Asset Protection Planning: An Important Resource For Clients in Difficult Times

BY RICHARD M. GUERARD

In these times, with the real estate bust and economic downturn, it is likely that most attorneys have had or will soon have a client seek his or her advice about asset protection planning, sometimes referred to by the term of wealth preservation planning. This article is intended as a brief introduction to this area of practice and will look at what asset protection planning is and what it is not. Every attorney who has, as a part of a real estate transaction, prepared a deed to a husband and wife as tenants in the entirety, formed a corporation or limited liability company, drafted a premarital agreement or prepared a will with a trust containing a spend thrift clause has engaged in an element of asset protection planning for his client. There is no body of law identifiable as the law of asset protection and courts rarely refer to it in reported cases.[1]

Asset protection is a term used to describe a broad area of strategies and methods encompassing the management of legal risks and provides a backup defensive strategy in the event there is a loss which results in a money judgment. Asset protection has been defined as, "risk management planning that is designed to discourage a potential lawsuit before it begins or to promote a settlement most favorable to the client".[2] Asset Protection is about taking chips off the table when times are good. Asset protection is not about cheating existing creditors or hiding assets. By the time that a person has signed a personal guarantee that pledges all their assets for a loan, or they have a serious accident, or they incur some other significant liability that threatens to wipe out their wealth, the time for effective asset protection has passed. Fraudulent transfer laws will nullify gifts and transactions that are meant to put assets out of the reach of creditors, and fraudulent conversion laws limit a debtor's attempts to put their money into exempt assets.

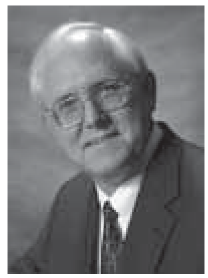
One of the characteristics that make asset planning difficult to define is that there is no perfect strategy that will protect all assets all the time. The tools that are available for this planning cross many disciplines of the law and the most effective asset protection plans will combine many of them with multiple layers of protection. Asset protection requires expertise in several areas of law and practice. It involves civil procedure, commercial law, business entity law, bankruptcy law, tax law, and trust and estate law. The interrelation of the various entities of the debtor can have significant tax consequences. And finally, often an asset

1 For a good overview of ethical considerations including a draft engagement letter see, Lestikow, *Practical and Ethical Considerations*, IICLE Asset Protection Planning chap. 2 (2007, sup. 2010)

2 Adkisson & Riser (2004), *Asset Protection, Concepts & Strategies for Protecting Your Wealth*, McGraw-Hill. p. 5 *et.seq.* (An excellent overview of asset protection strategies written with a practical approach for the practitioner)

protection plan is integrated with estate planning as an additional wealth preservation vehicle. The process of designing an asset protection plan involves in a comprehensive way, assessing the facts, circumstances and objectives of the client, evaluating the pros and cons of the various options, designing a structure that is most likely to accomplish the objectives of the client and then preparing the documents necessary to carry out the plan including assisting the client to maintain and update the plan as his circumstances and the laws change.

Asset protection planning is not a game, and there can be serious consequences if a client gets it wrong after a claim has arisen. If a debtor engages in the improper transfer of his assets after a significant claim arises or after he has become illiquid, then not only will any transfers that he makes be at risk of later being deemed to be fraudulent transfers and thus set aside by the Court, but he also may risk a denial of discharge if he later find himself in bankruptcy, voluntary or involuntary.



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The psychology of settlement dictates that for a debtor to reach a settlement the creditor must be convinced that the debtor's proposed settlement will result in the largest recovery for the least risk. Most settlements are reached because taking in to consideration all of the factors from the viewpoint of the debtor and the creditor the settlement makes sense for both parties. Asset protection planning is about utilizing legitimate techniques to create a plan, which has as its intended end result that assets are protected.[3] An asset protection plan should be one that is intended to be viewed, and is viewed in a favorable light, by whatever creditor, judge or jury which might evaluate it at a later time. The plan needs to be structured with the thought in mind that someday the plan may be laid out in front of a hostile judge who has entered a judgment and a creditor who is seeking to attack the plan to satisfy its judgment. Unless the client is willing to leave the United States and move to a jurisdiction that does not recognize the laws of the United States, it must be assumed that at the end of the day the client will personally be subject to the jurisdiction of a court and will be ordered to produce records, tax returns and give testimony on the status and disposition of his assets subject to the penalties of perjury.

Asset protection plans that are structured and implemented years in advance of claims will withstand almost any creditor attack. Whether or not transfers that are a part of an asset protection plan will hold up in court is primarily a function of the application of fraudulent transfer laws and the bankruptcy laws in the fact situation. Consequently, it is imperative to have a comprehensive understanding of these laws. A detailed analysis of these laws is beyond the scope of this article but in general, a transaction will be set aside by a court when a court determines that the debtor was made insolvent by the transfer or because the debtor actually intended to defraud his creditors. With such a finding, the court can then order the person holding assets to return them to the debtor to be available to the creditor or order the transferor to give them to the creditor directly.

The first codification of the law governing fraudulent conveyances was the Uniform Fraudulent Conveyance Act of 1918, with its origins in the Statute of Elizabeth, originally codified in 16th century England.[4] Illinois, along with most states, has adopted the Uniform Fraudulent Conveyance Act (UFCA).[5] Anyone with a right to payment, even if contingent or disputed is a creditor under the UFTA. Anyone with a liability, even if contingent or disputed, is a debtor under the UFTA. A bankruptcy trustee is permitted by Section 548 of the Bankruptcy Code, to avoid two types of transfers as fraudulent: those involving actual fraud (fraud in fact), and those involving constructive fraud (fraud in law).[6] If a transfer is deemed fraudulent the court will unwind it, reverse the transfer and put assets back where they were beforehand so that the creditor can attach the asset.

The UFTA, with some exceptions, has a general limitations period of four years from the date of a transfer within which a creditor seeking to challenge the transfers must file a claim. Some states have shorter periods such as 2 years and there are foreign jurisdictions with even more restrictive limitations periods (This becomes one of the considerations for the use of other domestic and foreign jurisdictions as a part of an asset protection plan). Although there are exceptions and jurisdictions vary, generally if more than four years have passed from the time a transfer was

3 Adkisson & Riser (2004), *Asset Protection, Concepts & Strategies for Protecting Your Wealth*, McGraw-Hill. P. 37-39.

4 13 Eliz., ch. 5 (1570)

5 740 ILCS 160/1, et seq.

6 11 U.S.C. sec. 548

made, the transfer usually will be safe. If the creditor challenges the transfer within the limitation period, the transfer will then be examined as to solvency, value and intent. Solvency is a test determined by a balance sheet test.[7] It adds up all the debtor's nonexempt assets and subtracts all of the debtor's liabilities, including the creditor's claim. If the debtor was insolvent when the transfer was made, or the transfer causes the debtor to be insolvent, the transfer will likely be deemed fraudulent, regardless of the intent of the debtor at the time of making the transfer. These are sometimes called constructive fraudulent transfers. The critical factor to avoiding a constructive fraud claim is to ensure that "reasonably equivalent value" is received in exchange for any transfer. If a gift is made when the debtor is insolvent, it will always be considered a constructive fraudulent transfer.

In the alternative, as a second test, a debtor is insolvent for UFTA purposes if he cannot pay his debts as they become due. Even if a debtor is insolvent under the balance sheet test, a court may find him solvent if he passes the cash flow test. Planners often have their clients provide a sworn affidavit of solvency that states their assets and liabilities on the date of a transfer to establish contemporaneous proof of solvency.

If a claim is made within the limitations period and the debtor was solvent, or was insolvent but received reasonably equivalent value, the final issue examined is of intent. A court can set aside the transfer if the court finds certain circumstances that indicate a bad intent by the debtor. To determine actual intent it may be proven by circumstantial evidence. The courts look to what are commonly referred to as badges of fraud which have included, whether the debtor retained possession or control of the property after the transfer, whether the transferee was a relative, whether fair consideration was given for the transfer, whether the transfer was disclosed or concealed, whether the transfer was made when a lawsuit against the debtor was threatened or pending, whether the transfer involved substantially all of the debtor's assets, whether the debtor absconded, and whether the debtor was insolvent or was rendered insolvent as a result of the transfer.[8] The trial court is given broad discretion in choosing which factors to consider, and what weight to give to each. A judge can often make a results oriented decision where he first determines how the transaction "smells" to him and then looks at the badges of fraud to justify his decisions. Because of this "smell" test from the debtor's standpoint the goal in an asset protection plan is to fashion transfers that are justified by legitimate economic reasons and that do not hint of a transaction meant to hinder creditors.

Federal bankruptcy law has its own set of fraudulent transfer laws that are similar to the UFTA and allow the bankruptcy courts to apply state law with regard to fraudulent transfers.[9] A bankruptcy court has the power to imprison a debtor for contempt of court when the debtor fails to comply with an order of the court compelling the debtor to turn over assets to the court. At this point, the debtor must either turn over the assets or show conclusively that, after making all reasonable good-faith efforts, turning over the assets is impossibility and that the circumstance was not self-created.

Among the commonly used structures in asset protection planning are the following:

Insurance. Insurance is often an effective and inexpensive asset protection tool. It is designed to transfer risk from the insured to the insurance company. It provides funds to settle liabilities and provide for the cost of defense of those claims. When there is sufficient insurance to cover risks it can be taken into consideration as to the solvency of the Debtor. To the extent that it is affordable and available, insurance always should be considered as a primary risk management method with an asset protection plan in the secondary role.

Exempt Assets Exclusions and Exempt Assets. Certain assets are excluded and exempt from creditor claims under Illinois law. Illinois has by state law opted out of the federal Bankruptcy Code exemption and denies Illinois residents the ability to utilize the federal exemptions.[10] In a bankruptcy proceeding Illinois residents must rely on state law to determine which assets are exempt from the claims of creditors.[11] Exempt assets include, qualified state tuition programs (529 plans) and Education IRA funds with certain exceptions[12], the death benefit and cash value of a life insurance policy where the wife or dependents are the beneficiary, the cash value of annuities payable to the spouse, child or dependents, and assets held in qualified

7 Spero, *Asset Protection, Legal Planning, Strategies and Forms*, Warren Gorham & Lamont, v1, s3.04(1)(f)

8 *In re Frierdich*, 294 F.3d 864, 869 (7th Cir. 2002)

9 This effectively incorporates the UFTA in the states, such as Illinois, that have adopted it. Illinois adopted the UFTA effective January 1, 1990, 740 ILCS 160/1, *et.seq*.

10 735 ILCS 5/12-1201

11 735 ILCS 5/12-1201, 735 ILCS 5/12-1001 pertains to personal exempt property.

12 735 ILCS 5/12-1001(j) Contributions made during the 365 day period prior to the filing of a bankruptcy petition are exempt only up to the amount of the federal gift tax annual exclusion and contributions made during the period beginning 730 days and ending 366 days prior to the filing of a bankruptcy petition are also exempt only up to the amount of the federal gift tax annual exclusion. Section 522(n) of the Bankruptcy Code provides for a 1 million dollar cap on any exemptions for IRAs or Roth IRAs.

retirement plans.[13] A principal residence held by spouses, as their homestead, as tenants by the entirety can shelter the tenancy by the entirety property in a situation where the debt or claim is as to only one spouse.[14] Illinois allows certain personal exemptions. The most commonly used are, a homestead exemption of up to $15,000 in a debtor's primary residence, certain personal property, equity interest not to exceed $4,000 in value in any other property, the debtor's interest, not to exceed $2,400 in value in any one motor vehicle, qualified retirement funds, social security benefits, unemployment compensation, veteran's benefits, disability benefits, alimony, support or separate maintenance to the extent reasonably necessary for the support of the debtor and any dependent of the debtor. Florida and Texas also have generous homestead exemptions as long as the debtor moved in at least 40 months before filing.

Holding Title Among Spouses. There is an unlimited gift tax exemption for transfers between spouses. Where there is a high lawsuit risk and divorce is not a concern, having a spouse hold title to property as his or her sole and separate property may be an appropriate strategy and combined with estate planning.

Tenancy by the Entirety. In Illinois, a principal residence (homestead Property) may be owned by husband and wife as tenants by the entirety.[15] Illinois law exempts from creditors of only one of the owners of property held in tenancy by the entirety provided that the property was not fraudulently transferred to a spouse with the sole intent of avoiding payment of existing debts.[16] The protection from creditors lasts only as long as the title to the property is held in this form.

Limited Liability Companies (LLCs and Family Limited Partnerships (FLPs). Assets can be placed into an LLC or FLP created under the laws of a state where creditors are limited to a charging order as to an LLC. A judgment against a member is not valid against an LLC and the assets it holds. The same holds true for a partnership as to the interest of a partner. The sole remedy of a creditor of a member or partner is a charging order. A charging order limits the creditor of a member or partner to the debtor's share of distributions, without giving the creditor any voting or management rights. If no distributions are made to the member, but profits are realized, then the creditor may end up having to pay income taxes on money he never received.[17] Operating agreements can be drafted with "poison pill" provisions, such as limiting assignability, discretion in distributions and forced buyouts for less than market value (even a nominal amount of money) with terms over many years, or withholding any distributions to a member so long as he has a charging order pending. It is obvious the impact such provisions can have to reduce the value of an interest in an LLC to a judgment creditor. In practice, creditors rarely choose to pursue charging orders.

Unbundling. Most attorneys are familiar with the concepts and importance when forming businesses which involve risk, of the use of limited liability entities such as, corporations, limited partnerships and limited liability companies. Unbundling assets is an important asset protection planning device. This involves removing valuable assets from an operating business entity that may have a high risk of liabilities and using leases, rents and licenses to continually flow the liquid and least liability assets to separate protected entities with very low risk and liabilities. The primary risks are then insured at the operating company level and the operating business does not accumulate significant value above what is needed to properly operate the company.

Equity Stripping. Equity stripping refers to encumbering property with legitimate debt and contract obligations such as leases and license fees to reduce its net value and make it less attractive to judgment creditors. Cash is easier to protect than real or tangible personal property for two reasons. First, cash can be converted into more easily protected assets, such as life insurance or retirement plan assets and second, cash can be moved. Real Estate is always

13 735 ILCS 5/12-1006 (there are numerous other statues within the Illinois Pension Code that provide that various plans and pension funds are exempt from claims. The Bankruptcy Code for traditional and Roth IRAs now caps the exemption at $1 million dollars unless "the interest of justice so require" the cap be increased.

14 735 ILCS 5/12-112. In Illinois the Supreme Court has held that to set aside a transfer of a property by a debtor from his individual name to himself and his spouse as tenants by the entirety could be done only by a showing that the transfer occurred for the sole reason of avoiding creditor claims. *Premier Property Management, Inc. v. Chavez*, 191 Ill.2d 101, 728 N.E.2d 476, 245 Ill.Dec. 394 (2000). The Second District Appellate Court has held that the "sole intent" standard refers to the intent of the debtor spouse and not the intent of the non-debtor spouse. *LaSalle Bank, N.A. v. DeCarlo*, 336 Ill.App.3d 280, 783 N.E.2d 211, 270 Ill.Dec. 636 (2d Dist. 2003).

15 765 ILCS 1005/1c

16 735 ILCS 5/12-1201

17 In Illinois pursuant to 805 ILCS 180/30-20(b) it is possible for a creditor to have a foreclosure sale of a membership interest in an LLC. The creditor's rights would still be limited by the operating agreement and as a flow-through entity, the purchaser, even though not admitted as a member would be obligated to include as income its share of income from the LLC even if it did not receive any distributions to pay the taxes. The jurisdictions of Delaware, Alaska, and Nevada are often used to organize LLC's and they do not have foreclosure rights associated with charging orders. Also, note in the case of a single owner LLC, where there are no non-debtors to protect a bankruptcy court may permit the trustee to seize control of the LLC for the benefit of the bankruptcy estate. *In re Albright*, 291 B.R. 538 (Bank. D.Colo. 2003)

subject to the jurisdiction of the court where the property is located and subject to local law and the order of the local court (*In rem* jurisdiction).

Domestic Asset Protection Trusts (DAPT's). Properly set up trusts are nearly impossible for creditors to penetrate as long as the assets weren't derived from criminal conduct and the trust was established long enough before the grantor became insolvent. A spendthrift trust is one in which the beneficiary cannot transfer his interest in the trust to a third party and where the beneficiary's right to distributions can be cut off if the distribution would otherwise go to a creditor of the beneficiary. The trusts are drafted to give the trustee discretion as to whether or not to make distributions. A growing number of states allow the use of spendthrift trusts for the benefit of the person who originally set up the trusts and are referred to as "self-settled" trusts or domestic asset protection trusts (DAPTs)(Illinois is not one of the states that has approved DAPTs). As an example, in a Delaware DAPT: (i) the trust must be irrevocable and spendthrift; (ii) at least one Delaware resident trustee must be appointed; (iii) some administration of the trust must be conducted in Delaware; and (iv) the settlor cannot act as a trustee.[18]

18 12 Del. Code sec 3570, *et.seq.* (Qualified Dispositions in Trust Act).

The Delaware Act differs from many other self-settled spendthrift statutes in that it permits the settlor to retain the right to receive trust income. Spendthrift trusts as asset protection tools for beneficiaries other than the settlor can be effective tools. Alaska became the first U.S. jurisdiction to adopt DAPT legislation to allow self-settled spendthrift trusts and was soon followed by Delaware, Nevada, Rhode Island, and Utah. The U.S. Constitution requires that the valid judgments of one state be given "full Faith and Credit: by the other states. Because of the Full Faith and Credit Clause, the remedies available to a creditor and the protections available for a debtor's assets depend on the state that the judgments are entered, not the state where the debtor resides.[19] This also applies to trust assets, since whether or not trust assets are protected depends on the creditor's remedies in the state where the assets are located, and not where the trust is formed or the trustee resides. To the extent a DAPT can protect assets from creditors; both the assets and the debtor should physically be in a state with DAPT laws. Under current bankruptcy law, a federal court can retrieve assets transferred to a self-settled trust during the previous ten years, if the intention was to avoid creditors.

International (Foreign) Asset Protection Trusts (IAPT's or FAPT's) Countries competing for asset protection business include Switzerland and Luxembourg, smaller countries of the Caribbean, the Bahamas, and countries in the Pacific such as the Cook Islands and various British protectorates and colonies. One of their principal advantages is foreign judgments are not easily enforced, if at all, in their courts. To recover assets in these jurisdictions usually requires actions to be started anew in these jurisdictions, despite the fact that the creditor already has a judgment in the United States. These jurisdictions have also adopted debtor friendly provisions, such as shortened statutes of limitations and restricted fraudulent transfer laws. They have strict confidentiality laws that prohibit, as a crime, financial institutions from divulging information about their clients without an order from the local court. These jurisdictions have become as debtor friendly as possible in order to attract asset protection business.

One of the biggest complications with utilizing off shore jurisdictions is that just as offshore courts do not respect U.S. laws and the judgments of U.S. courts, neither do U.S. courts have to respect the laws of these debtor havens or the judgment of their courts. So long as a U.S. court has jurisdiction over the physical person of a debtor and can jail him for contempt, it can order the debtor to bring back ("repatriate") his assets from the debtor haven

19 U.S. Const., Art. IV, sec. 1.

to satisfy a creditor's judgment. Upon discovery of the existence of offshore assets, the creditor will apply to a U.S. court for an order requiring the debtor to repatriate them. If the court issues the order ordering the debtor to return the assets to the United States, the debtor now has only three choices; obey the court order and repatriate the assets, flee the United States, or refuse to comply and, as a result risk being held in contempt of court and jailed for an indeterminate time. Debtors have been held in jail for years in such a scenario.[20] For offshore planning to work, by the mere fact that the debtor's assets are offshore, the debtor must physically remove himself from the reach of the U.S. court as well.[21] One use of offshore entities is as a manager or general partner for U.S limited liability companies and limited partnerships. Offshore courts ignore the discovery orders of U.S. courts and U.S courts cannot assert jurisdiction over an offshore person or entity. One caution, creating foreign bank and security accounts does not in itself protect the assets. There are asset reporting laws required of U.S. taxpayers and failure to report offshore assets and income is punishable by sever fines and has criminal penalties. The smart choice is not to rely on offshore secrecy, but to structure affairs so that they can withstand challenge even when fully disclosed. FAPT's are often combined with family limited partnerships (FLPs). The client transfers virtually all of his assets to a domestic limited partnership in exchange for a 99 percent nonvoting limited partner's interest and a 1 percent general partner's interest. The client would then transfer the interest in the FLP to the FAPT, as a gift. If a creditor presents itself the FLP interest is liquidated and all the assets are up streamed to the FAPT, and the assets are effectively shipped offshore and out of the reach of the creditors.

Foreign Entities. Jurisdictions can be chosen for entities in more debtor friendly jurisdictions and import favorable conflict of law's provisions. Most structures can be moved from one jurisdiction to another. Thus assets in entities in more conservative jurisdictions can be moved to more debtor friendly jurisdictions in time of duress.

Additional Considerations. An asset protection pla must be flexible. One cannot predict with certainty when a potential creditor will appear or how they might attack an asset protection plan. Claims can arise from both internal and external sources and involve a variety of claims such as negligence, fraud, breach of contract, statutory violations, divorce claim and guarantees, among others. The preferred methods of funding asset protection plans are by making investments that can be liquidated and by entering into business ventures or transactions that can be reversed or liquidated. For asset protection planning, often the worst method of transfer is the irrevocable gift because, once it is made, undoing the transfer is extremely difficult and gifts by definition are not transfers for reasonable equivalent value and are therefore more exposed to creditor attack. Asset protection planning should not appear to be done for asset protection reasons alone. Instead, asset protection plan should be done within the context of other planning, such as financial planning, business planning, succession, overall risk management and tax planning. At the end of the day the asset protection planning should be cost efficient and capable of continued maintenance by the client. The cost and effort must be justified by the protection it offers.

The method of transferring wealth to a structure is probably more important than the structure itself. It the transfer has been part of a business structure and the transfers were for reasonable equivalent value, it may be very difficult for a creditor to challenge it as a fraudulent transfer. As in investing, an important consideration is diversification. It is advantageous not for a client not to have his "eggs all in one basket" and to have multiple vehicles as a parts of an asset protection plan. Clients often have two incompatible goals, they want to possess the beneficial enjoyment or control of their assets, and they also want to distance themselves from the ownership and control over the assets, to have the assets unreachable by creditors. The challenge to the planner is to strike the right balance between surrendering the ownership of assets and retaining some control over and benefit from such assets.

Conclusion. It is important to understand that most of the laws that can defeat asset protection planning attack the transfer, not the structure. A planner needs to focus first on the available methods of transfer and the level of protection they offer and then develop the structure. The structure may encompass many of the legal structures traditionally used to limit liability, such as domestic and foreign corporations, trusts, family limited partnerships, limited liabilities companies. In asset protection planning there is not a magic bullet or impenetrable legal fortress and there are literally dozens of structures that can be used depending on the client's individual circumstance and objectives. The challenge of preparing the best plan for the client will involve a balancing of many competing factors, including the client's circumstances, financial condition, solvency analysis, claims or threatened claims, type of business, the assets to be protected, the timing available, tax or estate planning issues, family issues, relevant jurisdiction and their laws and the cost of instituting and maintaining the plan. □

20 See, *In re Lawrence*, 279 F.3d 1294 (11th Cir. 2002)

21 See, Adkisson & Riser, *Asset Protection, Concepts & Strategies for Protecting Your Wealth* (2000), p. 73-75.