

# Asset Protection Update (Headlines as of August 2005)

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## Update Slide 1

- **Biggest News: Bankruptcy Reform**
  - **New, Improved Retirement Fund Exemptions**
  - **Limits on Homestead Exemptions**
  - **Talent Amendment & 10 Year APT Look-Back Rule**
  - **Means-Testing of Consumer Bankruptcies**

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**BAPA.** The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPA”) is now law. In general, BAPA takes effect on or about October 17, 2005, although some provisions take effect right away (e.g., those dealing with homestead exemptions) and others take effect at other points in time. Among other things, BAPA’s highlights include:

- Uniform liberal exemptions apply to most retirement funds, regardless of whether a debtor asserts exemptions under the “state plus” or federal exemption options.
- State law homestead exemptions will have been restricted in many cases, although they remain quite viable in others.
- The Talent Amendment now gives bankruptcy trustees a 10 year look-back period in connection with alleged fraudulent transfers (actual fraud only) to self-settled trusts (i.e., APTs) and other “similar devices.”
- Consumer Ch. 7 bankruptcy cases will be means-tested with a strong bias in favor of either: i.) Agreed conversions of Ch. 7 consumer liquidations into Ch. 13 repayment plans, or, ii.) Dismissing the entire bankruptcy case.

## Update Slide 2

- **New States Join APT Ranks**

- **South Dakota**
- **Missouri**
- **Oklahoma**

**With AK, DE, NV, RI, UT →  
Grand Total of 8 DAPT States (9 if CO Counts)**

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**Three New Domestic APT States.** South Dakota, Missouri, and Oklahoma have joined the ranks of domestic APT states. South Dakota's law is similar to Delaware's. Oklahoma has a \$1,000,000 principal cap and requires use of "Oklahoma assets." Missouri's version of the UTC has domestic APT language buried in the fine print. As a result, the current complete roster of domestic APT states is now 8 states (9 if you count Colorado's ancient statute and case law). The statutory cites are as follows:

AK - Various provisions of the Alaska statutes, including AS §§ 34.40.010, 34.40.110

CO - C.R.S. § 38-10-111 (trusts for use of grantor void against "creditors existing")

DE - Qualified Dispositions Into Trust Act, 12 Del. Code § 3570, *et seq.*

MO - Missouri UTC, Mo. Rev. Stat. §456.5-505.3.

NV - Spendthrift Trust Act of Nevada, N.R.S. § 166.010, *et seq.*

OK - Oklahoma Wealth Preservation Trust Act, 31 Okla. Stat. § 10, *et seq.*

RI - Qualified Dispositions in Trust Act, Gen. Laws R.I. § 18-9.2-1, *et seq.*

SD - S.B. 93 and S.B. 94, adopted March 2005, available on-line at:

<http://legis.state.sd.us/sessions/2005/bills/SB93enr.pdf>

<http://legis.state.sd.us/sessions/2005/bills/SB94enr.pdf>

UT - Utah Code § 25-6-14 (dealing with "restricting transfers of trust interests").

## Update Slide 3

- ***Ehman*, 319 B.R. 200 (Bankr. D. Ariz. 2005)**
  - **Poison Pills In Bankruptcy**
- **Somewhat Old But Overlooked News**
  - **D.C.'s Unlimited Homestead (2001)**
    - Available to "Head of Family or Householder"
    - Available to Residents
    - Available to Non-Residents
      - Does Debtor "Earn Major Portion of Livelihood" in D.C.?
  - **Massachusetts' \$500K Homestead (2004)**
    - Formerly \$300K
    - Exceptions for Certain Debts

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**Executory Contract & Poison Pills.** A bankruptcy trustee takes a debtor's LLC interest subject to debtor's membership rights and obligations. If the operating agreement imposes real duties on debtor (and hence trustee), e.g., obligation to contribute capital, then agreement is an executory contract that trustee must assume or reject (i.e., abandon) under 11 U.S.C. § 365. *In re Ehman*, 319 B.R. 200 (Bankr. D. Ariz. 2005). The court expressly cited capital call provisions as the sort of obligation on members that could create an executory contract, and hence force a bankrupt member's trustee to assume or reject. The implication is that capital call provisions may be effective "poison pills" for LLCs with members in bankruptcy. That's because exposure to capital calls may wipe out the debtor's estate. This, in turn, may prompt bankruptcy trustees to reject operating agreements and abandon sizable percentage interests in valuable LLCs, and/or to accept the contract and sell the interests quickly – and at sharp discounts – before capital calls are made.

### **Often Overlooked Homestead Laws.**

• **Massachusetts.** The Bay State homestead exemption was amended effective July 28, 2004 and is now \$500,000 (formerly \$300,000). See M.G.L. Ch. 188, § 1. (Amd. July 28, 2004). The exemption statute, however, does allow attachment of homestead equity to satisfy judgments for:

- Taxes.
- Debts pre-dating the purchase of the homestead.
- Debts contracted for the purchase of the homestead.
- Spousal or child support.
- Payment of certain ground rents.
- Fraud, mistake, duress, undue influence or lack of capacity.

• **Washington, D.C.** The nation's capital joined the unlimited homestead ranks in 2001. D.C. Code § 15-501(a)(14). The exemption is available to the following persons:

- **Residents.** Any head of family or householder residing in D.C., or,
- **Non-Residents.** Any person who earns the major portion of his livelihood in D.C. who is a head of a family or a householder. This exemption under the "earnings" test is expressly available to anybody "regardless of his place of residence."

## Update Slide 4 - Offshore

- Continuing Global Growth of AML Laws
- *Minwalla* [2004] EWHC 2823 (Fam)
  - Sham Trust Doctrine Applied to Jersey Trust
  - Apparent Use of *Mareva* Injunction

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**Global AML Laws.** Anti-money laundering (“AML”) laws continue to be adopted throughout the world. See, e.g., *Offshore Red*, Vol. 10, No. 3 (April 2005), pp. 49 (cover page) (summarizing U.S. State Department report), 52 (regarding Bahamas); *id.*, Vol. 10, No. 1 (February 2005), pp. 1 (Taiwan adopts new AML rules), 2 (reviewing possible Swiss AML changes). Some countries are still moving slowly towards adopting AML laws. *Id.*, Vol. 10, No. 3 (April 2005), p. 50 (discussing Jordan’s proposed law). Additionally, enforcement concerns still exist. See, e.g., *id.*, pp. 51 (discussing U.S. Treasury views), 52 (discussing Bahamian enforcement concerns); *id.*, Vol. 10, No. 1 (February 2005), p. 2 (discussing Indonesia). For a comprehensive report by the U.S. State Department, go to:

[www.state.gov/g/inl/rls/nrcrpt/2005/vol2/html/42754.htm](http://www.state.gov/g/inl/rls/nrcrpt/2005/vol2/html/42754.htm)

Note that money laundering is a complex international problem with some surprising twists. For example, according to the above-cited State Department report, the “Major Money Laundering Countries in 2004” including the U.S.A., U.K., Canada, and Australia, and certain offshore jurisdictions, but did not include some key offshore venues, such as Bermuda, the Cook Islands, Nevis, St. Lucia, and St. Kitts.

***Minwalla* and Sham Trusts.** In *Minwalla v. Minwalla*, [2004] EWHC 2823 (Fam), 7 ITELR 457, the Family Division of the High Court of England and Wales dealt with a divorce case in which the husband set up an offshore structure, including a Jersey trust and various underlying entities and assets. Relying upon the English common law sham trust doctrine and facts showing that the husband ignored trust formalities and did what he wished with the trust structure, the court concluded that a sham transaction was afoot and that the husband used the structure (at least in part) to secrete assets from his wife. The wife obtained what appears to be a *Mareva* injunction, although the court was not explicit on this point. Additionally, the husband did not appear in the UK proceedings, fled to Pakistan, and commenced ancillary litigation in Karachi, Pakistan, which the UK court obviously considered to be an inappropriate exercise of jurisdiction over a UK divorce. The court awarded the £4,185,000, of which about £ 1,674,000 was attachable in the UK and Jersey. The court, however, expressed doubt as to the ability of the wife to collect the remaining amount owed.

## Update Slide 5 – Circular 230

- IRS Attack on Advice-of-Counsel Defense
  - Effective June 21, 2005
- Applies to Any Form of Written Advice
  - E-Mails, Faxes, Formal Opinions, etc.
- Written Opinions Must Meet IRS Standards
  - Violators May Lose Privileges to Practice Before IRS
  - Possible Monetary Fines in Future
- May Affect APP Related Tax Planning, But...
  - No Impact on Verbal Opinions
  - Shouldn't Affect "Tax Neutral" APP

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**Circular 230 & Written Tax Opinions.** IRS C. 230 seeks to deter taxpayer abuses by discouraging written tax opinions used as evidence to prove a “good faith” or “reasonable cause” defense to potential penalties, fines, etc. To implement this objective, the IRS targets opinion writers and imposes mandatory standards and potential penalties on them in connection with their written opinions.

**Applies to “Practitioners.”** C. 230 applies to “practitioners,” who “include any individual described in [31 CFR] § 10.2(e).” See new 31 CFR § 10.35(b)(1). Under § 10.2(e), a “practitioner” is broadly defined to include many people, including attorneys, and “practice” is broadly defined to include virtually any form of contact or communication with the IRS on behalf of taxpayers.

**Covered Opinions and Other Opinions.** C. 230 primarily targets “covered opinions,” which are written opinions regarding: 1.) Listed Transactions; 2.) Transactions the principal purpose of which is to avoid or evade taxes; and, 3.) Transactions in which a significant purpose is to avoid or evade taxes, but only if the written advice is a “reliance” opinion, a “marketed” opinion, is subject to conditions of confidentiality, or is subject to contractual protections. Circular 230 also applies to other, “non-covered” opinions, but less stringently.

**Standards Set & Penalties for Non-Compliance.** Practitioners must adhere to new, detailed standards of practice in connection with any of their written tax opinions. Failure to adhere to these guidelines due to willfulness, recklessness, or gross incompetence can result in penalties to the opinion writer, such as loss of a right to practice before the IRS. 31 CFR §§ 10.52. The IRS also plans to impose monetary fines in the future. See C. 230, “Explanation of Provisions.”

**C. 230 Summaries.** For summaries of C. 230, see Blattmachr, et al., *Decision Tree For Potential Application of Circular 230, § 10.35*, and *Required Compliance With Circular 230 § 10.35 For “Covered Opinions,”* available at [www.ilsdocs.com/docs/alerts/Circular\\_230\\_decision\\_tree\\_FINAL.pdf](http://www.ilsdocs.com/docs/alerts/Circular_230_decision_tree_FINAL.pdf) and [www.ilsdocs.com/docs/alerts/Circular\\_230\\_chart\\_FINAL.pdf](http://www.ilsdocs.com/docs/alerts/Circular_230_chart_FINAL.pdf).

## Update Slide 6 – New DE LLC Rules

- Assignees Bound by Operating Agreement
- Charging Order Made Very Debtor-Friendly
  - Exclusive Remedy
  - “If and When Distributions Made” Remedy
  - Creditors Appear to be Barred From Pursuing Equitable Trust Theories or Other “Direct Actions” Against the LLC or its Assets
  
- DE Made Similar Changes to its LP Act

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**New Pro-Debtor Delaware LLC Rules Adopted.** Effective August 1, 2005, Delaware adopted a series of new LLC rules that are designed to make Delaware’s LLC statute the most attractive in the country. As part of that effort, Delaware adopted pro-debtor rules that make Delaware LLCs very attractive to asset protection planners. This is in response to criticisms that had been leveled at Delaware’s current rules, which created significant opportunities for creditors.

**Assignees Bound by Operating Agreement.** Under new 6 Del. Code § 18-101(7), a debtor-member’s assignees will be bound by the terms of the LLC’s operating agreement, even if the assignees didn’t sign or approve the agreement. This clears up a significant lingering question regarding the efficacy of operating agreements against creditors who never agreed to the terms of thereof. The new language specifically states, “A member or manager of a limited liability company or an assignee of a limited liability company interest is bound by the limited liability company agreement whether or not the member or manager or assignee executes the limited liability company agreement.” Accordingly, planners can now write very protective LLC clauses and reasonably expect that the terms will be enforced against creditors.

**Charging Order Made Very Debtor Friendly.** Delaware has made its charging order provisions very debtor friendly. Creditors now expressly have no right other than to receive distributions that a debtor member might be entitled to receive. The legislative history to S.B. 84, which made the changes, states that the changes are meant “to clarify the nature of a charging order and provide that a charging order is the sole method by which a judgment creditor may satisfy a judgment out of the limited liability company interest of a member or a member’s assignee. Attachment, garnishment, foreclosure or like remedies are not available to the judgment creditor and a judgment creditor does not have any right to become or to exercise any rights or powers of a member (other than the right to receive the distribution or distributions to which the member would otherwise have been entitled, to the extent charged).”

**Redline Attached.** A redline of the new Delaware LLC statute is attached.

*New Delaware LLC Charging Order – Redline Version (Effective August 2005)*

**§ 18-703. Member's limited liability company interest subject to charging order.**

(a) On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the limited liability company interest of the judgment debtor to satisfy the judgment. ~~The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the limited liability company, which receiver shall have only the rights of an assignee, and the court may make all other orders, directions, accounts and inquiries the judgment debtor might have made or which the circumstances of the case may require.~~ To the extent so charged, the judgment creditor has only the right to receive any distribution or distributions to which the judgment debtor would otherwise have been entitled in respect of such limited liability company interest.

(b) A charging order constitutes a lien on the judgment debtor's limited liability company interest. ~~The court may order a foreclosure of the limited liability company interest subject to the charging order at any time. The purchaser at the foreclosure sale has only the rights of an assignee.~~

(c) ~~Unless otherwise provided in a limited liability company agreement, at any time before foreclosure, a limited liability company interest charged may be redeemed:~~

~~(1) By the judgment debtor;~~

~~(2) With property other than limited liability company property, by 1 or more of the other members; or~~

~~(3) By the limited liability company with the consent of all of the members whose interests are not so charged.~~

~~(d)~~ (c) This chapter does not deprive a member or member's assignee of a right under exemption laws with respect to the ~~member's~~ judgment debtor's limited liability company interest.

~~(e)~~ (d) ~~This section provides~~ The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest.

~~(f)~~ (e) No creditor of a member or of a member's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.

(f) The Court of Chancery shall have jurisdiction to hear and determine any matter relating to any such charging order.

Note: The legislative history to this aspect of the Delaware statute, as well as other changes wrought by S.B. 86, are available at:

[www.legis.state.de.us/LIS/lis143.nsf/vwLegislation/SB+86/\\$file/legis.html?open](http://www.legis.state.de.us/LIS/lis143.nsf/vwLegislation/SB+86/$file/legis.html?open)