By Gideon Rothschild

A Widening Net

Legislative developments in domestic asset protection trust states have helped generate interest from a wide variety of clients

With 2011 come and gone, we look back at the recent developments in the area of asset protection planning. With fewer clients concerned about estate taxes due to the increased exemption, more advisors are addressing asset protection needs of the modestly wealthy. This specialty niche, once thought to be of interest only to doctors and real estate investors, continues to evolve and attract interest from a wide variety of clients. Much of this interest has been precipitated by the legislative developments in domestic asset protection trust (DAPT) states—now numbering 12. And, at a recent American College of Trust and Estate Counsel meeting, one prominent litigation attorney suggested that it won't be long before an estate-planning attorney is sued for malpractice for not having discussed asset protection strategies with his client.

Charging Order Legislation

Though no additional states have passed self-settled trust legislation since Hawaii did so in 2010 (significantly amending its statute to make it more attractive), states continue to race to one-up each other with improvements to existing laws. Nevada, for one, has been very active, passing new charging order legislation for sole member limited liability companies (LLCs). It's also the first state to provide for exclusive charging order limitations with respect to corporate interests, including single shareholders of closely held companies. In addition, Nevada amended its DAPT statute to provide that any trust redomiciled to Nevada will benefit from a tacking on from its original funding date for purposes of determining the two year statute of limitations for fraudulent transfers with respect to DAPTs under Nevada law.

Readers will also recall the Florida case of *Olmstead v. Federal Trade Commission,*[1] which held that a charging order wasn't the exclusive remedy for LLC interests. As a result of that decision, the Florida bar proposed legislation, which was enacted early last year, to amend its LLC statute so that it now provides for the charging order to be the exclusive remedy for multi-member LLCs. Apparently, the bar was unable to extend the same protection to single-member LLCs. Readers may wonder whether one may gift a nominal interest in an LLC to obtain the exclusive remedy. That avenue, however, has so far been untested.

Inherited IRAs

Another recent Florida development was the amendment of Florida's statute relating to the exemption for individual retirement accounts. As I mentioned in my January 2011 *Trusts &Estates* column,[2] there have been numerous cases involving inherited IRAs and the decisions are all over the lot. Under this amendment, inherited IRAs will receive the same protection from a beneficiary's creditors as was previously only available to the participant.

Self-settled Trusts

Perhaps the most written about development was the recent decision by the Bankruptcy Court in Alaska, which negated the protection of an Alaska self-settled trust. *In re Mortensen*[3] provides a first look at how one bankruptcy court interprets the Bankruptcy Code Section 548(e)'s 10-year fraudulent transfer rule. Section 548(e)(1), which was enacted as part of the

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Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that:

> In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—
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> (A) such transfer was made to a self-settled trust or similar device;
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> (B) such transfer was by the debtor;
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> (C) the debtor is a beneficiary of such trust or similar device; and
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> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

Though *Mortensen* is of interest as a case of first impression, it's otherwise an unremarkable decision. It holds only that the debtor's transfer was made with an actual intent to hinder, delay or defraud his creditors and, since the transfer was to a self-settled trust, the 10-year statute of limitations period applied.

Thomas Mortensen, a resident of Alaska, without the aid of counsel, drafted a trust document in 2005 called the "Mortensen Seldovia Trust (An Alaska Asset Preservation Trust)," intending for the trust to qualify as an asset protection trust under Alaska law. Thomas deeded his interest in a parcel of land to the trust. Allegedly, that transfer was pursuant to an oral agreement between Thomas and his mother, whereby Thomas would transfer the land to the trust to preserve it for his children, and Thomas' mother would pay him $100,000 in consideration for the transfer. Thomas claimed that he used some of the funds his mother paid him to settle existing debts and that he transferred approximately $80,000 to a brokerage account in the name of the trust as seed money for operating expenses related to the property.

The silver lining of Section 548(e) is that it actually validates self-settled trusts after 10 years have elapsed.

Following the creation and funding of the trust, Thomas' financial condition deteriorated further and his income became sporadic. Ultimately, he filed for bankruptcy approximately four and a half years after the creation and funding of the trust. Although the Bankruptcy Court concluded that Thomas wasn't, in fact, insolvent when he established and funded the trust, it turned its analysis to the claim that Thomas' transfer of the land to the trust fell under Section 548(e) of the Bankruptcy Code, which it sustained.

Some practitioners have been quick to conclude that *Mortensen* should be read as enabling a bankruptcy trustee to reach any assets transferred to a self-settled trust during the 10 years following its creation, thereby vitiating the utility of any and all DAPTs, at least for the first 10 years of their existence. But, is that really the implication?

Unfortunately, the Bankruptcy Court agreed with the bankruptcy trustee's argument that Thomas' bad intent could be inferred from the trust language itself, because the trust agreement set forth its stated purpose as being, in part, "… to maximize the protection of the trust estate or estates from creditors' claims of the Grantor …"

The Bankruptcy Court cited other badges of fraud, which it found to constitute persuasive evidence of Thomas' intent to hinder, delay and defraud present and future creditors. Specifically, the Bankruptcy Court cited to the facts that "Mortensen was coming off some very lean years at the time he created the trust …" and that "Mortensen's transfer of the Seldovia property and the placement of $80,000 into the trust constitutes persuasive evidence of an intent to hinder, delay or defraud present and future creditors."

By using these asset protection trust laws to make completed gifts of their lifetime exemptions, clients can demonstrate that the trust's primary purpose isn't to avoid future creditors.

If there's any lasting significance to the *Mortensen* decision, it will almost certainly be that the continuing uncertain application of Section 548(e) of the Bankruptcy Code requires clients who wish to establish the most protective self-settled trust possible to continue to go offshore—at least for the first 10 years of the trust's existence. After 10 years have elapsed without a creditor issue developing, such trusts can safely migrate onshore, because the silver lining in connection with the enactment of Section 548(e) is that it actually validates self-settled trusts when more than 10 years have elapsed.[4]

Have Your Cake and Eat It Too

Perhaps of greatest significance from a pure estate-planning perspective is the fact that these self-settled trusts may be most advantageous in helping our clients use their $5.12 million dollar exemption. I've had many clients resist our recommendation to take advantage of this possible once in a lifetime opportunity to reduce their estate tax burden for fear of needing the funds, should they experience a financial reversal. By using these asset protection trust laws to make completed gifts of their lifetime exemptions, clients can demonstrate that the trust's primary purpose isn't to avoid future creditors. These trusts can allow the client to be a discretionary beneficiary of a trust that, barring any implied understanding with the trustee or an actual pattern of distributions, won't be includible in the client's estate. By following the road map laid out in Private Letter Ruling 200944002 (Oct. 30, 2009) and funding a self-settled trust in a DAPT state (which has no exception creditor provisions), our clients can now have their cake and eat it too!

Endnotes

1. *Olmstead v. Federal Trade Commission*, 2010 Fla. LEXIS 990 (June 24, 2010).
2. Gideon Rothschild, "Staying Out of Reach," *Trusts & Estates* (January 2011) at p. 33.
3. *In re Mortensen* (*Battley v. Mortensen*, Adv. D.Alaska, No. A09-90036-DMD, May 26, 2011).
4. For a detailed analysis of the *Mortensen* decision, *see* "Fraudulent Transfer Claims," by John E. Sullivan III, Mark Merric, Robert D. Gillen, Alexander A. Bove, Jr. and Richard W. Nenno, *Trusts & Estates* (December 2011) at p. 43.

SPOT LIGHT

Holy Mackerel! "A Mackerel Boat—The Run Home," (17.2 in. by 26.1 in.) by Charles Napier Hemy, sold for $8,138 at Christie's Maritime Art Sale in London on Nov. 24, 2011. Born in Newcastle-on-Tyne, Hemy spent time as a merchant seaman and even lived aboard a floating studio to better capture his subjects.