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Asset protection involves ongoing tension between creditor and debtor rights; namely, a creditor's right to collect on a judgment and a debtor's right to use asset-protection planning before an unforeseen claim arises. In the asset-protection arena, 2017 has already produced many court opinions. This Mid-Year 2017 Asset-Protection Update summarizes the most relevant court decisions from the first half of 2017.

Fraudulent Transfers

A BASIS FOR DENIAL OF DISCHARGE OF DEBTS IN BANKRUPTCY

In re Cork, 2017 WL 413078 (D.Az., Jan. 31, 2017)

John Cork was involved in real estate finance. He signed a personal guaranty in connection with a $5.6 million financing by Gun Bo, LLC. With the 2008 real estate bust, Cork had $250 million in debt on bad real estate projects and became insolvent. In 2010, Cork formed Arizona and Nevada LLCs that were owned by his children. While he was in the middle of litigation, he also funded an asset-protection trust. In 2011, Cork filed for bankruptcy protection.

In 2014, Gun Bo, LLC, convinced the Bankruptcy Court to deny the discharge of Cork's debt. Cork challenged the denial, alleging that he formed the LLCs and the offshore asset-protection trust to better provide funds to rescue the ailing real estate projects. He argued that this action benefited rather than hindered his creditors. Gun Bo, LLC, argued that Cork's actions held creditors at bay during his attempt to save his real estate projects. As a result, the transfers evidence fraudulent transfer intent before filing for bankruptcy. Gun Bo, LLC, also argued that the LLC and the trust assets were so intermingled—and Cork exerted so much control over these structures—that the trusts and Arizona and Nevada LLCs were mere alter egos.

The Bankruptcy Court sided with Gun Bo, LLC, and denied Cork's request to discharge the debt. Interestingly, the Bankruptcy Court had already incurred about $775,000 in chasing the assets. We will probably hear more as this matter continues toward an ultimate resolution.

TENANCY BY THE ENTIRETY PROPERTY AS AN EXEMPT ASSET: EXEMPTION GIVES WAY TO CREDITOR'S FRAUDULENT TRANSFER REMEDY

Knoll v. Uku, 2017 WL 117655 (Pa. Jan. 12, 2017)

Uku and Knoll were partners in a construction business. Over time, Uku pulled profits out of the business. Knoll sued Uku for Knoll's rightful share of those profits. Knoll obtained a judgment against Uku of over $175,000 because of the wrongful conversion.

After Knoll's claim arose but before he filed suit, Uku transferred Pennsylvania real estate from himself to his wife and himself as tenancies by the entirety. Under applicable state law, tenancy by the entirety property is treated as an asset that is exempt from creditor attachment (with some exceptions). Uku's wife also transferred real estate that was in her name to Uku and herself, also as tenancies by the entirety. The question before the Court was whether Uku's transfers of real estate made Uku insolvent and, as a result, constituted a fraudulent transfer.

The Court held that although Uku received real estate from his wife that was arguably of equal value to what he transferred to her (which normally prevents the occurrence of a fraudulent transfer), the fact that he transferred non-exempt assets and received exempt assets is equal to receiving no assets for purposes of determining solvency under the fraudulent transfer laws. Given that Knoll had a basis for a claim against Uku at the time of the transfer (even though no lawsuit had been filed), the Court found that the transfers made Uku insolvent and were fraudulent transfers. Because they were fraudulent, the transfers were void and the assets were subject to creditor attachment.

Charging Orders

IMPACT OF DEATH OF DEBTOR: CAUTIONARY TALE OF THE CHARGING ORDER UPON DEATH OF DEBTOR, LOSING ALL THE LIMITED LIABILITY COMPANY ASSET-PROTECTION BENEFITS

Delaware Acceptance Corp. v. Estate of Metzner, C.A. No. 8861-MA (May 22, 2017)

In *Metzner,* the Delaware Chancery Court ruled on the asset-protection aspect of a charging order against assets in an LLC in which the debtor had a 49 percent interest. A creditor that wanted to seize the assets inside the LLC obtained a charging order. The

charging order granted the creditor rights to the LLC assets only when the manager (who is usually also the debtor or a related party) distributed LLC assets. Because the LLC only owned the home that the debtor used as his residence, there was no reason for the LLC to ever make distributions.

The LLC's operating agreement had forced the termination/liquidation of the LLC on a member's death. This, coupled with the absence of any corrective action immediately after the member's death, allowed the creditor to attach the LLC assets.

These provisions still frequently appear in LLC operating agreements. This case highlights the need for those who are relying on an LLC's asset-protective qualities to revisit the operating agreement to determine if it should be amended before a later event, such as death, exposes the LLC assets to a creditor's reach.

CHARGING ORDERS AGAINST OUT-OF-STATE LLCS

JPMorgan Chase Bank v. McClure, 2017 CO 22, 2017 WL 1321334 (Colo., April 10, 2017)

In this recent Colorado Supreme Court decision, the Court ruled that, to enforce a charging order against an LLC, the creditor must bring the action to the jurisdiction where the targeted LLC was formed. This has interesting ramifications. For example, if a person forms an LLC outside of Colorado in a jurisdiction that has strong pro-debtor laws and that debtor is sued in Colorado, any charging order that the creditor obtains against the debtor's non-Colorado LLC will be unenforceable. As such, the Colorado legal system cannot hold the debtor accountable if the debtor, as an LLC manager, continues to take distributions from the non-Colorado LLC.

For example, Nevada has a strict charging-order law that makes it more difficult for a creditor to reach the assets inside the LLC. Let's say a Colorado resident (who later becomes the debtor) forms a Nevada LLC with a Nevada distribution manager who has the sole authority to declare distributions to LLC members. A creditor later obtains a charging order from a Colorado court regarding any LLCs owned by that Colorado debtor. According to the logic applied by the Colorado Supreme Court, the LLC interests owned by the debtor are treated as being in Nevada, and therefore outside of Colorado's jurisdiction. As a result, the Colorado Court cannot direct the Nevada LLC's manager to redirect distributions to the creditor. Apparently, this is true even if the manager—or the debtor—were a Colorado resident. The Colorado Supreme Court views the LLC as being located outside of Colorado, and a Colorado charging order is not enforceable against any non-Colorado LLC.

This case also has Full Faith and Credit Clause implications. The Colorado Supreme Court evidently would not view the U.S. Constitution's Full Faith and Credit Clause as requiring a Nevada LLC (in this example) to recognize a Colorado charging order unless

the charging order was first domesticated in Nevada. Presumably, if the LLC were formed in an offshore jurisdiction (like Nevis or Belize), the U.S. Constitution could not then be asserted *at all* to require the offshore LLC to honor any U.S. court order or judgment.

Even though the state of formation was considered the location of the LLC in the above case, the logic applied by the Court was likely motivated by a sense of fairness. This Court did not make its decision to aid a debtor in a battle over whether a debt would be paid. Often, courts of equity will apply laws to benefit the "wronged" creditor rather than the "debt-avoiding" debtor. Instead, this Colorado case involved two creditors, one of whom filed an action in Colorado and one of whom initially filed in Arizona. This Court was simply deciding which creditor had the superior claim. Therefore, a debtor applying this ruling to aid himself in not being held accountable for financial obligations will likely not find solace in this Court's rationale. In fact, see *Peach REO, LLC v. Rice,* 2017 WL 2963511 (W.D. Tenn., July 11, 2017) in which the Tennessee Court concluded a charging-order lien can be asserted against a debtor's interest in non-Tennessee LLCs.

Domestic (US) LLCs And Trusts

ALTER EGOS: THE ACHILLES HEEL TO DOMESTIC ASSET-PROTECTION LAWS?

Transfirst Group, Inc. v. Magliarditi, 2017 WL 2294288 (D. Nev., May 25, 2017)

This Nevada case involved fraudulent transfers that became the subject of an injunction to prevent the debtor from moving assets beyond the creditor's reach. The creditor took the position that certain entities (LLC, corporation, partnership, trust) were merely alter egos of the debtor; therefore, those entities were also subject to the claims that the creditor held against the debtor. The debtor argued that, in Nevada, the exclusive remedy for a creditor against an LLC is to obtain a charging order. The debtor also argued that the alter ego classification cannot apply to trusts because trusts are not entities. The Court held that an alter ego position *could* be maintained against an LLC in the right circumstances—when treating an LLC as an alter ego achieves justice—and suggested that Nevada law would most likely apply alter ego treatment to a trust when justice requires it.

SPENDTHRIFT CLAUSES: MAKE SURE THIS PROVISION IS NOT IN YOUR TRUST; OTHERWISE, ASSET PROTECTION DISAPPEARS

John M. Carmack v. Rick H. Reynolds (C.D. Cal. Bankr. Nos. 09-14039 MJ, 09-1205-MJ) and *Carmack v. Frealy,* 2017 WL 1090497 (Cal., March 23, 2017)

Reynolds encountered debt problems as he became a beneficiary to a multi-million-dollar trust at his parents' deaths. Reynolds filed for Chapter 7 bankruptcy relief from his debts while receiving sizable trust distributions. The trust provided for mandatory distributions of $250,000 within 30 days after the death of both parents, and then $100,000 per year for the following 10 years.

The Supreme Court of California held that the creditor can attach all the mandatory distributions once they become due under the trust terms. The Court reasoned that, if a trust mandates principal distributions, the trustmaker's intent to protect the principal ends with the mandatory distribution. If this trust had been drafted so that the distributions to Reynolds were discretionary instead of mandatory, the trust would have provided Reynolds with better asset protection.

MORE ON SPENDTHRIFT CLAUSES: IS THE TRIED AND TRUE SPENDTHRIFT PROTECTION FOR THIRD-PARTY TRUSTS DYING ON THE VINE?

US v. Harris, No. 16-10152 (April 20, 2017) (Per Curium w/ Tallmun, Watford & Guirola)

The *US v. Harris* case involved a beneficiary of some purely discretionary trusts. The beneficiary became subject to a federal restitution order of over $600,000. The beneficiary disclaimed any interest he had in these trusts, yet the Court order overrode the state law spendthrift protections that otherwise applied to the trust assets and any view that a disclaimer removed an asset from the federal government's reach.

The Court determined that California law would treat the trust assets as the beneficiary's property despite the discretionary nature of the trust and the subsequent disclaimer. The simple fact that the beneficiary could have brought an action against the trustee to make a distribution to the beneficiary—if he can show that such distribution comports with the purpose of the trust—makes his eligibility for distributions a sufficient property interest subject to a federal garnishment. Furthermore, the federal law's definition of property (specifically 28 U.S.C. § 3002(12)) is so broad that even a disclaimer cannot remove such property from the reach of a federal writ of garnishment. The *Per Curium* Opinion clearly states the general proposition that a spendthrift clause cannot withstand a federal lien.

SPENDTHRIFT CLAUSES IN DIVORCE WHEN BOTH PARTIES ARE DOMICILED IN A DAPT STATE: DOMESTIC ASSET-PROTECTION TRUST IS NOT OBLIGATED TO PAY SPOUSE'S ALIMONY AND CHILD SUPPORT

Klabacka v. Nelson, 2017 WL 2303609 (Nev., May 25, 2017)

Eric and Lynita Nelson each created their own separate property trust (each with their own legal counsel) and funded the respective trusts. The trusts were converted to

domestic asset-protection trusts (*DAPTs*) in 2001. A trustee served as the distribution trustee, but this discretion was subject to the trustmaker's veto. The respective trustmakers, in the additional capacity of investment trustees, retained the power to hold and manage the investments of the respective trusts.

Eric initiated divorce proceedings in 2009, eventually leading to the 2017 court opinion. At issue was the division of assets between Eric and Lynita. The parties eventually added the DAPTs as necessary parties. In the divorce proceedings, the Nevada district court "ordered [husband's] Trust to satisfy [husband's] personal obligations—specifically, [husband's] child- and spousal-support arrears." The Supreme Court held that this order was contrary to Nevada law. The Supreme Court affirmed that, under Nevada law, there are no applicable "exception creditors" here (i.e., super creditors who are not impeded by trust spendthrift clauses). The Supreme Court also made it clear that there is no public policy exception to penetrating the spendthrift protections in cases involving alimony or child support claims.

The case is noteworthy for several reasons:

- The court chose not to follow other positions that view alimony and child support as duties rather than creditor claims, meaning that the spendthrift barrier would not have applied to such duty-type claims.
- The Court opined that equitable remedies like constructive trust claims (in which a trust is deemed to be held for the creditor's benefit) are not a way to pierce through the protective spendthrift nature of a trust unless some future specific legislation is passed to allow for that.
- Eric testified that, although no known creditors existed at the time, the trusts were created to protect assets from creditors. This is interesting because some attorneys have raised the concern that simply making such an admission makes the trust funding a *per se* fraudulent transfer. This case makes that clear that this is not the case.
- The lower district Court mentioned that the trusts could be invalidated for failure to follow some trust formalities. The Supreme Court disagreed, saying that this may be a basis for trustee liability, but not a basis to invalidate a trust.
- The Supreme Court also ruled that when the trust agreement makes it clear that no creditors will have access to the trust assets, the court cannot consider extrinsic evidence to the contrary. In fact, considering such extrinsic evidence would be an abuse of the court's discretion.
- The Supreme Court reiterated that the spendthrift provisions in trust agreements are an effective prohibition on a court mandating that a trustee exercise the trustee's discretionary powers in favor of a creditor, absent a showing of any fraudulent transfer.

For those who are concerned that DAPTs don't work, this new case should provide some comfort. In the right circumstances, the asset protections afforded in properly designed asset-protection trusts are effective. This protection does not extend to a spouse's duty to pay alimony and child support.

MARTIAL PROPERTY V. SEPARATE PROPERTY AND HOW A DIVORCING SPOUSE CAN BE CAUGHT BY SURPRISE PART 1

Nelson v Nelson, Case No. 2D15-4585 (District Court of Appeal of Florida Second District, December 16, 2016)

A husband and wife's California home was transferred into a marital trust for the wife. The wife also served as the trustee. When a divorce ensued, the assets of both spouses were subject to division. The general rule is that the *marital property* the couple accumulated is placed into one pot with each spouse walking away with some percentage (assume 50%) of the pot's value. This pot of marital property does not include any of the spouses' respective *separate property*. Separate property includes gifts, assets owned before the marriage, and inheritances. Each spouse walks away with 50% of the marital property and all of his or her own separate property.

The wife argued that the California home in the marital trust was not marital property. The husband argued that it was marital property so that its value would be counted as part of her half of the marital asset pot, leaving more of the remaining marital pot to be allocated to him. He further argued that the gift to the marital trust was made for asset-protection and estate planning purposes. Therefore, because the marital trust no longer carried out the original purpose, the California home should be restored as marital property. The Court took the wife's side, concluding that the residence is not marital property. In fact, it was not either spouse's property at all, separate or otherwise. Instead, it was trust property and therefore beyond the reach of the parties in the divorce matter. The wife retained exclusive use of the California home in addition to her half of the marital assets.

This case makes it clear that spouses should think twice before making a spousal gift if there is any chance of divorce. This case is also relevant to situations in which one spouse creates and funds a children's trust to the exclusion of the other spouse. Based on this case, these trust assets also would not be marital assets and would have no impact on the asset division in the parents' divorce—even if the children were only the trustmaker's children.

MARTIAL PROPERTY V. SEPARATE PROPERTY AND HOW A DIVORCING SPOUSE CAN BE CAUGHT BY SURPRISE PART 2

Gibson v. Gibson (Supreme Court of Georgia, June 5, 2017)

Without his wife's permission, a husband transferred $3.2 million to two trusts for his wife (so long as she stayed married to him) and for his daughter. The husband he was neither a trustee nor a beneficiary of the trusts. In a later divorce action, the wife argued that the trust assets should be marital property. She also argued that the transfers to the trusts were fraudulent transfers because he intended those transfers to hinder her ability to get to those assets in a divorce.

The husband admitted that he made the transfers for asset-protection reasons, but for the benefit of his daughter to ensure her inheritance (although he had told his wife the trusts were created for tax reasons). In essence, his position was that he did not make the transfers in anticipation of getting a divorce or to defeat marital property division rights of his wife. He maintained this position even though he and his wife had been sleeping in separate bedrooms and she had repeatedly threatened divorce, because he did not take her threats seriously.

The Court sided with the husband—partly because the husband had truly relinquished control over the trust assets—and held that no fraudulent transfer had occurred. Therefore, the wife could not undo the transfers to the trusts in order to pull the assets back into the marital property category. However, there was $1.3 million in some Schwab accounts that—because of an error—did not effectively make it into the trusts. The $1.3 million in those accounts remained marital property.

Spouses should think twice before making a spousal gift if there is any chance of divorce. Before engaging certain gifting strategies such as a SLAT (spousal lifetime access trust), or *inter vivos* QTIP (qualified terminable interest property) trust, other marital trusts, or even outright gifts to a spouse, think about what happens if the spouses divorce.

DECANTING CAN ENHANCE PROTECTION IF RECIPIENT TRUST IS VALID: IF YOU CAN'T DEFEND, THEN DECANT!

Michael J. Ferri, trustee vs. Nancy Powell-Ferri, SJC-12070 (Suffolk March 20, 2017)

This case involved a Massachusetts trust beneficiary who was going through a divorce in Connecticut. The trustees (one of whom was the beneficiary's brother) were keenly aware that the beneficiary held a withdrawal power over trust assets, which raised the concern that the beneficiary's soon-to-be ex-spouse would be able to access the trust assets as marital property. More specifically, the concern was that the trust assets considered marital property would be subject to division in the divorce. The trustees therefore decanted the assets (i.e., transferred the potentially vulnerable trust assets

from the existing trust to a new and more protective trust). The purpose here was clearly asset protection.

The Connecticut Court asked the Massachusetts Court to address whether the trustees of the Massachusetts trust had the authority to decant the trust assets to the new trust. The Massachusetts Court suggested that if the existing trust provisions did not restrict such a decanting and if the trustmaker's intent when he created the trust for his son was consistent with such decanting, the trustees could validly do so.

The Massachusetts Court noted that since the Connecticut Court only asked narrow questions, the Massachusetts Court would not address a related issue. This issue was whether any Massachusetts public policy considerations that protect a non-beneficiary spouse's rights to marital property would make the new trust invalid as an attempt to defeat public policy considerations.

This case raises at least two drafting considerations in designing trusts for children. One, the trust should expressly allow trustees to decant trust assets for any purposes that are in the best interests of the beneficiaries, as determined in the trustees' sole discretion. Two, the trust provisions should clearly state that the assets to be decanted can be transferred to a trust that has its situs in another state or in a foreign jurisdiction with no public policies that could defeat the validity of the new trust.

Legislation

MICHIGAN DAPT LAW EFFECTIVE FEBRUARY 5, 2017: ANOTHER STATE JUMPS IN TO OFFER ASSET-PROTECTION TRUST LAW

MCL 700.1041 *et. seq.*

Michigan became the 17th state to enact self-settled spendthrift trust legislation. This new law allows a trustmaker to name himself or herself, along with one or more other beneficiaries, as a discretionary beneficiary of the trust and therefore eligible to receive trust distributions. The trust provides lawsuit protection in the appropriate circumstances.

The law provides generally that a creditor can challenge certain asset transfers to the trust only for a two-year period. Furthermore, the new law makes it more difficult to successfully lodge any such challenge.

Any transfers to the trust need to be accompanied by a signed affidavit averring, among other things, that the trustmaker has no undisclosed pending creditor issues and does not anticipate bankruptcy. Additional statements to be made in the affidavit

include one that the trustmaker is not more than 30 days in arrears on any child-support obligations.

That the 8th largest state has joined those that have adopted asset-protection trust law is further evidence that these trusts continue to gain acceptance as effective vehicles to protect a client's net worth from exposure to creditor and predator claims.

NEW NEVADA LAW: CONTINUES PROACTIVE NATURE OF THE NEVADA LEGISLATURE

Nevada Assembly Bill 314

Assembly Bill 314 approved by the Governor on June 2, 2017, which is effective October 1, 2017, adds a number of new provisions. Under this Bill's Section 51, for purposes of petitioning a court to establish in rem jurisdiction over a trust's assets, it states that "…a trust is domiciled in this State notwithstanding that the trustee neither resides nor conducts business in this State if: (a) The trust instrument expressly provides that the situs of the trust is in this State or that a court in this State has jurisdiction over the trust…" This Bill expands the courts' ability to assume jurisdiction over trusts when petitioned to do so.

STATE INCOME TAX PLANNING WITH ING TRUSTS: THE TRUST THAT BARS BOTH CREDITORS AND STATE INCOME TAXES AT THE SAME TIME

PLR 201729009

The IRS recently issued Private Letter Ruling 201729009, again blessing certain tax aspects of an incomplete non-grantor (ING) trust that protects against both creditors and state income taxes. This trust is created using the laws of a state that impose no state income taxes, even though the trustmaker or certain beneficiaries live in another state (such as California) that otherwise imposes state income taxes on that trustmaker's or beneficiary's income.

The trustmaker can place assets in these trusts beyond the reach of future creditor while receiving trust distributions at any time that a panel—with sole discretion—determines. This panel is referred to as a *trust committee* and comprises members selected by the trustmaker, which advisably includes beneficiaries such as the trustmaker's children. This is a self-settled trust, meaning the trustmaker is also a beneficiary.

If the trust sells an asset and realizes a significant capital gain, the entire capital gain is not subject to state income tax (13.3% in California)—even if the gain is the result of appreciation that occurred *before* the trustmaker placed that asset into the trust.

Furthermore, the trustmaker can place assets with unlimited value into the trust because these transfers are not subject to any federal gift taxation.

This new ruling is consistent with the view that this strategy works only if the trust does not terminate and revert to the trustmaker due to an attrition of the members able and willing to serve on the trust committee. Instead, under the facts in this ruling, if the trust committee ceases to exist, it appears no reversion occurs. The trustees would then remain as the only persons authorized to make distributions.

This ruling also states that the strategy works only if no Tax Code § 675 scenarios are in play, such as:

- The trustmaker or trustmaker's spouse borrowing funds from the trust without adequate interest or collateral requirements;
- A power being granted to allow a substitution of a trustmaker's assets of equal value in exchange for trust-owned assets;
- An independent trustee being able to make distributions to the trustmaker; or
- A non-trustee voting on certain securities that the trust and non-trustee collectively hold significant voting rights.

Conclusion

In conclusion, 2017 has started out with a continued proliferation of legal activity in the asset-protection arena, but with no real surprises. The court activity shows that making transfers with intent to hinder anticipated creditors and retaining too much control over assets can negate an otherwise effective asset-protection plan. On the other hand, statutory developments continue to demonstrate an acceptance of the legitimate measures that can be taken to better mitigate financial risk. Also, these cases remind us that that well-honed skills can make all the difference in creating an effective asset-protection plan. Any openings that creditors can find allows the courts, which are willing to oblige, to pierce the intended asset protection. Lastly, we see that certain super-creditors, such as the federal government, are a more formidable foe to the debtor.