Asset Protection

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I. INTRODUCTION

A. It's no secret that the United States is a litigious society and there's no indication that the trend line with respect to lawsuits will go anywhere from here but up. And although some claims have merit, far too many may not. In such an atmosphere, everyone, and high-income/high-net-worth individuals in particular, perceive themselves as being subject to an unacceptable level of exposure. Timely and professional asset protection planning can, however, help to weather the storm of litigation.

1. "Asset protection planning" may be defined as the implementation of various advance planning techniques which are intended to place assets beyond the reach of a person's potential future creditors.

a. The phrase "potential future creditors" is a term of art referring to non-existent and as yet unanticipated creditors; for example, creditors with whom a person has not yet done (or even contemplated doing) business at the time of a transfer of property.

i. When this outline speaks to the possibility of a person engaging in asset protection planning *vis a vis* his or her own creditors, it is important that such planning be undertaken only to protect against potential future creditors because a transfer of property to protect against either (i) one's existing creditors, or (ii) one's anticipated future creditors, would likely constitute a "fraudulent transfer" and, therefore, would probably be ineffective as well as illegitimate.

B. This seminar will discuss various planning techniques that can be used to place assets beyond the reach of creditors, will determine when it is appropriate to utilize such techniques and will discuss the optimal method of implementing such techniques.

C. The current litigation environment is often thought to create greater exposure to risk of loss than ever before (and this may be particularly true for high-income/high net-worth individuals who, for obvious reasons, present the most appealing targets for prospective plaintiffs). A number of reasons for increased exposure have been postulated, including:

1. Expanding theories of liability.

2. Ever higher jury awards.

3. Unpredictable and seemingly result oriented judges and juries.

D. Traditional forms of protection are often thought to be inadequate for many high income/high net-worth individuals. Such traditional forms of protection include:

1. Insurance.

a. Exclusions.

b. Policy limits.

c. Policy lapses.

d. Insurer insolvency.

2. Incorporation.

a. Piercing the corporate veil.

b. New and expanding theories of shareholder/officer liability.

3. Inter-Spousal Transfers.

a. The possibility of divorce.

b. The spouse's independent potential exposure to creditors.

c. A loss of control over the assets.

d. Potential gift tax consequences where the spouse is not a United States citizen.

e. Estate tax planning issues (*i.e.*, the transferor spouse should retain in his or her own name assets at least equal to the estate tax exemption amount – portability notwithstanding; in this regard, see the author's article, *Seven Good Reasons Credit Shelter Trusts Remain Relevant*, Journal of Accountancy, June 2011).

E. Candidates for asset protection planning include (amongst others):

1. Professionals.

2. Corporate officers and directors.

3. Fiduciaries.

4. Real estate owners.

5. Entrepreneurs.

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

7. Individuals seeking a prenuptial alternative.

F. Asset protection planning is by no means new; asset protection planning techniques have existed for decades, or even longer. Consider:

1. Incorporation of business activities.

2. Formation of LLCs, LPs, LLPs.

3. Domestic third-party spendthrift and discretionary trusts.

4. Offshore trusts (which have long been used to avoid forced heirship and governmental expropriation).

5. Exemption and pre-bankruptcy planning.

G. Asset protection planning should be considered as an integral part of an overall wealth preservation planning process, including:

1. Financial planning.

2. Insurance planning.

3. Income tax planning.

4. Gift, estate and generation-skipping transfer 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 at least to the enactment of the *Statute of Elizabeth* in England in the year 1571, provides that the transfer of assets in anticipation of a creditor claim will be disregarded by the courts and the creditor will be allowed to enforce the creditor's judgment against a transferee of the property.

B. Fraudulent transfer law can be found within the federal Bankruptcy Code, the debtor/creditor law of every state and the law of almost all foreign jurisdictions, as well.

1. For federal purposes, Bankruptcy Code § 548, entitled *Fraudulent Transfers and Obligations*, provides for the avoidance of fraudulent transfers in the Bankruptcy context.

    a. The trustee may avoid any transfer…of an interest of the debtor in property, or any obligation…incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily— (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business. 11 U.S.C. § 548(a)(1)

2. At the state level, fraudulent transfer law is largely governed by one of two main bodies of law promulgated by the National Conference of Commissioners on Uniform State Law (also known as the Uniform Law Commission).

    a. The Uniform Fraudulent Conveyance Act (promulgated in 1918 by the National Conference of Commissioners on Uniform State Laws).

    b. The Uniform Fraudulent Transfer Act (approved by the National Conference of Commissioners on Uniform State Laws in 1984 and in effect today in an overwhelming majority of the states, as well as the District of Columbia and the U.S. Virgin Islands).

        i. In 2014, the National Conference of Commissioners on Uniform State Laws adopted amendments to the Uniform Fraudulent Transfer Act. Among other things, the amendments renamed the UFTA as the "Uniform Voidable Transactions Act."

c. The remaining states follow either a version of the Statute of Elizabeth, or provide for a civil law analogue to the common law suit to set aside a fraudulent transfer (*i.e.*, Louisiana).

C. Notwithstanding the semantic similarity between the term "fraud" and the term "fraudulent transfer" (or "fraudulent conveyance"), the two concepts are wholly unrelated under the law.

1. According to Black's Law Dictionary, a "fraud" is "[a] knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."

2. By contrast, the most common incidence of a "fraudulent transfer" is a transfer made with the intent to hinder, delay or defraud a creditor.

a. A transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation: (1) with actual intent to hinder, delay, or defraud any creditor of the debtor. UVTA § 4(a)(1).

3. In addition, a transfer made without fair consideration by a person who is insolvent, or who will be rendered insolvent by reason of the transfer, is also deemed to be a "fraudulent transfer."

a. A transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation…(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor: (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (ii) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due. UVTA § 4(a)(2).

4. The difference between a fraud and a fraudulent transfer is also evidenced by the remedy available to the injured party; fraud vitiates all transactions *ab initio*, whereas a fraudulent transfer is merely voidable.

D. In determining when a transfer was made with the intent to hinder, delay or defraud a creditor, fraudulent transfer law usually divides creditors into three categories:

1. Existing creditors.

2. Anticipated future creditors.

3. Mere potential future creditors – being those nameless, faceless persons of whom the transferor had no awareness or expectation of even the potential for a debtor/creditor relationship when the transfer was made.

E. One can easily imagine that it will be the rare debtor who expressly admits or otherwise voluntarily disgorges proof that his or her transfers of property were made with an actual intent to hinder, delay or defraud his or her creditors. As a consequence of this inherent difficulty in proving the debtor's intent, historically the courts have permitted various "badges of fraud" frequently thought to attend the fraudulent transfer of property, to be taken into account as "proof" of the requisite intent.

1. The Uniform Fraudulent Conveyance Act relies upon common law badges of fraud.

2. In contrast, Section 4(b) of the Uniform Voidable Transactions Act provides a non-exhaustive list of factors that may be considered in determining the debtor's actual intent in transferring property or incurring an obligation. Those factors are:

a. Whether the transfer or obligation was to an insider;

b. Whether the debtor retained possession or control of the property transferred after the transfer;

c. Whether the transfer or obligation was disclosed or concealed;

d. Whether before the transfer was made or the obligation was incurred, the debtor had been sued or threatened with suit;

e. Whether the transfer was of substantially all of the debtor's assets;

f. Whether the debtor absconded;

g. Whether the debtor removed or concealed assets;

h. Whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

i. Whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

j. Whether the transfer occurred shortly before or shortly after a substantial debt was incurred; and

k. Whether the debtor transferred the essential assets of his or her business to a lienor who transferred the assets to an insider of the debtor.

F. Effect of Finding a Fraudulent Transfer and Transferee Liability

1. Section 7 of the Uniform Voidable Transactions Act provides for several alternative remedies where a fraudulent transfer is found to have been made. Those prospective remedies include:

a. Avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim;

b. An attachment or other provisional remedy against the asset transferred or other property of the transferee;

c. An injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property of the transferee;

d. An appointment of a receiver to take charge of the asset transferred or of other property of the transferee; or

e. Any other relief the circumstances may require.

2. A ceiling imposed upon the relief available where a fraudulent transfer has been found is that the creditor can obtain no greater relief in the face of the fraudulent transfer than such creditor might have obtained had the fraudulent transfer not been made.

3. In addition, under the Bankruptcy Code, the debtor's discharge may be denied due to the debtor having made a fraudulent transfer. See, 11 U.S.C. § 727.

G. Notably, it is not critical for the finding of a fraudulent transfer that a creditor's claim has yet coalesced into a lawsuit (which, of course, might be months or years after the actual claim arose).

H. **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 planning is not later undone as a fraudulent transfer!**

III. ETHICS OF ASSET PROTECTION PLANNING

A. Certain aspects of asset protection planning are sometimes suggested as raising heightened ethical issues (as well as other concerns for the asset protection planning advisor, such as potential civil or even criminal liability), because under certain circumstances the goal of placing assets beyond the reach of a person's creditors implicates the possibility that the advisor will assist, knowingly or unwittingly, in a fraudulent transfer. Creditors' rights counsel and other detractors of asset protection planning often argue that assisting in a fraudulent transfer is an unethical act.

B. In this regard, each of the fifty states, as well as the District of Columbia, regulates the conduct of attorneys practicing in that jurisdiction by a written code of professional ethics.

1. The most current code of professional conduct for lawyers is the American Bar Association's Model Rules of Professional Conduct, which was first promulgated in 1983, and often exists with state-specific amendment.

2. The Model Rules of Professional Conduct was preceded by the American Bar Association's Model Code of Professional Responsibility, which was first promulgated in 1969.

C. Application of Rules

1. Neither the Model Rules of Professional Conduct nor its predecessor Model Code of Professional Responsibility expressly speak to asset protection planning, *per se*, and consequently, the suggestion that asset protection planning is subject to unique ethical considerations is necessarily suggested as merely being implicit.

2. Specifically, each of the Model Rules of Professional Conduct and its predecessor Model Code of Professional Responsibility are sometimes said to preclude an attorney from advising or otherwise assisting a client in effectuating a fraudulent transfer (and, likely, also a fraudulent asset conversion (meaning the conversion of a non-exempt asset into an

exempt asset; *see*., *e.g*., Florida Statutes § 222.30), by reference to certain sections of the Model Rules (or the Model Code), which speak to arguably similar acts.

a. Misconduct

i. Model Rules Provision

- Model Rules of Professional Conduct Rule 8.4(c) (2002), *Misconduct*, provides, in pertinent part, that it is professional misconduct for a lawyer to "[e]ngage in conduct involving dishonesty, fraud, deceit or misrepresentation."

b. Respect for Rights of Third Persons

i. Model Rules Provision

- Model Rules of Professional Conduct Rule 4.4(a) (2002), provides, in pertinent part, that "a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person..."

c. Representation Within the Bounds of the Law and Scope of Representation & Allocation of Authority Between Client & Lawyer

i. Model Code Provision

- Model Code of Professional Responsibility, DR 7-102(A)(7) (1980), *Representing a Client Within the Bounds of the Law*, provides, in pertinent part, that "[a] lawyer shall not…[c]ounsel or assist his client in conduct that the lawyer knows to be *illegal* or fraudulent." (emphasis added).

ii. Model Rules Provision

- Model Rules of Professional Conduct Rule 1.2(d) (2002), *Scope of Representation & Allocation of Authority Between Client & Lawyer*, provides that "[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is *criminal* or fraudulent..." (emphasis added)

iii. The difference between the Model Code's proscription relating to conduct that the attorney knows is "illegal or fraudulent," and the Model Rules proscription against conduct that the attorney knows is "criminal or fraudulent" is, as shall be seen further, *infra*, highly significant.

d. Definition of Fraud

i. Model Code Provision

- The Model Code of Professional Responsibility does not define what is meant by the term "fraud".

    - However, as an example, New York, when it was a Model Code of Professional Responsibility jurisdiction, had provided that the term "…does not include conduct, although characterized as fraudulent by statute or administrative rule, which lacks an element of scienter, deceit, intent to mislead, or knowing failure to correct misrepresentations which can be reasonably expected to induce detrimental reliance by another." *See*, former New York Code of Professional Responsibility, Definition 9 (1990).

ii. Model Rules Provision

- Under the terminology section of the Model Rules of Professional Conduct (2002), each of the term "fraud" and the term "fraudulent" "…denotes conduct that is fraudulent under the substantive or procedural law of the applicable jurisdiction and has a purpose to deceive," which is, therefore, clearly not inclusive of a fraudulent transfer standing alone.

3. Interestingly, only a very few state or local bar ethics opinions exist that serve to apply the foregoing rules to the transfer of property in furtherance of an asset protection plan. What follows in this section are those ethics opinions that speak most directly to the question of the ethics of asset protection planning.

a. In *Connecticut Informal Opinion 91-22* (December 5, 1991), an attorney requested the opinion of the Connecticut Bar Association's Committee on Professional Ethics as to whether the attorney could ethically recommend and/or assist the attorney's client in transferring the client's jointly owned home to the client's wife at a time when the client had substantial debts beyond the client's ability to repay. Basing its opinion on Model Rule 1.2(d) and Model Rule 4.4, and in certain limited circumstances, Model Rule 8.4(c), the Committee opined that "…a lawyer may not counsel or assist a client to engage in a fraudulent transfer that the lawyer knows is either intended to deceive creditors or that has no substantial purpose other than to delay or burden creditors." Significantly, however, the Committee further stated that: "[a]lthough the inquirer invites us to focus on fraudulent transfers, we wish to point out that whether or not a particular transaction is a fraudulent transfer as a matter of substantive law is not the decisive factor in applying the Rules. The decisive factors are whether the lawyer knows that the transfer constitutes conduct having a purpose to deceive (see Rule 1.2(d)) or whether in counseling or assisting the client the lawyer is using means that have no substantial purpose other than to embarrass, delay or burden third parties (see Rule 4.4)."

i. With regard to Rule 4.4, the Connecticut Bar Association's Committee on Professional Ethics stated that "[f]raudulent transfers delay and burden those creditors who would be inclined to try and satisfy their unpaid debts from property of the debtor. It forces them to choose either not to challenge the transfer and suffer the loss of an uncollected debt or to file an action to set aside the transfer with the attendant costs in terms of time and money. If there is no other substantial purpose, Rule 4.4 applies. Where there is another substantial purpose, Rule 4.4 does not apply. For example, where there is a demonstrable and lawful estate planning purpose to the transfer, Rule 4.4 would not, in our view apply. What constitutes a "substantial purpose" under Rule 4.4 is a question of fact."

ii. In addition, with regard to Rule 1.2(d), the Committee stated that "…while all fraudulent transfers are generally thought of as illegal and can be set aside, the Rules do not apply to all illegal conduct but rather to conduct that is known to be criminal or fraudulent."

- *See, also*, Wolfram, *Modern Legal Ethics* § 13.3.9 (1986) ("What if the client wishes to pursue a course of conduct that is unconscionable under applicable law but is not criminal, fraudulent, or in violation of a court order? What of client conduct that violates the law of tort, contracts, property, or some other noncriminal law that does not deal with fraud?...Under the Model Rules a lawyer who assists the conduct described definitely commits no professional offense.")

  - Contrast the likely result if the Model Code of Professional Responsibility were applicable inasmuch as DR 7-102(A)(7), Representing a Client Within the Bounds of the Law, *supra*, prohibits an attorney from counseling or assisting a client in conduct which is illegal, though not necessarily criminal.

b. In *Ethics Opinion 1993-1 of the Legal Ethics and Unlawful Practice Committee of the San Diego County Bar Association*, the Committee considered the extent to which a member of the State Bar of California could ethically advise or otherwise assist a client in avoiding *existing and identifiable* creditors' rights and protecting the client's assets. The Committee held that an attorney could not furnish advice or institute asset protection techniques unless the attorney did so in compliance with California State Bar Rules of Professional Conduct, *Advising the Violation of Law*, Rule 3-210 which provides that "[a] member shall not advise the violation of any law, rule, or ruling of a tribunal unless the member believes in good faith that such law, rule, or ruling is invalid." Since California has criminalized the act of causing a fraudulent transfer, the Committee held that it would be a violation of the California State Bar Rules of Professional Conduct for the attorney to furnish advice or institute asset protection techniques where, as here, the client had *existing and identifiable* creditors.

   i. Beyond the effect of California's criminal statute, however, the Committee also noted that under the Rules of Professional Conduct of the State Bar of California, Rule 1-100, *Rules of Professional Conduct, In General*, "…an Attorney does maintain a duty to protect the public and to promote respect and confidence in the legal profession…[a]t a minimum…the Attorney's assistance with, and facilitation of the Client's expressed, wrongful intent is intolerable as a matter of public policy."

c. In *South Carolina Bar Ethics Advisory Opinion 84-02* it was held that it was ethical for an attorney to transfer a client's assets to protect against the potential claims of future creditors. Specifically, at issue was whether the Model Code (which governed professional ethics in South Carolina at the time of *Ethics Advisory Opinion 84-02*), prohibited an attorney from transferring a client's property from the client's name to the name of the client's spouse in anticipation of the possibility of a judgment being entered against the client. Although the Committee held that such conduct for the sole purpose of avoiding an immediate reasonable probability of judgment would be in violation of DR 7-102(A)(7), it noted that "[t]he critical issue would be whether or not the transfer took place with a reasonable prospect that a judgment would be obtained against the client, or whether or not the transfer took place to avoid some possibility in the distant future…[i]f…there does not exist the immediate reasonable prospect of a judgment being entered against the client, the transfer merely to avoid the future possibility of an action by a creditor or creditors would not be in violation of DR 7-102(A)(7)."

4. Ethical Obligation to Provide Asset Protection Advice

a. The United States Supreme Court has stated that "[t]he duty of the lawyer, subject to his role as an 'officer of the court,' is to further the interests of his clients by all lawful means... But this representation involves no conflict of interest in the invidious sense. Rather, it casts the lawyer in his honored and traditional role as an authorized but independent agent acting to vindicate the legal rights of a client, whoever it may be." *In re Griffiths,* 413 U.S. 717, 724 (1973).

b. Similarly, the Model Code of Professional Responsibility, DR 7-101, *Representing a Client Zealously,* provides in pertinent part that "[a] lawyer shall not intentionally fail to seek the lawful objectives of his client through reasonably available means permitted by law and the Disciplinary Rules, except as provided by DR 7-101(B)."

i. DR 7-101(B) provides in pertinent part that "[i]n his representation of a client, a lawyer may…[r]efuse to aid or participate in conduct that he believes to be unlawful, even though there is some support for an argument that the conduct is legal." Model Code of Professional Responsibility DR 7-101(B)(2) (1980).

c. Interestingly, the Model Rules of Professional Conduct contains no comparable provision to Model Code of Professional Responsibility, DR 7-101. The closest provision is Comment [1] to Rule 1.3, *Diligence*, which provides in part that "[a] lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf."

d. At a minimum, however, it can be safely stated that there exists no requirement that an attorney assert the potential rights of his or her client's adversary; instead the client's adversary is left to vindicate his or her own rights, if possible.

   i. "…when an opposing party is well represented, a lawyer can be a zealous advocate on behalf of a client and at the same time assume that justice is being done…" Model Rules of Professional Conduct, *Preamble and Scope, Preamble: A Lawyer's Responsibilities*, § 8

e. In fact, it is clear that in certain circumstances an attorney may be subject to discipline for failing to promote his or her client's lawful asset protection plan with sufficient zeal and vigor, not to mention that the attorney might be subject to a potentially significant malpractice exposure for such neglect.

   i. For example, *see*, *e.g.*, *In re Hockett*, 734 P.2d 877, 880 (Or. 1987), wherein the Oregon Supreme Court stated that "[a]s the lawyer for Mr. Beecroft and Mr. Neptune, the accused's obligation was to protect them from the claims of creditors, to the fullest permissible extent."

   ii. In addition, "[i]n light of the widespread discussion of asset protection issues, as evidenced by the increasing number of seminars, articles, and books on the subject, asset protection may be elevated to the domain of 'skill, prudence, and diligence as other members of the legal profession commonly possess and exercise,' thereby *creating a duty* on the part of lawyers to advise clients to engage in asset protection planning or to refer the client to another attorney qualified to do so." Spero, *Asset Protection,* Vol. 1, Thomson/RIA (2008) § 2.04(2) (emphasis added).

- Whether advising clients on asset protection matters are within the scope of an estate planning attorney's duties depends on the custom in the area. *Id*.

f. In addition, *Nichols v. Keller*, 15 Cal App. 4th 1672 (1993), stands for the proposition that an attorney has a duty to inform clients of issues even outside of the engagement. Specifically, in *Nichols* the court stated that "[t]he duty of a lawyer today is not that of a solver of legal conundrums: he is indeed a counselor at law...In the context of…consultations between lawyer and layperson, it is reasonably foreseeable the latter will offer a selective or incomplete recitation of the facts…and rely upon the consulting lawyer to describe the array of legal remedies available, alert the layperson to any apparent legal problems, and, if appropriate, indicate limitations on the retention of counsel and the need for other counsel. In the event the lawyer fails to so advise the layperson, it is also reasonably foreseeable the layperson will fail to ask relevant questions regarding the existence of other remedies and be deprived of relief through a combination of ignorance and lack or failure of understanding." *Id*. at 1686-1687.

IV. TRADITIONAL FORMS OF ASSET PROTECTION

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

1. Potentially effective (assuming the transfer is not later found to have been a fraudulent transfer or subject to a revocatory action).

2. However, numerous problems still exist in connection with transfers to a spouse, including as noted *supra*:

   a. The possibility of divorce.

   b. The spouse's independent potential exposure to creditors.

   c. The loss of control over the assets.

   d. Potential gift tax consequences where the spouse is not a United States.

   e. Estate tax issues where the spouses' estates are not, to some extent at least, "equalized."

B. Corporate ownership

1. Asset protection planning through the use of a corporate structure exists solely in connection with the limitation on shareholder liability for the debts of the corporation.

   a. This type of protection is sometimes referred to as "inside out" protection since the shareholder's personal assets (which are held outside of the corporation) are protected from the corporation's creditors (whose claims would arise "inside" the corporation in connection with the corporation's business dealings).

   b. The reverse, however, is generally not also the case, and if a shareholder is sued in his or her individual capacity, for something the shareholder has done (or omitted to do), the shareholder's shares of stock in the corporation will be reachable by the shareholder's judgment creditor.

      i. For this reason, a corporate entity is inherently less protective than those alternate business entities which also provide the "outside in" protection that is afforded where a "charging order" remedy is imposed upon the creditor (such as might be the case with a limited partnership or a limited liability company).

         - "…[a] charging order constitutes a lien on a judgment debtor's transferable interest and requires the [entity] to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor." *See*, Uniform Limited Liability Company Act § 503(a).

      ii. At least two states, however, Nevada and Wyoming, have extended charging order protections to the corporate form in specified circumstances.

         - *See, e.g.*, Nevada Rev. Stat. § 78.746, which provides that charging order protection applies to corporate stock provided only that the corporation has fewer than 100 stockholders, is not a publicly traded corporation or a subsidiary of a publicly traded corporation, and is not a professional corporation.

c. Absent the "outside in" protection of a charging order, the shares of the debtor can be attached and then sold by the creditor, and in the case of the debtor being a majority shareholder of the corporation, a creditor would be able to reach the assets of the corporation through a liquidation of the corporation.

2. Even the inside out protection is not necessarily absolute, however, and under certain circumstances the corporate "veil" might be "pierced".

a. For example, where the formalities of the corporate form (*i.e.*, formalities relating to the exercise of the corporation's powers or management of the corporation's activities and affairs) are not consistently respected, a veil piercing might be allowed by a court.

i. For example, Nevada Revised Statutes § 78.747(1), provides that: "[e]xcept as otherwise provided by specific statute, no stockholder, director or officer of a corporation is individually liable for a debt or liability of the corporation, unless the stockholder, director or officer acts as the alter ego of the corporation."

- Nevada Revised Statutes § 78.747(2) goes on to provide that: "[a] stockholder, director or officer acts as the alter ego of a corporation if: (a) The corporation is influenced and governed by the stockholder, director or officer; (b) There is such unity of interest and ownership that the corporation and the stockholder, director or officer are inseparable from each other; and (c) Adherence to the corporate fiction of a separate entity would sanction fraud or promote a manifest injustice."

C. Limited Partnerships and Limited Liability Companies

1. Like corporations, limited partnerships and limited liability companies provide "inside out" protection to the limited partners of a limited partnership (although not to the general partners), and to all members of a limited liability company.

a. In this regard, § 303(a) of the Revised Uniform Limited Partnership Act ("RULPA") provides that "[a] debt, obligation, or other liability of a limited partnership is not the debt, obligation, or other liability of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the partnership solely by reason of being or acting as a limited partner, even if the limited partner participates in the management and control of the limited partnership…"

i. In addition, and in contrast to the corporate form, § 303(b) of the RULPA provides that "[t]he failure of a limited partnership to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a limited partner for a debt, obligation, or other liability of the partnership."

b. Similarly, § 304(a) of the Uniform Limited Liability Company Act ("ULLCA") provides that "[a] debt, obligation, or other liability of a limited liability company is solely the debt, obligation, or other liability of the company. A member or manager is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the company solely by reason of being or acting as a member or manager..."

i. In addition, and in contrast to the corporate form, § 304(b) of the ULLCA provides that "[t]he failure of a limited liability company to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a member or manager for a debt, obligation, or other liability of the company."

2. Unlike a corporation, however, limited partnerships and limited liability companies also provide a second type of asset protection which is the "outside in" protection afforded by the "charging order" concept.

a. Section 703(a) of the RULPA provides that: "On application by a judgment creditor of a partner or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited partnership to pay over to the person to which the charging order was issued any distribution that otherwise would be paid to the judgment debtor."

i. However, § 703(c) of the RULPA provides that: "[u]pon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest [and] does not thereby become a partner…"

b. Section 503(a) of the ULLCA provides that: "[o]n application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment…a charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that otherwise would be paid to the judgment debtor."

i. However, § 503(c) of the ULLCA provides that: "[u]pon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest..."

3. Effect of a Charging Order

a. According to the comment to § 703 of the RULPA, the charging order "[w]hile in effect…entitles the judgment creditor to whatever distributions would otherwise be due to the partner or transferee whose interest is subject to the order. However, the judgment creditor has no say in the timing or amount of those distributions. The charging order does not entitle the judgment creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited partnership."

b. If the debtor is an owner of an interest in widely held limited partnership or limited liability company which regularly makes distributions, the charging order may be an effective means for a judgment creditor to collect part or all of its judgment. However, where the debtor is an owner of an interest in a "family" or other closely held limited partnership or limited liability company governed by a properly drafted agreement and with a friendly general partner of the limited partnership, or a friendly manager or managing member of the limited liability company, the result may be quite different.

4. Issues in Connection with Charging Orders

a. Business Purpose

i. Under the law of some states, a limited partnership or a limited liability company must be established for a "business purpose".

- *See*, *e.g.*, New York Partnership Law § 121-107, which provides that: "[a] limited partnership may carry on any business that a partnership without limited partners may carry on except as prohibited by law."

- *See*, *also*, New York Limited Liability Company Law § 201, which provides that: "[a] limited liability company may be formed under this chapter for any lawful business purpose or purposes except to do in this state any business for which another statute specifically requires some other business entity or natural person to be formed or used for such business."

ii. Where the limited partnership or limited liability company is established solely for asset protection planning purposes, and lacks any cognizable business purpose, the limited partnership or limited liability company may be disregarded as a separate entity, and the assets of the limited partnership or limited liability company may be subject to being attached directly.

- *See*, *e.g.*, *Evans v. Galardi*, 546 P.2d 313, 321 (Cal. 1976), wherein the California Supreme Court stated "[w]here, as in the instant case, the partnership is a viable business organization…there is no reason to permit deviation from the prescribed statutory process [relating to charging orders]."

  - The suggestion in *Evans* is, of course, that where the limited partnership is not a "viable business organization" the court might deem the charging order a non-exclusive remedy.

  - *See also*, *Hellman v. Anderson*, 233 Cal. App.3d 840, 284 Cal. Rptr. 830 (Cal. App. 1991) (limited partnership interest may be foreclosed so long as doing so does not unduly interfere with the business of the limited partnership.)

b. Single Member Limited Liability Companies

i. By definition, a "partnership" must have more than one owner. A limited liability company, however, may permissibly have a single owner. In the case of a limited liability company with a single owner, however, it is unclear whether a charging order should be upheld as an exclusive remedy.

ii. In the case of *In re Ashley Albright*, 291 B.R. 538 (2003), the Chapter 7 Trustee successfully argued against the imposition of the charging order remedy by claiming that because the debtor was the sole member and manager of the limited liability company at the time the debtor filed bankruptcy, the Trustee should gain control of the limited liability company and have authority to cause the limited liability company to sell its underlying property and distribute the net sales proceeds to the bankruptcy estate. Specifically, the Court held that "…[b]ecause there are no other members in the LLC, the entire membership interest passed to the bankruptcy estate and the trustee became a 'substituted member'." *Id*. at 540. The court also stated that, "upon the Debtor's bankruptcy filing, the Trustee now controls, directly or indirectly all governance of the entity, including decisions regarding liquidation of the entity's assets." *Id*. at 541.

- The *Albright* court recognized that "[a] harder question would involve an LLC…that also involves a passive member with a minimal interest. If the dominant member files bankruptcy, would a trustee obtain the right to govern the LLC? Pursuant to Colo. Rev. Stat. § 7-80-702, if the non-debtor member did not consent even if she held only an infinitesimal interest, the answer would be no. The Trustee would only be entitled to a share of distributions, and would have no role in the voting or governance of the company." *Id* at 541 fn. 9.

iii. In *Olmstead, et al., v. Federal Trade Commission*, 44 So.3d 76 (Fla. 2010), the Supreme Court of the State of Florida ruled on the question of whether "…a court may order a judgment-debtor to surrender all right, title, and interest in the debtor's single-member limited liability company to satisfy an outstanding judgment." *Id*. at 77. The Florida Supreme Court concluded that the charging order remedy authorized by Fla. Stat. § 608.433(4) does not preclude application of a creditor's remedy of execution on an interest in a single-member limited liability company since the owner of a single member limited liability company has an uncontested right to transfer the owner's full interest in the limited liability company.

iv. However, at least two states, Nevada (pursuant to Nev. Rev. Stat § 86.40(2)(a)), and Wyoming (pursuant to Wyo. Stat. § 17-29-503(g)), provide by statute that even as regards a judgment debtor who is the sole member of a limited liability company, the charging order is the applicable (and, indeed, also the exclusive) remedy by which a judgment can be satisfied from the judgment debtor's transferable interest or from the assets of the limited liability company.

c. Sole and Exclusive Remedy?

i. Each of the RULPA, under § 703(c), and the ULLCA, under § 503(c), provide that the charging order remedy shall not be the sole and exclusive remedy available to a judgment creditor and that when distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. This is in contrast, however, to the law of a number of states that have modified the RULPA and/or the ULLCA so as to provide that the charging order is a "sole and exclusive remedy".

- In the case of *In re Stocks*, 110 B.R. 65 (Bankr. N.D. Fla. 1989), the Bankruptcy Court interpreted Florida's Limited Partnership Act and held that the charging order was "the only means by which a judgment creditor can legally command payment from the debtor's partnership interest." *Id*. at 66. The Court distinguished the Florida limited partnership charging order statute from that provided under RULPA and held that the latter permitted foreclosure of a partner's interest while the former did not contain such a remedy.

- With regard to limited liability companies, Florida Statutes § 605.0503, expressly provides that, except with regard to single member limited liability companies, "…a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's transferee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company."

d. Tax Effect of a Charging Order

i. In Rev. Rul. 77-137, 1977-1 C.B. 178, a limited partner assigned his limited partnership interest to a third party under a partnership agreement that provided, in part, that an assignee of a limited partnership interest would not become a substituted limited partner without the written consent of the partnership's general partners; however, a limited partner could, without the consent of the general partners, irrevocably assign the right to share in the profits and losses of the partnership and to receive all distributions, including liquidating distributions, to which the limited partner would have been entitled had the assignment not been made. Under the terms of the assignment at issue, the assignor also agreed to exercise any residual powers as a limited partner solely in favor of and in the interest of the assignee. The Internal Revenue Services ruled that even though the general partners did not give their consent to the assignment, since the assignee acquired substantially all of the dominion and control over the limited partnership interest, for Federal income tax purposes the assignee would be treated as a substituted limited partner and must report the distributive share of partnership items of income, gain, loss, deduction and credit attributable to the assigned interest on the assignee's Federal income tax return in the same manner and in the same amounts that would be required if the assignee were a substituted limited partner.

ii. It is sometimes suggested that the tax effect in Rev. Rul. 77-137 would also apply to a creditor holding a charging order.

- However, arguments can be made both in support of and against such a result. For example, some would argue that a charging order is in substance no different than a garnishment of wages, and an employee continues to be taxable on his garnished wages under the principal of *Lucas v. Earl*, 281 U.S. 111 (1930).

- In addition, General Counsel Memorandum 36960, dated December 20, 1976, which was the prelude to Rev. Rul. 77-137, provided that: "to the extent that an assignor retains residual rights that may not be exercised on behalf of the assignee, the assignee may be said to lack dominion and control over the assigned interest."

e. With regard to planning, a number of steps can be taken that might serve to enhance the asset protection afforded a limited partner or limited liability company member under a charging order.

i. Since a judgment creditor has only the rights of an assignee, the limited partnership agreement or limited liability company operating agreement should contain specific provisions addressing the limited status of both voluntary and involuntary assignees.

- Similarly, the limited partnership agreement or limited liability company operating agreement should set forth with specificity the procedure by which any transferee may become a substituted partner or member.

ii. Consider providing for a right of first refusal to limit the salability of the limited partnership interest or limited liability company membership interest by a judgment creditor should the charging order not be determined to be the sole and exclusive remedy of the judgment creditor.

iii. Since the judgment creditor is entitled to the distributions that, absent the charging order, would have been made to the limited partner of the limited partnership or member of the limited liability company, it would seem advisable, in the family limited partnership or limited liability company context, to include a provision setting forth the owners' intent and understanding as to when distributions will be made from the limited partnership or limited liability company, and which further provides the general partner of the limited partnership or manager or managing member of the limited liability company with broad discretion to make, or to refrain from making, distributions.

- Note, however, that where one or more of the partners of the limited partnership or members of the limited liability company have obtained their interests in the limited partnership or limited liability company by gift from the general partner or managing member, such authority should be limited pursuant to a reasonably objective standard or else the Internal Revenue Service may deem the gifted interest as remaining includable in the general partner's or managing member's gross estate pursuant to Internal Revenue Code §§ 2036 and 2038.

- In addition, a problem may also exist with regard to obtaining the gift tax exclusion annual pursuant to Internal Revenue Code § 2503 since the gift of a limited partnership interest or limited liability company membership interest may not be a "present interest" gift under such circumstances. *See, e.g.*, *Hackl v. Comm'r*, 335 F.3d 664 (7th Cir. 2003).

iv. In view of the fact that a judgment creditor holding a charging order is entitled to distributions that would otherwise be made to the debtor limited partner of the partnership, or debtor member of the limited liability company, the limited partnership agreement or limited liability company operating agreement should preclude a withdrawing limited partner or member from receiving the value of his or her capital account except upon the dissolution of the limited partnership or limited liability company.

- Such a provision should be operative under all circumstances, and not just when a limited partner or member has a judgment creditor, or else the provision will potentially be held to be unenforceable as an *ipso facto* clause.

v. The governing agreement of the limited partnership or limited liability company should provide that the consent of all partners or members is required to liquidate the limited partnership or limited liability company.

vi. In a similar vein, the entity's formation documents and governing agreement should be drafted to provide the entity with a perpetual existence. Perpetual existence will avoid any possibility that the creditor of a debtor limited partner or member will be able to satisfy the creditor's claim out of the assets of the limited partnership or limited liability company by the simple expediency of the automatic dissolution of the limited partnership or limited liability company at the end of a fixed period.

vii. The governing agreement of the limited partnership or limited liability company should also not provide (as might otherwise be common), that the death, incapacity, retirement or other event of withdrawal of a limited partner or member shall cause a dissolution (even if the agreement were to then provide that a majority in interest of the limited partners or members could then affirmatively vote to continue the limited partnership or limited liability company).

viii. For a limited partnership, consideration should also be given to having more than one general partner, or in the alternative using a corporation, limited liability company or trust as the general partner, in order to diminish or preclude the possibility of the termination of the limited partnership by reason of the death or incapacity of the last acting general partner.

ix. In order to ensure that the limited partnership or limited liability company has the greatest likelihood of being respected as an entity separate and apart from its owners (and in particular an entity separate and apart from the debtor), all formalities relating to the existence of the limited partnership or limited liability company as an entity separate and distinct from the partners or members thereof should be strictly followed, even if not required under the law. More specifically:

- All of the entity's assets should be titled in the name of the entity.

- Any insurance policies on assets which are transferred to the entity must be revised to reflect the entity as the new owner of such assets.

- The books and records of the entity should be kept complete and up to date.

- Any major action of the entity should be the subject of a written resolution which, in particular, demonstrates that the proper consents for such action were obtained.

- All distributions from the entity should be made in proportion to the owners' relative ownership interests in the entity.

- Transactions between the entity and its owners (i) should be kept to a minimum, (ii) in all events should be strictly at arms-length and, (iii) in particular, in no event should personal use assets ever be contributed to the entity, or acquired by the entity, for direct or indirect use by a limited partner or member unless a fair market rent is to be paid for the use of such personal use assets pursuant to a well-documented and arms-length lease agreement.

D. Tenancy by the Entireties

1. A tenancy by the entireties is a special form of joint ownership of property that can exist only between spouses.

   - In some states, only real estate can be held in a tenancy by the entireties form while in other states personal property may also be held as tenants by the entirety.

     - *See*, *e.g.*, Florida Statutes § 655.79(1) which provides, in pertinent part, that "…[a]ny deposit or account made in the name of two persons who are husband and wife shall be considered a tenancy by the entirety unless otherwise specified in writing."

     - New York's Estates, Powers and Trusts Law § 6-2.1(4) allows a tenancy by the entireties form of ownership only as to real property except that, on and after January 1, 1996, a tenancy by the entireties form of ownership is also permissible as to shares of stock of a cooperative apartment corporation allocated to an apartment or unit together with the appurtenant proprietary lease.

2. Under common law, a tenancy by the entireties is characterized by five coincident unities: unity of possession (there must be 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 (the joint owners must be married to each other).

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

      - *See, e.g,, Roberts & Lloyd, Inc. v. Zyblut*, 691 A.2d 635, 638 (D.C. 1997) ("A tenancy by the entireties differs from a joint tenancy with right of survivorship in that a tenancy by the entireties cannot be partitioned during the marriage of the parties without the consent of the cotenants…Consequently, unlike a joint tenancy with right of survivorship, property held by tenancy by the entireties is not subject to execution or levy for the debts of only one of the cotenants.")

   b. As a result, in those states that follow the common law rule regarding tenancy by the entireties property, 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 a debtor's estate in bankruptcy.

      i. *See*, 11 U.S.C. § 522(b)(3)(B), which provides for an exemption for "[a]ny interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety or joint tenant to the extent that such interest as a tenant by the entirety or joint tenant is exempt from process under applicable nonbankruptcy law".

3. However, no asset protection is afforded by a tenancy by the entirety where:

   a. There is a divorce.

b. The non-debtor spouse predeceases the debtor spouse – because, in that event, the property will pass automatically to the debtor spouse.

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

d. If the governing state law provides that only real estate can be held in a tenancy by the entirety, the real property is sold and the asset converted to cash (*i.e.*, not real property).

4. Even where the tenancy by the entireties property is exempt from the claims of creditors under applicable non-bankruptcy law, however, the protection may still not be sufficient to overcome claims of state, local or federal government.

a. For example, in *United States v. Craft*, 535 U.S. 274 (2002), the Internal Revenue Service assessed substantial unpaid income taxes against Don Craft, the husband of Sandra Craft. When Mr. Craft failed to pay his income tax liabilities, a federal tax lien attached under Internal Revenue Code § 6321 to "all property and rights to property, whether real or personal, belonging to…" Mr. Craft. At the time the lien attached, Mr. and Mrs. Craft owned Michigan real property as tenants by the entirety. After notice of the lien was filed, Mr. and Mrs. Craft jointly executed a quitclaim deed transferring the couple's interest in the property to Mrs. Craft for one dollar. When Mrs. Craft attempted to sell the property a few years later, a title search revealed the lien. The Internal Revenue Service agreed to release the lien and allow the sale with the stipulation that half of the net proceeds be held in escrow pending determination of the government's interest in the property. The government claimed that its lien had attached to the husband's interest in the tenancy by the entireties and it further asserted that the transfer of the property by Mr. and Mrs. Craft to Mrs. Craft was invalid as a fraudulent transfer. The Michigan Uniform Fraudulent Transfer Act provided, however, that a tenancy by the entireties property cannot be the subject of a fraudulent transfer in a case where only one spouse is the debtor. Under long-standing doctrine, federal law looks to state law to determine what rights a taxpayer has in property the Internal Revenue Service seeks to reach, and then looks to federal law to determine whether a taxpayer's state-law delineated rights qualify as "property" or "rights to property" within the meaning of the federal tax lien legislation. In *Craft*, the United States Supreme Court, after recognizing that under Michigan law one tenant by the entirety has no interest in the property separable from that of the other, each being vested with an entire title, found that Mr. Craft had individual rights in the property to which the federal tax lien could attach.

- In addition, "[a]lthough *Craft* only dealt with tax liens, Congress has unequivocally stated that criminal fines are to be treated in the same fashion as federal tax liabilities." *In re Huchins*, 306 BR 82 at 90 (Bankr. D. Vt. 2004).

b. *See also, U.S. v. Barczyk,* 434 Fed. Appx. 488 (6th Cir. 2011) (once tax lien properly attaches to jointly-held marital property, i.e., property held by entireties, court may order forced sale over objection of non-liable spouse; absent compelling reason, such as atypically wide age difference between spouses, court will not use actuarial valuation to determine amount non-liable spouse entitled to from forced sale; thus, non-liable spouse entitled to 50% of proceeds of forced sale, with other 50% going to government to satisfy defaulting spouse's tax debt).

5. Where the common law rule is followed (and unless as noted *infra* there exists a joint creditor of both tenants, or the creation of the tenancy by the entireties was itself a fraudulent transfer), generally no fraudulent transfer can result from a transfer of one spouse's interest in the tenancy by the entireties property to the other spouse, or to a third party.

- *See, e.g., Watterson v. Edgerly,* 388 A.2d 934, 939 (Md. Ct. Spec. App. 1978) ("When, as here, a husband and wife hold title as tenants by the entirety, the judgment creditor of the husband or of the wife has no lien against the property held as entireties, and has no standing to complain of a conveyance which prevents the property from falling into his grasp.").

6. Significantly, and notwithstanding "portability", the asset protection afforded by spouses holding title to property as tenants by the entirety is frequently at odds with another aspect of the couple's personal planning, since proper estate tax planning often still 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 provided for under Internal Revenue Code § 2010.

a. The potential asset protection afforded by spouses holding property as tenants by the entireties must, therefore, be considered against the potential that such structure will garner transfer tax which could otherwise have been avoided, bearing in mind that post-mortem planning techniques such as disclaimers may be employed to "divide" an estate between spouses after the fact, thereby avoiding such transfer tax.

7. As noted, if the non-debtor tenant were to predecease the debtor tenant, the creditor protection afforded by a tenancy by the entireties would be lost since the survivorship feature of the tenancy by the entireties would cause the property to become the wholly owned property of the debtor co-tenant in that event.

   a. One solution to the problem that the creditor protection afforded by a tenancy by the entireties will be lost in the event of the death of the non-debtor spouse is to title the assets entirely in the name of the spouse with less creditor exposure, and to provide under that spouse's last will and testament that should he or she die, survived by his or her spouse, that the assets in question pass to the surviving spouse in trust, rather than outright.

   b. This approach may not be desirable, however, where:

      i. The spouses were previously married, with children from their prior marriages who might, therefore, inherit disproportionately if the assets are transferred outright to the spouse with less creditor exposure.

      ii. The spouse with "less creditor exposure" nevertheless still has significant creditor exposure.

   c. An alternative solution would be to create a tenancy by the entireties trust in a jurisdiction that has extended tenancy by the entireties protections to property held in trust.

      i. For example, Tennessee Trust Code Sec 35-15-510(b) provides that: "[a]ny property of a husband and wife that was held by them as tenants by the entirety and subsequently conveyed as tenants by the entirety to the trustee or trustees of one (1) or more trusts, and the proceeds of that property, shall have the same immunity from the claims of their separate creditors as would exist if the husband and wife had continued to hold the property or its proceeds as tenants by the entirety, so long as: (1) The husband and wife remain married; (2) The property or its proceeds continues to be held in trust by the trustee or trustees or their successors in trust; (3) The trust or trusts are, while both settlers are living, revocable by either settlor or both settlers, acting together; (4) Both the husband and the wife are permissible current beneficiaries of the trust or trusts while living; and (5) The trust instrument, deed, or other instrument of conveyance provides that this section shall apply to the property or its proceeds."

ii. The tenancy by the entireties trust is potentially better than a standard tenancy by the entireties because it will provide for a continuing protection for the property from the creditors of the surviving spouse after the death of the first spouse to die if the property continues in an irrevocable trust for the benefit of the survivor.

E. Exemption planning

1. Acceptable Use of Exemptions

a. An area of frequent and substantial contention between bankruptcy trustees and debtors in bankruptcy, as well as an area of deep division among the courts, is the extent to which a debtor's maximization of the debtor's exemptions immediately prior to bankruptcy (so-called "pre-bankruptcy planning") is acceptable planning rather than an inappropriate effort to hinder, delay and defraud creditors.

i. Importantly, pre-bankruptcy planning has been given a stamp of legitimacy by the legislative history to Bankruptcy Code § 522 of both the House of Representatives and the Senate, which provides that:

- "As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law." See, H.R. Rep. No. 595, 95th Cong., 1st Sess. 361 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 76 (1978).

ii. Notwithstanding the legislative history behind Bankruptcy Code § 522, however, it is clear that pre-bankruptcy exemption planning can yet be deemed fraudulent as to creditors, at least where the pre-bankruptcy exemption planning is engaged in with an intent to hinder, delay, or defraud creditors; in practice, an extremely fine line exists between acceptable and unacceptable pre-bankruptcy planning.

- For an example of permissible pre-bankruptcy planning see *In re Levine*, 40 B.R. 76 (Bankr. S.D. Fla. 1984), in which the debtor was advised by bankruptcy counsel that it was permissible to engage in pre-bankruptcy planning by converting otherwise nonexempt property into exempt property. On the basis of this advice, the debtor endorsed over to his mortgagee a $100,000 check that the debtor had recently received, thereby converting a nonexempt asset into an exempt asset. Although the trustee in bankruptcy argued that the conversion was, *per se*, an actionable fraud on the debtor's creditors, the *Levine* court held that the transaction was permissible pre-bankruptcy planning and stated that:

    - "The Trustee has failed to demonstrate through evidence in this case a factual scenario that constitutes a fraud sufficient to warrant an equitable lien or a finding of fraud under § 548 of the Bankruptcy Code. When reduced to its simplest form, the Trustee has attempted to convince this Court that a pre-bankruptcy transfer of nonexempt to exempt property is an ipso facto fraud and an intent to hinder and delay creditors. To accept that proposition this court would be required to ignore the substantial body of Florida law, together with the well-reasoned opinions of the various other courts throughout this country. The Trustee has failed to show a right to relief in this cause and therefore judgment shall be entered for the Defendant." *Id*. at 81-82.

iii. For an example of impermissible pre-bankruptcy planning in a case with remarkably similar facts to *Levine* see *In re Reed*, 700 F.2d 986 (5th Cir. 1983), in which the court denied a discharge to a debtor who, in an effort to create a better homestead exemption, liquidated nonexempt assets and used the proceeds to reduce the outstanding balance of mortgages on his home within two weeks prior to bankruptcy and during a period of agreed-upon delay with his principal creditor. It *Reed* was a combination of the delay and the liquidation, followed immediately by the filing of a petition in bankruptcy, that the court cited to show that the debtor had an actual intent to hinder, delay, or defraud creditors, rather than to merely make maximum use of the available exemption in an appropriate manner. In particular, the *Reed* court stated:

- "…[t]he legislative history of the exemption section…does not mean that conversion is never fraudulent as to creditors, but simply that, as under prior law, mere conversion is not to be considered fraudulent unless other evidence proves actual intent to defraud creditors. While pre-bankruptcy conversion of nonexempt into exempt assets is frequently motivated by the intent to put those assets beyond the control of creditors, which is, after all, the function of an exemption, evidence of actual intent to defraud creditors is required to support a finding sufficient to deny a discharge." *Id*. at 991.

iv. In the case of *In re Oberst*, 91 B.R. 97 (Bankr. C.D. Cal. 1988), the Bankruptcy Court for the Central District of California summarized the situation concerning the legitimacy of pre-bankruptcy planning as follows:

- "[w]hile the Court finds it very difficult to locate the exact line between bankruptcy planning and hindering creditors, Congress has decided that the key is the intent of the debtor. If the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the discharge. If the debtor is merely looking to his future well-being, the discharge will be granted. This is an uncomfortable test and does not seem equitable; but it is the law." *Id*. at 101.

2. 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 purpose behind a homestead exemption is the preservation of that asset that is, perhaps, most necessary for the subsistence of an individual debtor and his or her dependents – their home.

i. In fact, the family homestead is deemed so significant 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.

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

- Furthermore, even where the homestead exemption is "unlimited", this does not necessarily also mean that the exemption is also 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. *See*, *e.g.*, *U.S. v. Rodgers*, 461 U.S. 677 (1983) (upholding the judicial sale of a Texas homestead as a means of satisfying a federal tax liability).

c. In order to maximize use of the homestead exemption, one might consider moving to a state (like Florida), that allows a more generous or even an unlimited homestead exemption; provided, however, that in Bankruptcy it may be necessary to establish such residency in the new state at least a certain amount of time prior to the Bankruptcy filing.

- Following a number of high-profile cases that left the perception that debtors were abusing the homestead exemption available in some states, the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act imposed substantial restrictions upon the use of the homestead exemption in the Bankruptcy context.

d. Alternatively, where one is already domiciled in a state that provides for an unlimited homestead exemption, or even where one wants to make the best use of the homestead exemption available in a state that does not provide for an unlimited homestead exemption, 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.

e. An important case regarding the use of Florida's unlimited homestead exemption is *Havoco of America, Ltd. v. Hill*, 790 So.2d 1018 (Fla. 2001). In *Havoco*, the debtor filed a Chapter 7 bankruptcy petition in which he claimed that real property located in Florida was exempt as his homestead under the Florida Constitution. The creditor objected to the exemption of the property which had been purchased by the debtor, who had to that point been a long-time resident of Tennessee, 11 days after a jury verdict was rendered against the debtor in the amount of $15,000,000. In finding that the debtor's obvious intent to hinder, delay and/or defraud his creditors did not remove his residence from the homestead protection afforded by the Florida Constitution, the Florida Supreme Court noted that "[w]hile we are certainly loathe to provide constitutional sanction to the conduct alleged by the petitioner…this Court is powerless to depart from the plain language of article X, §4."

- However, consider whether or not an attorney can ethically recommend *Havoco* type planning. Specifically, consider Model Rules of Professional Conduct Rule 4.4(a) (2002), which, as noted, provides, in pertinent part, that "a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person..."

- In addition, note that a different result would exist in Bankruptcy. Specifically, under Bankruptcy Code § 522(o), where nonexempt property is converted within the ten year period preceding the filing of the bankruptcy case into: (i) real or personal property that the debtor or a dependent of the debtor uses as a residence; (ii) a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence; (iii) a burial plot; or (iv) real or personal property that the debtor or dependent of the debtor claims as a homestead, the exemption must be reduced to the extent such value was acquired with the intent to hinder, delay, or defraud a creditor.

- Separately, Bankruptcy Code § 522(p) provides generally that a debtor may not exempt any amount of interest in a homestead that was acquired during the 1,215 day period preceding the filing of the bankruptcy petition that exceeds in the aggregate $125,000 in value (subject to adjustment for inflation).

- The amount of such interest does not include any interest transferred from a previous principal residence (which was acquired prior to the beginning of the 1,215 day period) if the debtor's previous and current residences are located in the same state.

- Finally, Bankruptcy Code § 522(q) provides that a debtor cannot utilize a state homestead exemption in Bankruptcy to exempt an amount in excess of $125,000 (unless determined to be reasonably necessary for the support of the debtor and any dependent of the debtor) if any of the following circumstances apply:

    - The court determines, after notice and a hearing, that the debtor has been convicted of a felony, which under the circumstances demonstrates that the filing of the case was an abuse of the provisions of the Bankruptcy Code.

    - The debtor owes a debt arising from:

        - Any violation of certain federal securities laws, any state securities laws, or any regulation or order issued under federal securities laws or state securities laws.

        - Fraud, deceit or manipulation in a fiduciary capacity or in connection with the purchase or sale of certain registered securities.

        - Any civil remedy relating to the investment of income earned in racketeering or through the collection of an unlawful debt in an enterprise engaged in or affecting interstate or foreign commerce.

        - Any criminal act, intentional tort or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding five years.

3. Qualified Retirement Plans

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 in Bankruptcy pursuant to the 1992 decision of the United States Supreme Court in *Patterson v. Shumate*.

i. In that case, the Supreme Court ruled on the issue of whether the legally mandated 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 bankruptcy trustee in *Patterson* contended that the term "applicable nonbankruptcy law" was limited to state law, the Supreme Court 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. Specifically, the Supreme Court stated that:

    - "Our holding gives full and appropriate effect to ERISA's goal of protecting pension benefits…This Court has described that goal as one of ensuring that "if a worker has been promised a defined pension benefit upon retirement — and if he has fulfilled whatever conditions are required to obtain a vested benefit — he actually will receive it…Our holding furthers another important policy underlying ERISA: uniform national treatment of pension benefits…Construing "applicable nonbankruptcy law" to include federal law ensures that the security of a debtor's pension benefits will be governed by ERISA, not left to the vagaries of state spendthrift trust law." *Id* at 765.

b. Of course, a plan which is not "qualified" under ERISA will not garner the asset protection afforded to ERISA qualified plans. To limit litigation concerning the complicated question as to whether or not a plan is, in fact, "qualified" under ERISA, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added a new subsection (b)(4) to Bankruptcy Code § 522. Bankruptcy Code § 522(b)(4) provides that for purposes of determining the exemption for a debtor's right to receive "[r]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986," the following rules shall apply:

i. If the retirement funds are in a retirement fund that has received a favorable determination from the Internal Revenue Service, and that determination is in effect as of the date of the filing of the bankruptcy petition, the funds are presumed to be exempt.

ii. If the retirement funds are in a retirement fund that has not received a favorable determination from the Internal Revenue Service, the funds are only exempt from the bankruptcy estate if the debtor demonstrates that:

- No prior determination to the contrary has been made by a court or the Internal Revenue Service; and

- The retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code or, if the retirement fund fails to be in substantial compliance with the applicable requirements of the Internal Revenue Code, the debtor is not materially responsible for that failure.

c. Under state law, Qualified Retirement Plans are often also exempted. For example, see Florida Statutes § 222.21(2)(a).

4. Individual Retirement Accounts

a. Bankruptcy Code §§ 522(b)(3)(C) and (d)(12) exclude from the bankruptcy estate "[t]he debtor's right to receive, or property that is traceable to…[r]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986."

i. However, this exemption is subject to a monetary cap under Bankruptcy Code § 522(n) which provides that: "For assets in individual retirement accounts described in section 408 or 408A of the Internal Revenue Code of 1986, other than a simplified employee pension under section 408(k) of such Code or a simple retirement account under section 408(p) of such Code, the aggregate value of such assets exempted under this section, without regard to amounts attributable to rollover contributions…and earnings thereon, shall not exceed $1,000,000 in a case filed by a debtor who is an individual, except that such amount may be increased if the interests of justice so require."

- The $1,000,000 monetary cap on the Bankruptcy exemption for Individual Retirement Accounts is indexed for inflation.

- Since the monetary cap does not apply to amounts attributable to rollover contributions, or to earnings, it is advisable to maintain a clear distinction between (a) original contributions to an Individual Retirement Account, and (b) rollover amounts. Therefore, qualified plan account monies should probably not be rolled over into or otherwise commingled with existing contributory Individual Retirement Accounts.

- In addition, the Bankruptcy Court may increase the monetary cap in a particular case if it's required in the interests of justice.

ii. Note that the wording of the Bankruptcy Code exemption covers both traditional Individual Retirement Accounts through the statutory reference to Internal Revenue Code § 408, and to Roth Individual Retirement Accounts through the statutory reference to Internal Revenue Code § 408A.

b. State law exemptions relating to individual retirement account vary significantly from state to state.

i. A few state statutes provide an unlimited and unqualified exemption for Individual Retirement Accounts.

ii. More commonly, a state exemption for Individual Retirement Accounts is qualified in one or more ways, including the following common qualifications:

- A specific percentage or dollar limitation.

- A general exemption with an exception for contributions made within a certain period prior to the interposition of a claim.

- A limitation based upon an amount that is thought to be "reasonably necessary" for the support of the debtor and the debtor's dependents.

    - The determination of what is reasonably necessary for the support of the debtor and any dependent of the debtor is obviously fact-intensive. Factors that courts consider include:

        - The debtor's present and anticipated living expenses.

        - The debtor's present and anticipated income from all sources.

        - The age of the debtor and the debtor's dependents.

        - The health of the debtor and the debtor's dependents.

        - The debtor's ability to work and earn a living.

        - The debtor's job skills, training, and education.

        - The debtor's other assets, including exempt assets.

- The liquidity of the debtor's other assets.

- The debtor's ability to save for retirement.

- The special needs of the debtor and the debtor's dependents; and

- The debtor's financial obligations, such as alimony or support payments.

- Whether an exemption will be upheld under the "reasonably necessary" standard in any given case will depend on a balancing of the foregoing factors.

c. *Inherited* Individual Retirement Accounts

i. The exemption for Individual Retirement Accounts might not also apply with regard to "inherited" Individual Retirement Accounts. In fact, most courts that have considered this issue under state law have determined that inherited Individual Retirement Accounts are *not* protected under state law.

ii. Some states, however, have enacted statutory protection for inherited Individual Retirement Accounts.

- *See*, *e.g.*, Florida Statutes § 222.21(c), which provides, in pertinent part, that "[a]ny money or other assets or any interest in any fund or account that is exempt from claims of creditors of the owner, beneficiary, or participant under paragraph (a) does not cease to be exempt after the owner's death by reason of a direct transfer or eligible rollover that is excluded from gross income under the Internal Revenue Code of 1986, including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in s. 408(d)(3) of the Internal Revenue Code of 1986, as amended…"

- Other states that have enacted similar statutes include:

- Alaska - Alaska Stat. § 09.38.017(a)
- Arizona - A.R.S. 33-1126(b)
- Idaho - Idaho Code §§ 55-1011
- Ohio - ORC Ann. 2329.66(e)
- Missouri - Mo. Rev. Stat. § 513.430.1(f)
- North Carolina - N.C. Gen. Stat. § 1C-1601(a)(9)
- Texas - Tex. Prop. Code § 42.0021(a)

iii. In the Bankruptcy context, the United States Supreme Court determined in *Clark, et ux. v. Rameker, Trustee, et al*., 134 S.Ct. 2242 (2014), that an inherited IRA does not constitute "retirement funds" within the meaning of Bankruptcy Code § 522(b)(3)(C) and, therefore, is not an exempt asset under the Bankruptcy Code. Specifically, unlike an Individual Retirement Account or Roth IRA in the hands of the original contributor:

- The owner of an inherited Individual Retirement Account may withdraw funds at any time, without paying a tax penalty. Thus, the owner of an inherited Individual Retirement Account has "a pot of money that can be freely used for current consumption," and not funds specifically set aside for retirement. *Id*. at 2247.
- The owner of an inherited Individual Retirement Account must either withdraw the entire balance in the account within ten years of the original owner's death, or in certain limited situations take minimum distributions on an annual basis, no matter how many years the owner may be from retirement.
- The owner of an inherited Individual Retirement Account may not make contributions to the account. This is, of course, in sharp contrast to traditional Individual Retirement Accounts and Roth IRAs, the entire purpose of which is to

provide tax incentives for accountholders to contribute regularly and over time to their retirement savings.

d. Inasmuch as an inherited Individual Retirement Account will not be exempt from creditors, either in Bankruptcy or outside of Bankruptcy under the law of most states, an Individual Retirement Account owner concerned about providing creditor protection to his or her designated beneficiaries (other than a surviving spouse, who could, of course, simply roll-over the deceased spouse's Individual Retirement Account or Roth Individual Retirement Account into the surviving spouse's own Individual Retirement Account), should consider the advantages of designating a "see-through trust" as beneficiary.

i. A "see-through trust" is expressly permitted by the Treasury Regulations. Specifically, Treas. Reg. § 1.401(a)(9)-4, A-5(a) provides that "[i]f the requirements of paragraph (b) of this A-5 are met with respect to a trust that is named as the beneficiary of an employee under the plan, the beneficiaries of the trust (and not the trust itself) will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9)."

ii. Most significantly, Treas. Reg. § 1.401(a)(9)-4, A-5(b), requires that "[t]he beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable within the meaning of A-1 of this section from the trust instrument."

iii. Treas. Reg. § 1.401(a)(9)-4, A-1 provides, in pertinent part, that: "[a] designated beneficiary is an individual who is designated as a beneficiary under the plan…either by the terms of the plan or, if the plan so provides, by an affirmative election…specifying the beneficiary ...The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, to identify the class member with the shortest life expectancy."

iv. Essentially, these rules permit two types of trusts to qualify as a "see-through trust".

- A so-called “conduit trust”, which is a trust which, as its name suggests, merely acts as a conduit for the distributions from the inherited Individual Retirement Account. Specifically, a conduit trust would receive minimum required distributions from the inherited Individual Retirement Account and then pass those distributions out to the beneficiary of the conduit trust on a current basis. Although the distributions from the inherited Individual Retirement Account will, of course, no longer be protected from creditors after they are paid out to the conduit trust beneficiary, the advantage of the conduit trust is that the balance of the inherited Individual Retirement Account will be protected from the trust beneficiary’s creditors. *See* Treas. Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.

- A purely discretionary trust (sometimes called an “accumulation trust”), which will provide greater asset protection since the trustee is not required under the trust instrument to pass out to the beneficiary the minimum required distribution taken from the inherited Individual Retirement Account. However, in an accumulation trust consideration must be given to the identity of the various beneficiaries of the trust in order to calculate the distributions that might be required from the account. *See* Treas. Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 1.

5. Life Insurance

a. The exemption afforded to life insurance is intended to further the public policy goal of protecting dependents from financial destitution in the event of the debtor’s untimely demise. Therefore, the relationship between the owner and the insured, and the relationship between the owner and the beneficiary, are often key to determining whether and to what extent a life insurance policy will be protected from creditor claims.

b. The federal bankruptcy exemption for life insurance policies owned by the debtor is found at 11 U.S.C. §§ 522(d)(7) and (8) and provides 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.

i. 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

ii. The effect of the bankruptcy exemption for life insurance is to protect the actual insurance element of the policy and little else, since only a minimal portion of the cash surrender value of the policy is afforded any exemption. This may nevertheless be a valuable exemption where, for example, the debtor has become uninsurable since the life insurance policy was originally purchased, but it obviously does not provide significant opportunities for asset protection or pre-bankruptcy planning for the insured.

c. Under Bankruptcy Code § 522(d)(11)(C), if the debtor is the beneficiary of the policy (rather than the owner of the policy), the proceeds of the life insurance contract are exempt, without any specific dollar limitation, to the extent "reasonably necessary" for the support of the debtor and any dependent of the debtor.

d. Since the federal exemption scheme for life insurance that is owned by the debtor, as the insured, is so limited, where an exemption under an alternative state scheme is provided, its use in lieu of the federal exemption scheme should be carefully considered.

- For example, Florida Statutes § 222.14 provides, in pertinent part, that "The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state…shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured…unless the insurance policy…was effected for the benefit of such creditor."

e. Obviously, the fact that an unlimited exemption for the cash surrender value of life insurance exists in some states can be easily abused by debtors.

i. For example, in *In re White*, 185 F. Supp. 609 (N.D. W. Va. 1960), the bankruptcy trustee, objecting to the debtor's position that the cash surrender value of his life insurance policy should be exempted as part of the unlimited exemption for the "proceeds and avails" of life insurance under West Virginia's exemption statute, argued that to hold the cash surrender value exempt would "provide a debtor with an avenue for depositing his funds, in unlimited amounts, in a species of property which would place it beyond the reach of his creditors, but not beyond his own reach after his discharge in bankruptcy." *Id*. at 611

ii. Similarly, in *In re Beckman*, 50 F. Supp. 339 (N.D. Ala. 1943), the bankruptcy trustee argued that to hold the cash surrender value of the debtor's life insurance policy exempt would be to make an insurance policy "a refuge for fraud."

iii. In each of *White* and *Beckman*, however, the Bankruptcy Court responded by stating that such an argument overlooks the fact that the exemption statute expressly provides that premiums paid in fraud of creditors would, nevertheless, inure to the benefit of creditors. In any event, and as is often stated, "[i]f abuses to enacted exemptions are deemed to exist, the remedy is by other than judicial legislation." *In re Worthington*, 28 B.R. 736, 737 (Bankr. W.D. Ky. 1983).

iv. Such reasoning would seem to exempt even single premium policies purchased as a safe harbor for otherwise nonexempt funds, provided only that it cannot be proven that the single premium payment constituted a fraudulent transfer.

6. Annuities

a. The federal bankruptcy exemption for annuity payments is located at 11 U.S.C. § 522(d)(10)(E) and 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.

i. 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 and have generally proven extremely spare in applying such standard in any event.

- *See, e.g.*, *Warren v. Taff*, 10 B.R. 101, 107 (Bankr. D. Conn. 1981) ("[t]he reasonably necessary standard requires that the court take into account other income and exempt property of the debtor, present and anticipated…the appropriate amount to be set aside for the debtor ought to be sufficient to sustain basic needs, not related to [the debtor's] former status in society or the lifestyle to which [the debtor] is accustomed").

b. State law exemptions for the proceeds of an annuity vary widely from state to state, with some states providing for a total exemption and others only providing for only a limited exemption. Common limitations on the exemption for the proceeds of an annuity include:

i. A monthly limit on the exemption amount which is ostensibly tied to a basic standard of living in that state.

- *See, e.g.*, 42 Pa. Cons. Stat. Ann. § 8124(c)(3), which provides that: "[t]he following property or other rights of the judgment debtor shall be exempt from attachment or execution on a judgment…Any policy or contract of insurance or annuity issued to a solvent insured who is the beneficiary thereof, except any part thereof exceeding an income or return of $100 per month."

- *See, e.g.*, Del. Code Ann. tit. 18 § 2728(a)(2), which provides that: "[t]he benefits, rights, privileges and options which under any annuity contract heretofore or hereafter issued are due or prospectively due the annuitant shall not be subject to execution nor shall the annuitant be compelled to exercise any such rights, powers or options nor shall creditors be allowed to interfere with or terminate the contract, except…[t]he total exemption of benefits presently due and payable to any annuitant periodically or at stated times under all annuity contracts under which he or she is an annuitant shall not at any time exceed $350 per month for the length of time represented by such installments and that such periodic payments in excess of $350 per month shall be subject to garnishee execution to the same extent as are wages and salaries."

ii. Other states limit the exemption to annuities under which the named beneficiary is the debtor's spouse, children or dependents.

- *See, e.g.*, Ohio Rev. Code Ann. § 3911.10, which provides, in pertinent part, that: "[a]ll contracts of life or endowment insurance or annuities upon the life of any person, or any interest therein, which may hereafter mature and which have been taken out for the benefit of, or made payable by change of beneficiary, transfer, or assignment to, the spouse or children, or any persons dependent upon such person…or to a trustee for the benefit of such spouse, children [or] dependent persons…shall be held, together with the proceeds or avails of such contracts, subject to a change of beneficiary if desired, free from all claims of the creditors of such insured person or annuitant."

iii. Still other states, follow the federal exemption scheme and exempt only so much of an annuity as may be "reasonably necessary" for the support of the debtor and the debtor's dependents.

- *See, e.g.*, Mo. Ann. Stat. § 513.430(1)(10)(e), which provides, in pertinent part, that: "[t]he following property shall be exempt from attachment and execution to the extent of any person's interest therein…[a]ny payment under a[n]…annuity or similar plan or contract on account of illness, disability, death, age or length of service, to the extent reasonably necessary for the support of such person and any dependent of such person…"

- *See, e.g.*, N.Y. Ins. Law § 3212(d)(2), which provides, in pertinent part, that: "[t]he annuitant shall not be compelled to exercise any…rights, powers or options contained in the annuity contract, nor shall creditors be allowed to interfere with or terminate the contract…except 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…"

- New York, further qualifies its exemption for annuity contracts by providing that if the contract was purchased by the debtor within six months of the debtor's bankruptcy filing, then the exemption will be capped at $5,000. N.Y. Debt. & Cred. Law § 283(1).

  - The intent of this statute, according to the Bankruptcy Court, is to "limit the debtor's ability to deliberately 'load up' on exempt property." *In re Moore*, 177 B.R. 437 at 441 (Bkrtcy. N.D.N.Y. 1994).

c. In states where the exemption for the right to receive an annuity is unlimited, litigation has centered around the question of whether or not the interest held by the debtor is, in fact, an "annuity" within the meaning of the exemption statute.

i. In Florida, where Fla. Stat. § 222.14 provides in pertinent part that "…the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor…of the person who is the beneficiary of such annuity contract…," the courts have broadly construed the scope of the term "annuity".

ii. For example, the Florida Supreme Court in the case of *In re McCollam*, 612 So. 2d 572 (Fla. 1993), held that under the Florida exemption scheme an annuity received by the debtor pursuant to a structured settlement of her deceased father's wrongful death claim was exempt as an "annuity" rather than nonexempt as the equivalent of an account receivable by the debtor. The Florida Supreme Court noted that: "[h]ad the legislature intended to limit the exemption to particular annuity contracts, it would have included such restrictive language when the statute was amended to include annuity contracts." *Id*. at 574.

- Contrast, however, the Bankruptcy Court's decision in the matter of *In re Pizzi*, 153 B.R. 357 (Bankr. S.D. Fla. 1993), which held that the annual payment of a debtor's lottery winnings through a commercial annuity purchased by the State of Florida for the purpose of ensuring payment of the debtor's lottery winnings was not exempt from the bankruptcy estate as an "annuity" under Florida law since it was the State of Florida, rather than the debtor, that was named as the beneficiary of the annuity contract.

- A similar situation existed in *In re Solomon*, 95 F.3d 1076 (11th Cir. 1996), in which the debtor was the payee under a structured settlement agreement which required the counter-party to purchase a commercial annuity contract in the debtor's favor to ensure its compliance with the agreement's payment schedule. The debtor, however, was not a party to the annuity contract. The Eleventh Circuit held in *Solomon* that the mere periodic payments which the debtor was to receive under the structured settlement agreement did not itself constitute an "annuity contract" of the kind which the debtor could exempt from the bankruptcy estate pursuant to the Florida exemption. Specifically distinguishing the decision in *In re McCollam, supra*, the Eleventh Circuit stated that: "…the statute does not shield all debts or 'accounts receivable' structured to resemble annuities from a debtor's bankruptcy estate. We read *McCollam* to require the existence of an actual annuity *contract* before a series of payments may be exempt under section 222.14." *Id*. at 1078.

- *See also, In re Conner*, 172 Bankr. 119, 121 (Bankr. M.D. Fla. 1994) (stating that "if all that is required to establish an annuity contract is a stream of payments over time, all installment contracts would qualify as an annuity and that is clearly not what the *McCollam* decision requires”).

iii. *In re Mart*, 88 B.R. 436 (Bankr. S.D. Fla. 1988), took the broad definition of an “annuity” under Florida’s exemption scheme one step further and demonstrated an effective asset protection use of annuities (at least within the Southern District of Florida). In *Mart* the debtor’s daughter-in-law established an irrevocable trust for the benefit of seven children, nieces and nephews of the debtor and funded the trust with $2,000. The day after the trust was created, the debtor and his spouse entered into an annuity agreement with their daughter, who had been appointed as trustee of the trust. In furtherance of the annuity agreement, the debtor and his spouse transferred $350,000 to the trust in exchange for a return stream of annuity payments in the amount of $3,000 per month. Thirteen months later, the debtor filed bankruptcy and claimed that the annuity was exempt under Florida law. The objecting creditors argued that if the debtor’s “…income stream from the transfer of this property is an Annuity, any debtor can go to his cousin and give him all of his property in return for a promised stream of income. That debtor need only pull out his big rubber stamp with the word Annuity on it and label the agreement from his cousin to pay the money.” *Id*. at 438. The Bankruptcy Court in *Mart* held for the debtor, explaining that: “I agree that this statutory exemption, perhaps like all exemptions, invites abuse. I also agree that the debtor’s relationship with the…trustee, her evident willingness to accept her father’s proposals, and the fact that this is a completely private arrangement are grounds for careful scrutiny…I reject the argument and the objections, however, because, (1) …the statutory exemption is not restricted to annuities provided by completely unrelated, public entities, and (2) I find no intent to defraud creditors in this debtor’s conversion of his non-exempt assets to exempt assets through the establishment of this annuity contract.” *Id*.

7. Qualified Tuition Program Plans

a. Bankruptcy Code § 541(b)(6) provides that funds “…contributed to an account in accordance with section 529(b)(1)(A) of the Internal Revenue Code of 1986 under a qualified State tuition program (as defined in section 529(b)(1) of such Code) not later than 365 days before the date of the filing of the petition…" are excluded, in whole or in part, from the bankruptcy estate provided that "….the designated beneficiary of the amounts paid or contributed to such tuition program was a child, grandchild, stepchild or step-grandchild of the debtor for the taxable year for which funds were paid or contributed."

b. The extent of the exclusion depends upon the timing of the contribution:

i. Contributions made at least two years prior to bankruptcy are excluded from the bankruptcy estate to the extent that such amount does not exceed the total contributions permitted under Internal Revenue Code § 529(b)(7).

ii. Contributions made between one and two years prior to bankruptcy are excluded from the bankruptcy estate to the extent that such amount does not exceed $5,000.

c. In addition to the exclusion provided under Bankruptcy Code § 541(b)(6), slightly more than half of the states also provide Internal Revenue Code § 529 plans with at least some level of protection from creditor claims. Those states are:

i. Alaska - Alaska Stat. § 14.40.802(h)

ii. Arkansas - A.C.A. § 6-84-110(b)(2)

iii. Colorado - C.R.S. § 23-3.1-307.4

iv. Delaware – 10 Del. Code § 4916

v. Florida - Fla. Stat. § 222.22(1)

vi. Idaho - Idaho Code § 11-604A

vii. Illinois -15 ILCS 505/16.5; 735 ILCS 5/12-1001(j)

viii. Kansas - K.S.A. § 60-2308(j)(2)-(4)

ix. Kentucky - Ky. Rev. Stat. § 164A.350

x. Louisiana - La.R.S. 17-3096G

xi. Maine - Me. Rev. Stat. Ann. Title 20-A, § 11478

xii. Maryland - Md. Education Code Ann. § 18-1913

xiii. Nebraska - R.R.S. Ned. § 85-1809

xiv. Nevada - NRS § 21.090

xv. New Jersey - N.J. Stat. § 18A:71B-41.1

xvi. New York - NY CPLR § 5205(j)

xvii. North Carolina – N.C. Gen. Stat. § 1C-1601

xviii. North Dakota - N.D. Admin. Code 12.5-02-01-06

xix. Ohio - ORC Ann. 3334.15(A)

xx. Oklahoma - 31 Okl. St. § 1, A, 26

xxi. Oregon - ORS § 348.863(2)

xxii. Pennsylvania - 24 P.S. § 6901.309.2

xxiii. Rhode Island - R.I. Gen. Laws 21 9-26-4(15)

xxiv. South Carolina - S.C. Code Ann. § 59-2-140

xxv. South Dakota -S.D. Codified Laws § 13-63-20

xxvi. Tennessee - Tenn. Code Ann. § 49-7-822

xxvii. Texas - Tex. Prop. Code § 42.0022

xxviii. Virginia - Va. Code Ann. § 23-38.81

xxix. West Virginia - W.Va. Code § 18-30-7(i)

xxx. Wisconsin - Wis. Stat. 14.64

d. Again, the creditor protection varies widely from state to state, and in some states such protections may only be against the beneficiary's creditors.

i. In most states, the creditor protection is limited to plans established under that state's program; however, the Florida, Tennessee and Texas statutes provide creditor protection to Internal Revenue Code § 529 plans established under the program of any state.

- For example, Florida Statutes § 222.22(1) provides that "[m]oneys paid into or out of, the assets of, and the income of any validly existing qualified tuition program authorized by s. 529 of the Internal Revenue Code of 1986, as amended, including, but not limited to, the Florida Prepaid College Trust Fund advance payment contracts under s. 1009.98 and Florida Prepaid College Trust Fund participation agreements under s. 1009.981, are not liable to attachment, levy, garnishment, or legal process in the state in favor of any creditor of or claimant against any program participant, purchaser, owner or contributor, or program beneficiary."

ii. Many states protect Internal Revenue Code § 529 plans, without specifically delineating against whom the creditor protection is effective. Seemingly, as an asset protection planning device, protection against the creditors of the account holder is the most important consideration, since the account holder is the sole party with the right to withdraw funds from the plan. However, a number of state statutes provide that the protection is *vis a vis*:

- Creditors of the beneficiary only

    - For example, Wis. Stat. § 14.64(7)(a) provides that: "[a] beneficiary's right to qualified withdrawals under this section is not subject to garnishment, attachment, execution or other process of law."

- Creditors of the beneficiary and the contributor

    - For example, N.J. Stat. § 18A:71B-41.1 provides that "[m]oneys paid into or out of an NJBEST account by or on behalf of a contributor or designated beneficiary for the purposes of financing the cost of qualified higher education expenses under this article are exempt from all claims of creditors of the contributor or the designated beneficiary."

- Creditors of the beneficiary and the account owner

  - For example, W. Va. Code § 18-30-7(i) provides that: "[n]otwithstanding any provision of this code to the contrary, money in the savings plan trust fund is exempt from creditor process and not subject to attachment, garnishment, or other process; is not available as security or collateral for any loan, or otherwise subject to alienation, sale, transfer, assignment, pledge, encumbrance or charge; and is not subject to seizure, taking, appropriation or application by any legal or equitable process or operation of law to pay any debt or liability of any account owner, beneficiary or successor in interest."

- Creditors of the beneficiary, the contributor and the account owner

  - For example, Va. Code Ann. § 23-38.81 provides that: "[n]otwithstanding any provision of law to the contrary, money in the Plan shall be exempt from creditor process and shall not be liable to attachment, garnishment, or other process, nor shall it be seized, taken, appropriated, or applied by any legal or equitable process or operation of law to pay any debt or liability of any purchaser, contributor or beneficiary."

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

A. What is a "Trust"?

1. According to the Restatement Third, Trusts § 2, "[a] trust…is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of…one or more persons, at least one of whom is not the sole trustee."

a. Comment f to the Restatement Third, Trusts § 2, provides "[i]n the strict, traditional sense, a trust involves three elements: (1) a trustee, who holds the trust property and is subject to duties to deal with it for the benefit of one or more others; (2) one or more beneficiaries, to whom and for whose benefit the trustee owes the duties with respect to the trust property; and (3) trust property, which is held by the trustee for the beneficiaries."

2. Similarly, George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 1 (rev. 2d ed. 1984), provides that "[a] trust may be defined as a fiduciary relationship in which one person holds a property interest subject to an equitable obligation to keep or use that interest for the benefit of another."

   a. As to what, exactly, is a "fiduciary relationship," comment b to the Restatement Third, Trusts § 2, provides that "[t]he trust relationship is one of many forms of fiduciary relationship…one characteristic is common to all [fiduciary relationships]: a person in a fiduciary relationship to another is under a duty to act for the benefit of the other as to matters within the scope of the relationship."

3. Stated most simply, when a person transfers property to another person "in trust" for one or more beneficiaries, or for a legally-acknowledged beneficial purpose, a "trust" is formed.

4. As shall be explored in greater detail in the immediately following section of this outline, the fact that a trustee is the actual legal owner of the trust property is a key concept from which follows the asset protection generally afforded to a beneficiary through the holding of property in trust.

B. 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).

   a. "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).

2. Spendthrift trusts are free from creditors' claims because the settlor has explicitly provided, through the incorporation of a spendthrift provision

in the governing instrument, that the trust fund shall be exempt from the claims of the beneficiary's creditors. In other words, the policy underlying the spendthrift trust is that it carries out a stated intent of the settlor.

a. 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.

b. "The validity of a spendthrift provision in a trust is predicated upon the [public policy] consideration that a person is free to make any desired disposition of his property." *Estate of Johnson*, 252 Cal.App.2d 923, 925 (1967). "[C]onsideration for the beneficiary does not even in the remotest way enter into the policy of the law; it has regard solely to the rights of the donor. Spendthrift trusts can have no other justification than is to be found in considerations affecting the donor alone." *Estate of Morgan*, 223 Pa. 228, 229, 72 A. 498, 499 (1909).

c. In addition, it is often said that the use of a spendthrift trust takes nothing from the beneficiary's creditor that he or she had previously.

- "The doctrine that property may be made inalienable by such declaration of a [spendthrift] trust rests upon the theory that a donor has the right to give his property to another upon any conditions which he sees fit to impose, and that, inasmuch as such a gift takes nothing from the prior or subsequent creditors of the beneficiary to which they previously had the right to look for payment, they cannot complain that the donor has provided that the property or income shall go or be paid personally to the beneficiary and shall not be subject to the claims of creditors." *Parscal v. Parscal*, 148 Cal.App.3d 1098, 1102-1103.

d. However, "[f]reedom of disposition in this country allows a property owner to impose conditions and limitations on beneficial interests he or she creates in a trust, but only to the extent they are not illegal or contrary to public policy." *Reporter's Notes on § 59 of the Restatement (Third) of Trusts, Comments a-a(2).*

e. How is a Trust Structured as a Spendthrift Trust?

i. Under § 502(b) of the Uniform Trust Code, "[a] term of a trust providing that the interest of a beneficiary is held subject to a "spendthrift trust," or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest."

C. 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).

2. The effect of a discretionary trust is to limit the extent of the beneficiary's interest in the trust so as to make it sufficiently tenuous so that it does not qualify as a property right which is subject to attachment by creditors. In effect, the beneficiary's interest will only come into existence when and to the extent that the trustee decides to make a distribution to the beneficiary.

   a. "In a discretionary trust it is the nature of the beneficiary's interest rather than a provision forbidding alienation which prevents the transfer of the beneficiary's interest. The rule…is not dependent upon a prohibition of alienation by the settlor; but the transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel payment to himself or application for his own benefit." *Restatement (Second) of Trusts §155, cmt. b. (1959).*

      i. "A transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so." *Comment e to Restatement (Third) of Trusts § 60 (2003).*

      ii. Similarly, "[w]here by the terms of the trust a beneficiary is entitled only to so much of the income or principal as the trustee in his uncontrolled discretion shall see fit to give him, he cannot compel the trustee to pay to him or to apply for his use any part of the trust property. In such a case, an assignee of the interest of the beneficiary cannot compel the trustee to pay any part of the trust property, nor can creditors of the beneficiary reach any part of the trust property…If the beneficiary himself cannot compel the trustee to pay over any part of the trust fund, his assignee and his creditors are in no better position." *2A Scott & Fratcher, The Law of Trusts §155, at 154 (4th ed. 1989).*

b. In this regard, the courts will generally not substitute their judgment for the judgment of a trustee; provided, however, that the trustee exercises the trustee's judgment in good faith and within reasonable bounds. In general, a court will only interfere with a trustee's exercise or failure to exercise a discretionary distribution power, when an abuse of discretion has been shown to have occurred.

i. "At the heart of this issue, then, is the critical inquiry whether any court can substitute its discretion for that which a settlor has vested exclusively in the trustee, and thereby force the premature distribution of trust property by distributing same not to the beneficiary but to his seizing creditors. We are persuaded that question must be answered in the negative." *Read v. U.S. ex rel. Department of Treasury*, 169 F.3d 243, 254 (5th Cir. 1999).

D. 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).

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

i. In *Nichols*, the trust in question was a testamentary trust established by a mother for her sons, one of whom 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.

ii. 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.

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

i. In *Sligh v. First National Bank of Holmes County*, the beneficiary of two spendthrift trusts established by the beneficiary's mother with the defendant bank as trustee was operating a motor vehicle while intoxicated and was involved in an accident which left the plaintiff paralyzed, with the loss of the use of both legs, the loss of all sexual function and the loss of the ability to control bowel and urinary function. The plaintiff won a $5 million civil judgment against the beneficiary for compensatory and punitive damages and tried to collect against the trusts by alleging that the beneficiary's mother had actual knowledge that the beneficiary was an alcoholic and that she had created the trusts to shield the beneficiary's interest from the likely claims of involuntary tort creditors.

ii. The plaintiff alleged that it was a violation of public policy to enforce and give priority to spendthrift trust protections against involuntary tort judgments and urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary tort creditors. The Mississippi Supreme Court ultimately allowed the plaintiff to collect against the trusts by concluding that spendthrift protections should not extend to judgments for "gross negligence and intentional torts."

iii. More significant, perhaps, is the fact that the Mississippi legislature promptly negated the import of *Sligh* on a going forward basis through the 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 the interest is actually paid to the beneficiary.

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

i. 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.

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

- Furthermore, 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.

E. 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 spendthrift and discretionary trusts.

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.

   a. Accordingly, the settlor may not permit a beneficiary to assign trust assets while prohibiting a beneficiary's creditors from collecting on an involuntary basis.

   b. 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 § 503 sets forth exceptions to the spendthrift provision, which are discussed in detail below.

4. 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 special circumstances 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.

F. 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. children with child support claims.

   e. (sometimes) spouses with support claims.

f. (very rarely) involuntary tort creditors.

3. Exception creditors obviously 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 provides.

4. In contrast, with regard to a discretionary trust, Uniform Trust Code § 504(c), 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 benefit of the beneficiary had the trustee complied with the standard or not abused the discretion."

VI. SELF-SETTLED SPENDTHRIFT TRUSTS

A. Domestic Asset Protection Trusts

1. 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 been unenforceable with respect to a beneficiary who is also the settlor to the extent of his or her beneficial interest in the trust. 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.

- For example, Florida Statutes § 736.0505(1)(b) provides that "With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution."

2. However, since 1997 eighteen 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:

   a. Alaska

   b. Connecticut

   c. Delaware

   d. Hawaii

   e. Indiana

   f. Michigan

   g. Mississippi

   h. Missouri

   i. Nevada

   j. New Hampshire

   k. Ohio

   l. Rhode Island

   m. South Dakota

   n. Tennessee

   o. Utah

   p. Virginia

   q. West Virginia

   r. Wyoming

3. 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 Oklahoma), for the benefit of his or her spouse, descendants and any one or more Internal Revenue Code § 501(c)(3) charities, and to retain the right to revoke the trust, without causing the trust to thereby be available to creditors. In addition, the law provides that no court shall have the authority to compel the settlor to exercise his or her power to revoke the trust. The law does, however, limit the protection to $1 million of transferred assets plus any subsequent appreciation thereon. In addition, the corpus of the trust must consist of assets in Oklahoma based banks, real estate located in Oklahoma, and securities issued by Oklahoma based companies (including corporations, limited liability companies and limited partnerships formed or domesticated in Oklahoma and having a principal place of business in Oklahoma). However, the Oklahoma law does not technically provide for "self-settled" spendthrift trusts because the settlor himself cannot be a beneficiary of such a trust.

4. Delaware (as an example)

    a. 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.

        i. The Delaware Qualified Dispositions in Trust Act was enacted "…to facilitate the establishment in Delaware of irrevocable trusts that will allow trust settlors to transfer assets from their estates, in order to reduce the federal estate taxes that would otherwise be due upon their death." Del. Code Ann. tit. 12, §3570–3576; 1997 Del. H.B. 356.

        ii. In addition, the Act noted the then recently enacted 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."

    b. 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 means of a trust instrument 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.

c. The trust instrument must be irrevocable but can include one or more of the following provisions:

i. The settlor may retain power to veto distributions;

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

iii. 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);

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

v. 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

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

d. The trust instrument must provide for Delaware law to apply and must contain a spendthrift clause.

e. Provided that the transfer of property to the trust was not intended to hinder, delay or defraud creditors, no action to enforce a judgment generally can be brought for attachment against such qualified disposition. If, however, the transfer of property to the trust can be proven to have been intended to hinder, delay or defraud creditors, an action must be brought within the following statute of limitations periods:

i. 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.

ii. 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 such creditor.

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

i. "…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 under Delaware law.

ii. 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.

5. Constitutional Issues

a. 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 twenty-five years, foreign asset protection trusts may offer a more substantial barrier to creditors than will domestic asset protection trusts because of certain issues under the United States Constitution.

i. 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.

- Assuming that personal jurisdiction is obtained over the trustee, there are only two apparent limitations upon the application of the Full Faith and Credit Clause to an asset protection trust.

  - 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).

- 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, if that is even possible, in the offshore jurisdiction.

ii. 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 asset protection trust to distribute assets to a creditor.

  - This concern has been mitigated somewhat, however, by 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 those limited situations where (i) the transfer is a fraudulent transfer, which (ii) was made within ten years before the date of the filing of the bankruptcy petition.

  - In the case of In re Mortensen (*Battley v. Mortensen*, Adv. D. Alaska, No. A09-90036-DMD, May 26, 2011), 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 facts 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 to his bankruptcy filing. Notably, at the time of the filing of the Bankruptcy petition, the transfer to the Trust was outside of Alaska's own fraudulent transfer statute of limitations period of four years.

iii. 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 effectively contract since it would allow a contracting party, through the use of an asset protection trust, to avoid paying damages under a breached contract.

B. Foreign Asset Protection Trusts

1. Overview

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

b. Such trusts, if properly funded, would 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 any domestic jurisdiction). Such trusts provide procedural, substantive and psychological barriers to creditors.

i. Importantly, such trusts *do not* rely on secrecy or concealment to be effective.

2. Selecting a Jurisdiction

a. The following jurisdictions have enacted favorable asset protection trust legislation (some obviously 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

b. 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 of 1571 (discussed *supra*), which provides no limitations period within which a creditor must bring a fraudulent transfer claim or be thereafter barred from asserting its claim.

c. Other factors to consider in selecting a foreign asset protection trust jurisdiction include:

i. The need for a professional and responsible institutional trustee in a stable country;

ii. The effect of tax laws;

iii. Whether language barriers may exist;

iv. The jurisdiction's reputation in the global financial community;

v. The jurisdiction's statutory trust law framework;

vi. Whether and to what extent a settlor can be a beneficiary and a protector (*i.e.*, with the right to remove and replace trustees, and potentially to veto certain trustee actions);

vii. Whether and under what circumstances foreign judgments may be recognized;

viii. The standard of proof required to succeed in a fraudulent transfer action; and

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

3. Overview of Cook Islands (as an example)

a. General Characteristics

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

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

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

iv. 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.

v. 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.

b. Confidentiality

- The Cook Islands banking laws mandate secrecy of client information, and impose a year's imprisonment as punishment for a violation.

c. Taxes

- The Cook Islands are a “no-tax” jurisdiction.

d. Fraudulent Disposition Law

i. The Cook Islands first enacted comprehensive asset protection trust legislation with passage of the International Trusts Act 1984. The legislation was then significantly amended pursuant to the International Trusts Amendment Act 1989. There have been several less extensive amendments since 1989.

ii. The legislation addresses “International Trusts” and the effect thereon of fraudulent dispositions and bankruptcy.

iii. 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, instead, 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.

- Even 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 simply be paid from the property that would have been subject to such claim but for the transfer.

- Furthermore, any punitive damage award which is part of the creditor’s claim is disregarded.

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

v. Amendments (in 1997 and 1999) contain statute of 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 as of the date of the transfer.

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

- Finally, if a transfer (whether initial or subsequent) to an International Trust occurs before a creditor's cause of action accrues, such transfer will not be fraudulent as to that creditor. For this purpose, a "cause of action" is defined as the first cause of action capable of assertion against a settlor.

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

vi. The Cook Island International Trusts Act also defines certain circumstances that are not to be deemed badges of fraud for purposes of determining whether or not a transfer to an International Trust is a fraudulent transfer. Specifically, intent to hinder, delay or defraud a creditor 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 of the International Trust.

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

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

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

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

C. Choice of Law Clause

1. The general rule regarding the choice of law applicable to trusts is that the settlor's designation of controlling law will govern administration, 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 domicil, the law of the state of the place of administration, rather than that of his domicil, 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).

b. Restatement (Second) of Conflicts of Laws § 273 similarly states 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."

2. 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..."

i. Interpreting a prior version of this statute, New York's highest court stated that "[t]he statute makes [a settlor's] express declaration of intention [of controlling law] conclusive..." *Hutchison v. Ross*, 262 N.Y. 381, 187 N.E. 65, 71, 89 A.L.R. 1007 (1933).

ii. Furthermore, although the *prima facie* ability of a New York domiciliary settlor to create a valid trust governed by the laws of a foreign jurisdiction is not expressly conferred by this statute, it is either set forth under existing case law or can be logically inferred.

- For example, see *In re New York Trust Co.*, 87 N.Y.S.2d at 792 ("It is inconceivable that a state committed to [the policy of ESTATES, POWERS AND TRUSTS LAW § 7-1.10] would deny its own residents the corresponding right to establish trusts in other states...[U]nder the law of this state, a New York resident may choose another state as the situs of a trust as freely as a non-resident may create a trust in New York.").

b. Furthermore, a strong argument can also be made that principles of judicial comity require that a settlor's designation of controlling law be respected by the court. *See generally* 17 C.J.S. § 12(1).

3. The Restatement (Second) of Conflict of Laws § 270 (1971), however, provides that "[a]n inter vivos trust of interests in movables is valid if valid...under the local law of the state designated by the settlor to govern the validity of the trust, provided...that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6."

a. Section 270 of the Restatement (Second) of Conflict of Laws has been cited by more than one court dealing with the question of the validity of self-settled spendthrift trusts, to the effect that the validity of a self-settled spendthrift trust should <u>not</u> be upheld.

See, e.g., *In re Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996); *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998); *In re Lawrence*, 227 B.R. 907 (Bankr. S.D. Fla. 1998) ("This Court is persuaded by the decisions of *Portnoy*, *Brooks* and *Cameron*"). *Id*. at 917.

b. In *In Re Huber*, 201 B.R. 685 (Bankr. W.D. WA, 2013) the settlor, a Washington State real estate developer, created an Alaska asset protection trust at a time when he "…was or had to be aware of the 'gathering storm clouds'," including "…the threat of a collapsing housing market," and when his prospects for repayment of several substantial loans was "fragile at best". The court in *Huber* cited to § 270 of the Restatement (Second) of Conflict of Laws (1971) and held the trust invalid as a matter of conflict of laws by applying Washington law, rather than Alaska law, to the trust. More specifically, after finding that the trust had its most significant relationship with Washington, partially based on the debtor's residence, *Huber* held (albeit without any substantive analysis), that Washington had a strong public policy against "asset protection trusts".

- It is not clear, however, why the *Huber* court felt compelled to address the conflicts of law issue, since the same result was obtainable by reference to the fact that the funding of the trust was clearly a fraudulent transfer. Thus, a question left remaining after *Huber* is whether another court would rule similarly on the conflicts of law question absent the fact of the fraudulent transfer.

c. However, the fact that a forum state might not permit self-settled spendthrift trusts to be created under its own law does not necessarily mean that it would violate a *strong* public policy of the forum state to recognize a self-settled spendthrift trust if it was validly created under the law of a foreign jurisdiction.

- "It would seem that the policy of a state, whether it be to restrain alienation in order to protect the beneficiary, or to permit alienation in order to protect creditors and assignees, is not so strong as to preclude the application of the law to the contrary prevailing in another state." SCOTT & FRATCHER, *The Law of Trusts*, § 626, at 414 (4th ed. 1989).

d. There are, of course, also a number of cases that have applied conflicts of law principles to spendthrift trusts without resort to an exception for public policy.

i. For example, 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." *Id*. at 339. As recognized by the lower court's opinion, the 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:

- "If 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." *Id*. at 340.

- 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 domicil where the property, the domicil and place of business of the trustee, and the place of administration intended by the settlor are in another State." *Id.* at 341.

ii. In *Togut v. Hecht*, 54 B.R. 379 (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."

4. 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.

VII. TAX AND REPORTING ISSUES

A. Income Taxation and Related Reporting Requirements

1. Residence of Trust

a. 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:

i. A court within the United States is able to exercise primary supervision over the administration of the trust; and

ii. 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, of necessity, be a foreign co-trustee), and that a United States court will have primary supervision over the administration of the trust, even though it would 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, being that additional information reporting requirements will be triggered if the trust is a foreign trust). This is because the trust will be treated as a "grantor trust" for federal income tax purposes (even if not otherwise specifically structured as a grantor trust), by dint of:

i. 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…"

ii. Being a foreign trust, since Internal Revenue Code § 679 provides that "[a] United States person who directly or indirectly transfers 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. A Form 1041, *United States Income Tax Return for Estates and Trusts* (or, alternatively, if the trust is a foreign trust, 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. 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.

g. 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)."

B. Gift and Estate Taxation

1. Generally, the settlor 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, e.g.*, ILM 201208026.

- In this regard, Treas. Reg. § 25.2511-2(b) provides that "…if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case...For example, if a donor transfers property to another in trust…and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift."

2. The fact that the transfer of property to an asset protection trust is incomplete for gift tax purposes enables the settlor to fund the trust with an amount of property in excess of the applicable exclusion amount without incurring any gift tax.

3. Notwithstanding that the transfer of property to an asset protection trust might be structured as an incomplete gift, a Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, should nevertheless be filed in order to record the transfer.

VIII. EFFECTIVENESS OF AND CHALLENGES TO OFFSHORE TRUSTS.

A. The effectiveness of any asset protection plan should be determined by the results ultimately achieved. That is, in the final analysis, to what extent has a high-income/high-net-worth person protected his or her assets from creditors?

B. In the real world plaintiffs must weigh the costs of litigation against the likelihood of a successful recovery. If, as a result of a person availing himself or herself of certain asset protection planning techniques, he or she is in a better position to settle a dispute upon more favorable terms than would have otherwise been possible, the benefits of asset protection planning are realized.

C. The few reported decisions which involve offshore asset protection trusts offer insight into how courts, both in the United States and abroad, view and deal with 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 1994. During 1993 and 1994 the defendant created a trust in the Cook Islands and transferred assets thereto. The creditors obtained a *Mareva* injunction (similar to a temporary restraining order) *ex parte*. The case settled. It may not have been difficult, however, for the creditor to have satisfied its burden to prove a fraudulent transfer beyond a reasonable doubt under the timeline indicated.

2. In *Brown v. Higashi*, U.S. Bankruptcy Court 95-3072 (D. Alaska 1996), the debtors, husband and wife, argued that certain assets sought by their tort judgment creditor were protected from attachment by reason of the debtors' self-settled spendthrift trust (which the debtors had created under the law of Belize). The Bankruptcy Court, however, found application of the law of Belize to be "inappropriate" and the law of the forum jurisdiction of Alaska (which at the time did not permit the creation of self-settled spendthrift trusts under Alaska law), controlling. Applying Alaska law, the *Brown* court determined that the asset protection trust's assets were includable in the debtors' bankruptcy estate. The *Brown*

court, however, was clearly indisposed to the law cited by the debtors as governing under the trust instrument since, at all times, the trust was administered as a mere alter-ego of the debtors, rather than as a legally distinct entity; specifically, the trust was a common law business trust which incorporated features found in both corporations and trusts and the debtors were respectively the president and the secretary of the trust. In such capacity, the debtors exercised complete control over the trust assets to the complete exclusion of their named Belize trustee. For this reason, the court called the trust a "sham" and cited the settlors' retention of direct control over the trust's assets as the "primary reason" for finding that the settlors' transfers to the trust were fraudulent. *Id*. at 8.

3. In *Marine Midland v. Portnoy*, 201 Bankr. 685 (S.D.N.Y. 1996), the Bankruptcy Court summarized the case by stating at the very beginning of its opinion that: "[a]t the heart of this debtor's summary judgment motion lies an irrevocable offshore trust into which the debtor placed virtually all of his assets at a time when he knew that his personal guarantee of his corporation's indebtedness was about to be called. The debtor, Larry Portnoy, claims not only that his assets have been successfully insulated under the law of the Jersey Channel Islands ("Jersey"), but that he is entitled as a matter of law to a discharge of all debts including the indebtedness which he guaranteed." *Id*. at 688. Marine Midland Bank argued that Mr. Portnoy had "transferred substantially all of his assets to an offshore trust before one year prior to the petition date but remained *de facto* owner by continuing to maintain unlimited control over the assets and conceal the trust within one year of the petition date." *Id*. at 695. In rebuttal, Mr. Portnoy argued that this key legal issue of whether he "retained" a property interest in the trust ought to be determined under Jersey, Channel Islands, law rather than under New York law. The court, however, denied Mr. Portnoy a discharge in Bankruptcy concluding that: "New York has the weightier concern in determining whether or not whatever rights Portnoy retained after he formed the trust could be considered to constitute a property interest such that that interest should have been disclosed in his bankruptcy schedules. The trust, the beneficiaries, and the ramifications of Portnoy's assets being transferred into trust have their most significant impact in the United States. In addition, I believe that application of Jersey's substantive law would offend strong New York and federal bankruptcy policies if it were applied." *Id*. at ___.

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 (here, the laws of Bermuda and of Jersey, Channel Islands) to the spendthrift trust exemption under § 541(c)(2) of the Bankruptcy Code (which provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is

enforceable under applicable nonbankruptcy law is enforceable in a case under this title.") The court set forth the parties' arguments by stating that: "[t]he plaintiff argues that the trusts are property of the estate because they are self-settled and invalid as a matter of law. The defendants argue that the trusts are not property of the estate because they are enforceable spendthrift trusts." *Id*. at 100. Thus, the crux of *In re Brooks* was a conflict of laws issue, since whether the trusts were invalid or enforceable as spendthrift trusts depended upon whether Connecticut or foreign law governed as the "applicable non-bankruptcy law." Citing *Portnoy* as precedent, the Bankruptcy Court found the assets of the debtor's two trusts includable in the bankruptcy estate. Specifically, the court stated that "on the basis of public policy considerations…the enforceability of the spendthrift provisions of the trusts is determined under Connecticut law." *Id*. at 102. Although very little of the factual background in *Brooks* 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 Bankruptcy Court to perceive the funding of the trusts as fraudulent since the Bankruptcy Court twice characterized the debtor's acts in creating the trusts as a "scheme." *Id*. at 102-103. 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.

a. The Brooks court seemingly relied heavily upon a passage from the Connecticut Superior Court's opinion in *Stetson v. Morgan Guaranty Trust Co. of N.Y.*, 164 A.2d 239 (Conn. 1960), stating that, "Connecticut courts have held '…the legality of the trust of personalty [is determined] by the law of the settlor's domicile…'" *In Re Brooks* at 101. Interestingly, however, the full quote from the *Stetson* opinion provides a very different import than the one suggested by the *Brooks* court since it provides that: "[w]hile in general the validity of a trust of realty has been determined by the law of the situs of the land and the legality of the trust of personalty by the law of the settlor's domicile, there are many opportunities for complications and variations. Among other considerations, the courts are influenced by the nature of the property involved and its location; the domicile of the settlor and the trustee; the situs of the trust administration and whether the question is the legality of the act of trust creation or the rule governing trust administration. There is a tendency to respect the expressed will of the settlor as to the controlling law." *Stetson* at ___.

5. In the matter of *In re Stephan Jay Lawrence*, 227 B.R. 907 (Bankr. 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 *Brooks* the Bankruptcy Court found that the sole purpose of the trust was to shield the debtor's assets from a creditor which "was about to obtain a staggering $20 Million arbitration award against him" and that "[t]he timing of the trust's creation is further evidence of this intent." *Id*. at 914. The court also found the debtor's testimony before the court to have not been credible (and on several occasions perjurious), and that the debtor was "shockingly less than candid" with the court. *Id*. at 910, 916. The court, therefore, entered judgment against the debtor, thereby denying him a discharge in bankruptcy. Instead of citing the basis of its decision as the debtor's fraudulent transfer, however, the Bankruptcy Court in Lawrence purported to base its holding upon an analysis of the conflict of laws issue, but stating only that "[t]his Court is persuaded by the decisions of Portnoy, Brooks and Cameron. The Debtor's rights and obligations under the Mauritian Trust are governed by Florida and federal bankruptcy law, which have an overriding interest in the trust, and not the law of the Republic of Mauritius." *Id*. at 917.

a. It is curious, however, that the *Lawrence* court was, in part, "persuaded" by the decision of *In re Cameron*, 223 B.R. 20 (Bankr. S.D. Fla. 1998), with regard to the conflict of laws issue since (i) that case accepted the trust's designated law of New York as controlling, and (ii) there could necessarily be no conflict of laws issue in *In re Cameron* since neither the designated law nor the law of the forum state permitted self-settled spendthrift trusts.

6. *FTC v. Affordable Media LLC, et al*., 179 F.3d. 1228 (9^{th} Cir. 1999) (colloquially known as the "Anderson" case after its individual defendants), involved facts as bad as, if not worse than, those in the foregoing cases. However, 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 that had been invested offshore in the name of the trust. Specifically, the settlors, who were also co-trustees of the 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 the settlors' removal as trustees by reason of said order and ensured that the assets would not be repatriated. When the assets were not timely repatriated, the settlors were held in civil contempt for failing to comply with the court order and were jailed

pending repatriation of the assets. After the FTC lost several rounds in the Cook Islands, the case was settled.

- Note that impossibility of performance would be a complete defense to a charge of coercive civil contempt. See, *United States v. Rylander*, 460 U.S. 752 (1983). In holding the Andersons to be in civil contempt the district court simply found that the Andersons *were* in control of the trust since the trust agreement provided them, as the protectors, with the exclusive power to determine what constituted an event of duress (which would negate their power to instruct the trustee to repatriate the trust fund).

  - Notably, however, certain lower courts have since suggested that even where performance is demonstrably impossible, an exception exists where the impossibility is self-created (at least where the impossibility is self-created within a close nexus of time of the anticipated judgment).

7. The facts in *United States v. Grant*, No. 00-8986, 2005 U.S. Dist. LEXIS 22440 (S.D. Fl. Sept. 2, 2005), were that in 1983 and 1984, Raymond Grant created a Bermuda trust and then a Jersey, Channel Islands, trust. Raymond was the beneficiary of the Bermuda trust, and his wife, Arline, 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, and in 2003 judgment was entered against the Grants for more than $36 million. Raymond died, and thereafter 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."

   a. Arline took steps to have the trustees remit the funds or resign in favor of a US trustee; all of which were unsuccessful. Therefore, the Court denied the government's motion to hold Arline in contempt as her demonstrated impossibility to comply was found to be a complete defense to the civil contempt charge. 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.

b. However, some years later, after further discovery revealed that trust distributions were indirectly benefiting Arline, the Court ordered Arlene to turn over all future distributions and prohibited her from informing the trustees that she was under a court order. See, *U.S. v. Grant*, 2013 WL 1729380 (S.D. Fla., April 22, 2013).

8. In *Rush University Medical Center v. Sessions*, 980 N.E.2d 45 (2012), the plaintiff, Rush University Medical Center, sued the defendant's estate to enforce a charitable pledge. Upon obtaining a successful judgment, plaintiff learned that the deceased settlor had transferred his assets to a Cook Islands trust one year prior to making the pledge. The defendant's estate argued that Cook Islands law governed the trust and any transfers thereto, while the plaintiff argued that the transfers were fraudulent under Illinois law and noted that Illinois common law does not recognize self-settled trusts as effectively spendthrift as against the settlor's creditors. The Illinois Supreme Court, in reversing the lower court, held in favor of plaintiff without any analysis as to the conflict of laws question. And, since the trust held limited partnership interests in a limited partnership invested in Illinois real property, its assets were likely subject to attachment.

- The decision demonstrates the challenge for foreign asset protection trusts that have U.S. sitused assets.

9. 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, might be thought to have reached the right result. The best results will be obtained where the trust is settled sufficiently in advance of a creditor problem, is properly structured and is properly administered.

- A decision recognizing a foreign self-settled spendthrift trust as valid is *Reichers v. Reichers* (NY Supreme Court, Westchester County), (New York Law Journal July 1, 1998). In that case 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 him for divorce in 1994. The Court in its decision, wrote that: "[a]ssuming 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."

IX. USING "ASSET PROTECTION" TRUSTS FOR ESTATE PLANNING PURPOSES

A. If the settlor's creditors can reach the settlor's beneficial interest in the trust, the settlor will be deemed, at least indirectly, to have retained the "use and enjoyment" of the transferred assets and Internal Revenue Code § 2036(a)(1) will cause the transferred property to be brought back into the settlor's estate due to the "retained right to possession or enjoyment, or to income".

- *See*, *e.g.*, *Paolozzi v. Comm'r.*, 23 T.C. 182 (1954), acq., 1962-1 CB 4 ("petitioner's creditors could at any time look to the trust of which she was settlor-beneficiary for settlement of their claims to the full extent of the income thereof. This being true, it follows that petitioner…could at any time obtain the enjoyment and economic benefit of the full amount of the trust income").

B. In contrast, in PLR 200944002 (which involved an "asset protection" trust under Alaska law), the Internal Revenue Service ruled that "…the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036."

- *See also,* Rev. Rul. 76-103, 1976-1 CB 293, "…if and when the grantor'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 grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in § 25.2511-2 of the regulations."

C. Thus, an "asset protection" trust can serve as an estate planning vehicle if the gift to the trust is structured as a "completed gift."

1. This is particularly useful in the situation where the settlor is unmarried and does not have any children because, under such circumstances, it is unlikely that a prospective settlor would otherwise be inclined to utilize his or her gift tax exemption amount in connection with the funding of a trust of which he or she is not a discretionary beneficiary, even if he or she anticipates having a spouse and children at some future date.

2. In addition, 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).

X. *Inter Vivos* QTIP Trusts

A. A basic tenet of estate planning (and particularly prior to the introduction of "portability" under Internal Revenue Code § 2010) is that each spouse should own sufficient assets in his or her own name to utilize his or her own estate tax exemption. However, due to the possibility that the transferee spouse may have existing or future creditor issues, an outright transfer might be ill advised from an asset protection perspective.

B. An alternative to an outright transfer to a spouse is to effect such transfer via an *inter vivos* QTIP trust which would qualify for the unlimited marital deduction from federal gift tax under Internal Revenue Code § 2523(f), assuming that the necessary election is made.

1. If, however, the settlor-spouse survives the donee-spouse, the trust may then have been structured to continue for the settlor-spouse's benefit. Technically, the result in such a case would be a self-settled trust which, in most states as noted hereinbelow, would then subject the trust property to the claims of the settlor-spouse's creditors.

a. While Treas. Reg. § 25.2523(f)-1(f), Ex. 11 provides that assets held in trust for the settlor-spouse's benefit after the donee-spouse's death will not be includable in the settlor-spouse's estate under Internal Revenue Code §§ 2036 and 2038, this does not govern the question of the availability of such assets to the settlor-spouse's creditors under state law.

2. A number of states have, however, enacted legislation to provide that such trusts will not be treated as self-settled trusts in the hands of the donor-spouse, irrespective of whether or not such states also respect self-settled spendthrift trusts more generally.

3. Those states include: Arizona, Delaware, Florida, Kentucky, Maryland, Michigan, North Carolina, Ohio, Oregon, South Carolina, Tennessee, Texas, Virginia and Wyoming.

a. For example, in Arizona, A.R.S. § 14-10505(E)(1) provides that "…amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:…[a]n irrevocable inter vivos marital trust that is treated as qualified terminable interest property under section 2523(f) of the internal revenue code if the settlor is a beneficiary of the trust after the death of the settlor's spouse."

b. The Arizona statute does not, however limit this result to QTIP trusts, and further provides that amounts and property contributed to the following trusts are also not to be deemed to be self-settled:

i. An irrevocable inter vivos marital trust that is treated as a general power of appointment trust under Internal Revenue Code § 2523(e) if the settlor is a beneficiary of the trust after the death of the settlor's spouse.

ii. An irrevocable inter vivos trust for the settlor's spouse if the settlor is a beneficiary of the trust after the death of the settlor's spouse.

4. In other states, however, only an inter-vivos QTIP trust would engender protection as having been deemed to not be self-settled.

a. *See, e.g.,* Florida Statutes § 736.0505, which provides such a result only for "[a] trust described in s. 2523(e) of the Internal Revenue Code of 1986, as amended, or a trust for which the election described in s. 2523(f) of the Internal Revenue Code of 1986, as amended, has been made…."