FROM COMMENT

Practical Guide to Domestic and Foreign-Based Asset Protection Techniques

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Howard Fisher and William Norman provide a comprehensive array of foreign-based asset protection techniques, as well as the counter-techniques that estate planners and wealth managers should be aware of.

Asset protection is the lawful transfer of assets or the establishment of a structure principally for estate planning or business purposes, and not principally for creditor protection reasons. Asset protection, as the phrase implies, is the practice of using a variety of techniques and strategies to conserve accumulated wealth from involuntary transfers to ‘others’. This article will explore some of the fundamentals of the subject.

Asset protection is not an art, but a science built around a thorough knowledge of multiple aspects of the law (eg, litigation, contracting, corporate and taxation), as well as an understanding of rules of multiple jurisdictions, both foreign and domestic.

The Asset Protection Process in a Nutshell

Planners need carefully to qualify a client who intends to restructure the ownership of assets or the transfer of assets. There are two reasons the practitioner needs to take care in advising a client: the numerous civil and criminal violations that could occur in advising a client in the wrong situation; and the potential liability to the client incurred by not meeting their expectations. These are not the only details a practitioner should be aware of, though. The following is what amounts to a checklist for the astute:

- the client should be proceeding with the transfer or restructure primarily for reasons unrelated to creditor protection – the so called 'business purpose'. Specifically, the transferor should not have the specific intent to hinder the collection of debts by any foreseeable creditor.

Taking on a client – deciding which clients not to represent is often the most important decision the advisor has to make:

- the client should not have present creditors including persons with unliquidated claims that will be hindered or disadvantaged by the transfer or restructure;
- the client needs to be fully informed as to the limitations, risks and financial burdens of asset protection planning. This is must be done in writing; and
- the client needs to be psychologically and financially prepared, if the need should arise, to engage in litigation over the propriety of transfers and restructures. They may well need to meet heavy evidentiary burdens to avoid being held in contempt of court should they refuse to make available funds transferred outside the jurisdiction.

The advisor should obtain a 'declaration of solvency' and other representations from the client, in writing, so that if necessary the advisor has the requisite information to defend themselves if the client's information about their financial affairs later turns out to be 'inaccurate.'

Potential Candidates for Asset Protection

In a sense, asset protection is designed to insulate the client from the claims of 'others.' These 'others' may include:

- *spouse:* to minimise claims by a spouse raised by a future marital dissolution proceeding (consider 'premarital' or 'post marital' agreements which have the effect of minimising the impact of otherwise applicable marital rights laws, such as the community property regime). Spouses often have extraordinary right to discovery/information which other creditors do not have access to, and courts often craft extraordinary remedies to protect a spouse;
- *creditor of a child:* to minimise risk of claims by a creditor of a child to whom a gift is to be made (consider making gifts to trust with spendthrift and/or discretionary features), or from the errant actions of the child themselves;
- *clients of a professional:* to minimise risk of claims of future clients and patients (consider a marital property division, establishment of a private retirement plan and/or a so-called domestic asset protection trust, and employ liability limiting contractual provisions in the engagement process);
- *future creditors of a new business owner:* to minimise risk of claims of future creditors (consider use of a limited liability company(LLC), marital property division, establishment of a private retirement plan and/or a domestic asset protection trust or foundation, and have adequate insurance);
- *tort claimants of an owner of high-risk business:* to minimise risk from future tort claimants (consider a marital property division, holding assets in multiple entities, establishment of a private retirement plan and/or a domestic asset protection trust or foundation);
- *buyer of a business:* to minimise risk of claims against a buyer of a business for breaches of warranties and representations of the seller (consider establishment of a private retirement plan and/or a domestic asset protection trust);
- *tort claimants:* to minimise the risk of future tort claimants (consider marital property division, establishment of a private retirement plan and/or a domestic asset protection trust);

- *contractually based claimants:* to minimise the risk of contractual claims (consider including special protection clauses in contracts); and
- *governmental agencies:* to protect against future claims by governmental agencies, eg, the Internal Revenue Service (IRS), Resolution Trust, the state tax authorities and environment-based claims (use extreme care before even considering planning to protect assets against governmental claims – such action can result in criminal liability, eg hindering or money laundering). It is not appropriate to employ asset protection techniques to defeat existing or reasonably anticipated governmental claims. It is a crime to inhibit collection of obligations to the US government – see discussion below, eg: IRC §§ 7201 and 7212, 18 U.S.C. § 371, 18 U.S.C. §§ 1956 and 1957, 28 U.S.C. § 3301 *et seq.*

The Planning Process

An often overlooked aspect of asset protection is 'risk management.' The client should evaluate the sources of potential liability in their personal and business life. The attorney should advise as to actions to limit liability. This could be as simple as carefully crafting agreements between the client and their customers (eg agreement between physician/patient, or landlord/tenant), or it may require restructuring of business operations.

The second consideration is to be sure the client obtains and maintains adequate insurance against as many risks as are foreseeable. In today's litigious society the cost of defending a claim can sometimes be worse than the ultimate liability. Hence the need for insurance that provides both defense and indemnification.

When it comes to the actual planning, most asset protection strategies involve one or more of the following concepts:

- maximisation of the value of exempt assets under the law of the jurisdiction of residency;
- change of non-exempt assets to exempt assets as permitted

under applicable law;
- transfer of outright ownership of assets to another person as permitted under applicable law;
- transfer of assets to a trust for benefit of another person with limited exposure to the creditors of beneficiaries;
- change of the legal form of ownership without significant loss of economic benefits;
- change of ownership of assets so as to require any future claimants to proceed under another legal regime (import foreign law); and
- change of situs of assets so as to subject the assets to another legal regime (export assets).

Techniques

A short list of techniques often employed for asset protection includes the following:

Basic Estate Planning Techniques with Asset Protection Benefits

Outright Gifts; Gifts to Irrevocable Spendthrift Trust; Charitable Trusts (Lead or Remainder); Qualified Personal Residence Trust (QPRTs); Intervivos Irrevocable Trusts with Spendthrift Clauses; Bypass (Exemption) and Marital (QTIP) Trusts with Spendthrift Clauses; Disclaimers; Limited Powers of Appointment; Qualified Retirement Plans and Individual Retirement Accounts (IRAs)

Core Domestic Asset Protection Techniques

Adequate Insurance Umbrella; Fictitious Name Holding Vehicles; Lease Not Buy;

Leveraging Down of Values; Prenuptial Agreement; Corporate Holding of Assets; Community Property Division; Multiple Legal Entities; Homestead for Family Residence; Exemption for Wages;

Exemption for Annuity Contracts; Exemption for Private Retirement Plans

Major Financial Planning Techniques with Asset Protection Benefits

Tenancies by the Entirety for Property in a Qualified Jurisdiction; Family Limited Partnership; LLC; Alaska, Delaware, Nevada, Wyoming or South Dakota Domestic Asset Protection Trust (see attached chart comparing domestic jurisdictions); Redomiciliation to a Major Exemption State; Foreign Irrevocable Trust; Civil Law Foundation; Nevis Single Member LLC.

Unfortunately, as with any benefit, there are often offsetting liabilities. Below is a partial list of some of the countervailing considerations that go into a benefit analysis of any type of asset protection planning:

Fraudulent Transfer Act; Information Disclosures – Creditor Exams and Discovery Orders; Loss of Direct Control; Risk of Civil Contempt by United States (US) Court; Risk of Receivership over US Situs Assets; Anti Money Laundering and Racketeer Influenced and Corrupt Organisations (RICO) Statutes; Regulation of Assisting Professionals; Freeze Orders by Court; Disregard or Sham Treatment; Constructive Trust Over Assets in Trust; Tolling of Statute of Limitations; Reconstruction of Trust Terms by Beneficiary Action; Recognition of California Judgment in Another Jurisdiction; Recognition of Trustee in Bankruptcy; Establishment Costs; Maintenance Costs; Compliance Costs; Future Litigation Defence Costs.

Domestic Structures

Planning is often divided between ‘onshore’ strategies and ‘offshore’ techniques. Many of the ‘onshore’ or domestic structures are concepts that attorneys have used for decades, sometime centuries, without thinking of them as asset protection vehicles (eg pre- or post-marital agreements). Some of the key domestic strategies that are employed include:

- the use of federal and state ‘exemptions’ from creditor claims (eg pension plans and homesteads);
- contractual provisions to limit liability (eg waivers, limitation on damages and choice of law);
- use of legal entities to provide a shield from claims and to limit direct access to assets held in a legal entity (eg LLC's);
- use of the common law trust as both an estate planning and asset protection vehicle (‘integrated estate and asset protection planning’); and
- domestic ‘self-settled’ spendthrift trusts, *(*eg asset protection trusts typically established and administered under the laws of Alaska or Delaware).

Foreign Structures

Foreign structures tend to be more exotic, and are typically formed in jurisdictions that have specifically enacted ‘designer’ law specifically tailored for asset protection. The most notable of these is the Cook Islands, which initially created its asset protection trust laws at the request of several attorneys who were seeking the ideal jurisdiction. Over the years, the Cooks have amended their laws to address issues that subsequently arose (eg addressing community property issues).

Foreign strategies include:

- use of a foreign entity, such as a trust or civil law foundation, often established in a jurisdiction with ‘designer legislation’ created specifically for asset protection (recently the Antilles and Panama enacted asset protection ‘foundation’ laws);

- annuity contracts; and
- insurance arrangements.

Often, foreign structures are combined with domestic techniques, for rarely is there a single action item solution to most problems.

Foreign vs. Domestic

Many practitioners claim that there are distinct advantages of using an offshore structure, such as 'designer laws' which are more suited to asset protection. Some of these laws include:

- elimination or restrictions on flatulent transfer principals;
- short statutes of limitation;
- requirement of a bond as a condition of any litigation against a trust;
- presumption of validity of the structure.

Five of the main reasons to avoid an offshore structure include:

- lack of knowledge of foreign law and different legal system;
- greater costs;
- the client's feeling of total lack of control;
- enhanced IRS and other reporting required; and
- uncertainty of how the structure will be treated by a US court.

For example, Stephen Lawrence moved assets to an offshore trust, then filed for bankruptcy. The US Bankruptcy Court did not believe that Mr. Lawrence had parted with his assets, and jailed him for several years (In Re: Stephen Jay Lawrence ("Lawrence III") 279 F.3d 1294 (11th Cir. 2002)).

Classically designed offshore asset protection trust (and now the foundation) remains the 'top dog' in many practitioners' minds because:

- typically, there is no local deposit or investment requirement

under foreign law;
- typically, there are no exceptions from protection for claims of creditors based on events or circumstances occurring after the transfer;
- typically, there are no statutory exceptions to the fixed period of the statute of limitations applicable to actions against the transfer;
- typically, full protection is available under foreign law until actual distribution is received, even if the settlor is entitled to a fixed benefit;
- typically, the settlor may have a power to revoke subject to an anti-duress clause without loss of protection under the laws of the governing jurisdiction.

Even though a classically designed offshore asset protection trust or foundation may be an effective shield against creditor claims, the risk of imposition of court contempt may be unacceptable to many US settlors. However, a properly presented showing of impossibility is a valid (even constitutionally protected) defence.

Potential Problems – Limitations on Asset Protection Structuring

As many techniques as there are for asset protection, there are multiple limitations on asset protection strategies, each of which need to be explored both by the practitioner and their client. Some of the key limitations include:

- federal criminal statutes (eg, Acts to Evade or Defeat Collection of Federal Taxes (IRC § 7201); Obstruction or Impeding Federal Tax Administration (IRC § 7212); Conspiracy to Defraud The United States (18 U.S.C. § 371); Hindering of the Collection of Debts by the Federal Government; Money Laundering (18 U.S.C. §§ 1956 and 1957); and Criminal Violations of the Federal Bankruptcy Act);
- state criminal statutes (state criminal laws may apply to acts that hinder the collection of a private or state's debts (eg California Penal Code § 531 – fraudulent transfers). The crime of participating in a scheme to defraud creditors (Cal. Pen. Code,§ 531) or the unprofessional conduct involved in an intentional and

successful deception of a bank officer is grounds for disciplining an attorney. *Allen v The State Bar* (1977) 20 Cal 3d 172. Note that many state statutes have extraterritorial application.);
- often state substantive laws such as those relating to marital property and rights, trust and creditor rights, also have an impact;
- fraudulent conveyance (transfer) statutes which generally prohibit the 'transfer' of assets if the principal reason is to prevent present or future creditors from gaining access to the debtor's assets[i].

The courts have long taken the position that a person cannot create a trust with his assets, retain a beneficial interest and have spendthrift protection against his own creditors, even if no fraudulent conveyance is involved. This principle is known as the prohibition on 'self-settled trusts.' Some states have adopted laws allowing such trusts:

- US constitutional principles (eg full faith and credit) available to creditors;
- conflicts of law principles; and
- laws and rules regulating professional conduct.

Some 'Do's and Don'ts' in Trust Design

Reviewing the various domestic cases that have dealt with asset protection structures, the authors have developed a list of 'dos' and 'don'ts', as follows:

- trustee should not hold assets physically located in the United States (US) in accounts with persons subject to the jurisdiction of US courts, in domestic legal entities;
- at the time the trust is established, the drafting attorney should require the settlor to acknowledge in writing addressed to the trustee the extent of his or her retained powers, if any;
- at the time the trust is established, the drafting attorney should require the settlor to confirm in writing the reasons for establishing the trust and the selection of the trustee including any motive to protect assets held in the trust against the claims of future, currently unforeseen, remote creditors;
- at the time the trust is established, settlor should execute a

statement of financial position and attach an accurate financial statement with full disclosure of any contingent liabilities;

- neither settlor nor any person under his or her control should be appointed as co-trustee or protector with power to remove a trustee;
- neither the settlor nor any US resident should have the power to determine in his or her own discretion whether an event of duress under the trust instrument has occurred;
- under the trust instrument, the trustee should be authorised (but not required) to seek an order of a court sitting in the forum of the administration of the trust confirming the validity of any refusal to act because of the duress of a power holder;
- settlor should retain copies of all trust documents and financial reports, eg, brokerage statements, and provide them if an appropriate request is made;
- settlor should cooperate in discovery or creditor's exams and not conceal information concerning the trust during a bankruptcy proceeding or even during settlement negotiations with a creditor;
- settlor should disclose his or her contingent interest in the trust in any bankruptcy petition;
- at the time the trust is established, settlor's counsel should prepare a brief supported by credible evidence and law of impossibility including legal opinions concerning rights of settlor and beneficiaries;
- settlor should hire litigation or bankruptcy counsel who understands foreign trusts, who is willing to listen to the advice of experts including lawyers qualified in the jurisdiction whose laws are designed as the proper law, and who is willing personally to read the relevant court cases including but not limited to those cited herein and the pertinent parts of major journal articles and treatises in the area; and
- under the trust instrument, the trustee should be specifically authorised to defend (directly or with financial support) *against* any lawsuit brought (i) to invalidate any transfer of assets to the trustee, (ii) to impose a constructive trust over any assets held in trust for the benefit of anyone other than a person named (or designated) as a beneficiary in the trust instrument, (iii) to invalidate the terms and conditions of the trust as set forth in the trust instrument itself, or (iv) to cause a distribution to any person other than an individual named (or designated by class) as a

beneficiary.

Concluding Thoughts

The timely imposition of a solid asset protection structure can, in many situations, provide a near-impenetrable shield against erstwhile litigation. However, an ‘after the fact’ restructuring, a poor structure or improperly implemented structure is doomed to failure and has the potential for liability on the part of the planner. As the French say – *en garde*.

[1] Sullivan, Future Creditors And Fraudulent Transfers: When A Claimant Doesn’t Have a Claim, When A Transfer Isn’t A Transfer, When Fraud Doesn’t Stay Fraudulent, And Other Important Limits To Fraudulent Transfer Law For The Asset Protection Planner, 22 Del J. Corp. L. 955 (1997).

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