

Asset Protection Planning: A Brief Overview (2005 Version)

By John E. Sullivan III
Sullivan & Sullivan Ltd.
25201 Chagrin Boulevard, Suite 350
Beachwood, Ohio 44122
216.896.0001 (Tel.) 216.896.0002 (F)
Jesullivan3@SullivanAndSullivan.com
www.SullivanAndSullivan.com

What is Asset Protection Planning?

- Seeking Ways To Shelter Wealth From Creditors
 - During Lifetime of Client
 - After Client Dies
- Whose Creditors?
 - Client's Heirs and Beneficiaries
 - Traditional Concern
 - Client's Own Creditors
 - Old Issue, But More Emphasis on it Today
 - Pre-Position Assets In Advance of a Problem

Aside: Fraudulent Transfer Issues

- Fraudulent Transfers – A Real Concern
 - UFTA, ORC § 1336.01, et seq.
 - 11 U.S.C. §§ 548, 727 (Bankruptcy Issues)
- These Issues Can Be “Planned Around”
- Today’s Discussion Assumes:
 - Good Planning
 - Good Due Diligence
 - No UFTA Violation

“Rainy Day” Planning Is OK

"[I]t is manifest that [the transferor] had done no more than any businessman has a right to do, to provide against future misfortune when he is abundantly able to do so."

Schreyer v. Scott, 134 U.S. 405, 414 - 415, 10 S.Ct. 579, 582 (1890). See also Riechers v. Riechers, 679 N.Y.S.2d 233, 236, 178 Misc.2d 170, 174 (1998) (referring to “legitimate purpose of protecting family assets” in connection with a Cook Islands trust); Stratton v. Edwards, 174 Mass. 374, 378, 54 N.E. 886, 887 (Mass. 1899) (“a general purpose to secure the property from the hazards of future business and the claims of future creditors” is not, by itself, actionable).

Why Asset Protection Planning?

- Clients Don't Trust the System!!!
 - McDonald's Hot Coffee Case
 - McDonald's "You Didn't Warn Me I'd Get Fat!" Cases
 - Other Cases
- Clients Want to Shelter Wealth From the System's Capricious, Illogical Results

Example of a Black Hole: The Bench (Per Justice Neely)

"As long as I am allowed to redistribute wealth from out-of-state companies to injured in-state plaintiffs, I shall continue to do so. Not only is my sleep enhanced when I give someone else's money away, but so is my job security, because the in-state plaintiffs, their families, and their friends will reelect me."

Justice Richard Neely, West Virginia Supreme Court, *The Product Liability Mess*, Free Press, p. 4 (1988).

Not Just W.Va. Thinking

“Doctrines of tort law have changed significantly over the past century... No longer is individual ‘blameworthiness’ the acid test of liability; the principle of equitable loss-spreading has joined fault as a factor in distributing the costs of official misconduct.”

Owen v. City of Independence, Mo., 445 U.S. 622, 657, 100 S.Ct. 1398, 1418 (1980)
(comment made in connection with decision regarding municipal liability under the Civil Rights Act, 42 U.S.C. § 1983).

Hierarchy Of Tools

Avoid Debt

Avoid Certain Types of Debt – Cognovits

Offshore APTs

Exempt Property (Traditional, Domestic APT, ERISA)

Holding Companies (LLCs Preferred Over LPs)

Gifting: S&D Trust With Ltd. POA and Distribution Veto

Gifting: Spendthrift & Discretionary Trusts (Non-UTC States)

Gifting (Outright)

Expatriation: Foreign

Expatriation: Domestic (Delaware Banks – No Garnishment)

Segregating Assets & Liabilities

Pre-Nuptial Agreements

Insurance (Policy Limits, Coverage Disputes, Exclusions)

+ Zone

Bury Assets (Sham Transfer, UFTA Violation)

– Punitives; Attorneys Fees; Transferee Sued

– Divorce Issues

- Zone

Exemption Planning

Exempt Property: Great If You Can Get It

- Exempt Property Is Legally Off Limits to Creditors
- Debtor Can Keep It, Use It, Benefit From It
- Exemptions Vary From:
 - State to State
 - Bankruptcy Ct. vs. Non-Bankruptcy Proceedings

How's Ohio? Adequate at Best

- ORC § 2329.66 Has Good Exemptions For:
 - CV Life Insurance
 - Annuities
 - Traditional IRAs, Rollover IRAs, Roths, Coverdells

- Lousy Exemptions for All Else:
 - Homestead (\$5,000 of Equity)
 - Wages
 - About \$15,000 Per Year After Tax – But...
 - 75% Rule Under 15 U.S.C. § 1671 , et seq.
 - Personal Property (the “Sticks” Exemptions)
 - No Tenancy by the Entireties Estates
 - *Lampkins* Problem (SEPs and SIMPLEs)
 - Still a Problem Outside Bankruptcy Even After BAPA

Big Points re Exempt Property

- Clients Can Move to “Good” States
- Many Good Homestead Jurisdictions (Moving Client)
 - 7 “Unlimited” – TX, FL, SD, KS, IA, OK, DC
 - Massachusetts – A Virtual “Unlimited” State
 - \$500,000 (Subject to Fraud Exception)
 - TBE On Top of That
 - Tenancy by Entireties States
 - Examples: FL, IL, MA, PA, DE
- TBE Is Potentially Useful (Moving Assets)
 - Law of Property’s Situs, Not Debtor’s Domicile, May Control
 - See, e.g., 11 U.S.C. § 522(b)(3)(B) (“State Plus” Menu)
 - Lurie v. Blackwell, 51 P.3d 846 (Wyo. 2002)
 - Some States Give TBE to Personalty – FL, VT, DE, etc., see, e.g.:
 - The Beacon Milling Co. v. Larose; 418 A.2d 32 (Vt. 1980)
 - Fla. Stat. Anno. § 689.15
 - Widder v. Leeds, 317 A.2d 32 (Del. Ch. 1974)

Best “Total Package” States

■ Texas:

- Unlimited Homestead
- Good Financial Asset Exemptions
 - Unlimited for Most Pensions, CV Insurance, Annuities
- Almost Impossible to Garnish Wages
- \$30,000 of “Eligible Personal Property” (Old Phrase)

■ Florida:

- Unlimited Homestead
- Good Financial Asset Exemptions (Similar to TX)
- Big Wage Exemption (Unlimited “Head of Family” Rule)
- TBE for Personalty as Well as Realty

LLCs & Limited Partnerships

LLCs & LPs – Key General Rules

- LLCs Preferred Over LPs
- Delaware Preferred Over Other States
- Don't Use Ohio Entities for APP
- Multi-Member LLCs Better Than 1 Man LLCs

Why Not LPs? They're Porous!

- Broad Creditors Rights Against Debtor's LP Interests... Per RULPA Charging Order
 - Foreclosure, Receivership, Accounting
 - Catch-All (A Judicial Blank Check)
 - Court May Order That Which "Circumstances.... May Require"
- How Do These Broad Rights Arise?
 - Old RULPA – Gap Clause (§ 1105)
 - Allows “Importing” of Broad UPA Remedies into RULPA § 703
 - RULPA (2001) - § 703 Expressly Says So
 - No Need to “Import” From UPA... It's Right in RULPA!
- Note: Some States Differ, e.g.:
 - DE, AK, NV (legislative history?) WY? (No Importing?)

LLC's Can't "Borrow" From UPA

- LLCs Don't Have a Uniformity Clause
 - No Statutory Authority to "Import" UPA Remedies
- Caution:
 - LLC Statutes Are State-Specific
 - Some Expressly Allow Broad UPA-Style Remedies
 - Foreclosure, etc. (Including the "Judicial Blank Check")
 - Examples: IL, CO
- DE, AK, AZ, NC, NV Are More Protective

Why Delaware?

August 2005 Law & Charging Orders

- DE Expressly Adopts the “Narrow View”
 - Creditor “Has Only the Right to Receive... Distributions... the Judgment Debtor Would Otherwise Have Been Entitled” to Receive
- Charging Order “Exclusive”
- Other Remedies Expressly Barred
 - No Resulting Trust, Constructive Trust, etc. Claims

More on DE's August 2005 Law: Assignees Bound by Operating Agreement

- DE Law Now Says Assignees Bound by Operating Agreement
 - Even if Assignees Didn't Sign
 - Clears Up Major Ambiguity or Uncertainty
- If Creditor Takes Assignment → Bound by Op. Agr.
 - “Creditors” ≠ “Assignees” in DE Charging Order System
 - Mere Creditor Only Gets “Narrow Remedy”
 - Gets Debtor's Share of Distributions “If & When” Made
 - “Assignee” Issues Arise Only if Assignment Made
- Opportunity for “Poison Pills” & Other Nasty Terms

What Sort of Poison Pills?

- Capital Call Provisions
 - Give Manager Right to Demand Big K Contributions
- Phantom Income Risks
 - Give Manager Right to Accumulate LLC Income
 - Assignee is K-1 “Attributee” for His Pro Rata Share
 - Even if Income is Undistributed
 - Makes Real the Threat that Was Previously Suspect
- Forum Selection & Consent to Jurisdiction
 - Assignees Agree to Suit in DE Unless LLC Waives DE Forum
- Monetary Fines – OA Says Assignees:
 - Have No Right to Interfere in Management or Compel Distributions
 - Subject to Big Monetary Fines if They Try to Interfere, Compel
- Fee Shifting (Write Your Own “English Rule”)
 - Assignees Liable for LLC’s Fees, Costs for Defending Against Interference or Collecting Fines

Delaware Is Convenient, Cheap

- Certificate of Formation Can be Filed by Fax
- Payments Can be Made by Credit Card
 - Card Number is Also “Faxable”
- Base Filing Fee is Cheap (\$90)
- Expedited Fees Can be Cheap (or Expensive)
 - 24 Hour – \$50
 - Same Day – \$100
 - Two Hours – \$500
 - One Hour – \$1,000
- Registered Agent Fees Cheap (as Little as \$50)
- No Income Tax on Non-DE Source Income
 - 30 Del. Code §§ 1121 et seq., 1601 et seq.

Why Not Ohio LLCs? Charging Order is Unclear!

O.R.C. § 1705.19 States:

“If any judgment creditor of a member of a limited liability company applies to a court of common pleas to charge the membership interest of the member with payment of the unsatisfied amount of the judgment with interest, the court may so charge the membership interest. To the extent the membership interest is so charged, the judgment creditor has the rights of an assignee of the membership interest.”

O.R.C. § 1705.19 Doesn't Use “Only”

- Key Sentence Says: “the judgment creditor has the rights of an assignee of the membership interest.”
- It Doesn't Say: A “creditor has only the rights of an assignee”
- Ohio LLC Charging Order Remedy May be Cumulative, Not Exclusive
 - Ordinary Attachment, Receivership, etc. May Be Allowed

Single Member LLCs More Exposed Than Multi-Member LLCs

- Membership Interest is Property of Bankruptcy Estate Under 11 U.S.C. § 541
 - SMLLC Interest → Whole LLC Gone if Member Bankrupts
 - See In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2004)
 - Note: Debtor's Management Rights May Not Be Estate Asset. Desmond v. U.S. Asset Funding, L.P. (Bankr. D. N.H. 2004), Adv. Pro. 04-1168), www.nhb.uscourts.gov/Court_Opinions/Desmond.017.opn.pdf
- SMLLCs Often Used as Personal Back Pockets
 - Creates Risk of Resulting or Constructive Trust (But See New DE Law)
- Multi-Member LLCs →
 - Courts Must Respect Rights of Other Non-Litigant Members
 - Non-Debtor's Share of LLC Wealth Relatively Safe
 - Creditor Must Deal With Other Members, Manager

Asset Protection Trusts

(Foreign and Domestic)

What is an APT?

In A Nutshell:

A Self-Settled Spendthrift Trust That Is
Effective Against the Settlor's Own Creditors
As Well As the Creditors of
Other Beneficiaries

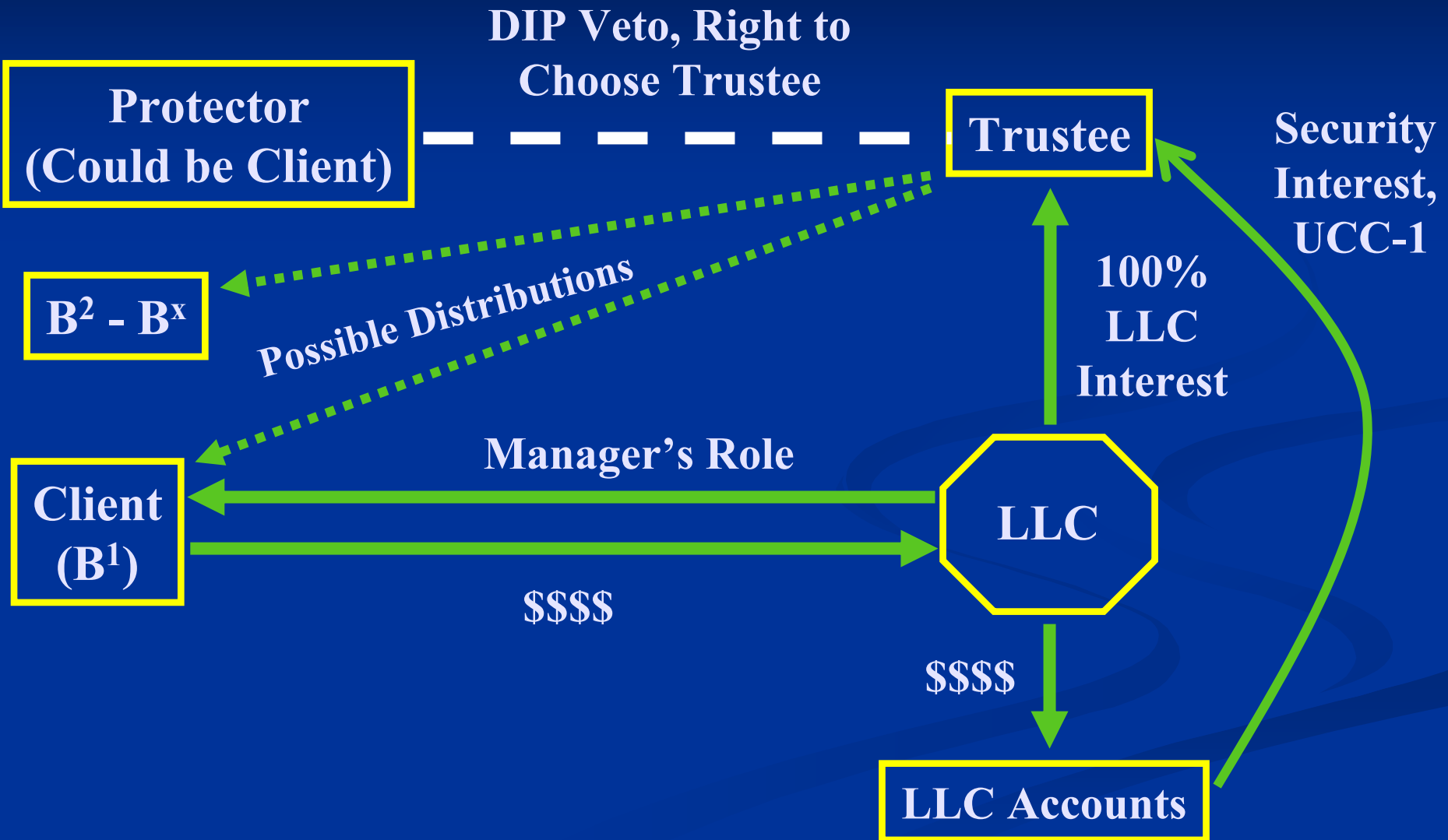
The Crux and the Caveat

- The Crux: In General, a Settlor's Creditors Can't Attach Trust Property, Even If a Settlor:
 - Is a Trust Beneficiary
 - Has Retained Powers Over the Trust Fund
- Repeals the “Rule Against Self-Settled Trusts”
 - See Restatement 2d, Trusts, § 156 and Related Cases
- The Catch:
 - Trust Settlement Must Not Be a Fraudulent Transfer

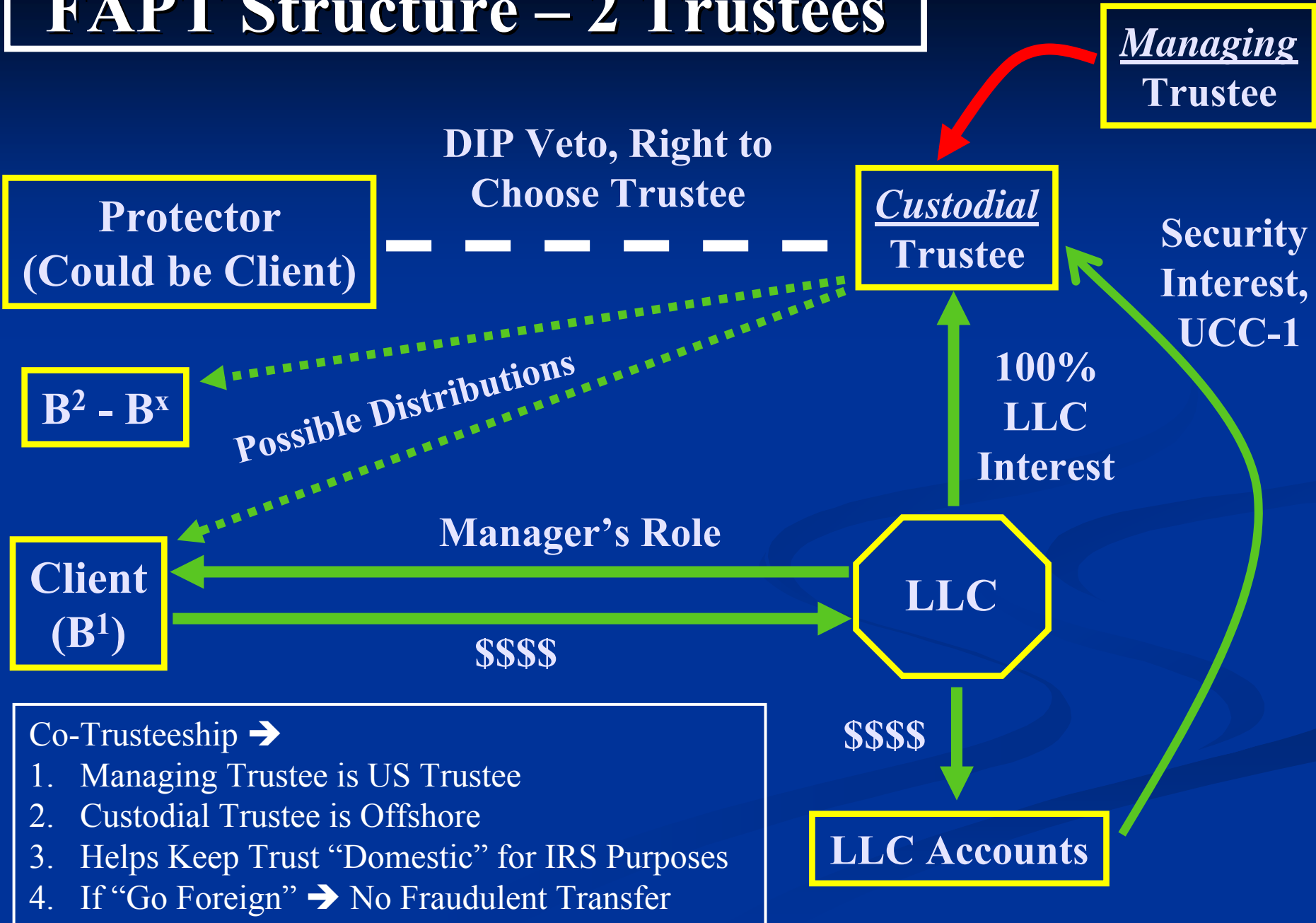
APTs Available Onshore & Offshore

- Available in 8 States in USA
 - AK, DE, MO, NV, OK, RI, SD, UT
- Modern “Statutory” Offshore Jurisdictions
 - Cook Islands, Nevis, St. Kitts, St. Lucia
- Plan Structure Often Looks the Same:
 - Trust Combined With LLC

The Basic FAPT Structure – 1 Trustee



FAPT Structure – 2 Trustees



Aside: Client Control Via LLC

- Client is LLC Manager
- LLC Owns Relevant Assets
 - (Cash, Securities, etc.)
- This Gives Client More:
 - Day-to-Day Control
 - Security Against Embezzlement

Aside: Control Via Protector

- Many APTs Include a “Trust Protector”
- Protector is Akin to Advisor
- Typical Protector Powers:
 - Veto Distributions
 - If Distributive Veto Not Vested in Client
 - Veto Investments
 - Veto Personnel Engagements (Accountants, etc.)
 - Remove and Replace Trustee
 - Narrow Class of Eligible Replacements
 - Eligible Replacement Class Excludes Creditors, Others

Domestic APTs – Some Basics

- Settlor Can Receive or Retain at Least:
 - Discretionary Distributions of Income or Principal
 - Ltd. Testamentary POA
 - Veto Over Distributions
- Some States Allow Broader Retained Rights
- Way Cool, Dude... If it Works!

Big DAPT Issue: Full Faith & Credit

- What if Court from Non-DAPT State Refuses to Apply DAPT State's Law to Trust in Suit Against Trustee?
 - DAPT State May Be Forced to Enforce Judgment
 - See, e.g., *Franchise Tax Bd. of California v. Hyatt*, 538 U.S. 488, 123 S.Ct. 1683 (2003)
- But, If OH Confronted With DE Trust:
 - FF&C, Comity, Are 2-Way Streets
 - Ohio Disregards DE Law → Big Constitutional Fight
 - Many Good Reasons to Apply DE Law
 - Settlor's Intent, Predictability, Situs of Administration, etc.
- DAPTs Should "Work"
 - But... Nobody Knows for Sure!

**FF&C Worries & Other Concerns
Encourage Offshore Trusts
(Either Alone or In Conjunction With
DAPT)**

Offshore Often Seen As:

**More Protective
&
More Flexible**

FAPTs: More Flexibility & Control

- Domestic APTs Allow Settlor to Retain Ltd. Testamentary POA
- Offshore APTs Allow Settlers to Retain
 - Ltd. or General Power of Appointment
 - Ltd. Preferred – No Compelled Exercise for Creditors
 - Testamentary or Lifetime POA

FAPTs Are More Protective...

For Lots of Reasons

Creditors Must Sue Offshore To Get \$\$\$

- Assets are Usually Out of U.S.
 - Maybe in Several Places
 - No Requirement That Trustee Move Assets Out of U.S.
 - However, Trustees Usually Move \$\$\$ During Time of Crisis
 - No Stateside *In Rem* Attachments
- Can Try Nation-by-Nation *In Rem* Proceedings
 - Expensive
 - Ineffective (“Fleeing Assets” Syndrome)
- Trustee is Controlling Focal Point
 - Trustee is Out of U.S.
- Have to Go to the Trustee’s Home Court

Problems Await Creditors Offshore

- U.S. Judgments Not Recognized
 - Must Obtain a Foreign Judgment to “Bust the Trust”
- Future Creditor Claims Abolished
 - Present Creditors Only – Post-Settlement Suits Barred
- Short Limitations Periods
 - 2 Years or Less
- Expensive Litigation
 - No Contingent Fees – Hourly Rates up to £250/Hr.
 - Loser Pays (Including Security for Costs)
- Elevated Fraud Standard – 2 Prong Test
 - Intent to Defraud Specific Plaintiff + Insolvency
 - “Beyond Reasonable Doubt” Evidence Standard

No Tax Advantage to Typical APT Structure: “Tax Neutral” Devices

- Underlying LLC is a Flow-Through Device
 - Single Member LLC
 - Income Flows to Trust
- APT: Typical Reserved Powers, Interests →
 - Income Tax: Grantor Trust (Flow-Thru to 1040)
 - Gift Tax: Incomplete Gift
 - Estate Tax: Trust is Included in Settlor’s Estate
 - § 684 “Exit Tax”: Inapplicable to Grantor Trusts
 - FAPT Concern Only; Inapplicable to DAPT

Caveat: Foreign Trusts & S Corps

- General Rule: Grantor Trusts Can Own S Stock
 - IRC § 1362(c)(2)(A)
- Exception: Foreign Trusts
 - IRC § 1362(c)(2)(A) and Related Regs
- Tax Lesson: DAPTs Preferred for S Stock Cases

Triad of Legal Issues

Tax Laws

- State
- Federal
- Foreign

Creditor's Rights

- Rule 65 (Freezes)
- UCC
- Bankruptcy
- RASST

**Constant Need to
Coordinate Issues**

Pro-Debtor Laws

- APTs
- Exemptions
- Etc.

The Litigation Flow Path

Settlement Path: Available At Any Time

**Objective:
Settle
Cheaper,
Quicker
Than if
No APP**

