McDonald & Kanyuk, PLLC

Attorneys at Law
Concord, New Hampshire

Asset Protection Planning in New Hampshire: Seven Years Later

By: Joseph F. McDonald III, Esq.

A. **Foreword**.

At one time, planning to protect assets from the claims of creditors was done almost exclusively for high risk professionals, mainly surgeons and other medical specialists, exposed to financial ruin by malpractice judgments in excess of insurance coverage limits. Adequate and affordable liability insurance protection was commercially available. Attorneys advising such clients roamed a relatively narrow cage: the art of asset protection often involved nothing more than doing business in the corporate form and shifting most assets to the unexposed spouse.

This situation has changed dramatically in the last thirty years. Affluent clients are now more creditor conscious. They place a greater premium on asset protection and insist that it be a part of their overall estate and financial planning. The boom/bust cycle of the 1980's saw fortunes made and decimated in less than a decade. The fallout-bankruptcy, workouts, fraudulent transfer litigation, divorce, criminal convictions, even suicide-played an important role in raising consciousness. The well publicized litigation explosion and the popular image of the plaintiff's attorney as predator has created its own momentum.[1] Parents express the desire to protect their children's inherited wealth against their creditors or spendthrift tendencies or bad marriages. Other factors, including increasingly porous and expensive[2] liability coverage, potential federal[3] and state[4] environmental liabilities, and fears concerning the devaluation or even confiscation of financial investments and private wealth,[5] have also contributed.

Some argue that much of the "litigious society" paranoia has intentionally been stoked by a carefully orchestrated lobbying and public relations campaign financed by interest groups seeking to protect their economic interests in the name of "tort reform."[6] Local opponents of tort reform have cited evidence that despite any excesses or abuses that might exist outside this state, New Hampshire remains an island of sanity and a relatively safe harbor for private wealth.[7] It is clear, however, that the academic debate concerning the finer points of tort reform is not what keeps most asset protection clients awake at night. The root cause of their insomnia is the perception, not necessarily the reality, of vulnerability. Asset protection becomes an obsession for many of them.

The organized bar has responded by focusing more time and attention on building asset protection into the client's estate, financial and business planning. Many legitimate, legally sound and innovative techniques have evolved in recent years which can help make these clients and their assets less attractive targets. Asset protection planning can help discourage the filing of frivolous nuisance suits designed only to use a cooperative judicial system to extort monetary settlements. In the event of a lawsuit, it can also help the litigation playing field by providing bargaining leverage from which to negotiate a reasonable settlement. Such prospective planning is not irresponsible or disreputable for the attorney who has invested the time and effort to understand the available strategies and is careful not to accommodate nefarious clients.

Most well conceived asset protection plans employ multiple strategies and entities which are carefully integrated with the client's overall estate, financial and tax planning. One commentator compared this "multiple entity approach" to a war ship with a series of bulkheads that place wealth in different compartments. If one compartment is hit, the others should remain secure.[8] The bulkheads reviewed in this article will include investments in special assets protected under New Hampshire and federal law, and creditor-safe structures in which to hold otherwise unprotected assets. The courts and the legislature have been busy in the last seven years making many changes in the principles of debtors/creditor, bankruptcy trust and business organization law. This article will describe many of those changes.

B. <u>Client "Vetting" and the Art of Expectation Management</u>

The most successful, beloved attorneys are those who have mastered the art of managing their client's expectations. Many clients arrive at their lawyer's office armed with half-baked schemes suggested by non-lawyer asset protection consultants and anecdotes related by friends in the late stages of cocktail parties. This is particularly true of clients seeking to protect their assets with a single "magic bullet"-be it a family limited partnership or an offshore trust. Some clients who may be already financially embarrassed are seeking a professional partner to aid in the concealment of assets at the eleventh hour.

The best antidote for such prospective clients is a harsh does of reality. The already distressed client seeking shelter from existing creditors or impending claims is easily dispensed with if the lawyer explains that there is no quick fix and suggests a meeting with a bankruptcy attorney or workout specialist, if appropriate.[9]

Assuming that an erstwhile asset protection client's case is not hopeless, there are two basic concepts which both the attorney and the client should understand at the outset.

1. **The Irrevocable Transfer Principle.** There is no free lunch here. Seven years ago, to protect wealth, a client would have been ready to sacrifice all or substantially all the benefits of its ownership. While that statement remains generally true today, it should be noted that the purchase and retention of certain assets exempt from creditors' claims under New Hampshire law and federal bankruptcy laws, and the use of certain domestic and offshore asset protection trusts, will allow clients to retain the use and enjoyment of the property and still protect it from creditors to greater degree than was the case in 1995.

2. **The Law of "Fraudulent Transfers".** Understanding the irrevocable transfer principle and its implications is only the first step in managing a prospective client's expectations. Many would-be asset protectors will be unable to cross that threshold. A second hurdle which may limit asset protection opportunities is that body of debtor/creditor law which seeks to balance the client's right to own and freely transfer or rearrange property with the property rights of creditors who may lose all or a portion of their claim when confronted with a judgment proof debtor. The law makes this accommodation by requiring that no asset transfer or other protection technique maybe "fraudulent" as to creditors. New Hampshire's codification of the Uniform Fraudulent Transfer Act ("UFTA") embodies this rule.[10]

The UFTA allows creditors to recover from a transferee any fraudulently transferred assets, regardless of whether the transferor retained no benefit in or power over the porperty.[11] Generally, to prove that an asset protection strategy was fraudulent as to them, creditors must prove that a fraudulent intent (whether actual or presumed) was behind the strategy.[12] It is important to note that these laws can apply to creditors' claims arising both before **and after** a fraudulent transfer.[13]

a. Gift or Bargain Sale Transfers Which are Presumed Fraudulent: "Insolvent" Debtors, Net Worth and Cash Flow Insolvency Standards. Clients must understand that civil "fraud" in the debtor/creditor context is different from criminal fraud. A creditor seeking recovery of an asset from a debtor's transferee need not prove that the transferee and the debtor somehow colluded in a misrepresentation or intentional concealment with the specific intent of placing the transferred property beyond the plaintiff's reach. A transfer may be vulnerable as fraudulent even if the transferee received the asset in good faith without knowledge of the transferor's motives. The law also recognizes that it would be unfair to require a creditor to prove in every case the existence of an insolvent debtor's actual subjective fraudulent intent. The plaintiff/creditor's proof of the existence of certain factors and circumstances will by themselves be sufficient to set aside a transfer, regardless of the debtor's intent.[14] Such transfers are said to be "constructively" fraudulent.

Generally, transfers included in this constructive fraud category are those made by an insolvent debtor (I) without the payment of fair consideration (a gift or a bargain sale), or (ii) to an insider for an antecedent debt where the insider had reasonable cause to believe that the debtor was insolvent.[15] Creditors with claims existing on the date of the transfer and future creditors whose claims arise later on have standing to attempt to recover the transferred property or its value. However, in the absence of proof of actual fraudulent intent, only plaintiffs with claims existing on the date of the transfer have standing to challenge a transfer.[16]

A debtor may be insolvent under either the net worth standard or the cash flow standard.[17] Under the net worth standard, the debtor is insolvent if the amount of the debtor's liabilities exceeds the fair value of his or her assets.[18] Under the more liberal cash flow standard, a debtor who is generally not paying debts as they come due is presumed to be insolvent.[19] A creditor who proves the existence of the debtor's insolvency under the net worth standard is automatically entitled to have the challenged transfer set aside.[20] Proof under the cash flow standard, by contrast, creates a presumption of fraud, which the debtor my rebut with evidence that the transfer or restructuring was done for legitimate purposes.[21] It bears repeating that a creditor successfully relying on either presumption may reach the asset regardless of the debtor's actual intent at the time the transfer was made.[22]

b. Transfers Deemed Fraudulent Based on Evidence of Actual Fraudulent Intent. The insolvency tests are somewhat objective and certain in their application. The result is less predictable in cases involving transfers made while the debtor was comfortably solvent. Here, the creditor must prove the debtor's "actual" fraudulent intent.[23] These cases confront the creditor with the difficulty of proving a state of mind. The law will presume an actual fraudulent intent if the creditor proves the existence of certain fact combinations, colorfully referred to by the courts as "badges of fraud," which may establish fraud: the gift or bargain sale nature of the transfer; the relationship between the transferor and the transferee (e.g., intra-family transactions); the pendency or thereat of litigation; secrecy or concealment; the transfer of the debtor's entire estate; the reservation of any benefit to the debtor; the debtor having incurred a large debt immediately before or after the transfer; and the extent of the debtor's financial solvency at the time of the challenged transfer.[24] The defendant will adduce evidence demonstrating independent, non-fraudulent motives for the transfer. Such independent purposes often cited by debtors and their transferees include the debtor's intention to avoid federal transfer taxes through annual exclusion and unified credit shelter leveraging strategies, and transfers to irrevocable "special needs trust" designed to provide for the future management of the transferred property for a minor or disabled member of the transferor's family without rendering the beneficiary ineligible for public asistance.[25] Inter-spousal transfers of property motivated by an intention to fund the non-propertied spouse's $600,000 unified credit exemption or $1 million generation-skipping exemption amounts are also often cited. The attorney should document and emphasize these purposes in all correspondence and planning memoranda sent to the client. If asset protection is mentioned, it is a good idea to characterize it as a secondary, incidental benefit.[26]

c. Other Steps to Support Asset Transfer Strategy and Protect Against a Fraudulent Transfer Challenge. A superior court judge or master will retrospectively determine whether the transfer was actually made fraudulent intent based on the circumstances and the implications reasonably drawn from them. It is often impossible to predict with certainty whether any particular transfer or ownership restructuring under consideration will be vulnerable as a fraudulent transfer. Taking the following steps may substantially reduce the risk of a creditor's successful challenge.

(1) Comprehensive Analysis of the Client's Financial Solvency.

This refers to solvency under both cash flow and net worth standards. Have the client's accountant produce personal financial statements, including a critically prepared net worth statement and a cash flow analysis, to determine whether the client would be comfortably solvent in the balance sheet sense both before and after the implementation of the asset protection strategy. The balance sheet will include contingent liabilities, such as guarantees of another's personal or corporate loan regardless of whether the primary obligor has defaulted or is likely to default. It will value assets conservatively to avoid any appearance of impropriety. The cash flow projections should cover at least a one year period following the implementation of the strategy. The strategy will be vulnerable if it involves the transfer of income producing assets with an existing or potential positive cash flow, and over a period of a year or tow following the transfers there is a reasonable possibility that the client will be unable to meet current and anticipated debts as they become due. All of these analyses and projections should be memorialized and saved as evidence of solvency should a creditor later challenge the strategy.

For a good discussion of the parameters of such a pre-transfer solvency analysis, see Osbourne and Schurig, What ACTEC Fellows Should Know About Asset Protection, 25 ACTEC Notes 367, 370-71 (2000). The authors observe that in determining net worth for the purposes of the fraudulent transfer analysis, the financial statement should list the value of all assets, subtract all debts, liabilities, claims and contingent liabilities, and also subtract the value of any assets already protected from creditors' claims under applicable state and federal law because exempt assets will not be available to creditors and the solvency analysis should be based on a methodology designed to protect creditors. After determining the amount by which the client is solvent, the authors suggest that the attorney apply a percentage to determine the amount available for asset protection planning so that after the contemplated transfer, the client is not only marginally solvent, but rather has sufficient non-exempt assets to apply to creditors' claims should they arise. The article mentions a 30% figure as the suggested multiplier, leaving 70% of the assets vulnerable, but admits that the choice of the percentage figure is a "matter of subjective judgment". The authors caution that "…only in very rare cases do these authors exceed 50%, and the figure is usually less". Id. at 370.

(2) Existence of Independent Business, Financial, or Estate Planning Purpose. Proving financial solvency both before or after the implementation of a strategy may disable a creditor from conclusively proving fraud based on insolvency. Complaining creditors will be forced to prove actual fraudulent intent.[27] This will be difficult if at the time of the transfer there was only an abstract possibility that the complaining creditor was one of a broad number of potential future claimants who might sue for some act of contract the client had not yet contemplated taking or entering.[28] Even asset transfers or restructuring made by a solvent client for the sole purpose of protecting assets from nameless, faceless possible claimants are theoretically invulnerable, regardless of whether there was any non-defensive purpose for them.[29]

Federal bankruptcy judges and the New Hampshire Supreme Court have decided several cases which add additional gloss to the state and federal fraudulent transfer statutes.

(A) *Schreiber v. Emerson*, 244 B.R. 1 (Bankr. D.N.H. 1999). Judge Deasy authored this opinion, consuming some 40 ½ pages of the bankruptcy reporter in the process. The case involved a Chapter 7 trustee's suit against the debtors seeking to deny their discharges on various grounds. The suit also named transferees of assets and challenged four specific asset transfers seeking to recover those assets on behalf of the bankruptcy estate.

While the holding is highly fact-sensitive, there is a good discussion of the defendant transferees' status as "insiders" under 11 U.S.C. §101(31). Although the defendant transferees were not family members, Judge Deasy finds in the history of their "personal and business relationship" something "…more akin to a family relationship". Id. at 34. Partly on this basis the court denied the debtors' discharge and voided the transfer of an airplane. Id. at 40-41. While the decision applied the fraudulent transfer provisions of the Federal bankruptcy laws, the court notes that New Hampshire law (RSA 545:A:1(vii)) also includes a transfer to an "insider" as a "badge of fraud", and the court's analysis of the transferees' relationship to the debtors may be helpful in determining how a New Hampshire court might apply our fraudulent transfer statute under similar facts.

(B) *Premier Capital, Inc. v. Gallagher*, 144 N.H. 284 (1999). This involved the plaintiff's appeal of a superior court ruling dismissing breach of contract and fraudulent transfer claims made by AMRESCO, the plaintiff's predecessor in interest. Id. at 285. The defendant was guarantor of a corporate debt. The superior court's dismissal upheld the defendant's statute of limitations defense in part based on the finding that the defendant's actions did not constitute an implied promise to renew his personal guarantee and therefore did not toll the statute of limitations period which began to run on the primary obligor's execution of the demand promissory note in question. While the court did not reach the merits of the fraudulent transfer claim, the opinion does affirm the dismissal of that claim because it arose out of the underlying contract claim, recognizing that a fraudulent transfer action must be predicated on an underlying right or potential right to receive payment. Id. at 288.

(C) *Tsiatsios v. Tsiatsios*, 144 N.H. 438 (1999). The plaintiffs were the children of the late George Tsiatsios. The plaintiffs had previously prevailed in a separate contract action against Mrs. Tsiatsios (Mr. Tsiatsios's second wife and the children's step-mother) as executrix of her deceased husband's estate. In that case, a civil jury found an oral promise from Mr. Tsiatsios to leave the family farm and a motel to his children in his will in return for uncompensated work the children performed. Mr. Tsiatsios breached his contract before his death by creating joint tenancies in the properties with his wife. The children won monetary judgments in that first case which the supreme court affirmed. The subsequent fraudulent transfer action was brought against Mrs. Tsiatsios in her individual capacity. The lower court granted the children's petition to set aside the transfer of the motel as fraudulent, and Mrs. Tsiatsios appealed.

The court rejected the defendant's argument that Mrs. Tsiatsios as executrix and as Mr. Tsiatsios' personal representative was not a necessary party to the fraudulent transfer action. The court based this conclusion on the estate's lack of an interest in the motel property because prior to Mr. Tsiatsios' death he had created the joint tenancy with Mrs. Tsiatsios, and Mr. Tsiatsios' one-half interest passed without consideration to Mrs. Tsiatsios on Mr. Tsiatsios' death by the operation of the right of survivorship. Because Mr. Tsiatsios had not received any consideration from Mrs. Tsiatsios for the transfer, the court reasoned that the estate would not lose any advantage from setting aside the conveyance. The plain language of the fraudulent transfer statute does not require that a judgment be entered against the transferor before any action be taken against the transferee.

C. Selected Strategies. Each of the strategies discussed below assumes the absence of facts and circumstances which would support a finding of the client's actual or constructive fraudulent intent.

1. Outright Gift Transfers of Property Within the Family. Gifts to family members such as spouses and children can help reduce estate taxes and protect assets from creditors. These include gifting fractional interests which the debtor will co-own with the transferor.[30] Although the donor's creditors cannot reach legitimate transfers even if they stay within the family unit, problems with outright gifts include: (I) the donor loses control, use and enjoyment of the asset and its income; (ii) the gift may be squandered by a financially irresponsible child or diverted by the child's creditors or spouse in the event of a divorce, and (iii) if the donee is a spouse, significant transfers may lessen the donor's bargaining leverage in the even of a divorce and property settlement.

2. **Purchase or Improvement of "Safe Harbor" Assets.** Laws exist in all of the states which place certain of a defaulting debtor's assets beyond the reach of creditors and trustees in bankruptcy. The Federal Bankruptcy Code also provides a list of exemptions.[31]

a. **New Hampshire is No Longer An "Opt-Out" State.** In prior years, New Hampshire residents filing bankruptcy were not entitled to have the federal exemption and could only use the state exemptions. This is no longer true. By 1996 N.H. laws 151:2, effective January 1, 1997, the legislature repealed RSA 511:2-a, which formerly denied New Hampshire debtors the choice between New Hampshire and federal bankruptcy exemptions. While our state's status as a former opt-out jurisdiction is now of historical significance only, the bankruptcy judges have had occasion to comment on the intersection of New Hampshire and federal bankruptcy laws, and the repeal of RSA 511:2-a, in two noteworthy cases.

(1) Simpson v. Drewes, 217 B.R. 978 (Bankr. D.N.H. 1998). This case denies the debtor's claim of an exemption of $4,000 on a 1978 Harley Davidson motorcycle based on RSA 511:2 XVI which exempts up to $4,000 of the value of an "automobile". The court noted that at the time the defendant filed his bankruptcy petition, September, 1996, the exemption statute did not include the new "wild card exemption" discussed in note 1, infra. The effective date of this new exemption and the repeal of RSA 511:2-a both fell after the defendant filed his bankruptcy petition, and the court applied the law as of the date of the filing to determine the scope of the exemption. Judge Vaughn noted, however, "…that debtors who currently wish to exempt motorcycles may do so under [the wild card exemption], or may elect to exempt a motorcycle under §522(d)(2) of the Bankruptcy Code, which provides an exemption up to $2,400 (now $2,775) for "one motor vehicle." Id. at 979, n.2.

(2) Caron v. Farmington National Bank, 82 F.3d 7 (1st Cir. 1996). This case involved a debtor's appeal of the bankruptcy judge's denial of an exemption for life insurance cash value, and is discussed in more detail infra. In upholding the lower courts' rulings, the appellate opinion notes that "…generally courts are to construe exemption statutes liberally to reflect their remedial purposes…". Id. at 7. The court found, however, "…reasons here to afford a more narrow reading", including the legislative history which indicates that New Hampshire opted-out of the federal exemption scheme because it was too "liberal," overly indulgent of debtors at the expense of creditors. Id., citing New Hampshire House Judiciary Comm. Report, Journal of the House, 1981 January session, April 23, 1981, at 533 (the proposed opt-out statute "prevents New Hampshire residents from filing with the more liberal federal bankruptcy law.") It is interesting to speculate how a court would interpret the legislature's repeal of the opt-out statute and the significant liberalization of several of the New Hampshire exemption statutes as described infra.

(3) Choosing Between Federal and State Exemption in a Bankruptcy Context. Bankruptcy Judge Vaughn's observations in footnote 2 of the Caron case illustrate how New Hampshire debtors facing bankruptcy since 1997 can choose the state or federal exemption scheme which allows them to emerge from bankruptcy with the greatest value under the circumstances. As a general proposition, the exemptions under RSA 511:2 are significantly more generous than those listed under 11 U.S.C. §522(d), so most debtors and counsel are likely to choose the state scheme over the federal system.

b. The Home. There have been several developments in this area.

(1) Increased Exemption Amount. Effective January 1, 2004, the legislature increased the exemption amount to $100,000 from the $30,000 amount quoted in the article. Thus, if a husband and wife co-own a homestead, up to $200,000 of equity can be sheltered from attachment or be exempted in a bankruptcy proceeding if the debtor chooses the New Hampshire exemptions.

(2) Transfers of Homesteads to Revocable Trusts. The legislature also enacted 1997 N.H. Laws 97:1, effective January 1, 1998, adding subsection 9 to chapter 480. New RSA 480:9 provides that conveyances of homesteads to revocable trusts will not forfeit the homestead exemption unless the deed expressly releases the exemption. The new statute does protect the interests of lien holders acquiring their interests after a transfer to a revocable trust unless the lien holder has notice of the trust's revocability. Such notice can be provided by including the word "revocable" in the name of the trust as recited in the deed, or by recitation in the deed or a subsequently recorded document that at the time of the conveyance the trust was revocable.

(3) Notice of Homestead Exemption to Debtor; Foreclosure Procedures for Homestead Properties. RSA 529:20-a, effective January 1, 1995, now requires an executing creditor to provide notice by certified mail of the existence of the homestead exemption, and of the debtor's right to notify the sheriff and the creditor of the exemption prior to a foreclosure sale, precluding the sheriff from selling the property for less than the amount of the exemption without further order of the court. The notice must also notify the debtor of the debtor's rights to receive from the creditor the amount of the homestead exemption after the expiration of the one year period during which the debtor may redeem the property under RSA 529:26 if prior to the sale the debtor fails to give the creditor and sheriff notice that the debtor will claim the exemption.

The procedure for perfecting the debtor's claim of the homestead exemption, the prohibition on sales if a debtor's or the debtor's spouse's equity does not exceed the exemption amount, the debtor's right of redemption after a sale, and the creditor's obligations to remit to the debtor the exemption amount after the foreclosure sale, are provided in RSA 529:25-a which was also effective on January 1, 1995.

(4) **In Re Mirulla, 163 B.R. 910 (1994).** In this Chapter 7 bankruptcy case, Mr. Mirulla attempted to claim a homestead exemption under RSA 480:1 for a 32 room hotel property, five rooms of which the debtor, his wife and adult daughter had resided for the past year. Id. at 910. The debtor also sought to exempt a separate 14 room motel property located nearby. Mr. Mirulla cited Libbey v. Davis, N.H. 355 (1895), which held that a separate parcel adjacent to a debtor's homestead was part of the homestead since the separate parcel was necessary to the "convenient enjoyment of the house by them as a home". Id.

In denying the exemption for the motel and all rooms in the hotel except the five being occupied by the debtor and his family, the court noted that when Libbey was decided, "…the adjoining parcel was used as part of the homestead as then commonly understood for food and sustenance as part of a working farm." Id. The court rejected the debtor's claim that the Libbey situation was analogous to his use of the rental proceeds from the hotel and motel rooms to allow him to reside in the five rooms he occupies. "Unlike the use of adjoining land for the growing of crops, pasturing of cattle, and cutting of fire wood in 1895, the income from these particular rooms is not necessary to the convenient use of the five rooms in which he resides." Id. at 911. The court also cited cases from other bankruptcy court districts to support the court's holding that a proportional percentage of an integrated property could be exempt, and the remainder not exempt, even though the property is not technically subdividable. Id. at 911-12.

(5) **In Re Bartlett, et al, 168 B.R. 488 (1994).** These consolidated bankruptcy cases required Judge Yacos to decide whether the debtors, each of whom filed their bankruptcy petitions after the increase in the exemption amount from $5,000 to $30,000 effective January 1, 1993, could claim the $30,000 exemption amount even though the liens impairing the exemption claim were perfected prior to the effective date of the change. Id. The court cited the "well established" rule that "…[d]ebtors' exemptions in a bankruptcy proceeding are to be determined as of the date of filing of the bankruptcy petition." Id. at 493 (citations omitted). Towards the rehabilitative end of giving debtors a "fresh start", "the Bankruptcy Code generally is to be liberally construed in favor of the debtor". Id. at 494 (citations omitted). Also as a remedial law, an increase in the homestead exemption designed to implement an important social policy should likewise be construed in favor of the debtor. Id. Judge Yacos found an important social policy of ensuring that families have a roof over their heads and they be kept off welfare, and stated his belief that "…society would want such law to be implemented as soon as possible". Id. The question whether the policy of the law will overcome the creditors' rights -- i.e., whether the exemption is applicable in these cases -- is a matter of federal law, even though the amount and items of exemptions are defined and set forth in the state statute. Id.

The judge went on to find that under federal law, the application of the increased exemption amount was not an invalid retrospective application of the statute because each creditor in this case "…held [a] non-consensual lien which provided a remedy to reach the debtor's collateral provided that the creditor acted expeditiously before a 'triggering event' occurred that would affect that creditor's rights. One such 'trigger' that could and did occur, which is certainly not an unusually event in today's society and economy, was the occurrence of a bankruptcy filing". Id. at 496. The creditors' rights were not taken away by the statute and the increase in the exemption amount but rather by the creditors' own inaction, and under these circumstances the judge found no impermissible retroactive application of the statutory provision.

Although Judge Yacos noted that he need not address the New Hampshire constitutional prohibition on the enactment of retrospective laws given his conclusion that federal law controls, the opinion nonetheless analyzes state law from other jurisdictions to determine that the prohibition on retrospective laws would not apply, and also determines that the creditors were not denied due process under the Fifth and Fourteenth Amendments to the United States Constitution, i.e., a taking without just compensation. Id. at 498-501.

This case has further significance in the bankruptcy context now the legislature has increased the homestead exemption amount to $50,000. Presumably a bankruptcy judge will follow Bartlett and apply the higher exemption amount for bankruptcy petitions filed after the January 1, 2002, the effective date of the increase to $50,000, even if all or a portion of the debtor's debt (including any mortgage debt on the debtor's homestead) was extended prior to that date.

This does not mean, however, that a state court would apply the same reasoning outside the bankruptcy context, where, for example, a foreclosing mortgagee with a pre-2002 mortgage lien asserts that the proper homestead amount is the $5,000 or $30,000 amount available when the credit was extended. As is discussed in my analysis of the Stewart bankruptcy case relating to the effective date and prospectivity provisions of the new RSA 511:2 XIX exemption, it may be that debtors claiming the homestead exemption in a federal bankruptcy forum will have an advantage over debtors claiming homestead in a state court or foreclosure outside of bankruptcy where the credit in question was extended prior to January 1, 2002.

c. Life Insurance. In New Hampshire, the lawful beneficiary of a life insurance policy, other than the insured, is entitled to the policy's "proceeds and all other benefits against creditors."[41] The cash value of a "permanent" (as opposed to "term") life insurance policy owned by a debtor-insured as of the date of a bankruptcy filing is the estate's property and is not exempt under New Hampshire law.[42] The only possible exception for cash values within or outside of bankruptcy are those values accruing in policies payable to or for the benefit of "a married woman,"[43] provided that the debtor/bankrupt possesses no right to revoke the policy and assign it for his or her own benefit.[44] This appears to allow a husband to purchase and fund a creditor-safe cash value insurance policy on his life, provided that his wife (or another "married woman") is the beneficiary, and the husband assigns the rights to revoke or cash surrender the policy to someone else, such as his spouse or one of his children. Presumably, the husband could retain such incidents of ownership as the right to borrow against cash values or change the beneficiary.

In In re Monahan, [45] bankruptcy Judge Yacos interpreted the insurance exemption in determining the insurance exemption in determining the trustee's claim to death benefits and cash values of several life insurance policies owned by various debtors on the date of their bankruptcy filings. A portion of the judge's ruling held that although a policy's cash surrender value is generally not exempt, the policy's proceeds are exempt if they are paid to a non-debtor or noon-estate beneficiary after a debtor's post-bankruptcy death.[46] The trustee in bankruptcy does not have rights to the death proceeds superior to the beneficiary's,[47] even if the insured owned and controlled the policy at the time of his death and retained the right to change the beneficiary.[48]

The Monahan opinion struggles to apply our arcane and ambiguous life insurance exemption statutes and some of their confusing common law gloss.[49] The ruling does not answer all questions and has little, if any, precedential value outside of bankruptcy. Other uncertainties and limitations in this area are also noteworthy: (I) the exemption does not appear to apply to the proceeds of any annuity or "endowment" contract;[50] (ii) the exemption for proceeds appears to protect them against only the creditors of the insured or the insured's estate, not the creditors of the beneficiary; and (iii) the exemption will not apply to the extent of any premiums fraudulently paid during the life of the insured.[51]

Clients are often counseled to transfer insurance policies to irrevocable insurance trust (or, better, arrange for the initial purchase of a policy by the trustee) to avoid federal estate taxation of the insurance proceeds received upon the insured's death. Use of this strategy will protect the cash values and proceeds because the policy is no longer owned by the insured but rather by a trust over which the insured can retain no direct control or "incidents of owndership."[52] This protection is available only to the extent that a complaining creditor cannot prove that the policy or cash for the trustee's premium payments were fraudulently transferred to the trust.

(1) The Caron Case. In Caron v. Farmington National Bank, supra, 82 F.3d at 5-**7,** the First Circuit Court of Appeals analyzed the language of RSA 480:2 and the New Hampshire Supreme Court cases interpreting it in upholding the district court's and bankruptcy judge's determinations that the debtors' cash value policies were not exempt under the statute restricting the exemption right to "the beneficiary" and providing no protection for the insured/owner of the policy. Id. at 4-8. In this case, the debtor, Mr. Caron, retained ownership and the right to reach the policy's cash value and change the beneficiary. The interest of the primary beneficiary (Mr. Caron's wife) was defeasible by the debtor and contingent upon Mr. Caron's death. Id. at 10. Although finding the statute as something other than a "model of clarity", the court strictly construed it as providing an exemption only in favor of a beneficiary. Id. Because Mrs. Caron had no rights to the proceeds, cash value or other benefits, she had no interest in the policy that could be exempted by the statute. The court bolstered its position by reference to legislative history, finding a legislative purpose to deny the exemption "when the owner/insured retained the power to change the beneficiary", and authorizing a "creditor or bankruptcy trustee [to step] into the policy owner's shoes to exercise policy rights, such as reaching the cash value or changing the beneficiary". Id. at 10-11. Thus, RSA 480:2 will only protect the death benefit received by the beneficiary of the policy after the insured's death.

(2) RSA 511:2 XIX. The Fifth Circuit decided the Caron case in 1996. As indicated in the immediately succeeding section, the legislature enacted RSA 511:2 XIX to be effective on January 1, 1999. I will refer to that new exemption as the "subsection XIX exemption". It provides an unlimited exemption for any "retirement plan or arrangement qualified for tax exemption purposes." While one might logically conclude that this exemption is limited to IRAs and other tax qualified retirement accounts, the statute defines the exempt class of assets as "includ[ing] without limitation, trusts, custodial accounts, insurance, annuity contracts, and other properties and rights constituting a part thereof." Subsection XIX is reprinted in its entirety infra.

Some might argue that the legislature's intention in listing insurance and annuity contracts among the "arrangements" exempt under subsection XIX is not to provide an unlimited exemption for the life insurance and annuity cash values in general, but rather exempt them only when the policy or annuity in question is held in qualified retirement trusts or IRAs which themselves qualify for federal tax exemption. Creditors and bankruptcy trustees proponing such a limited construction might point to the inclusion of "trusts" and "custodial accounts" which, if read in isolation and not in the context of the obvious intention to define only federal income tax-exempt trusts and custodial accounts, could lead to the conclusion that all non-retirement trusts and custodial accounts were covered by the statute -- something the legislature could not conceivably have intended. The language of the statute is perhaps best interpreted as excluding life insurance policies and annuities, the internal cash value build up of which is exempt from federal income taxation until distributed under rules contained in Code §§72 and 7702.

Such a broad construction is certainly at odds with the language and legislative history of RSA 480:2; the First Circuit's discussion in Caron of the legislative history of RSA 480:2, and the legislature's apparent prior decision not to extend exempt status to policy cash values, but is consistent with the laws of several states which provide an unlimited exemption based on the important social policies (tax favored retirement savings and death benefit) such policies are intended to provide. See, e.g., Zabel and Baptiste, Asset Protection and Estate Planning: Three Scenarios, 134 Trusts & Estates at 47 (Dec. 1995) (discussing New York and Florida laws which protect an unlimited amount in life insurance and annuities), and New York Insurance Law, §3212(b) and Fla. Stats. Ann. §222.14. See also Greer, The Great Annuity Rip-Off, Forbes, February 9, 1998, at 106 ("three quarters of the states, among them New York, Washington, Florida and Texas, protect assets in variable annuities from creditors, to one degree or another"). Indeed, the bankruptcy Judge Vaughn in the Stewart case discussed infra applied the subsection XIX exemption to an annuity contract owned outside an IRA without any discussion whatsoever, apparently finding that the language of the statute clearly extends exempt status to the contract.

d. Retirement Benefits Held in a "Qualified Retirement Trust". The exempt status of qualified retirement benefits and IRAs, has changed dramatically in the last seven years.

(1) RSA 511:2 XIX. Under federal law, qualified retirement plans (but not IRAs) have long been accorded creditor-safe status under the Employee Retirement and Income Security Act of 1974, as amended ("ERISA"). This protection is limited to any "employer sponsored plan", which includes defined benefit pension plans and defined contribution plans, such as profit sharing, 401K, and certain Keogh arrangements. In the 1992 case of Patterson v. Shumate, the United States Supreme Court recognized that this protection applies both inside and outside of bankruptcy. Since Patterson was decided, however, several lower court cases have eroded its holding with respect to the interests of sole owner-participants in ERISA qualified plans; such interests may be an asset of the bankruptcy estate and, depending on applicable state law, may be reachable by creditors outside of bankruptcy. See, e.g., In re Witwer, 148 B.R. 930 (C.D. Cal. 1992).

Patterson applies only to ERISA qualified plans. It does not apply to IRAs. Thus, IRA assets are excludable from the bankruptcy estate and creditors' claims outside of bankruptcy only if state law exempts such property.

New subsection XIX (RSA 511:2 XIX, made effective on January 1, 1999, by 1998 N.H. Laws 300:1), provides as follows:

> Subject to the Uniform Fraudulent Transfer Act, RSA 545-A, any interest in a retirement plan or arrangement qualified for tax exemption purposes under present or future acts of Congress; provided,

> any transfer or rollover contribution between retirement plans shall not be deemed a transfer which is fraudulent as to a creditor under the Uniform Fraudulent Transfer Act. "Retirement plan or arrangement qualified for tax exemption purposes" shall include without limitation, trusts, custodial accounts, insurance, annuity contracts, and other properties and rights constituting a part thereof. By way of example and not by limitation, retirement plans or arrangements qualified for tax exemption purposes permitted under present acts of Congress include defined contribution plans and defined benefit plans as defined under the Internal Revenue Code (IRC), individual retirement accounts including Roth IRAs and education IRAs, individual retirement annuities, simplified employee pension plans, Keogh plans, IRC section 403(a) annuity plans, IRC section 403(b) annuities, and eligible state deferred compensation plans governed under IRC section 457. This paragraph shall be in addition to and not a limitation of any other provision of New Hampshire law which grants an exemption from attachment or execution and every other species of forced sale for the payment of debts. This paragraph shall be effective for retirement plans and arrangements in existence on, or created after January 1, 1999, but shall apply only to extensions of credit made, and debts arising, after January 1, 1999.

The 1997 repeal of RSA 511:2-a and the 1999 addition of RSA 511:2, XIX have ended years of uncertainty regarding whether and to what extent retirement benefits, particularly IRAs, are protected from creditors. Retirement benefits, whether held in an ERISA qualified plan or an IRA, are now exempt from attachment under state law both inside and outside of bankruptcy (assuming a bankrupt debtor chooses the New Hampshire exemptions).

(2) *In re Stewart*, 200 B.N.H. 9 (2000); *In re Weinstein*, 164 F. 3d 677 (1st Cir. 1999), *cert. den.*, 527 U.S. 1036 (1999). The Stewart case is notable for bankruptcy Judge Vaughn's application of the subsection XIX exemption in a bankruptcy context.

Mr. and Mrs. Stewart filed a joint Chapter 7 petition. Their three most significant financial assets -- a $28,000 annuity and two IRAs valued at approximately $15,000 -- were listed as exempt assets under new subsection XIX. The bankruptcy trustee challenged the availability of the exemption, asserting that the new statute expressly provides that it does not reach debts arising on or before January 1, 1999. The Stewarts did not dispute that most, if not all, of their over $90,000 of unsecured debts arose before the effective date of the statute.

Judge Vaughn acknowledged that under these circumstances, the exclusion of pre-effective date debts would leave the Stewarts without protection if they were defending an attachment exclusively under state law. However, because the matter was to be resolved under federal bankruptcy law, the judge was forced to apply §522(c) of the Bankruptcy Code to determine whether it preempted the language of the New Hampshire statute excepting antecedent debts. §522(c) provides that exempt property is not liable during or after a bankruptcy case for any debts arising before the commencement of the case, except for certain debts enumerated in three subparagraphs, none of which applied here.

Fortunately for Judge Vaughn this was not a case of first impression in his jurisdiction. The First Circuit Court of Appeals had addressed this issue in In re Weinstein, supra, 164 F.3d at 682-83. In Weinstein, the First Circuit found that §522 preempted language of a Massachusetts statute defining the homestead exemption which would have otherwise precluded the availability of the exemption to Mr. Weinstein because he perfected his homestead rights by filing a Declaration of Homestead after incurring his debt and immediately before filing the bankruptcy petition.

Judge Vaughn found Weinstein to be controlling despite the bankruptcy trustee's attempts to distinguish the Massachusetts statute based on technical differences in the wording of the two exclusions. He also discounted the trustee's "…policy concern that applying the Weinstein holding to RSA 511:2 (XIX) creates an economic incentive for some debtors to file for bankruptcy since bankruptcy will provide an enhanced exemption regarding certain financial assets as compared to state law", noting that "a court's role is not to make public policies; legislation is the exclusive province of Congress." Id. at 14 (citations omitted). Finally, the opinion rejects the trustee's final argument that ignoring the exclusion for antecedent debts violates the contracts clause of the federal constitution, noting that the contracts clause applies only to state laws, not the interpretation of state laws under a federal preemption statute. Id. at 17-18.

e. The New "Wild Card" Exemption. The wild card exemption of RSA 511:2 XVIII is discussed in detail above. The application of this exemption will produce more equitable results for debtors who are not homeowners and do not have sufficient other property to make use of the specific statutory exemptions.

2. Lifetime Transfers of Property Into Various Types of Creditor Protection Trust and Partnerships.

a. Irrevocable Domestic Trusts.

(1) New Hampshire Spendthrift Trusts: RSA 564:23 and Scheffel v. Krueger. The grantor could give a third party "disinterest" (i.e., non-grantor and non-beneficiary) trustee discretion to make distributions among a broad class, including the grantor's spouse and any one or more of the grantor's children, but not including the grantor himself or herself.[62] Including the grantor's spouse as an eligible "sprinkle" beneficiary allows distributions to the grantor's generation for as long as the spouse lives. Such trusts often require the spouse's beneficial interest to terminate upon his or her divorce or legal separation for the grantor, with any subsequent spouse succeeding to the same conditional spousal beneficial interest. Careful selection of a cooperative (but not subservient) trustee should give the grantor some comfort that the property will remain in trust and available to the grantor's spouse for as long as he or she lives. The use of precatory language, letters of wishes, and exoneration provisions often allay the fiduciary concerns which otherwise give a third party trustee pause.[63] The grantor might retain the power to remove and replace an uncooperative or recalcitrant disinterested trustee.[64] "Spendthrift" language may have an in terrorem effect of discouraging borrowing heirs or their creditors. Be aware, however, that such restrictions appearing in New Hampshire trust may not be enforced if they are challenged.[65]

The New Hampshire Supreme Court's reluctance to enforce spendthrift provisions does not mean that a beneficiary's interest in a New Hampshire trust is always reachable by his or her creditors. Spendthrift restrictions seeks to establish an external roadblock for creditors of beneficiaries by transforming a beneficial interest which is otherwise creditor-vulnerable into one which is creditor-safe. An example of a creditor-vulnerable interest would be a mandatory income interest, or a beneficiary's interest in a "support trust" from which a beneficiary can compel distributions if necessary for his or her health, support, maintenance and education. Because a beneficiary can compel distributions from such trust if income is produced or if the ascertainable standards are met, any creditor claiming through such beneficiary can likewise compel the distribution for the creditor's benefit.

By contrast, the beneficiary of a fully discretionary trust has no "ascertainable" interest in the trust. Distributions are committed to the sole, absolute discretion of the third party trustee. No external roadblock need be interposed between the beneficiary's creditors and the trust property; creditor protection inheres in the contingent, non-ascertainable nature of the beneficiary's interest.[66]

By 1996 N.H. Laws 180:2, effective June 3, 1996, the legislature enacted RSA 564:23 which specifically recognizes the effectiveness of spendthrift provisions preventing voluntary or involuntary alienation or assignment of a beneficiary's interest, subject to two exceptions: when the funding of the trust was a fraudulent transfer under RSA 545-A, see RSA 564:23 III, and when the beneficiary asserting the spendthrift protection is also the settlor (the "self-settled trust exception"), see RSA 564:23 II.

The New Hampshire Supreme Court had occasion to apply the spendthrift trust statute in <u>Scheffel v. Krueger</u>, 782 A.22d 410 (2001). Citizens Bank was the trustee of a "spendthrift" trust Mr. Krueger's grandmother created for him in 1985. The trust agreement directs the trustee to pay all of the net income to Mr. Krueger. As trustee Citizens was also authorized to pay "…any of the principal to the beneficiary if in the trustee's sole discretion the funds were necessary for the maintenance, support and education of the beneficiary." Mr. Krueger was precluded from demanding the principal until he reached the age of 50 which would not occur until April 6, 2016. He apparently was given a testamentary power of appointment over any assets remaining in the trust upon his death. The trust's spendthrift provision specifically precluded Mr. Krueger from assigning his trust interest in anticipation of its receipt, and stated that Mr. Krueger's interest was not "…subject to…the interference or control of any [of Mr. Krueger's]…creditors…or to be taken or reached by any legal or equitable process in satisfaction of any [of Mr. Krueger's] debt(s) or liability…".

The plaintiff in the trial court was acting on behalf of her daughter who, at two years old was the victim of egregious sexual abuse at the hands of Mr. Krueger for which he was convicted in a separate criminal proceeding. The victim's mother won a civil judgment against Mr. Krueger which, the criminal case indicated, were for some 90 plus instances of felonious sexual abuse, at least some of which Mr. Krueger videotaped and broadcasted over the internet. The trial court awarded a judgment of over $500,000 and the plaintiff sought to join Citizens as a defendant and reach the trust assets in a trustee process action. Citizens defended by citing RSA 564:23 which provides:

> In the event the governing instrument so provides, a beneficiary of a trust shall not be liable to transfer his or her right to future payments of income and principal, and the creditor of a beneficiary shall not be able to subject the beneficiary's interest to the payment of its claim.

The plaintiff urged the court to create a judicial "policy" exception to the statute for "tort creditors". In the alternative, the plaintiff argued that the trust does not qualify as a spendthrift trust under the statutory definition "…because the trust document allows the beneficiary to determine the frequency of payments, to demand principal and interest after his fiftieth birthday, and to dispose of the trust assets by will…" -- rights which, the plaintiff asserted, allowed the beneficiary too much control to allow the trust to be recognized as a spendthrift arrangement under RSA 564:23. The trial court disagreed and dismissed the trustee process action, and the plaintiff appealed.

This could have been another "hard facts make bad law" example of judicial activism. In support of their arguments, the plaintiff's attorneys cited <u>Sligh v. First Nat. Bank of Holmes County</u>, a case in which the Mississippi

Supreme Court was confronted with similar egregious facts (in that case severe injuries to a family inflicted by an uninsured drunk driver) and found a “intentional tort” policy exception to a Mississippi statute recognizing spendthrift trusts. (Sligh was subsequently legislatively superceded after a firestorm of criticism from the trust and estate bar and community). Demonstrating admirable restraint, the Scheffel court upheld the trial judge’s dismissal of the trustee process action and Citizens’ as a defendant. In doing so, the court recognized RSA 564:23 as evidencing a legislative intent to repudiate the common law policy reflected in the 1957 case of Athorne v. Athorne which refused to recognize a spendthrift restriction to thwart a beneficiary’s creditors claim against trust assets. The legislative enumeration in RSA 564:23 of only two exceptions to the spendthrift trust rule -- one for self-settled trusts and the other for fraudulent transfers -- indicated a legislative intent that the listing be exhaustive and that no implied exceptions could be recognized. The court cited prior precedents which precluded it from “question[ing] the wisdom or expediency of a statute”.

(2) Self-Settled Spendthrift Trusts. As mentioned in a preceding section, RSA 564:23 II expressly negates spendthrift trust protection for “…a beneficiary’s interest in a trust to the extent that the beneficiary is the settlor and the trust is not a special needs trust established [under 42 U.S.C. § 1396p(d)(4)] for a person with disabilities”. This codifies the common law “self-settled doctrine”. In a recent supplement to his “Wills, Trusts and Gifts” treatise, Mr. DeGrandpre cites the Sullivan County Superior Court case of Thornblom v. Wehringer, No. 97-E-0035. See DeGrandpre, 7 New Hampshire Practice, Wills, Trusts and Gifts, §31-5 (Supp., 2001). Mr. DeGrandpre:

> A recent case in the superior court raises the issue whether or not a creditor can reach assets placed in a trust by a grantor who is sole trustee and beneficiary of a trust for his own benefit during his lifetime, with his children being beneficiaries after his death. [citation omitted] The trial judge in the superior court denied relief to the creditors of the deceased grantor, refusing them access to the only trust asset was real estate in New Hampshire.

Mr. DeGrandpre goes on to indicate the New Hampshire Supreme Court’s summary affirmance of this decision without an opinion.

The Superior Court’s order in Thornblom is unpublished. I am attaching as “Exhibit A” a copy of the order. Note that the decision is based on the application of New York law, the New York doctrine of merger of beneficial and legal interests to create a life estate and remainder relationship, and a conclusion that the interests of the remainder beneficiaries vested prior to the commencement of the plaintiff’s legal action. Therefore, despite Mr. DeGrandpre’s comments on the case, the self-settled trust doctrine is still alive and well in New Hampshire.

(3) ***Flaherty v. Flaherty*, 138 N.H. 337 (1994).** Mr. Flaherty, the defendant in a divorce action, appealed the trial judge's rulings (i) including husband's one-sixth reversionary interest in a Massachusetts irrevocable spendthrift trust in the marital estate for property settlement purposes (Mr. Flaherty's parents, the grantors, were life beneficiaries and were still living), and (ii) awarding Mrs. Flaherty a one-half interest in that remainder interest. The court held that the property settlement statute, RSA 458:16-a, includes in the marital estate "…all tangible and intangible property and assets…belonging to either or both parties…". The court included the husband's trust interest, which the court characterized as "vested", within this definition. The court applied Massachusetts law to find that despite the spendthrift provision, although valid in Massachusetts, Mr. Flaherty's remainder interest would be recognized by Massachusetts courts as "…included in the marital property to be considered for division" under Massachusetts' "equitable division" statute. Applying New Hampshire's list of property division factors under RSA 458:16-a, the court held finally that the trial court did not abuse its discretion in awarding one-half of the defendant's one-sixth remainder interest "if and when" that interest became possessory. The court exempted from the award only the husband's interest in any property the husband's parents added to the trust after the date the divorce was granted.

This case illustrates the extent to which New Hampshire divorce courts may consider a trust beneficiary's future interests in trusts in a property settlement decree. There is ample precedent for awarding a "deferred distribution" order, sometimes referred to as a "if, as and when" order, which can reach any future interests a beneficiary may have in the trust. This can be done without making the trustee a party to the divorce action by the entry of the order against the beneficiary spouse as a party to the proceedings and in the exercise of the court's "in personam" jurisdiction over the parties themselves. In Flaherty, the court had jurisdiction over the defendant husband who just happened to be a co-trustee of the trust in question.

The Flaherty court applied Massachusetts law in determining whether the spendthrift provision precluded the trial court from considering the trust asset as part of the marital estate. Some optimistic lawyers representing beneficiaries who are parties to a divorce action may see in this a glimmer of hope that result would have been different had the court been confronted with a New Hampshire trust and the New Hampshire spendthrift statute, especially in light of the result in the Sheffel case discussed supra. However, given the liberal posture of the court in past property settlement cases involving intangible property rights, I doubt that this would have mattered. This is not to say that if joined as a party to a divorce action or served with an attachment or trustee process order a trustee should not vigorously defend a non-beneficiary spouse's attempt to bring his or her spouse's beneficial interest in a New Hampshire spendthrift trust within a marital estate. I mean only to say that such efforts may be futile.

(4) <u>Domestic and Offshore APTs</u>.

(A) <u>Domestic APTs</u>. Some American jurisdictions have watched as an increasing number of affluent US residents have spent substantial time, energy and money creating offshore APTs. Some states have decided that it would be good economic and social policy to encourage wary US citizens to keep their liquid assets stateside by offering domestic asset protection trust alternatives. The five states which have adopted domestic APT legislation to date are Alaska (1997), Delaware (1997), Missouri (1989), Nevada (1999) and Rhode Island (1999). Colorado apparently also recognizes the validity of self-settled trusts has against creditor's claims based on an 1861 statute, but this cannot fairly be considered an APT law. Rhode Island's and Nevada's APT laws are modeled after Delaware's. Delaware and Alaska have been the most publicized and promoted statutes, so the focus of this comparison will be on those two statutes.

Both states have the same statute of limitations. If the claim arose after the transfer to the trust, then the fraudulent conveyance claim can only be made if brought within four years after the transfer to the trust. If the claim arose prior to the transfer to the trust, the claim must be made within four years of the transfer of the trust or one year after the creditor discovered or reasonably could have discovered the claim.

The settlor of an irrevocable Delaware or Alaska trust may retain the power to veto a distribution or have a special testamentary power of appointment. Note that if a settlor retains either of these powers, the transfer to the trust will not be a completed gift and it will probably result in the inclusion of the trust assets in the settlor's gross estate under Code §2038.

Both statutes provide that a transfer to the trust can be voided, if at all, only to the extent necessary to satisfy the settlor's debt to the creditor who voided the transfer.

Although both statutes allow an individual to serve as trustee, the Alaska law requires the individual to be *domiciled* in Alaska, whereas the Delaware law requires the trustee to be a *resident* of the state of Delaware. It is conceivable that a Alaska citizen domiciled in Alaska could acquire a residence in Delaware and serve as a trustee of asset protection trusts in both Alaska and Delaware.

Alaska law does not expressly require a trustee to be independent, unrelated and not subordinate, although a settlor may not receive a trust distribution unless it is from a trustee other than the settlor. Delaware law requires that the trustee be "neither the transferor nor a related or subordinate party of the transferor within the meaning of IRC §672(c)." Arguably, the Delaware language requiring trustee independence will provide the best creditor and tax protection, although the same language can of course be inserted into an Alaska trust document.

Delaware law specifies that a non-resident individual or entity not authorized to act as a Delaware trustee under Delaware law cannot be a qualified trustee. A non-resident individual or entity may, however, be an advisor to the Delaware trustee. Delaware law provides that an advisor may have the authority under the trust instrument (a) to remove and appoint qualified trustees or trust advisors, (b) to direct, consent to or disapprove trust distributions, and (c) to serve as an investment advisor. These provisions respecting advisors are included with numerous refinements made to the Delaware legislation in 1998.

Importantly, Delaware law provides for trustee exoneration by stating that a trustee acting in good faith will have a first lien against any property transfer being voided under the APT fraudulent transfer provisions. That lien is to be in an amount equal to the costs to the trustee of defending the trust, including attorney's fees. The trustee can also recover from the voided transfer proper fees, costs, preexisting rights, claims and interests of the trustee and any predecessor trustee who has acted in good faith. The law provides a presumption that a Delaware trustee did not act in bad faith merely by accepting a transfer of the property.

The two statutory schemes also differ in the definition of certain preferred creditors who can invade the trust to satisfy their claims. Unlike Alaska, Delaware defines a class of preferred creditors which include the settlor's spouse and children, any person to whom the creditor is indebted because of an agreement, and any other person who have claims against the settlor for death, property damage or personal injury based on acts that occur before the trust is funded. Some commentators view the provision for preferred creditors' claims as reflecting a sense of fairness which will bolster the status of Delaware law in the view of any courts (Delaware or non-Delaware) resolving claims against the trust.

(B) **<u>Limitations of Domestic APTs</u>**. Alaska and Delaware are positioning themselves to compete with the foreign jurisdictions by offering a lower cost alternative without all the insecurity and expensive "bells and whistles" associated with offshore trusts. However, while these jurisdictions can offer the advantages of political stability, lower cost and simpler, more local structuring, the level of asset protection they offer is inferior to the foreign jurisdictions in two important respects.

(i) **<u>Fraudulent Transfer Laws</u>.** The offshore APT jurisdictions, particularly the Cook Islands, have much more debtor-friendly fraudulent transfer laws -- most notably shortened limitation periods and burden of proof provisions -- than the domestic APT jurisdictions. Both Alaska's and

Delaware's statutes of limitations for fraudulent transfers are four years from the date of the transfer or, importantly, one year from the date the creditor could have "reasonably discovered" the transfer. It is therefore possible that a judge could extend the statute indefinitely with a determination that the creditors could not have "reasonably discovered" the fraudulent transfer until less than a year before litigation commenced. By contrast, many offshore jurisdictions require that litigation be commenced within one or two years.

Further, with respect to Alaska's statute specifically, transfers are voided if intended "to hinder delay or defraud creditors". Alaska case law appears to have recognized numerous badges fraud and provides a low standard of proof, so that it may be easier for a creditor to make a case in Alaska than in most other states. A fraudulent transfer claim is generally considered to be a tort claim. Alaska law seems to provide that punitive damages are awarded only in tort cases. Most offshore jurisdictions provide that the loser pays all costs and legal fees. Thus, punitive damages may be available if civil fraud or another tort claim is combined with underlying contractual claims made against an Alaska APT. This is to be contrasted with the general rule in offshore jurisdictions, which prohibits punitive damages.

(ii) <u>The "Full Faith and Credit" Clause</u>. As a part of our federal system of government, Alaska and Delaware are constitutionally obliged to give full faith and credit to the judgments of their sister states. As a New Hampshire resident I can place $1 million into a self-settled discretionary trust managed by a Delaware trustee and designed to satisfy the requirements pertaining to "qualified dispositions" under the Delaware Trust Act. Five years later I can be sued by a New Hampshire claimant and suffer a $1 million judgment in a New Hampshire court. My adversary can take that judgment, docket it in a Delaware state court, and require the Delaware court to enforce it without requiring the plaintiff to retry the merits of the case. However, once armed with that judgment, the Delaware court must apply Delaware law concerning the post-judgment remedies available to the plaintiff. That law says that my trust is off-limits, assuming that the plaintiff cannot prove that the transfer was fraudulent as to him or cannot fit within one of the law's preferred claimant categories -- arguments my hypothetical facts assume he will not have. So far, so good.

The full faith and credit requirement is therefore not a problem. But what if instead of seeking to have his judgment docketed in Delaware and proceeding under Delaware remedies laws, my adversary's lawyer asks the New Hampshire court to exercise its "long-arm" jurisdiction to directly attach the assets in my Delaware trust? To assert its long arm jurisdiction, the New Hampshire court must find that the Delaware trust or trustee had some "contacts" with New Hampshire. Some commentators have speculated that promoting Delaware trusts in New Hampshire to New Hampshire attorneys might give a results-oriented judge a sufficient "nexus" under conflicts and choice of law principles to apply New Hampshire remedies law and the New Hampshire self-settled trust doctrine. So far no decided cases have allowed this. The ink is not dry on the statute long enough to say for sure whether this will be a problem.

b. Important Development Regarding Offshore Asset Protection Trusts: The "Anderson Case". This case has received substantial attention from the asset protection bar. In Federal Trade Commission v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999), the Ninth Circuit upheld contempt orders against the settlors of a Cook Island's trust based on facts which are admittedly egregious, but still instructive and helpful concerning how an indignant US court might seek to overcome legal theories marshaled to protect settlors and their foreign APT assets.

In July of 1995, Mr. and Mrs. Anderson created a foreign asset protection trust in the Cook Islands. They designated a popular offshore service provider as the trustee. The Andersons who were co-trustees as well as "trust protectors". The trust was irrevocable and at the time it was formed the Andersons were solvent and had no significant claims against them.

Mr. and Mrs. Anderson were telemarketers in the San Diego area. Almost two years after they created their APT they agreed to telemarket for a seller of novelty products such as water-filled dumbbells. The Andersons formed a LLC and through it sold high-return "media units" used to market the products. They raised $13 million from selling the media units and their LLC allegedly generated over $6 million in commissions, much of which were gradually transferred from the LLC to their APT.

While the Andersons were successful at selling the media units, the producer not as successful selling its products, causing the value of the units to plummet. The entire arrangement collapsed in a fashion reminiscent of the Ponzi scheme.

A year after entering their deal with the producer and two years after forming the APT, the FTC sued the Andersons in federal court for defrauding consumers. The FTC sought a preliminary injunction to force the Andersons to cease selling the media units and also sought to require the Andersons to repatriate all of the APT assets.

The district court judge granted an ex parte restraining order and, after an initial hearing, issued a preliminary injunction requiring the Andersons to repatriate the assets. The Andersons immediately faxed the APT trustee a letter advising the trustee of the order and instructing the trustee to repatriate the trust assets to the United States. The trustee reviewed the trust documents and replied that it was self-evident from the Anderson's letter that they were under "duress" as defined by the terms of the trust. The trustee concluded that it could not comply with the instructions to repatriate the trust assets, and invoked another provision of the duress clause of the trust and removed the Andersons as co-trustees.

After being informed of the trustee's response, the district court judge found the Andersons in contempt for their failure to repatriate the assets. He gave them two weeks to purge the contempt by repatriating the assets. When the assets were not returned the judge ordered Mr. and Mrs. Anderson incarcerated. They appealed to the Ninth Circuit, claiming that compliance with the district judge's order was impossible.

The issues on appeal involve the Andersons' assertion that impossibility is a defense to a charge of civil contempt. The three judge Ninth Circuit panel first focused on a possible exception to the rule which arises when the party asserting the impossibility defense created the impossibility in the first instance. To the panel, it was "readily apparent that the Andersons' inability to comply with the district court's repatriation order is the intended result of their own conduct -- their inability to comply and the foreign trustee's refusal to comply appears to be the precise goal of the Andersons' trust." The opinion looks to historical purposes for creating offshore trusts to conclude that the Andersons' APT had been created in anticipation of later claiming the impossibility defense. The court cited articles in various estate planning journals which discuss the purposes for and the mechanics of APTs as proof that "asset protection trusts are designed to shield wealth by moving it to a foreign jurisdiction that does not recognize U.S. judgments or other legal processes, such as asset freezes", thereby frustrating and impeding the United States courts by moving their assets beyond those courts' jurisdictions.

Importantly, the opinion recognizes that offshore APTs are designed to make it impossible for the settlor to repatriate the trust assets and give the settlor a supposedly fool-proof defense to charges of contempt, suggesting that the court might not find the Andersons' alleged inability to repatriate the assets to be a defense to contempt because "these offshore trusts operate by means of frustrating domestic courts' jurisdiction". The court that left that issue, however, "for another day", because it found that the Andersons had not met their burden of proving impossibility in the first place.

This points out a problem with many APT structures: the attorneys creating them establish a protection strategy whereby legal ownership or any appearance of control is given up in a strictly technical legal sense, but <u>de</u> <u>facto</u> control is maintained over the assets. The <u>Anderson</u> court explicitly recognized this practice by stating that "[APTs] are often designed to assist the settlor in avoiding being held in contempt of a domestic order while only feigning compliance with the court's orders". The court found this as justification for imposing a "particularly high" burden on an APT's settlor's assertion of an impossibility defense "…because of the likelihood that any attempted compliance with the court's orders will be merely a charade rather than a good faith effort to comply". The court applied this "especially high" burden to the Andersons' proof and refused to overturn the district court's determination and incarceration order.

In this case, there was ample evidence of de facto settlor control. Evidence adduced at trial included the Andersons' use of $1 million from the trust to pay their taxes. The appellate court opinion also focused on the Andersons' role as trust protectors giving "them affirmative powers to appoint new trustees and mak[ing] the anti-duress provisions subject to the protectors powers [enabling them to] force the foreign trustee to repatriate the trust assets to the United States". It is noteworthy that after the repatriation order the Andersons had attempted to resign as trust protectors. The appellate court rejected this self-serving act, seeing it as evidence that the Andersons knew that as protectors of the trust they retained control. This, in Ninth Circuit panel's view, was "[p]erhaps the most telling evidence of the Andersons' control over the trust." In short, the panel was simply unwilling to believe the Andersons had parted with control through their resignation as trust protectors or otherwise.

The language of the opinion is rife with sarcasm and cynicism concerning the Andersons motives. This is the crux of the case: the Andersons presented evidence that they did not have any control and the Ninth Circuit simply refused to believe that proof, based on -- as the district judge had put it -- "the totality of the scheme".

Some commentators have suggested that Anderson represents the death knell for the impossibility defense. They argue that the Affordable Media case makes it easy for any district court arbitrarily to disregard the defense and incarcerate an offshore APT settlor until the assets are repatriated. Others see the case as a good example of hard facts making bad law. They argue that the FTC's statutory injunction remedy, the Andersons' admitted fraud, and unusual facts involving their serving as trust protectors with affirmative powers to remove and replace the offshore trustee, and not merely the traditional veto powers over trust distributions, etc., make the case nothing other than a cautionary tale. For an interesting colloquy on Anderson, and the future of offshore APTs, see A Conversation on the Anderson Case between Jay Adkisson and Dennis Kleinfeld, 2 J. Asset Prot. No. 1 at 15 (2000).

c. FLPs and LLCs: The *Baybank* Case. FLPs have become an extremely popular tool for protecting accumulate wealth.[71] Clients who transfer assets to an FLP own the partnership interests they receive in return, not the assets themselves.[72] The nature and attributes of those partnership interests under estate partnership and federal tax law may create some creditor protection and transfer tax saving opportunities.[73]

(1) Family Limited Partnerships ("FLPs"). A typical FLP strategy would involve the parents' transfer of assets to a newly formed New Hampshire FLP. Each parent receives limited partner interests representing forty-nine percent of the total outstanding equity in the partnership and a general partner interest representing one percent. The parents retain the general partner interests which entitle them to control the partnership's activities, manage partnership property, and determine when and if distributions are made to the limited partners. They gift the limited partner interest to their children.[74] Many attorneys and other advisors tell their clients that this offers the best of both worlds: the parents retain the right to control the use and enjoyment of the partnership property, and realize substantially all of its economic benefits, while still being deemed to made a completed gift of ninety-eight percent of the equity to their children as far as the IRS and the parents' creditors are concerned.[75] As general partners, the parents remain accountable for the debts and liabilities of the partnership. However, because of the unique nature of a limited partner's interest, their children are absolved from partnership liabilities unless they attempt to participate in the management of the affairs of the partnership.[76] The value of their interest as limited partners, and the partnership assets, are also protected from the children's creditors because of the unique legal and tax attributes of a limited partner interest.

A creditor's remedy against a limited partner is not to attach or force sale of the limited partner's interest, but rather to obtain a "charging order" against it.[77] This entitles the creditor only to receive the partnership distributions to which the client, as limited partner, would be entitled. The creditor has only the rights of an assignee of the partnership interest.[78] The creditor cannot become a limited partner unless all of the partners (i.e., the client and any family members to whom the client has transferred limited partner interest) consent. The creditor therefore has no control over whether the general partner makes partnership distributions.[79] Control remains in member of the debtor's family who presumably will not consent to partnership status for a hostile creditor, or make partnership distributions to that creditor. The creditor will nonetheless be treated as a substitute partner for federal income tax purposes and be accountable for the limited partner's share of partnership tax attributes regardless of whether the creditor receives a partnership distribution to aid him or her in paying any resulting federal income tax liability.[80] This has been referred to as being "K-O'd by the K-1."

(2) <u>The Limited Liability Company (LLC)</u>. Although LLCs are relatively new in this country, over 40 states now specifically authorize their creation. Most of the small minority of the states which do not are in the process of adopting LLC statutes.[81] The New Hampshire legislature first expressly recognized LLCs in 1993.[82] They are becoming popular because they are a hybrid entity: if properly drafted, they combine the protection of limited liability normally associated with corporations with the favorable tax treatment of a partnership. Note, however, that Vermont and Massachusetts have not enacted LLC statutes as of this writing. It is possible that these states could treat an LLC as a general partnership, in which case LLC members would have unlimited liability for the LLC's debts and obligations incurred or enforceable in those jurisdictions.[83] Until the situation changes, owners of New Hampshire based interstate businesses act at their peril when they operate in the LLC form.

An LLC is an unincorporated entity which is owned by member rather than shareholders. A member may be any natural person, partnership, LLC, trust, estate, association, corporation, custodian, nominee, or representative.[84] New Hampshire's statute allows an LLC to have classes of members similar to classes of corporate shareholders.[85]

The taxation of LLCs is evolving very quickly, due in large measure to the LLC's growing popularity as a vehicle for holding income producing real estate. The attorney must carefully draft the LLC agreement to ensure that the LLC is taxed as a partnership, not a corporation, for both federal income and New Hampshire business tax purposes.[86]

In certain circumstances LLCs may be more advantageous than family limited partnerships because unlike FLPs, LLCs allow all members-including the managing members-to avoid personal liability.

The text accompanying footnote 77 refers to the "charging order" remedy available to a creditor attaching a limited partner interest. The same remedy is available to a creditor attaching a member's interest under the LLC act. In Baybank v. Catamount Construction, Inc., 141 N.H. 780 (1997), the Supreme Court strictly construed the statutory charging order remedy and reversed a superior court judge's decision to order a liquidation of a family limited partnership and appoint a receiver to receive the limited partner/debtor's liquidation proceeds and apply them to the creditor's debt.

D. Conclusion.

A timely, well considered multiple entity asset protection plan can hedge a client's bets against certain economic risks and the excesses of litigious society. In considering whether a prospective client is a candidate for asset planning, and selecting asset protection strategies, it sometimes helps to consider the following bromides:

Timing is everything. Short of legitimate prebankruptcy planning, there is little an already financially distressed debtor can do at the eleventh hour.

Caveat Emptor. Public fear loathing always creates opportunities for hucksters and other opportunists. There is copious snake oil being marketed in the name of asset protection. Clients are well advised to remember that "if it sounds too good to be true, it probably is." The best asset protection plan involves multiple layered strategies which establish fire walls between assets, not a prepackaged, one size fits all strategy.

Don't let the asset protection tail wag the dog. The objective is not to allow a client to "go bare," stripped of assets or insurance coverage, to avoid their legitimate debts. Attorneys and their clients are best counseled not to go overboard attempting to leverage back against every conceivable risk. The client's plan should be a measured response to the uncertainties of the modern world which seeks reasonably to manage risk without allowing it to rule the client’s life.