Asset Protection for the Rest of Us

Estate Planning Council of Greater Miami

March 19, 2015

Patrick J. Lannon, Esq.
Board Certified Specialist in Wills, Trusts and Estates
Bilzin Sumberg Baena Price & Axelrod LLP
plannon@bilzin.com

Asset Protection for the Rest of Us

Estate Planning Council of Greater Miami

March 19, 2015

Asset Protection - Or Wealth Preservation?

Asset protection is often presented as a standalone legal specialty focused on assisting clients who are at a high risk of significant loss. Accordingly, attorneys with an asset protection focus are often specialists in offshore trusts and other complicated, expensive, structures that are not accessible to the average client. Increasingly, however, estate planners are incorporating asset protection - perhaps better phrased as "wealth preservation" - into estate plans created for clients who are not experiencing a high risk of loss. Estate planning that has wealth preservation as only a secondary goal should by its nature be more effective in thwarting creditor claims than stereotypical last minute "asset protection." This presentation will describe a comprehensive approach to wealth preservation to be implemented routinely for wealthy, and sometimes not so wealthy, clients.

The Goal of Wealth Preservation

Wealth preservation is ***seldom*** about creating a foolproof "lock box" for all, or even some, of the client's assets - especially if the client wants to control and/or have access to the assets in the future. Rather, wealth preservation planning usually focuses on protecting a nest egg and creating ***barriers*** to future creditors. The complexity, expense, and inconvenience of each strategy must be weighed against the protection offered and the realistic likelihood of future creditor claims on a case by case basis. Wealthy clients who are more concerned about return ***of*** their capital than return ***on*** their capital are good candidates for wealth preservation planning. In an environment of high applicable exclusion amounts and portability wealth preservation has replaced estate tax planning as an important motivating factor in many estate plans.

Tailored Strategies

Specific wealth preservation strategies must be tailored to the client's individual situation. For example, a client concerned about contractual liability might want to start with a review of the relevant contracts and perhaps renegotiate them to reduce liability. A client worried about divorce, on the other hand, might start with a prenuptial or postnuptial agreement. One size does not fit all for wealth preservation planning.

Specific Guidance

I. First, Do No Harm - voidable (fraudulent) transfers

   a. Florida Statutes § 726.105 provides in part:

   > "(1) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(a) With actual intent to hinder, delay, or defraud any creditor of the debtor; or

(b) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

1. Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

2. Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due."

b. While such transfers have traditionally been referred to as "fraudulent" transfers, the new Uniform Act (not yet adopted in Florida) refers to "voidable" transfers to alleviate the confusion of attorneys, clients, and courts alike that such transfers have some relation to common law fraud.

c. Note that transfers may be voidable not only as to current creditors but also as to reasonably foreseeable future creditors. As a result, it may be too late to effectively assist a client who is in a rush to put an asset protection plan in place - the client may already be aware of potential future creditors. This distinction is lost on many clients who will insist they have no creditors even if they expect they may have creditors.

d. Note that even traditional estate planning involving gifts may result in a voidable transfer.

e. A voidable transfer not only risks creditor access to the transferred assets, it also may prevent discharge in bankruptcy. This can result in a very bad result for the client - submitting all of his or her assets to control of a bankruptcy trustee without the possibility of a clean slate discharge of debts.

f. A bankruptcy court may look back 10 years, rather than the shorter state statute of limitations, so clients should start wealth preservation planning as early as possible.

g. A planner may want to obtain a financial statement and affidavit of solvency in appropriate cases to help rebut any future creditor claims. A planner should certainly memorialize the legitimate non-asset protection purposes of a plan to show no "actual intent."

II. Common Wealth Preservation Strategies - And Their Limitations

a. Insurance. Clients who have specific creditor concerns may choose to purchase extra insurance instead of, or in addition to, other wealth preservation strategies. For example:

i. Malpractice insurance.

ii. Long term care insurance (to free up other assets for paying creditors).

iii. Life insurance (to provide an inheritance even for an insolvent estate).

iv. Casualty insurance with umbrella coverage.

v. D&O coverage.

vi. Insurance for trustees for fiduciary liability.

b. Statutory protections in Florida.

i. Homestead.

1. Pay off mortgage.

2. Trade up to more valuable residence.

3. Add expensive fixtures - golden doorknobs.

4. Keep in mind acreage limitations, lien for proceeds of fraud, and bankruptcy limitations.

ii. IRA, 401K, 529 Plan.

1. Inherited IRAs are protected in Florida, but what if the beneficiary is not in Florida? Consider using a trust to hold inherited IRA accounts.

iii. Annuities (§ 222.14).

1. Private annuity?

iv. Cash value life insurance (§ 222.14).

1. Many clients find life insurance to be an expensive investment, if they are not otherwise interested in the death benefit. Others view it as a tax free vehicle for investment for retirement.

c. Tenancy by the entireties.

i. There is some question whether one spouse can unilaterally fund a TBE account and have the creditor protections apply, since the account would lack the unities of time and title. This does not apply to real estate, which has a clear statute on point.

ii. TBE property is subject to the joint debts of the married couple.

iii. TBE property loses its protection if the non-creditor spouse dies first.

iv. Divorce can be an issue.

v. Some states have adopted statutory tenancy by the entireties trusts. Do these work for Florida residents?

d. Gifts. Clients often choose to give away assets in excess of their projected needs.

i. Assuming no voidable transfer, and assuming gift tax issues can be avoided (for example, through use of the annual exclusion, marital deduction, or lifetime applicable exclusion amount) this can be a very powerful technique.

ii. Trusts are often used to protect the assets from the recipients creditors as well, and to control access to the funds after the gift is made.

1. Trusts should for maximum protection be discretionary and contain spendthrift language.

2. The court in *In re Castellano* 2014 WL 3881338 (Bk. N.D. Ill. Aug 6, 2014) refused to shield trust assets where the trust terms were open to the interpretation that distribution to a spendthrift trust was only made because of the beneficiary's direction, and where the trustee was a close family member. Careful drafting and an independent trustee would likely have led to a different result.

3. In *Berlinger v. Casselberry*, 133 So.3d 961 (2013) the court allowed a former spouse access to distributions from a spendthrift trust for alimony. Some attorneys are recommending that trusts be moved out of Florida to avoid this result. One option for future trusts is to include a provision conditioning beneficiary status on the execution of a prenuptial agreement whereby any spouse of a beneficiary foregoes any right (i) to trust distributions or (ii) to have the trust assets taken into account in any way upon divorce.

4. One popular version is a spousal lifetime access trust, or SLAT. This is a trust where one spouse gifts assets for the lifetime benefit of the other spouse. If reciprocal trust concerns are accounted for, the other spouse may also create a SLAT for the first spouse. In this manner, each spouse has indirect access to the assets he or she has given away, based on the expectation (but without any prior arrangement) that should the donor in the future become insolvent the beneficiary spouse would use trust distributions for the joint benefit of the married couple.

a. A major weakness of the SLAT (or its less sophisticated relative, the outright gift to a spouse) is that donor indirect access to the funds ends upon divorce or death of the spouse.

5. A very powerful - but apparently not very popular - version is the inter-vivos QTIP trust. This is a trust where the donor spouse creates a lifetime QTIP trust for the benefit of the recipient spouse - and the donor spouse may in turn receive creditor protected benefits from the trust on the recipient spouse's death.

    a. As with the SLAT, potential divorce is a major stumbling block for this planning. Unlike a SLAT, the trust cannot be drafted to remove the beneficiary spouse's rights on divorce.

6. Clients may also coordinate with their parents and other relatives to receive any expected inheritance in trust for their own benefit, protecting these assets even from known creditors.

    a. For example, a spouse may choose to forego a simple "portability" plan and instead use a credit shelter trust, in order to protect assets from a surviving spouse's later creditors (such as upon a subsequent divorce). Such planning must of course be balanced with income tax concerns.

iii. Prenuptial agreement or postnuptial agreement.

1. A marital agreement can settle entitlements for the largest creditor most clients will ever have - the divorcing spouse.

2. Marital agreements can also protect against outside creditors by clarifying spousal rights. However, they can also backfire spectacularly when used in this manner, upon divorce.

e. Domestic Asset Protection Trust.

i. Noted commentator Gideon Roshschild wrote in Trusts & Estates Magazine (January 2015) that "I've yet to read a court decision that respects these laws when there's no evidence of a "voidable transfer"…." However, at a Heckerling Institute presentation the same month he explained that they can nevertheless be very useful, because any litigation to access such a trust will be long and hard such that most cases will settle. Query whether the litigation will continue to be so long and hard, and settlements favorable, if caselaw continues to be against the DAPT.

1. Potential weaknesses are alter-ego, voidable transfer, and full faith and credit.

2. In *Dahl v. Dahl*, 2015 UT 23, the Utah Supreme Court refused to apply the choice of law provision in a Nevada DAPT, determining

that Utah had a strong public policy in the equitable division of marital assets and so would apply its own law. However the court then decided that the trust, clearly intended to be irrevocable, was revocable.

3. It has been recommended by some commentators that a DAPT will be more difficult to challenge if the grantor is not an initial beneficiary but may be added by a protector in the event of future emergency.

f. Offshore Asset Protection Trust.

i. Offshore asset protection trusts when properly drafted and administered provide very strong protection - perhaps the most powerful technique that allows the donor potential access to the funds.

ii. However, many clients are not willing to transfer assets to "a trustee I do not know in a country I never heard of."

iii. In some notably "bad facts" cases trust creators have gone to jail over their refusal/inability to remove assets from an offshore trust.

g. Entity "Inside" Protection.

i. Entities such as corporations, limited liability companies, and others may be used to limit a creditor of the entity to the entity assets, and thereby protect the owner's other assets. Even a single member LLC works for this purpose.

1. A common example is rental real estate owned by an entity. A claim in connection with the property - for example, for injuries from a fire - may be limited to the assets of the entity.

2. However, an individual may still be individually liable for actions taken on behalf of the entity - for example, for installing electrical wiring incorrectly and so causing a fire.

3. Weaknesses include piercing the corporate veil (ignoring the entity if the entity formalities were not maintained and the entity is inadequately capitalized).

h. Entity "Outside" Protection.

i. Entities such as multi-member limited liability companies limit a creditor to a "charging order" - the creditor steps into the shoes of the debtor for purposes of receipt of distributions, but otherwise may not access the underlying assets or vote the interest.

ii. A creditor receiving only a charging order while the debtor continues to control the underlying assets may be willing to settle in order to receive liquid funds.

iii. Since single member LLCs offer limited protection in Florida (and the protection in other states is not completely certain), an LLC should have at least two members.

iv. LLCs offer many other benefits to the client, including simplification of gifting, creating opportunities for joint investment among family members, and introduction of the younger generation to investment management. LLCs also may offer valuation discounts for estate and gift tax purposes.

v. Planning Tip: Many family businesses are organized as corporations (typically S-Corporations). Why not convert these to LLCs (taxed as S-Corporations for those previously so taxed)? The family then has charging order protection and a more flexible entity structure to work with.

vi. However, LLCs require ongoing expenses and maintenance. A partnership income tax return will be required. Corporate formalities in administration and distributions need to be maintained. Meetings should be held. Annual reports need to be filed.

i. Proactively protecting an estate from creditors.

i. Creditors in Florida may find it very difficult to collect, or even learn about, non-probate assets passing by beneficiary designation or form of ownership. This does not mean they are protected from creditors legally (though some attorneys argue that they may be), but as a practical matter simple titling may put assets beyond the reach of creditors (especially if no probate is opened for two years).

ii. Life insurance death benefit will be protected from creditors if not payable to the estate or available to creditors of the estate. (§ 222.13) Avoid a life insurance beneficiary designation in favor of the estate or in a manner that may allow use of proceeds to pay creditors of the estate.

Combining Techniques

Often the most sensible wealth preservation plan coordinates estate planning (and estate tax planning) with a number of wealth preservation techniques. For example, a client may create a grantor trust Dynasty Trust/SLAT and fund that trust with a 5% (discounted) interest in a newly formed LLC. The rest of the LLC might be held as tenants by the entireties or a portion might be sold to the trust in return for a private annuity.