ARTICLES

Asset Protection Planning — Current Strategies and Pitfalls

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Some commentators have claimed that offshore asset protection trusts are dead.[2] Others continue to expound moral and ethical reasons why they should be outlawed (or at least disregarded).[3] And with the recent passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"), legislators have demonstrated an unease with such strategies. Yet, a careful analysis of legislative history and court decisions may suggest simply that asset protection planning, when effected well in advance of the appearance of creditors' claims, and without fraudulent intent, is still a viable objective that should be considered by many high net worth individuals.

An understanding of recent developments in this area will assist the planner and client to understand the risks and opportunities that should be considered prior to recommending and implementing a strategy.[4]

BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

When Congress approved the Act, there was a perception among legislators that certain individuals recently involved in bankruptcy filings, or against whom securities fraud charges had been brought, were availing themselves of homestead exemptions and self-settled ("asset protection") trusts in an attempt to avoid creditor claims. This perception was, in significant part, due to a *New York Times* article that criticized Congress for retaining certain loopholes for millionaires who (allegedly) availed themselves of asset protection trusts to avoid their legitimate creditors.[5]

Senator Charles Schumer of New York, in reaction to such criticism, proposed an amendment to the Act to limit the exemption for self-settled trusts to $125,000. After considerable debate [6] his amendment was defeated and replaced by Senator Talent's amendment that added a new provision to Bankruptcy Code §548 providing, in essence, a fraudulent transfer statute of limitations for transfers to "self-settled trusts or similar devices" made with intent to hinder, delay or defraud creditors within the 10-year period prior to filing a bankruptcy petition.

During the debate, Senator Talent remarked:

> We should not allow criminals to hide their assets and avoid paying their bills. This amendment makes certain that dishonest people can't hide their assets, especially if they have caused others to lose their jobs, retirement pensions, health care benefits and, in some cases, their life savings . . . It is fundamentally unfair to allow these crooks to abuse the trust laws of certain States to hide their wealth . . . . My amendment closes the loophole that the *New York Times* wrote a good article about. That article noted how difficult it is to determine how much money these crooks have sheltered into these asset protection trusts. Some estimate that criminals have stashed away billions of dollars in these types of trusts.

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[2] Jay Adkisson in *Steve Leimberg's Asset Protection. Planning Newsletter* #66 (May 3, 2005).

[3] *See e.g.*, Gingiss, "Putting a Stop to 'Asset Protection' Trusts," 51 *Baylor L. Rev.* 987 (1999).

[4] The reader is referred to the author's BNA Tax Management portfolio, 810 T.M., *Asset Protection Planning*, for a detailed discussion of such considerations.

[5] Gretchen Morgenson, "Proposed Law On Bankruptcy Has Loophole," *New York Times*, March 2, 2005.

[6] 151 Cong. Rec. S. 2427; Gideon Rothschild, "Did Bankruptcy Reform Act Close the Loophole for the Wealthy?" *Tax Notes*, April 25, 2005, p. 492, 75 TNT 79-43.

ISSN 0886-3547

Other provisions intended to close the "loophole" include limitations on the homestead exemption and new provisions regarding qualified plans and IRAs.[7]

ASSET PROTECTION TRUST DEVELOPMENTS

Since 1997, eight states [8] have enacted legislation providing for protection of self-settled trusts from a settlor's future creditors. Although there has been no reported case of a creditor challenging a domestic self-settled trust since the passage of such legislation, anecdotal evidence suggests hundreds (if not thousands) of such trusts have been settled to date. There is, however, a continuing concern that domestic asset protection trusts may not be effective against creditors unless the settlor resides in one of these eight states. While earlier cases dealing with foreign asset protection trusts were decided on public policy considerations at a time when no U.S. jurisdiction recognized the validity of such self-settled trusts, the current trend in the U.S. to enact such legislation, albeit by a minority of states to date, portends the possibility that public policy may be shifting towards acceptance of such trusts when created at a time when no clouds have appeared in the form of creditors' claims. Additional support for this shift may be found in the colloquy on the Senate floor [9] in conjunction with the defeat of Sen. Schumer's $125,000 cap on asset protection trusts.

Notwithstanding the recent trend in domestic trust legislation, due to the continuing uncertainties therewith, combined with the Act's 10-year fraudulent transfer provision, some clients may prefer to go offshore to obtain more certain protection. The advantages of going offshore (including non-recognition by local courts of U.S. judgments, shorter statutes of limitations, etc.) and the protection afforded such trusts by the foreign courts, however, must be weighed against the spate of recent U.S. court decisions that have resulted in outcomes that were less than desirable, albeit predictable given the bad facts.[10] Practitioners have become most concerned with the recent cases holding the settlor in contempt of court when trustees, following the terms of the trusts, declined to pay creditors. No discussion with a client on foreign trusts would be complete without a thorough understanding of these cases and appropriate caution in implementing such a strategy.

The basis of imposing civil contempt (in contrast to criminal contempt, which is imposed as a punitive measure) is to coerce the contemnor to comply with the court's order. Although impossibility of performance is generally a complete defense to civil contempt, it has been difficult for some debtors who have settled foreign asset protection trusts to meet the burden of proving impossibility to the court's satisfaction.

Critics of foreign asset protection trusts have suggested that the recent cases imposing contempt upon the settlor demonstrate that foreign asset protection trusts are, in many cases, imprudent, reasoning that the self-creation of the trust itself creates the impossibility. Such an interpretation, however, ignores the legal precedent in this area. In one recent case, the court distinguished between criminal contempt, invoked as a punitive measure, and civil contempt whose goal is to coerce the defendant to comply with the court's order.[11] Where the defendant can demonstrate to the court's satisfaction that it is impossible for him to comply, the inquiry must end there.[12] The rule, however, is that the burden of showing inability to comply is upon the debtor. And in many of the cases thus far the debtors have failed to meet this burden.[13]

Where the impossibility was self-created by the contemnor he cannot benefit by the impossibility defense. In this regard, however, the courts have required that such self-created impossibility occur within a nexus of time where the court's action was anticipated. For example, where, in anticipation of a discovery subpoena, the defendant destroys the sought-after records, the impossibility defense would not be available because he self-created it in close proximity to the issuance of the subpoena. However, if the defendant had disposed of the documents in the normal course of business without any knowledge of an imminent court order, the impossibility defense is a complete defense to contempt notwithstanding that he self-created it. An order of civil contempt is then appropriate only when it appears that compliance is within the charged party's power.

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[7] See below in this issue Osborne, Johnson, Gopman & Lancaster, "Wealth Protection Planning under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," 30 *Tax Mgmt. Estates, Gifts and Trusts J.* (Sept./Oct. 2005) for a summary of such provisions.

[8] *See* Alaska Code §34.40.110 (1997); 12 Del C. 3570-3576 (1997); Nev Rev. Stat §166.040 (1)(b) (2003); OK. St. Ann. Tit. 31, §§10-18 (Supp. 2005); R.I. Gen Laws §18-9.2-1 to 18-9.2.-5 (2003); Utah Code Ann. §25-6-14 (Supp. 2004); Mo. Stat. 456.080 (2005); So. Dakota Codified Laws §55:16-1 to 55:16-16.

[9] See fn. 6, above.

[10] *See e.g., In re Portnoy,* 201 B.R. 685 (Bankr. S.D. Fla. 1996); *F.T.C. v. Affordable Media,* 179 F.3d 1228 (9th Cir. 1999); *In re Lawrence,* 238 B.R. 498 (Bankr. S.D. Fla. 1999), *aff'd* 251 B.R. 630 (S.D. Fla. 2000), *aff'd* 279 F.3d 1294 (11th Cir. 2002).

[11] *Britannia Holdings Ltd. v. Bernard Greer,* 2005 West App. Lexis 1342.

[12] *See e.g., Maggio v. Zeitz,* 333 U.S. 56 (1948), *U.S. v. Rylander,* 460 U.S. 752 (1983)

[13] See fn. 10, above.

ISSN 0886-3547

PLANNING AFTER THE ACT

Planners will now need to consider how the various strategies used in the past will be impacted by the aforementioned recent developments. As was always the case, the need to inform clients of asset protection strategies early on in the engagement has become even more critical now. The author recalls innumerable situations where (potential) clients have called to inquire about asset protection when they were already in the midst of litigation (or even on the eve of trial!). In this regard, a careful planner will interview prospective clients in detail and conduct independent due diligence to ascertain the existence and status of potential claims. In the past, clients may have been able to obtain some relief by taking advantage of the generous homestead exemptions in certain states like Florida or Texas. Such strategies are now significantly limited and those individuals who do not plan until the clouds have formed will find themselves with fewer options. Other strategies, including transfers to limited liability companies or limited partnerships and investing in annuities, may also be affected by the Act as a result of the catch all "similar device" reference in the statute.

Similarly, due to the extended 10-year fraudulent transfer period for self-settled trusts and the potential for civil contempt, the use of self-settled trusts will require more advanced planning to be effective. Notwithstanding the greater exposure to self-settled trusts imposed by Bankruptcy Code §548(e), planners should not overlook the possible silver lining therein. The legislative history suggests that an asset protection trust settled more than 10 years prior to a bankruptcy filing may more likely be respected. If the debtor does not reside in one of the states with self-settled trust legislation, however, Bankruptcy Code §541(c)(2), which generally exempts spendthrift trusts under applicable non-bankruptcy law, will still need to be contended with.

Since the bankruptcy court's jurisdictional net is national in scope, domestic self-settled trusts may be subject to greater risk than foreign trusts if the settlor were to file bankruptcy. In such event, foreign trusts may offer greater protection in jurisdictions that do not, as a matter of law, recognize judgments of U.S. courts. But, as noted earlier, one must balance this analysis with the risk of civil contempt in the U.S. proceeding, which will likely only apply in the foreign trust context, albeit, perhaps, only in the most egregious situations.

It should be noted that the provisions of the Act only apply in the context of a bankruptcy filing. Therefore, clients should be forewarned that only in the most unusual circumstances should a bankruptcy filing be considered where a self-settled trust has been utilized. Outside of bankruptcy, exemptions under state law will still continue to apply. And even where bankruptcy cannot be avoided, there exist numerous ambiguities and conflicts in the recent legislation yet to be resolved.[14]

When considering whether to recommend a domestic or foreign self-settled trust, the planner should take several factors into account. First and foremost, the settlor should retain sufficient assets to minimize a fraudulent transfer claim. A nest egg approach, where the settlor contributes less than 50% of his non-exempt assets, is more likely to withstand a challenge than a transfer of essentially all of the settlor's assets. Additionally, if motivations other than asset protection are present, it may be more difficult for a bankruptcy trustee to prove that a debtor had the requisite fraudulent intent. Some other motivations that may lead clients to utilize self-settled trusts include estate planning,[15] foreign investment diversification, and planning for expatriation.[16]

If the client chooses to settle a foreign trust, the assets should be transferred to a foreign institution when the trust is initially settled. Some advisors continue to utilize structures that enable settlors to retain control over the assets by contributing the assets to an underlying limited liability company or partnership. Then, when the clouds form, the client is directed to liquidate the underlying entity and remit the proceeds offshore so as to remove assets from the U.S. courts' jurisdiction. Given the recent cases holding settlors in contempt of court, it is conceivable that the court, in such situations, may find that the settlor self-created the impossibility by moving the assets offshore after litigation was commenced. The settlor may then find himself in the unenviable position of holding the keys to his jail cell.

For clients who are not averse to investing in hedge funds and who wish to minimize the tax inefficiency in this form of investing, investing assets offshore through a private placement life insurance policy may provide additional justification for going offshore. Even if the trust were to be disregarded, the insurance policy may not be reachable, particularly where the foreign jurisdiction also exempts insurance policies

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[14] In one of the first cases to interpret the homestead exemption provisions under the Act, the court held that the Act's $125,000 exemption cap for a homestead acquired within 1,215 days did not apply in states that have opted out of the federal exemption scheme. *In re Robin Bruce McNabb*, 2005 Bankr. LEXIS 1231, 2005 WL 1525101 (Bankr. D. Ariz).

[15] *See e.g.*, PLR 9332006.

[16] Foreign trusts and/or other foreign entities are often utilized to acquire foreign investment opportunities that are not registered with the SEC and therefore cannot be offered to U.S. persons. This includes broader options available for investment through private placement insurance policies to achieve income tax savings.

ISSN 0886-3547

from the owner's and beneficiary's creditors. For example, this is the case in Bermuda.

In order to minimize the risk of being held in contempt of court, clients should generally be advised to utilize offshore trust structures only if the skies are void of any clouds. Given that clients may not always inform their advisors of all the facts, the more cautious advisor will conduct his own due diligence to avoid violating any ethical rules or exposure to a civil suit for conspiring to defraud creditors.[17]

But what of the client who has settled a foreign trust and now has a judgment creditor pursuing him? In every instance, settlement is always preferable to the risks posed by filing a bankruptcy petition, given the Act's new restrictions and the U.S. courts' negative perceptions of offshore trusts.

And what of the client who is faced with the threat of contempt and whose trust funds are controlled by a foreign trustee? For some, expatriation is likely to be the best option. However, most clients are not likely to consider it a viable solution. A more palatable option might be to have the trust redomiciled to Delaware, where state law provides that the Chancery Court has exclusive jurisdiction over the trust assets.[18] The litigation will then have to play out stateside, where, due to the current unresolved issues, the client may retain some leverage and avoid the implications of a 4×4 cell.

If clients are either not comfortable with moving assets offshore, have assets that are not easily liquidated without significant tax consequences, refuse to give up complete control, or where the mere risk of being held in contempt of court is too much to bear, the use of a domestic trust may be more appropriate. Where the client who settles a domestic trust is willing to redomicile to the state where the trust is situsted (prior to any judgment being entered), that state's exemption should be available to protect the trust's assets without the risks attendant with offshore trusts.

Given the uncertain future of self-settled trusts, consideration should also be given to using non-self settled trusts. Assuming transfers are not fraudulent, third-party beneficiary trusts are protected under every state's spendthrift trust laws, subject to certain limitations for support creditors. Where clients are reluctant to exclude themselves entirely as beneficiaries, however, a third party (e.g., a protector) can be given the power to add beneficiaries (including the settlor) at a later time, if necessary. In this manner, if the settlor is not a beneficiary for the 10-year period following the transfer, and were then to be added as a beneficiary, the trust is, arguably, not self-settled and therefore should not be subject to the 10-year lookback period. Alternatively, if a client is married, the settlor's spouse (who can be defined in the trust instrument as the person to whom the settlor is married at the time of a distribution) may be included as a beneficiary, enabling distributions to be made for the spouses' mutual benefit. In addition, a provision triggering a change in beneficial interest by adding the settlor in the event of a divorce or the spouse's prior death should not, prior to such triggering event, cause the trust to be treated as self-settled. And giving the spouse a testamentary power of appointment exercisable in favor of the settlor provides yet another option to consider.

Other traditional estate planning techniques may also be utilized to achieve asset protection. For example, the use of a Grantor Retained Annuity Trust would allow the appreciation above the applicable federal rate to be removed from the grantor's estate as well as from his creditors' reach provided the grantor survived the initial retained term. Finally, ensuring that clients who may in the future be subject to creditor exposure do not become donees of outright gifts or inheritances is paramount.[19]

Given the aforementioned recent developments, asset protection planning may be more difficult to achieve with impunity. In many respects, however, the new law may not have as significant an impact as some critics may have expected. As in the estate planning arena, if clients and their advisors avoid the minefields along the way, homestead exemptions and self-settled trusts will remain available tools for most clients who, with proper advance planning, can still achieve the desired results.

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[17] *See Morganroth & Morganroth v. Norris, McLaughlin*, 331 F.3d 406 (3d Cir. 2003); *Cf. Nastro v. D'Onofrio*, 236 F. Supp. 2d, 448 (2003).

[18] 12 Del C.3572 (g).

[19] *See* Rothschild, "More Clients Should Choose Trusts," 143 *Trusts and Estates* 32 (March 2004).

ISSN 0886-3547