

Adding Protective Measures to Commonly Utilized Estate and Business Planning Vehicles

Tulsa Estate Planning Forum

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Is it Appropriate for Estate Planning Attorneys to Render Asset Protection Advice?

- ◆ Some commentators suggest that estate planning attorneys have a duty to render asset protection advice
- ◆ Most estate planning advice has an asset protection or wealth preservation component
 - premarital or post marital agreements – protection against spousal creditors
 - entity structures – protection against business and other third party creditors
 - wills & trusts – protection against governmental and other third party creditors
 - disability documents – protection against unwanted personal results

How Do You Know Whether a Client Needs Asset Protective Measures?

- ◆ Every client needs asset protection to some degree
- ◆ The greater the client's net worth the more difficult it is to achieve asset protection without taking more sophisticated protective measures

Isn't Asset Protection Against Public Policy?

- ◆ “[T]he doctrine that the owner of property, in the free exercise of his will in disposing of it, cannot dispose of it, but that the object of his bounty . . . must hold it subject to the debts due his creditors . . . is one which we are not prepared to announce as the doctrine of this court. . . . **[E]very State in this Union has passed statutes by which a part of the property of the debtor is exempt from seizure [for] the payment of his debts. . . . To property so exempted the creditor has no right to look** . . . as a means of payment when his debt is created [and] this court has steadily held that [such exemptions are] invalid as to debts then in existence [but] as to contracts made thereafter, the exemptions [are] valid. This distinction is well founded in the sound and unanswerable reason, that the creditor is neither defrauded nor injured by the application of the law to his case, as he knows, when he parts with the consideration of his debt, that the property so exempt can never be made liable to its payment.”¹

¹ Nichols v. Eaton, 91 U.S. 716, 725-726 (1875) (Justice Samuel Freeman Miller).

Creditor Protection: Fraudulent Transfer Law

- ◆ General rule
 - A gratuitous transfer of property with the actual or constructive INTENT to avoid creditors is fraudulent and may be set aside by creditors
 - Any transfer of assets from nonexempt status to exempt status should be tested to assure that it is not a fraudulent transfer
- ◆ Three classes of creditors
 - Present creditor – solvency analysis
 - Potential subsequent creditor – badges of fraud
 - Unknown future creditor

Creditor Protection: Fraudulent Transfer Law (cont.)

◆ Statute of limitations

- Statute of limitations on fraudulent transfer claims in most states is four years or, if later, within one year of when the transfer could reasonably have been discovered
- A bankruptcy trustee can have a fraudulent transfer set aside if the transfer is made within two years of bankruptcy - certain transfers to a self-settled trust or similar device subject to a ten year statute of limitations

Solvency Test

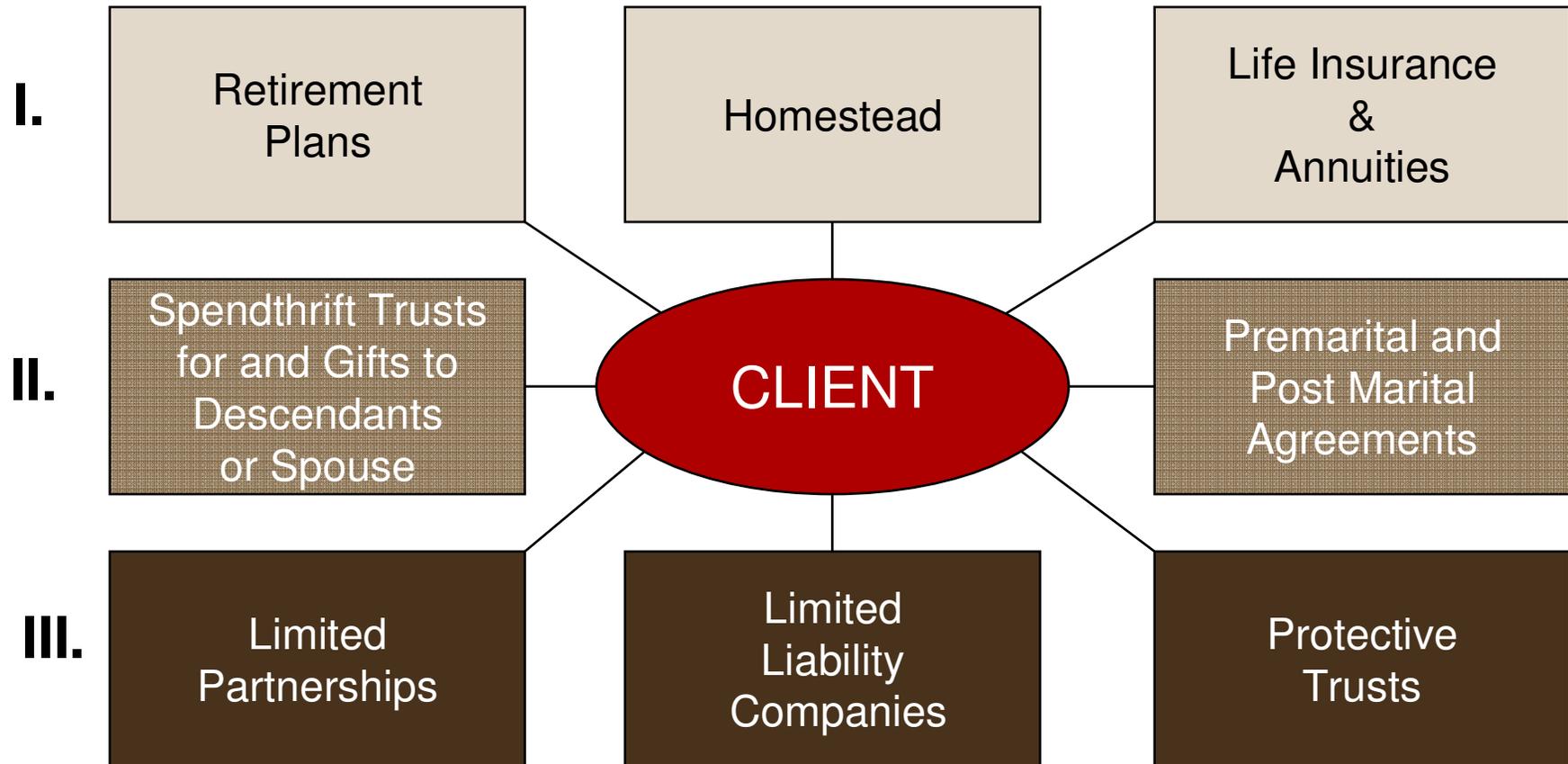
Total value of assets

Less: Liabilities (including contingent)

Less: Creditor protected assets (e.g., homestead)

Equals: Amount that can be transferred

Tools Which Can be Used to Achieve Asset Protection



Retirement Plans: Advise Clients to Fund (or Establish if Necessary) Retirement Plans

- ◆ In most states, unlimited exemption as long as the plan “qualifies” under the Internal Revenue Code
- ◆ ERISA contains anti-alienation provisions
- ◆ Fully protected in bankruptcy if they are exempt from taxation under IRC §§401, 403, 414, 457, or 501(a)
- ◆ Protection for IRAs (under IRC §§408 and 408A) in bankruptcy capped at \$1,000,000 adjusted for inflation (currently \$1,171,650)
- ◆ Rollover amounts to IRAs are excluded from bankruptcy cap

Homestead: Advise Clients to Fund Homestead

- ◆ State homestead exemptions based upon either acreage (for example, Florida, Texas, and Kansas) or value (for example, California and Missouri)
- ◆ 2005 Bankruptcy Act Amendment possibly limits equity obtained in homestead during 40 months prior to bankruptcy to \$125,000 adjusted for inflation (currently \$146,450)

Homestead: Kansas and Missouri

- ◆ Kan. Stat. Ann. §60-2301 exempts a residence (including a mobile home) together with improvements with no value limitation; acreage limited to 160 acres of farming land or 1 acre within the city limits
- ◆ Mo. Ann. Stat. §573.475 exempts a dwelling house and appurtenances and surrounding land, together with rental issues and products of the homestead, subject to an aggregate value limit of \$15,000 (mobile homes have an aggregate value limit of \$5,000)

Homestead: Protective Planning Opportunities

- ◆ Move available cash into the homestead
- ◆ If there is no available cash then consider moving equity out of other assets and into the homestead
- ◆ If the client desires more aggressive homestead protection than is offered by the state of residence, consider advising the client to establish residence in a state with greater homestead protection (for example, a move from Missouri to Kansas)

Life Insurance and Annuities: Advise Clients to Purchase One or More Policies

- ◆ Many states exempt cash value and policy proceeds of life insurance and annuities, even if the insured retains the power to change the beneficiary or the insured or the insured's estate is a contingent beneficiary
- ◆ In some states this exemption extends to policy proceeds in the hands of the beneficiary and protects those proceeds from the beneficiary's creditors as well

Life Insurance and Annuities: Kansas and Missouri

◆ Kansas

- Cash value and proceeds are exempt if payable to a beneficiary other than the insured's estate. Kan. Stat. Ann. §40-414; *Shawnee State Bank of Topeka v. Royal Union Life Ins. Co. of Des Moines, Iowa*, 127 Kan. 456, 279 P. 132 (1929)
- Cash value is not exempt for policies issued within one year of execution on a judgment by a creditor. Kan. Stat. Ann. §40-414(b)

◆ Missouri

- Mo. Ann. Stat. §513.430 exempts cash value
- Proceeds are not exempt

Life Insurance and Annuities: Protective Planning Opportunities

- ◆ Advise the client to move exposed cash into a life insurance or annuity product that is protected under the state statute
- ◆ If the costs of the product are low enough (both the product and tax costs) then the purchase will be both a good investment and a prudent protective device
- ◆ If the product chosen is life insurance rather than an annuity then the investment return inside the product will also avoid income tax

Life Insurance and Annuities: Protective Planning Opportunities (cont.)

- ◆ If there is no available cash then consider moving equity out of other assets and into the life insurance or annuity contract

Section 529 Plans: Advise Clients to Fund Section 529 Plans

- ◆ Some states exempt the assets held in §529 plans if the debtor and the plan assets are held by that state's authorized plan
- ◆ Other states, like Texas, exempt the plan assets regardless of where the assets are held as long as they are held in a state qualified tuition program that meets the requirements of IRC §529

Section 529 Plans: Advise Clients to Fund Section 529 Plans (cont.)

- ◆ Bankruptcy Code exempts funds in §529 plans but generally limits the exemption to the contribution limits contained in §529 and specifically limits the exemption by completely disallowing contributions made 1 year before bankruptcy and only exempting contributions that do not exceed \$5,000 per beneficiary that were made between 2 years and 1 year before bankruptcy
- ◆ In states that allow debtors to choose state rather than federal bankruptcy exemptions §529 plans may be fully exempt in bankruptcy

Section 529 Plans: Kansas and Missouri

- ◆ Kan. Stat. Ann. §75-646(q) exempts from attachment assets held in §529 Plans
- ◆ No state statutory protection in Missouri

Section 529 Plans: Protective Planning Opportunities

- ◆ Because Section 529 Plan assets can be used to benefit any beneficiary, including the Grantor, the plan assets can be a valuable protected class of assets
- ◆ Move available cash into Section 529 Plans
- ◆ If there is no available cash then consider moving equity out of other assets and into Section 529 Plans

What is a Spendthrift Trust?

A spendthrift trust is one in which the beneficiary is precluded or restrained from voluntary or involuntary transfers of trust assets. In some states, this includes a prohibition on the ability to pledge as collateral any interest in a trust. The consequences of these types of provisions in trust documents is that the beneficiary's creditors are precluded from reaching trust assets. In most states, settlors cannot utilize a spendthrift trust to protect assets from the settlor's creditors.

Spendthrift Trusts

- ◆ Primarily statutorily created – not a part of English common law
- ◆ Some states have no spendthrift statutes, but judicial decisions have validated spendthrift provisions (for example, Hawaii, Maryland, Massachusetts, Michigan, Minnesota, and Vermont)
- ◆ Spendthrift protection is being eroded by statute and by precedent
- ◆ Uniform Trust Code 2000 contains provisions validating spendthrift provisions in trusts and addressing rights of settlor's creditors

Advise Clients to Form and Fund Trusts for Family Members With Spendthrift Protection

◆ Trusts for Descendants

- Crummey Trust
 - \$13,000 per donee annual exclusion possible
- §2503 (c) Trust
 - Contributions to trusts for children under age 21 are not gifts of a future interest
- Life insurance trust

Advise Clients to Form and Fund Trusts for Family Members With Spendthrift Protection (cont.)

- ◆ Inter vivos QTIP after partition
 - All income to spouse required, but document can disallow distribution of principal on the happening of some event like divorce
 - Consider funding interest in the family business into an inter vivos QTIP

Spendthrift Trusts: Protective Planning Opportunities

- ◆ Draft the trust document to contain a purely discretionary distribution standard rather than an ascertainable standard
- ◆ Consider forming the trust in a jurisdiction that has either repealed the common law rule against perpetuities (for example, Delaware, South Dakota, or Arizona) or has extended the perpetuities period (for example, Alaska – 1,000 years, Florida and Tennessee – 360 years, Nevada – 365 years)

Spendthrift Trusts: Protective Planning Opportunities (cont.)

- ◆ Include a provision stating that it is the Settlor's intention that all property of the trust will be the separate property of the beneficiaries and that no property of the trust will be the communal or marital property of any beneficiary
- ◆ Include provisions allowing the trustee to change the situs or governing law of the trust
- ◆ Include provisions allowing for amendment of the trust document by either the trustee or protector

Spendthrift Trusts: Protective Planning Opportunities (cont.)

- ◆ Consider establishing the trust in an asset protection jurisdiction like Nevada or Alaska and allowing the settlor to be a permissible beneficiary (see PLR (200944002))

Advise Clients to Enter Into Premarital and Post Marital Agreements

- ◆ Properly drafted marital agreements create clearly defined property parameters, thereby lessening exposure to each other on divorce
- ◆ In the case of second or successive marriages or other relationships, property agreements will protect children and other interested parties on the death of one of partners to the marriage or other relationship
- ◆ Properly drafted marital agreements can segregate property of the underexposed spouse so that creditors cannot reach them

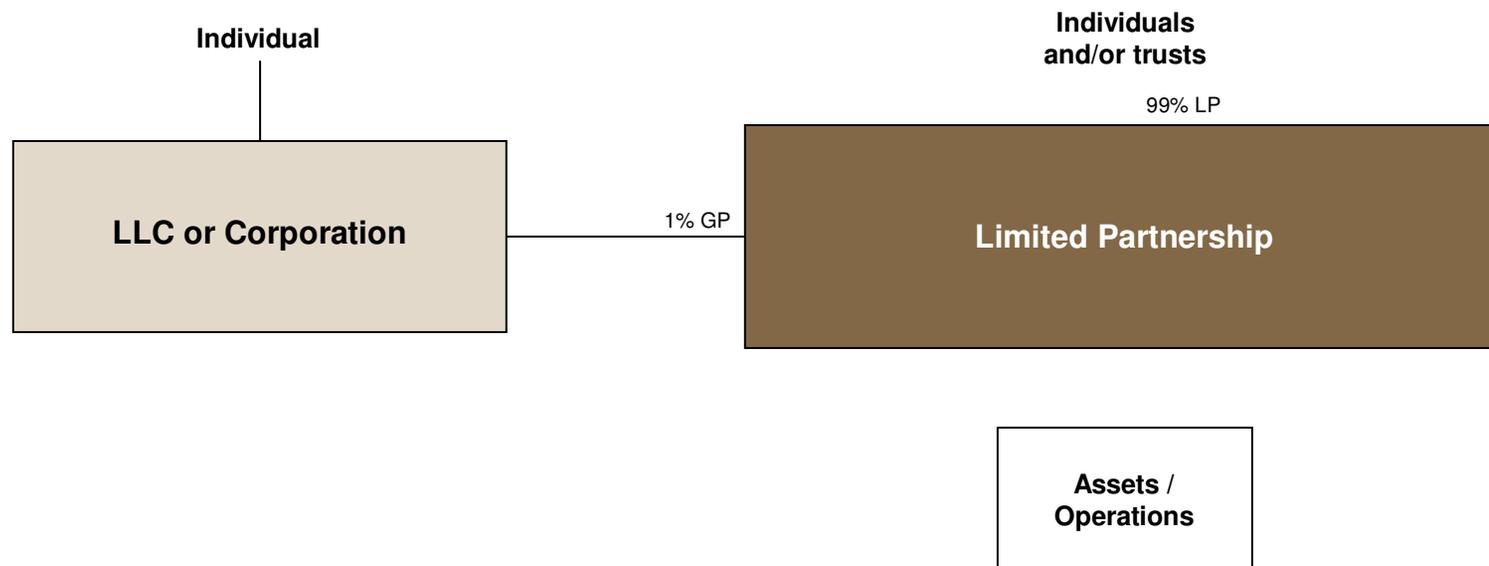
Marital Property Agreements: Protective Planning Opportunities

- ◆ If the creditor concern is third parties rather than spouses, divide assets so that the exposed spouse's assets consist of exempt assets and so that the unexposed spouse's assets consist of nonexempt assets
- ◆ Consider unequally severing the assets so that the exposed spouse receives less than the unexposed spouse, and then the unexposed spouse can create an *inter vivos* QTIP for the benefit of the exposed spouse

Planning reminder – in community property states, this type of planning causes a loss in the basis step up in the surviving spouse's property so it must be used cautiously and in a considered fashion.

Limited Partnerships

- ◆ General partner manages the entity and is liable for partnership liabilities
- ◆ Limited partners liable for partnership liabilities only to extent of contribution to partnership



Evolution of Limited Partnerships

- ◆ Man has utilized partnerships to conduct his affairs with others from the beginning of time—evidence of use in Babylon, classical Greece, and Rome.¹
- ◆ General partnerships are simply contracts among individuals who have joined together for a common, usually commercial, purpose.
- ◆ Forerunner of the limited partnership was the *commenda* by which nobles and clergy, who had the capital but could not directly engage in commercial enterprise, could obtain the benefits of such enterprise without personal liability. The result being that capital that would have otherwise been unavailable to the merchant and trading classes provided the foundation for the elevation of these classes to influential status.²

¹ Bromberg & Ribstein, “Partnership” Vol. I, §1.02(a)

² Bromberg & Ribstein, “Partnership” Vol. III, §11.02(a)

Evolution of Limited Partnerships (cont.)

- ◆ England codified its common law and mercantile law concerning partnerships in the Partnership Act of 1890 and its Limited Partnership Act in 1907³
- ◆ The U.S. codified its partnership common law in 1914 in the Uniform Partnership Act
- ◆ Early limited partnership law in the U.S. was codified only at the state level and was based on the French Commercial Code of 1807, Sections 23-28, because of its unique provisions avoiding the doctrine of partnership liability to third persons

³ Bromberg & Ribstein, "Partnership" Vol. I, §1.02(b)

Evolution of Limited Partnerships (cont.)

- ◆ The first Uniform Limited Partnership Act was codified in 1916 and it reduced the liability exposure of limited partners from that contained in existent state statutes
- ◆ The Revised Uniform Limited Partnership Act (1976) was drafted to address the needs of the large, multi-partner partnerships that were in existence at that time and moved closer to the corporate or entity model than the earlier aggregate model
- ◆ 2001 revision of the Uniform Limited Partnership Act has produced the Uniform Limited Partnership Act (2001)

Limited Liability Companies

- ◆ Limited liability vehicles should be used to contain liability to the extent of contribution to the entity
- ◆ Multiple limited liability companies may be used to sequester liability exposure
- ◆ Corporate formalities must be followed
- ◆ Taxed as a disregard if there is a single owner and as a partnership if there are multiple owners

Evolution of Limited Liability Companies

- ◆ Historically a South American concept
- ◆ Wyoming was first state to adopt an LLC Act effective June 20, 1977, which created an entity that provided owners with limited liability from business debts like a corporation but is taxed as a partnership
- ◆ Hamilton Brothers Oil Company formed a Wyoming LLC in 1977 and immediately applied to the IRS for an administrative ruling that it qualified as a partnership for federal income tax purposes
- ◆ IRS granted the ruling on a private basis in 1988 (Rev Rul 88-76)
- ◆ By 1996 every state had enacted an LLC Act
- ◆ Most modeled on partnership statutes because of desire to be taxed as partnership
- ◆ Since IRS issuance of the Check the Box Regulations in 1997, which provide absolute tax certainty with regard to LLCs, partnership characteristics are no longer necessary and are being removed from the state statutes

What is the Third Party Creditor Issue in the Limited Partnership and Limited Liability Company Context?

Can a creditor of an individual partner or member reach the debtor's interest in the entity, the management rights held by the debtor, or the underlying entity assets?

The Key Components of This Issue Are:

1. Charging order
2. Foreclosure
3. Ability of creditor to force a dissolution of the entity

Charging Order

A charging order is an order issued by a court pursuant to statute which charges the debtor's interest in the entity with the amount due to the judgment creditor. Under a charging order, the creditor only gets distributions from the entity to the extent of the debt. Once the debt is extinguished, the charging order is fulfilled. The debtor's interest in the underlying partnership or company assets is preserved.

Foreclosure

If a creditor's lien on a debtor's interest in a partnership is foreclosed upon, the debtor loses the partnership interest and all of the future benefit in that interest forever (even if that benefit greatly exceeds the debt) including a right to that partner's pro rata share of the new assets at liquidation (The Uniform Limited Partnership Act (2001) §702(b)). In addition, upon foreclosure, the debtor-partner may also lose the managerial rights afforded him by §702(b) if the other partners consent to expel him in accordance with §601(b)(4). Depending on the relationship with the other partners, this could be incentive for the partner to settle with the creditor instead of forcing a settlement the other way around.

Ability to Force a Dissolution of the Entity

- ◆ Limited Partnership — Creditors do not have ability to force a dissolution of the partnership
- ◆ Limited Liability Company — Section 503 of the Uniform Limited Liability Company Act (1996) allows a transferee after foreclosure to force a dissolution of the company
 - Dissolution of an LLC has also occurred in the bankruptcy context
- ◆ Limited Liability Company — Section 503 of the Revised Uniform Limited Liability Company Act (2006) does **not** allow a transferee after foreclosure to force a dissolution of the company

Limited Partnerships

Two Versions of Creditor's Rights Statute

Revised Uniform Limited Partnership Act (1976) with the 1985 Amendments

The Uniform Limited Partnership Act (2001)

Limited Partnerships

Revised Uniform Limited Partnership Act (1976) with the 1985 Amendments

“§703 Rights of Creditor

On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This [Act] does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest.”

Limited Partnerships

The Uniform Limited Partnership Act (2001)

“§703 Rights of Creditor of Partner or Transferee

- (a) On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the transferable interest of the judgment debtor with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of a transferee. 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 partnership and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances of the case may require to give effect to the charging order.
- (b) **A charging order constitutes a lien on the judgment debtor’s transferable interest. The court may order a foreclosure upon the interest subject to the charging order at any time. The purchaser at the foreclosure sale has the rights of a transferee.**
- (c) At any time before foreclosure, an interest charged may be redeemed:
 - (1) by the judgment debtor;
 - (2) with property other than limited partnership property, by one or more of the other partners; or
 - (3) with limited partnership property, by the limited partnership with the consent of all partners whose interests are not so charged.
- (d) This [Act] does not deprive any partner or transferee of the benefit of any exemption laws applicable to the partner’s or transferee’s transferable interest.
- (e) This section provides the exclusive remedy by which a judgment creditor of a partner or transferee may satisfy a judgment out of the judgment debtor’s transferable interest.”

Limited Liability Companies

Four Versions of Creditor's Rights Statute

Uniform Limited Partnership Act (1976) - Derived

Uniform Limited Liability Company Act (1996) with Dissolution Provision

Uniform Limited Liability Company Act (1996) without Dissolution Provision

Revised Uniform Limited Liability Company Act (2006) without Dissolution Provision

Limited Liability Companies

Uniform Limited Liability Company Act (1996)

“§ 504. Rights of creditor.

- (a) On application by a judgment creditor of a member of a limited liability company or of a member's transferee, a court having jurisdiction may charge the distributional 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 and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances may require to give effect to the charging order.
- (b) **A charging order constitutes a lien on the judgment debtor's distributional interest. The court may order a foreclosure of a lien on a distributional interest subject to the charging order at any time. A purchaser at the foreclosure sale has the rights of a transferee.**
- (c) At any time before foreclosure, a distributional interest in a limited liability company which is charged may be redeemed:
 - (1) by the judgment debtor;
 - (2) with property other than the company's property, by one or more of the other members; or
 - (3) with the company's property, but only if permitted by the operating agreement.
- (d) This [Act] does not affect a member's right under exemption laws with respect to the member's distributional interest in a limited liability company.
- (e) This section provides the exclusive remedy by which a judgment creditor of a member or a transferee may satisfy a judgment out of the judgment debtor's distributional interest in a limited liability company.“

“§ 503. Rights of transferee

..(e) A transferee who does not become a member is entitled to: . . .

MORGAN ADLER & SECKLER, LLP **judicial determination that it is equitable to dissolve** and wind up the company's business.”

Limited Liability Companies

Uniform Limited Liability Company Act (2006)

“§ 503. Charging Order.

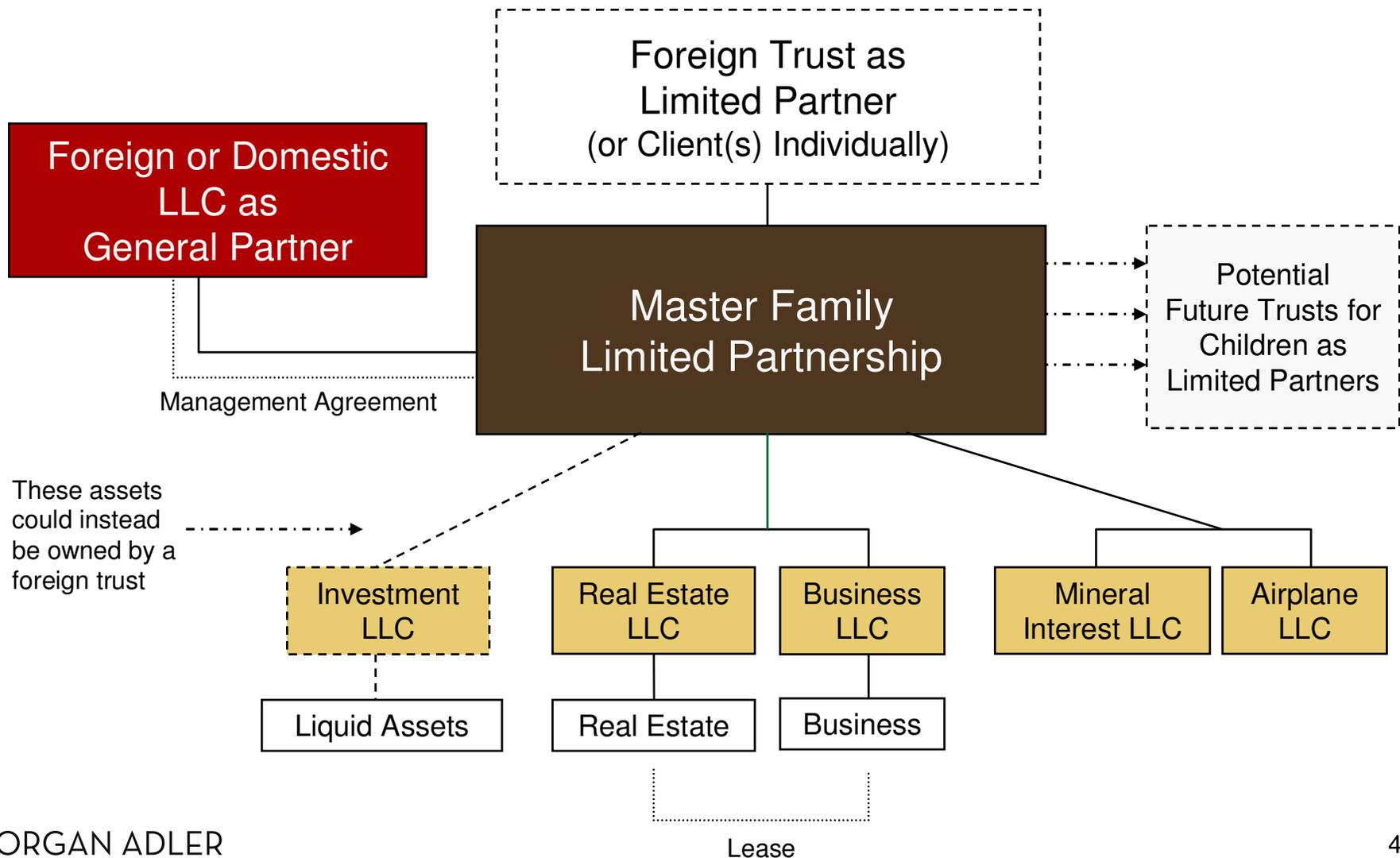
- (a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor.
- (b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may:
 - (1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and
 - (2) make all other orders necessary to give effect to the charging order.
- (c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale only obtains the transferable interest, does not thereby become a member, and is subject to Section 502.
- (d) At any time before foreclosure under subsection (c), the member or transferee whose transferable interest is subject to a charging order under subsection (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.
- (e) At any time before foreclosure under subsection (c), a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.
- (f) This [act] does not deprive any member or transferee of the benefit of any exemption laws applicable to the member's or transferee's transferable interest.
- (g) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment from the judgment debtor's transferable interest.”

Limited Partnerships and Limited Liability Companies: Protective Planning Opportunities

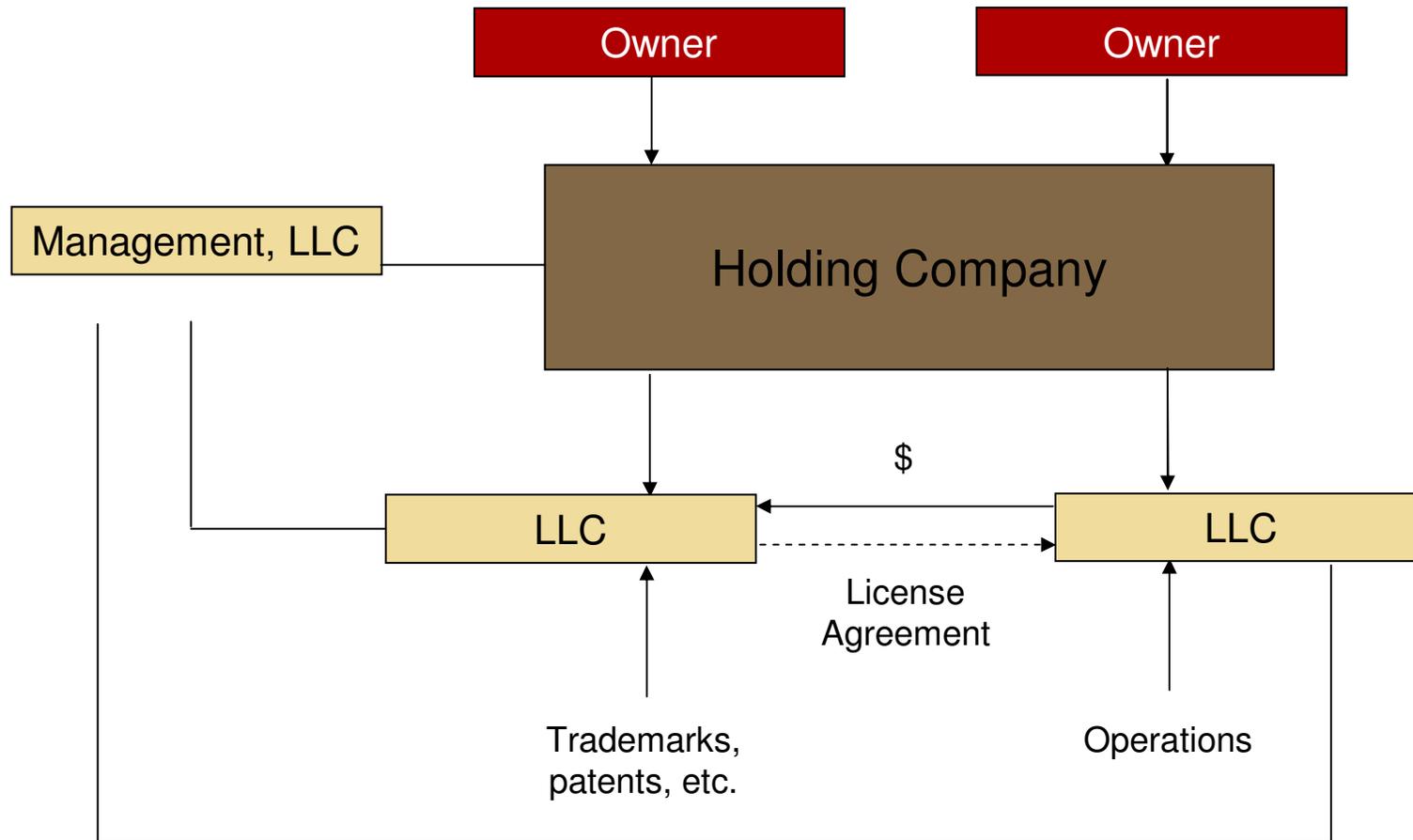
- ◆ Establish entities in protective jurisdictions
- ◆ Draft operating, company, and/or partnership agreements to restrict transferability of interests
- ◆ Use supermajority provisions to protect control of the entity
- ◆ Transfer control of the entity away from any creditor exposed owner
- ◆ Segregate entity assets into separate entities

Entity Structural Options

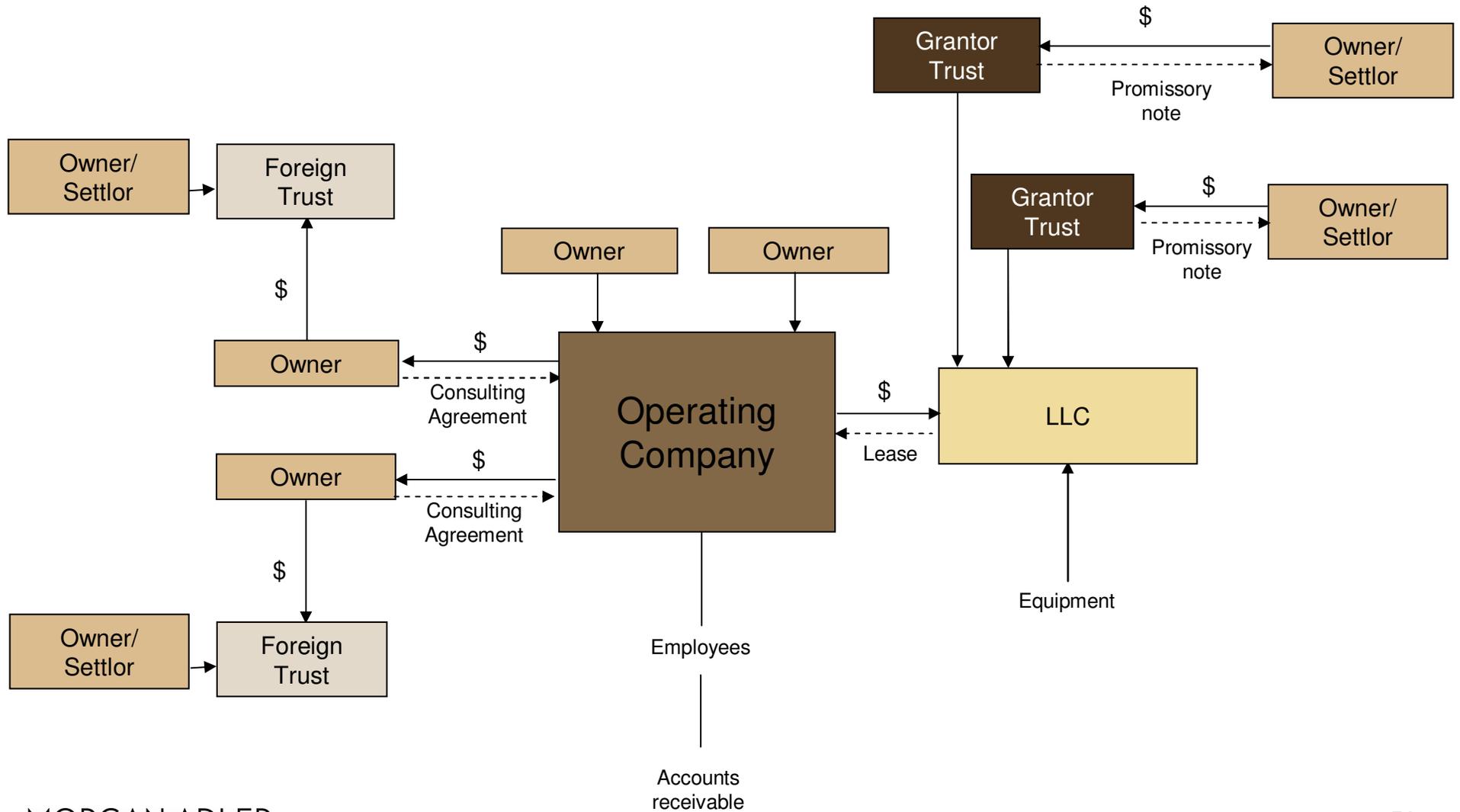
Master Family Limited Partnership Structure



Centralized Holding Company Structure



Decentralized Business Structure



Protection for Accounts Receivable

- ◆ Professional firm assets are primarily accounts receivable rather than hard assets
- ◆ To the extent that contractual liens can be created over the accounts receivable, the creditors holding such liens will have priority over subsequent creditor liens or judgments

Accounts Receivable Leveraged Transaction

