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Asset Protection In Context

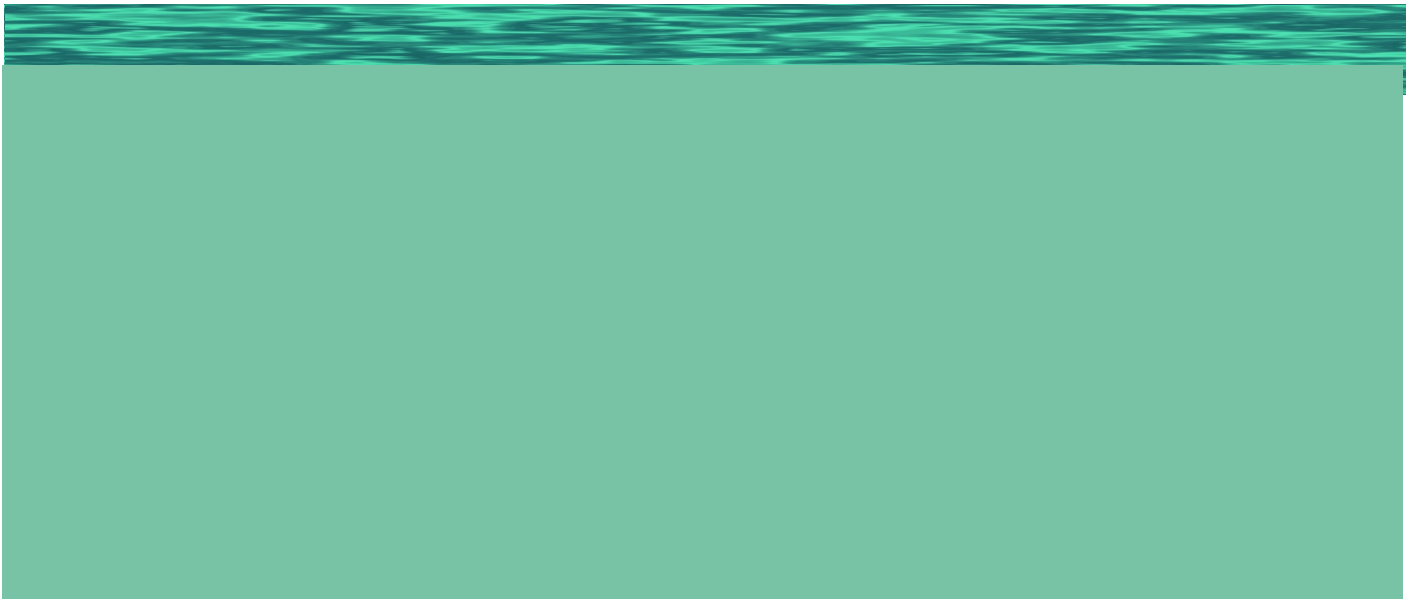
Estate-planning commentators of America have provided a wave of new and valuable ideas and warnings regarding asset protection. Some are fairly sophisticated; not your standard fare for the basic estate, but fascinating and instructive nonetheless.

What does asset protection mean these days? Should an estate plan consider an asset protection trust (APT)? What about variations such as a BAPT or a DAPT ...and what exactly are those? How does the Uniform Trust Code fit into these considerations?

Let's review some of the best asset protection ideas discussed in recent literature. But first let's review how we arrived at this point.

Birth of a Niche

Was there ever a time when estate planners didn't protect assets? Or, for that matter, was there a time before the planning needs of the elderly were recognized?



Those seem like ridiculous questions; asset protection is what estate planning has always attended to. Practitioners have always endeavored to protect assets and the elderly. Yet it was only in the past 15 years that both of these niches were defined and organized to the point where there are books, journals, law sections, and organizations devoted to these as specialized areas of expertise.

A wave of asset protection articles arrived in the early 1990s and several books were published during 1994, prompting book reviews in the August, 1995 issue of this newsletter. What caused the asset protection niche to come into focus? Here are a few candidates for your consideration:

The rise in stock market assets as a percentage of estates

The progression in age of the baby boomer demographic

The rise in personal bankruptcies

The increased usage of limited partnerships and LLCs

The shift away from immediate transfer tax planning to longer term wealth protection over several generations.

We don't know anyone who can say for sure, but all of those are likely to have had some contributory effect.¹

But what does asset protection actually mean? The answer depends on whom you ask. To an estate planner, the world fits into subcategories of the estate. Asset protection is just an item on a checklist of estate planning concerns such as liquidity, providing for a smooth probate process, tax planning, etc. To an asset protection specialist, protecting assets is the main category and estate planning is a subgroup of that.

For the sake of discussion, however, let's follow the organizational perspective of a noted scholar, Barry S. Engle, who was there at the beginning, when our current collective awareness of asset protection was first raised.

Mr. Engle placed asset protection as the third piece of a pie, with estate planning and financial investment planning as the other two slices.

PLANNING

ESTATE
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Seen in this perspective, he defined asset protection as "lifetime planning to preserve assets from various identifiable risks, the most significant of which is the possibility of protracted, costly, aggravating, and demeaning litigation that could devastate one not only emotionally but financially as well."²

Assets come under threat from many directions, so the avoidance of risks touches upon laws in several areas:

Liability

Insurance

Divorce

Catastrophic illness

Long-term nursing care

Fraudulent transfers

Limited liability companies

Bankruptcy

These areas reflect successive lines of defense against liability and involve a variety of laws from different jurisdictions. Assembling the various laws that apply in each of the 50 states would be quite an undertaking.³

Asset Protection Basics

Asset protection has certainly come of age over the past 15 years, but at the core of this emerging niche there is an old chestnut, the spendthrift trust. This is a trust designed to protect assets from the creditors of a beneficiary. As asset-protection techniques have developed in recent years, planners have pushed the envelope of spendthrift trusts, expanding them into every context in which trusts arise and using them for trusts in which the settlor is a direct or indirect beneficiary.

What if the proverbial spendthrift, i.e., the wayward son who has more creditors than friends, decides to sit right down and write himself a letter, placing his assets in the trust, and making believe his assets came from someone else?

Numerous courts and state legislatures, responding to the upsurge in spendthrift trust activity, have imposed limits on this approach. In fact, the Restatement of Trusts and the Uniform Trust Code had been amended to provide exceptions to spendthrift trusts for child support, alimony, necessities, services rendered and material furnished

which benefit the interests of the beneficiary, and claims of the state or federal government. 4

As one article noted: "Because of the issues surrounding the UTC, planners should consider moving all trusts and the underlying liquid assets intended to be creditor-protected out of UTC states."⁵

Because creditors stand in the shoes of the debtor/settlor, spendthrift trusts with the slightest flaw may allow creditors to reach the assets. Suppose there is a sole beneficiary and the terms of the trust result in the beneficiary becoming the sole trustee without having to give his or her consent. The moment the beneficiary and trustee has sole control, the two interests merge and the creditor can seize the assets.

Mandatory distributions can also expose assets to creditors. Providing a spouse with five-and-five power to invade trust principal may also enable creditors to make inroads against trust assets.

Support trusts and discretionary trusts can be effective but the choice of language for the trust terms is absolutely critical. If the support trust does not include spendthrift provisions, creditors may be able to reach distributable amounts that exceed what is required for support.

If a discretionary trust includes a standard for distribution, that distribution may no longer be truly discretionary and creditors may benefit.

Note that particular assets, such as homes, may have specialized local rules. In particular, retirement benefits are subject to a variety of rules. Qualified plans are subject to an anti-alienation provision of ERISA that protects beneficiaries from creditors. IRAs are typically not covered by such provisions unless they contain rollovers from a qualified plan. 6

Ethical Boundaries

How far can a professional go in assisting a debtor to avoid creditors? The short answer is that attorneys and other professionals must use every legal means to assist their client. But these actions affect third parties and it may only be a matter of time until these ethical boundaries are tested in court.

Anticipating that day, practitioners are well advised to document their due diligence in directing a debtor's lawful efforts.⁷

BAPTs: Having good ethics can also be useful as an affirmative defense for business executives and public officials. Those in the public eye will eventually come under fire for making decisions that benefit their own stock portfolio.

To avoid these attacks and even the appearance of impropriety, assets such as company stock and stock options can be placed in a blind asset protection trust (BAPT). A double-blind approach is possible where information is not exchanged between the client and the trustee.

The independent trustee (usually a corporate trustee) manages and disposes of assets without the public figure's participation, influence, or knowledge. Since public figures are also susceptible to liability claims, a blind trust established as a self-settled spendthrift trust (in one of the states that permits it) can be an effective protection.⁸

Evolving Concerns

A review of recent asset protection articles reveals a broad range of interesting ideas that are worth noting. Four of these articles appeared in the July, 2004 issue of *Trusts & Estates*.

Florida As Debtor's Haven: Although Florida has a reputation as a friendly haven to those seeking protection from creditors, a recent article notes the limits on both homestead and bankruptcy protections in that state.⁹

To meet Florida's homestead exemption, one must be a resident, own a house in an individual capacity (not through a trust or LLC), and meet acreage limitations. Recent case law has demonstrated how courts will force the sale of homesteads on more than ½ acre and then apportion the proceeds.

As we go to press, the Senate has passed a Bankruptcy package that would limit the use of state homestead exemptions (such as Florida's) to \$125,000 for those residing in a state for 40 months prior to declaring bankruptcy.

Beware of Offshore Forms: One of the leaders of the asset protection field recently noted that 15 years ago only a handful of firms in the United States were preparing offshore asset protection trusts. He warns that even now, "because offshore asset protection planning is a young specialty from a case law standpoint, some of the forms now in use are untested and, at best, guesswork."¹⁰

Offshore Contempt: Stephan Jay Lawrence lost a \$20-million arbitration against Bear Stearns, but tried to protect his wealth in a trust in Mauritius, an island off the coast of Madagascar.

In 1993, he amended the trust with a clause that directs the trustee to ignore instructions from him made under duress such as "a process of law for

the benefit of creditors.” This clause was invalidated by the Eleventh Circuit Court of Appeals and Mr. Lawrence has remained in jail for contempt for more than four years. 11

Nonresident Settlers: Domestic asset protection trusts (DAPTs) did not protect assets from creditors prior to 1997. Since that time, Alaska, Delaware, Nevada, Rhode Island, Utah, and Oklahoma have enacted statutes allowing DAPTs. One purpose for the DAPT is simply to serve as a substitute for a prenuptial agreement by protecting assets unilaterally. Individuals immigrating to the United States may also set up a DAPT without incurring gift taxation. DAPTs can also be used to transfer assets out of an estate for transfer tax purposes.

Creditors can still attack DAPTs by arguing that the law of the state of residence of the settlor applies rather than the law in which the DAPT was set up. Fraudulent transfers can also be set aside. And if the DAPT was set up improperly, such as where the settlor retains some form of control, the arrangement can be pierced by creditors. 12

Conclusions

Estate tax planning was the *raison d'être* of estate planning in general, and even after the estate tax repeal has been in effect for 10 years or more, people will continue to plan for the potential of its return. Yet in the absence of transfer taxes, asset protection concepts will continue to rise in relevance and usage, particularly as those areas relate to wealth preservation over several generations.

TECHNICAL REFERENCES

1. Prince and Harris, *Shelter from the storm*, 142 Trusts & Estates 9, p. 38 (Sept., 2003). This article summarizes results of 227 private client attorneys who were interviewed. The attorneys linked higher client interest in asset protection to general fear (“people are more afraid now”), the litigious environment, and rising divorce rates. Note that the survey discovered that only 13.2% of those surveyed were familiar with the Uniform Fraudulent Transfer Act, but 66.1% said asset protection would become an increasingly important part of their practice.
2. Engle, *Asset protection planning: A critical part of any estate plan*, Financial and Estate Planning Reports (CCH) (Jan., 1992); Engle, *Dodging the litigation explosion*, Chief Executive (March, 1993); Engle and Rudman, *Family limited partnerships; new meaning for “limited,”* 132 Trusts & Estates 4, p. 46 (July 1993); Engle, *Using foreign situs trusts for asset protection planning*, 20 Estate Planning, 4, p. 212 (July 1993); Engle, *Protecting the estate through foreign trusts*, 134 Trusts & Estates 7, p. 48 (July, 1995). Editor’s Note: We have not kept track of Mr. Engle’s articles since this period and point out that in the context of those times, the articles were warning of inroads made by creditors in several jurisdictions against the FLPs of that era; for example, forcing the sale of partnership assets and not having to settle for a charging order that merely gives the creditor the rights as an assignee of partnership distributions. In response, those articles discussed the merits of combining FLPs with asset protection trusts, specifically in offshore jurisdictions that do not automatically honor judgments from American courts.
3. At least one website has, in fact, assembled applicable statutes related to asset protection for each of the 50 states. But, as is inevitable when relying on 100 or more websites on various servers, there may be dead or outdated links at any given time and some of the links tested here were AWOL. But even having an outline of applicable statutes, listed by state, is a worthwhile resource. See: www.assetprotectionbook.com/state_resources.htm
4. Sandoval, *Drafting trusts for maximum protection from creditors*, 30 Estate Planning 6, p. 290 (June, 2003).
5. Merric and Oshins, *Effect of the UTC on the asset protection of spendthrift trusts*, 31 Estate Planning 8, p. 375 (Aug., 2004). This was the first of an excellent three-part collaboration between two of the best in the business. The articles feature flow chart analyses.
6. Golden, *Asset protection for IRAs and QRPs*, 142 Trusts & Estates 11, p. 40 (Nov., 2003).
7. Rothchild and Rubin, *Asset-protection planning: Ethical? Legal? Obligatory?*, 142 Trusts & Estates 9, p. 42 (Sept, 2003).
8. Ianni, *Remove Temptation*, 142 Trusts & Estates 6, p. 42 (June, 2003). This article identifies Alaska, Delaware, Missouri, Nevada, and Rhode Island as states with laws permitting asset protection trusts.
9. Nelsen and Packman, *Florida homestead traps*, 143 Trust & Estates 7 p. 38 (July, 2004).
10. Bove, *Drafting offshore trusts*, 143 Trust & Estates 7 p. 44 (July, 2004). For a variety of asset protection case laws updates, a 44-page treatment can be found online in PDF format. It is Chapter 23 of the 2002 work, Asset Protection Strategies., Noteworthy Legal Developments Affecting Asset Protection Planning, by Alexander A. Bove, Jr., Esq. and Melissa Langa, Esq., which summarizes updates from the Asset Protection Journal from 1999 through 2001.
11. Davis, *Asset Protection’s Bad Boy*, 143 Trust & Estates 7 p. 50 (July, 2004).
12. Shaftel and Bundy, *Domestic asset protection trusts created by nonresident settlors*, 32 Estate Planning 4, p. 17 (April, 2005).