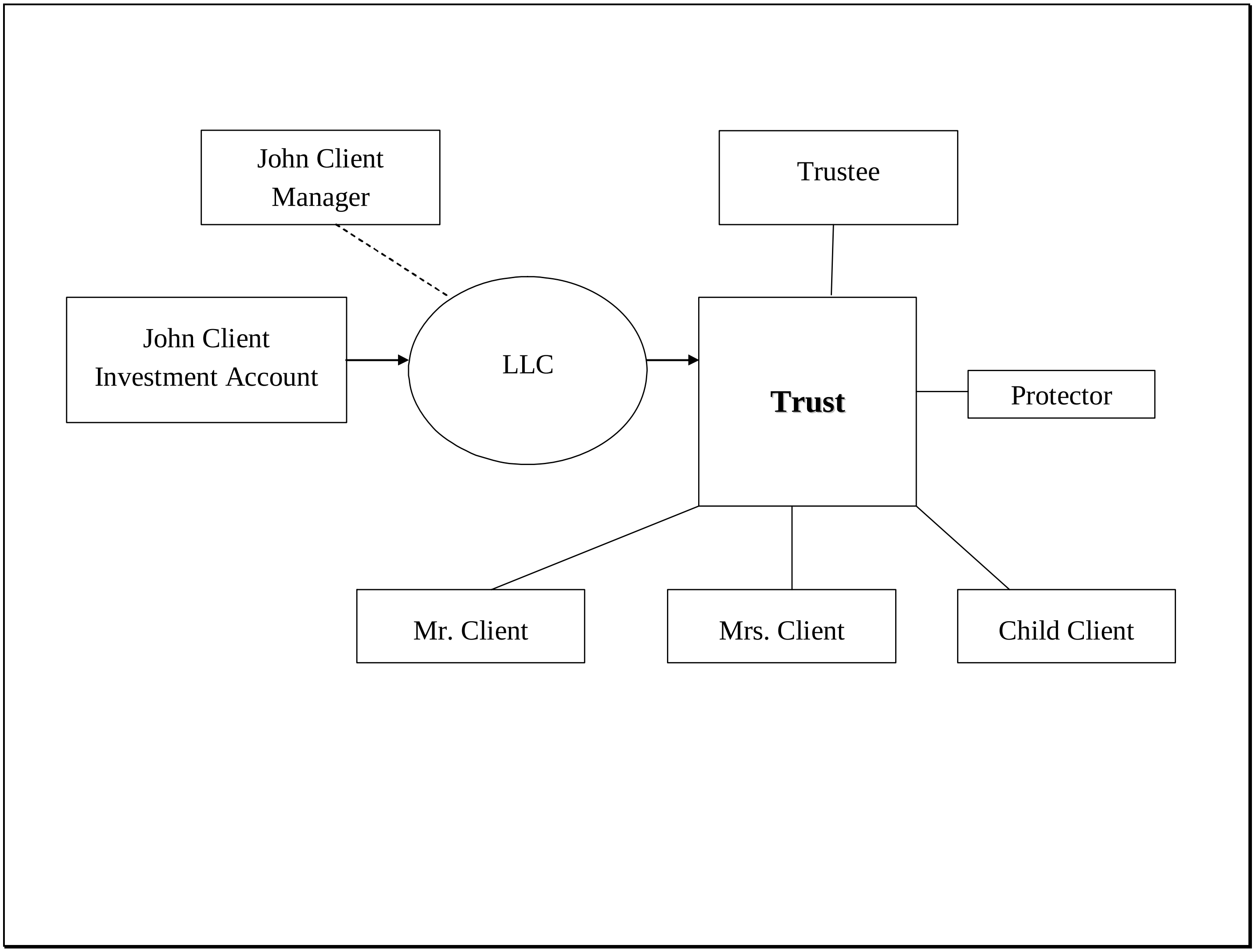
e. Considerations in Favor of Alaska/Nevada

i. Due to the carve-outs available to certain creditors under the asset protection legislation of certain states (*i.e.*, Delaware's statute (*see* I.5., *supra*)) there is a risk the IRS may take the position that the trust property, being subject to claims of creditors, even though restricted, nonetheless renders the transfer incomplete for gift and estate tax purposes.

EXAMPLE

	Dynasty Trust	Outright Gift
Initial Amount (Grantor 50 Years Old)	$ 5,000,000	$ 5,000,000
Value at Grantor's Death – 25 Years*	$ 27,137,163	$ 27,137,163
Estate Tax @ 45%	$ 0	-$ 12,211,723
	$ 27,137,163	$ 14,925,440
Value at Child's Death – 50 Years*	$147,285,125	$ 81,006,820
Estate Tax @ 45%	$ 0	-$ 36,453,069
	$147,285,125	$ 44,553,751
Value at Grandchild's Death – 75 Years*	$799,380,097	$241,812,482
Estate Tax @ 45%	$ 0	-$108,815,617
	$799,380,097	$132,996,865

*assumes 7% growth per year


John Client
Manager
Trustee
John Client
Investment Account
LLC
Trust
Protector
Mr. Client
Mrs. Client
Child Client

ASSET PROTECTION AUDIT CHECKLIST

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I. Determine Possible Sources of Liability

A. Professional Malpractice

B. General Torts (Auto accident, etc.)

C. Contract Claims

D. Creditor Exposure

E. Officer and Director Liability

F. Environmental Liability

G. Divorce

H. Forced Heirship (*i.e.*, Right of Election)

I. Political Threats

J. Economic Risks

K. Existing Lawsuits

II. Insurance Adequacy Analysis

A. Homeowners

B. Auto

C. Umbrella

D. Business Risks

E. Directors and Officers

F. Disability

G. Life

III. Maximization of Exemption Allowances

A. Does Client Participate In/Have Retirement Plans?

1. Determine Exempt Status

B. Is Homestead Exemption Available?

1. Ascertain How Title is Held

2. Consider Effects (Tax and Non-tax) of Changing Title

C. Determine Extent of Joint Ownership/Community Property

IV. Review Estate Plan and Nature of Asset Holdings With View Towards Creditor Protection

A. Does Client Expect Large Inheritance?

1. Ascertain Whether Outright or in Trust

B. Do Wills and Trusts Provide for Outright Distributions to Beneficiaries?

1. Consider Amending to Retain Assets in Trust

C. Business Activities

1. What Form of Entity is Utilized?

☐ LLC ☐ Corp. ☐ Sole Proprietor

☐ LLC ☐ L.P.

2. Is Client a General Partner?

3. Has Client Provided Guarantees?

4. Consider Reorganizing Holdings and Segregating Assets with Liability Potential

V. Prepare Solvency Analysis.

VI. Consider/Discuss Following Techniques to Protect Wealth

A. Domestic Trusts

1. Non-Self-Settled

a. QPRT

b. CRT/CLT

c. QTIP

d. Discretionary

e. Power of Appointment

f. Sale to Grantor Trust

2. Self-Settled

B. Foreign Trusts

C. Swiss Annuities

D. Foreign Life Insurance

E. Limited Liability Entities