

By Gideon Rothschild

Staying Out of Reach

Lessons learned from recent developments, including new state legislation and court rulings

When asset protection planning was in its infancy in the mid-80s, there were few developments and even fewer mentions in the estate-planning literature. Nowadays, there's nary an estate planning symposia in which asset protection planning isn't mentioned, and each year brings new developments in the field. This past year was no exception. The highlights include new self-settled trust legislation in Hawaii, amendments to several state statutes enhancing asset protection and judicial decisions involving asset protection, inherited individual retirement accounts and limitations on charging order remedies.

Self-Settled Trusts

With the enactment of the Permitted Transfers in Trust Act (the Act) on June 30, 2010,¹ Hawaii became the eleventh state to provide for self-settled trust spendthrift protections. Like other state laws that offer these protections, the Act provides for the enforceability of a spendthrift provision protecting a trust's assets from the creditors of a beneficiary who's also the transferor of the trust.

Although the legislature may have had good intentions, it's unlikely that many clients will choose Hawaii law to govern their trusts due to some serious flaws with the Act. The most significant of these is the imposition of a 1 percent excise tax imposed on all transfers of property to the trust, as well as a limit on what constitutes "permitted property."

The Act defines "permitted property" as "cash, marketable securities, life insurance contracts and non-private

annuities." It doesn't include limited partnerships, real estate or closely held business interests. Among the Act's other negative features, when compared with some of the other self-settled trust jurisdictions, are the broader class of exception creditors that are excluded from the spendthrift provision and the limit on how much of the settlor's net worth can be transferred to the trust.

In a laudable attempt to reduce the statute of limitations period within which a creditor can bring a fraudulent transfer action, the Act provides that the settlor must sign an affidavit stating that the amount transferred isn't greater than 25 percent of his net worth and that the transfer won't result in a fraud or hindrance of a known or knowable creditor. If this requirement is met, even an existing creditor would be time-barred and future creditors would only have two years to bring an action. This compares favorably to most of the other self-settled trust statutes. But, say a settlor makes a good faith transfer and doesn't sign this affidavit. It's not clear what effect that transfer will have on the creditor's ability to reach the trust's assets.

Although the Act has some flaws, by adding to the number of states with self-settled trust protections, its existence further weakens the argument that there's a strong public policy against the validity of self-settled trusts established under the law of another forum. More specifically, as self-settled spendthrift trust protections become more and more commonplace, any perception that there exists a strong public policy against their validity becomes less likely.

QTIP Trusts

Among other legislative developments, one of the most significant is the recent Florida legislation that protects inter vivos qualified terminable interest property (QTIP) trusts from creditors of a donor spouse if a donor spouse is designated as a beneficiary after



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a donee spouse's death. Although Florida's legislature recently rejected the adoption of self-settled trust legislation, it did enact Section 736.0505 of the Florida Trust Code by adding that such beneficial interest isn't to be considered a self-settled trust (unless the initial transfer was a fraudulent conveyance). This legislation follows similar enactments in Arizona, Delaware and Michigan. Such provisions will enable a wealthy person, who is happily married, to protect his assets by establishing an inter vivos QTIP trust that will provide estate tax

Asset protection planners should pay closer attention to Wyoming as a beneficial self-settled trust jurisdiction.

savings as well as asset protection from both the settlor's and the settlor's spouse's creditors.

Inherited IRAs

In the judicial arena, we've seen a number of significant cases that have had an impact on asset protection. One area with much activity is that of inherited IRAs. An IRA is generally protected from the claims of the IRA owner's creditors. However, it's unclear whether an inherited IRA is protected from the claims of the beneficiary's creditors. Bankruptcy law specifically exempts from a debtor's bankruptcy estate "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under Sections 401, 403, 408, 408A, or 501(a) of the [Code]."

The vast majority of courts have denied creditor protection to inherited IRAs for various reasons, including that inherited IRAs (1) don't base withdrawal on age or retirement status, (2) are subject to a different tax treatment from other IRAs, and (3) don't fulfill the public policy of providing for a secure retirement. For example, in *In re Chilton*,² the Bankruptcy Court for the Eastern District of Texas held that inherited IRAs aren't protected from the claims of creditors under federal bankruptcy law, stating that "[t]he funds contained in an inherited IRA are not funds

intended for retirement purposes but, instead, are distributed to the beneficiary of the account without regard to age or retirement status."³ However, the most recent cases have begun to buck this trend.

For example, in April 2010, the U.S. Court of Appeals for the Eighth Circuit in *In re Nessa*⁴ stated that an inherited IRA still contained "retirement funds" within the meaning of federal bankruptcy law, even though they weren't the debtor's own retirement funds and stated that the *Chilton* court's conclusion was "erroneous." Since then, the bankruptcy courts in California and Pennsylvania have agreed with the *Nessa* reasoning.

Given the uncertainty in the law and not knowing which jurisdiction an inherited IRA beneficiary may reside in, a safer approach to protecting an IRA account is to designate a trust as a beneficiary of the account. Such a trust can be either a conduit trust or an accumulation trust. Though conduit trusts may be easier to draft to meet the Internal Revenue Code requirements, accumulation trusts may afford greater protection.

Charging Order Protection


Another recent judicial development involved the extent of charging order protection provided for by limited liability companies (LLCs). Prior to 2010, the limited authority on point was a bankruptcy court decision, *In re Ashley Albright*⁵ (involving a single-member LLC). 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'"⁶ with the power to liquidate the entity. Later in *Olmstead v. Federal Trade Commission*,⁷ the Florida Supreme Court concluded that Fla. Stat. Section 608.433(4) doesn't preclude application of a creditor's remedy of execution on an interest in a single-member LLC. The court determined that the charging order remedy isn't the exclusive remedy for a creditor of an LLC member. In fact, Wyoming is the only state that provides for the exclusive charging order remedy for single-member LLCs. Combined with its self-settled trust legislation, it may be a state that should receive greater attention from asset protection planners.

Offshore Asset Protection Trust

One final development involves yet another case of a civil contempt order involving an offshore asset protection trust. In *Securities Exchange Commission v. Solow*,⁸

the SEC sued Jamie E. Solow in November 2006, alleging that he had engaged in a fraudulent trading scheme. The court found that the defendant violated various antifraud and other provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933 and issued a disgorgement order requiring him to pay over \$6 million. When the defendant didn't pay, the SEC asked the court to hold the defendant in contempt of court for having depleted his net worth through a "purposeful campaign of asset dissipation."⁹ The defendant and his wife liquidated securities accounts totaling over \$1.5 million, some of the funds having been used to pay "asset protection attorneys" retained by the defendant's wife a mere four days after the court's ruling. The defendant later signed a \$5.2 million mortgage on his residence in Florida, the proceeds of which were used to fund a certificate of deposit held by a Cook Islands trust settled by and for the benefit of the defendant's wife.

The defendant argued that the assets sought by the SEC were formerly held by him and his wife as tenants by the entirety and, therefore, wouldn't have been reachable by the defendant's creditors under Florida law even if they hadn't been transferred to the defendant's wife. However, the district court rejected the defendant's argument and held him in contempt of court, ordering his incarceration and stating that disgorgement orders, unlike judgments, can be enforced by civil contempt. The court noted that in the case of a disgorgement order, it possessed remedies that weren't limited by state law exemptions. The defendant appealed the order to the Eleventh Circuit, which recently affirmed it.¹⁰

What can be learned from yet another case in which a wrongdoer utilizes an offshore trust to avoid his creditors? First, that where disgorgement is ordered, one must not rely on exempt assets for protection. And, more important perhaps, that planning with offshore trusts should only be considered when there are no clouds on the horizon, since the risk of a contempt order may be significant when the clouds have thickened. 

Endnotes

1. Act 182, The Permitted Transfers in Trust Act, Session Laws of Hawaii 2010 (Aug. 5, 2010).
2. *In re Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. March 5, 2010).
3. *Ibid*, at p. 618.
4. *In re Nessa*, 426 B.R. 312 (8th Cir. 2010).
5. *In re Ashley Albright*, 291 B.R. 538 (Bankr. Colo. 2003).

6. *Ibid*, at p. 540.

7. *Olmstead v. Federal Trade Commission*, 2010 WL 2518106 (Fla. 2010).

8. *Securities and Exchange Commission v. Solow*, 682 F. Supp.2d 1312 (S.D. Fla. Jan. 22, 2010).

9. *Ibid*, at p. 1314.

10. *SEC v. Solow*, 2010 WL 3623172 (11th Cir. Oct. 20, 2010).

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