

What Estate Planners Should Know About Bankruptcy Law

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Many estate planners are familiar with asset protection mechanisms, such as state law exemptions, family limited partnerships (FLPs), offshore asset protection trusts (OAPTs), and domestic asset protection trusts (DAPTs). They also are acquainted with some creditor protection rules such as state fraudulent transfer acts as well as ethical considerations that apply to creditor protection planning. Many advisors also have some knowledge of the U.S. Bankruptcy Code.

Unfortunately, though, even those advisors who are familiar with portions of the Bankruptcy Code are unaware of certain provisions—such as those governing preferential transfers—that can have a catastrophic effect upon an estate plan. Indeed, many estate tax- and income tax-oriented planning structures risk being dismantled by a bankruptcy judge, even though the plan’s primary purpose had nothing to do with creditor protection.

That is why it is critical to not only know the basics, but also to recognize certain rules that apply in the bankruptcy forum and the need to consult with a bankruptcy lawyer in certain situations. The following information will provide an update, review, or excellent introduction to this most important segment of financial services.

THE BASICS

Any estate planning client could end up in a bankruptcy proceeding, whether voluntarily or involuntarily. In many cases, it is unlikely that a client would choose to file a voluntary bankruptcy petition. Often, a client may be forced into a bankruptcy proceeding on an involuntary basis.² And since the implementation of the 2005 Bankruptcy Abuse Prevention and Creditor Protection Act (2005 Bankruptcy Act), there are more stringent requirements imposed on consumer debtors that must be met for them to be eligible to file a petition.

In general, there are three types of bankruptcy:

¹ Substantial portions of this outline were used with permission from an outline entitled “What Estate Planning Lawyers Should Know About Bankruptcy Law” prepared by Alberto F. Gomez, Esq. of Johnson, Pope, Bokor, Ruppel & Burns, LLP in Tampa, Florida, and Alan S. Gassman, Esq. of Gassman Law Associates, P.A. in Clearwater, Florida.

² 11 U.S.C. § 303 (2007).

Chapter 7 is essentially a liquidation mechanism.

Chapters 11 and 13 contemplate a repayment plan.

A Chapter 7 debtor must meet a “means test.” Upon filing a petition to implement an automatic stay against creditor actions, a Chapter 7 trustee is appointed and the assets become property of the bankruptcy estate, many of which may qualify as exempt. In Chapter 7, the court essentially takes a snapshot of the debtor’s assets and liabilities as of the date of filing.

This is significant because the debtor’s post-petition earnings are not property of the estate. For example, if a debtor won the lottery post-petition, the lottery winnings would not be property of the estate. Typically, 90 days from filing, the debtor obtains a discharge from responsibility for pre-bankruptcy debt. The debtor is afforded a fresh start. However, there are some exceptions to the discharge rule. For instance, only individuals receive a discharge in Chapter 7; corporations cannot be discharged. Debts excluded from discharge include claims not listed by the debtor on the schedules, taxes, and domestic support obligations.

Chapter 13 is only available to individuals (not corporate or other business entities). To be eligible to file a Chapter 13, an individual must have unsecured debts of less than \$383,175 and secured debts of less than \$1,149,525.³ Chapter 13 repayment plans are for three to five years and are funded by the debtor’s disposable income. In exchange for paying under a Chapter 13 plan, a debtor keeps his or her assets. Chapter 13 is prospective as opposed to the snapshot concept of Chapter 7. The Chapter 13 trustee administers payments under a plan once a court confirms the plan. At the conclusion of the plan, after payments are made, the debtor obtains a discharge.

Chapter 11 is used primarily for business entities, but individuals with significant assets or who do not meet the debt limits for Chapter 13, may file a Chapter 11. Instead of a trustee, the debtor becomes the debtor-in-possession (DIP) and is afforded an opportunity to propose a plan. The DIP remains in possession and control of her assets. Chapter 11 requires the debtor to obtain the vote of creditors in order to confirm the plan, unless the debtor is able to “cramdown” the plan as authorized by the Code. The cramdown rules allow the bankruptcy judge to approve the debtor’s plan over the objections of dissenting creditors. The cramdown is only permitted if the plan does not discriminate unfairly, and is fair and equitable to the dissenting classes.

Estate planners should become well-versed in the nuances of these three types of bankruptcies, because significantly different results could occur depending on what chapter applies. For instance, in the case of the lottery winnings, if the winnings were obtained post-petition in a Chapter 7, the debtor would keep the winnings. On the other hand, if the winnings occurred while in a Chapter 13 or Chapter 11, the winnings are property of the estate.

³ 11 U.S.C. § 109(e) (2010).

Moreover, the application of the attorney/client privilege differs depending on whether a client files for Chapter 7, 11, or 13. When a Chapter 7 bankruptcy petition is filed, the Chapter 7 trustee may become the owner of the attorney/client privilege, as well as all client files for purposes of asserting or waiving the privilege. There is a split of authority on this point.⁴

Therefore, correspondence to the client that may reveal significant risks or adverse issues with respect to potential creditor planning might cause irreparable damage to the client, and the estate planner, if and when a bankruptcy petition is filed. However, the above privilege issue would not arise in the context of a Chapter 13 or Chapter 11 bankruptcy.

INVOLUNTARY BANKRUPTCY

It only takes *one* creditor to force a debtor into involuntary bankruptcy when the debtor has fewer than 12 creditors. Under 11 U.S.C. § 303, when a debtor has 12 or more creditors, an involuntary bankruptcy can be commenced only when 3 or more creditors file a petition, with each creditor holding a claim that is (1) not contingent as to liability, and (2) not subject to a bona fide dispute as to liability or amount.

A creditor cannot be counted in the three-or-more-creditor requirement if it holds a lien on the debtor's property, unless its claim exceeds the value of the property liened by at least \$12,300. Generally, employees and "insiders" are not counted as creditors in determining whether 12 creditors exist. Because of the stricter bankruptcy rules, which are now applicable, more clients with large judgments against them will be rendered insolvent, yet will attempt to avoid or delay bankruptcy while maintaining their creditor exempt assets. Creditors may respond by utilizing the involuntary option.

There have been many notable decisions, including one by the U.S. Court of Appeals for the Fifth Circuit in *Denham v. Shellman Grain Elevator*,⁵ where the bankruptcy court refused to count small and recurring claims as "countable" under the 12 creditor requirement. However, the Seventh Circuit has held that, in the absence of any indication that Congress intended for creditors holding small and recurring claims to be excluded from the 12 creditor requirement, such claims are included in the count. *Matter of Rassi*, 701 F.2d 627 (7th Cir. 1983).

Cases in the Seventh Circuit have further dismissed the *de minimis* exception as an argument to disqualify one or more creditors based upon the argument that Congress has not explicitly ruled

⁴ *Community Futures Trading Comm'n v. Weintraud*, 471 U.S. 343 (1985), held that a trustee may waive the attorney client privilege for a corporate Chapter 7 debtor, but it did not extend its holding to individual debtors. See *Miller v. Miller*, 247 B.R. 704 (Bankr. D. Ohio 2000), discussing the split of authority.

⁵ *Denham v. Shellman Grain Elevator*, 444 F.2d 1376 (5th Cir. 1971), the debtor listed 18 creditors with an aggregate indebtedness of only \$467.13, all but one of whom were owed less than \$100, to defeat an involuntary petition for bankruptcy filed by one of Denham's very large creditors. The court found that all of the debts were open and unliquidated, as opposed to claims reduced to judgments, and that small recurring debts cannot qualify creditors to be counted toward the necessary amount required to initiate a petition.

out small and/or recurring debts and the statute,⁶ therefore, should be applied literally.⁷ Some courts, however, such as the court in *Matter of Runyan* have indicated that a \$25 debt would not be sufficient, and will evaluate the claims on a case-by-case basis.⁸

Filing an involuntary petition is an aggressive creditor strategy and there are serious and costly consequences if the petition is dismissed. A creditor who files for an involuntary bankruptcy “in bad faith” can be forced to pay the debtor’s fees, costs and actual and punitive damages.⁹ In *In re Cannon Express Corporation*, 280 B.R. 450 (Bankr. D. W. Ark. 2002), the U.S. Bankruptcy Court for the Western District of Arkansas awarded compensatory damages and punitive damages where three creditors filed involuntary bankruptcy proceedings against debtor and the court found them to be in bad faith.

The decision was based on a combination of 5 tests identified in *In re Landmark Distributors, Inc.*¹⁰ The *Cannon* court combined¹¹ and restated the tests finding that:

1. the claims were not well grounded in fact because the creditors did not speak with an attorney, talk to other creditors or attempt to collect the money from the debtor directly;
2. the creditors could have advanced their own interests in a different forum by using a collections agency or setting up a payment system with debtor or other forum, instead holding that using bankruptcy courts is an improper use of judicial resources.
3. the creditors used the bankruptcy proceedings to gain a disproportionate advantage over other creditors because the creditors, who were unsecured, testified that they thought filing involuntary bankruptcy proceedings would put them ahead of other unsecured creditors, thus gaining priority; and

⁶ 11 U.S.C. § 303(b)(2) (2007).

⁷ See *In re Okamoto*, 491 F.2d 496 (7th Cir. 1974) which allowed eight debts, all of which were below \$65 each, to count toward the 12 creditor threshold and stated that most courts abandon *Denham* because *Denham* refused to acknowledge Congressional intent by specifically differentiating between large and small debts and removing a prior provision excluding debts below \$50; See *Matter of Rassi*, 701 F.2d 627 (7th Cir.1983) which prevented the petitioner from forcing the debtor into an involuntary bankruptcy by allowing two claims, both \$10 or less; See also 11 U.S.C. § 548(e); See also Steve Leimberg’s Estate Planning Newsletter Number 485 by Alan S. Gassman.

⁸ *Matter of Runyan*, 832 F.2d 58 (Tex. Court App. 1987).

⁹ 11 U.S.C. § 303(I) (2007).

¹⁰ 189 B.R. 290,309-10 (Bankr. D.N.J. 1995).

¹¹ Those five tests are 1) the improper use test which finds bad faith if a creditor files involuntary bankruptcy to gain a disproportionate advantage for himself over other creditors, 2) the improper purpose test which finds bad faith if creditor’s motivation for filing is ill will, malice or harassment, 3) the objective test which asks if a reasonable person would have also filed involuntary bankruptcy, 4) the subjective test which looks at the subjective motivation of the creditor (almost identical to the improper purpose test), and 5) the two part test which combines the subjective and objective tests. *Cannon* at 453.

4. the creditors were motivated, the court held, by an improper use because the creditor “knew that he was not going to be paid” but thought filing would force the debtor to make payment. Finally, the court held no other reasonable person would have filed the same or similar claim without first investigating whether or not the debtor was paying its debts on time or attempting to collect the debts in some other fashion. For the improper filing the court awarded more than \$14,000 compensatory damages and \$35,000 in total punitive damages. Had the debtor proven losses in sales by preponderance of the evidence, the court would have awarded these damages as well, which were to be \$2,768,288.00 according to the debtor.

In re Meltzer, 615 B.R. 504 (Bankr. D. E. Ill. 2014) is a good example of an involuntary bankruptcy filing that backfired on the petitioning creditors. In *Meltzer*, the petitioners filed the involuntary petition against Meltzer in order to stall Meltzer’s eviction case against one of the petitioners. Additionally, two of the petitioners formed a Hong Kong corporation, Pegasus Electronics HK, Ltd., for the sole purpose of meeting the three creditor requirement, as Meltzer had more than 12 creditors. In fact, Pegasus had no claim against Meltzer. The court dismissed the involuntary petition and awarded Meltzer punitive damages under 11 U.S.C. § 303(i) due to the petition being filed in bad faith. Indeed, the *Meltzer* court characterized the bad faith demonstrated in the case as “grotesque.”

The Bankruptcy Code can affect an estate plan if your client is a debtor, a recipient of a transfer from a debtor, or has an interest in a debtor. In general, upon filing for bankruptcy, assets of a debtor become property of the estate. 11 U.S.C. § 541. Some assets are specifically excluded, such as an interest in a spendthrift trust, as defined in 11 U.S.C. § 541(c)(2) or social security or veterans benefits under 11 U.S.C. § 522(d)(10)(a) and (b). If your client is a debtor, a recipient of a transfer from a debtor, or has an interest in a debtor, then bankruptcy law can dramatically affect the estate plan.

During pre-bankruptcy planning, advisors need to consider whether to leave assets in an estate that would become accessible to a trustee in bankruptcy. On one hand, there is less likelihood that transfers made before the filing of bankruptcy would be considered “fraudulent,” when remaining assets that would be usable to pay creditors were, arguably, sufficient to pay a substantial portion of expected debt.

Also, courts may be sympathetic to situations in which debtors have lost “sacrificial lambs” as a part of their bankruptcy filings.¹² Judges may be more lenient in looking at fraudulent transfer and other issues with debtors who lose some assets upon filing bankruptcy, as compared to clients

¹² A common refrain from bankruptcy lawyers regarding this topic is that “pigs get fat and hogs get slaughtered.” Leaving a sacrificial lamb may tip the scales more favorably towards a debtor since the perception of treating creditors fairly increases. Also, there is a much better chance that a settlement will result, especially with a Chapter 7 trustee. The Chapter 7 trustee is a court fiduciary who is required to promptly convert assets and disputes to cash, unlike some litigants who pursue litigation out of principle or some ulterior motive.

who have moved all of their assets to the exempt category and at filing show no assets going into the bankruptcy estate.

On the other hand, if a trustee has funds derived from bankruptcy estate assets to spend on attorneys' fees and costs to pursue a debtor or recipient of a transfer, it is more likely that the bankruptcy or pre-bankruptcy transfers will be challenged. Often, creditors do not want to "throw good money after bad," so some planners believe that only enough money to pay a small distribution is appropriate to leave in the debtor's name in the event of a bankruptcy.

JUDICIAL POWERS

Bankruptcy courts are courts of equity, able to fashion broad and extensive remedies typically not available to state court judges. For instance, under 11 U.S.C. § 105 of the Bankruptcy Code, bankruptcy judges can enter "any order, process or judgment that is necessary and appropriate to carry out the provisions of this title." In addition to equitable powers, bankruptcy trustees are empowered with certain "strong arm powers" under the Bankruptcy Code. Presumptions concerning fraudulent transfers and avoidance of transfers are built into the Code. Examples of this include 11 U.S.C. Section 548 (relating to fraudulent transfers) and in 11 U.S.C. Section 547 (relating to preference), which are described below.

As a matter of bankruptcy law, a trustee is the equivalent of a hypothetical judgment creditor, and the court can step into the shoes of creditors to exercise statutory strong-arm powers to set aside and recover transfers deemed to be fraudulent or preferential. For instance, Section 548 provides for a two year presumption of fraud for transfers of property owned by the debtor.

There are many bankruptcy cases in which courts have disregarded transfers that were ostensibly motivated by estate planning purposes. In most of these cases, the court's decisions were fact-specific, involving transactions that occurred when the creditor claim was known or should have been known by the debtor. One of the critical factors considered by courts is the "timing" of the specific transfers.

Lesson learned: Get your client's estate and income tax plan underway early and document your client's business, estate, tax, family, and other legitimate motives to ensure that a bankruptcy court will not dismantle legitimate planning that occurs before a bankruptcy petition is filed.¹³

Bankruptcy judges often apply substance over form and rely on equitable principles, in rendering decisions, which often favors the trustee and creditors. For example, in *In re Larry Portnoy*,¹⁴ the bankruptcy court ignored the law of the applicable offshore jurisdiction and applied the law of the jurisdiction where the bankruptcy court resided, to determine that offshore trusts were not effective creditor protection devices. In *FTC v. Affordable Media*¹⁵ and in *Lawrence v.*

¹³ For bankruptcy cases dealing with estate planning issues, see *In Re Kossow*, 325 B.R. 478 (S.D. Fla. 2005); *In Re Jennings*, 332 B.R. 465 (M.D. Fla. 2005); *In Re Ludwig*, 345 B.R. 310 (Bankr. D. Colo. 2006); *Joseph J. Luzinski v. Peabody & Arnold, LLP and Joel Reinstein, P.A. (In Re Gosman)*, Adv. No. 03-3228-BKC-SHF-A (S.D. Fla. 2007).

¹⁴ *In re Larry Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

¹⁵ *Federal Trade Commission v. Affordable Media, LLC, Denyse Lindaalyce Anderson and Michael K. Anderson*,

*Goldberg*¹⁶ debtors were held in contempt and jailed for not turning over offshore assets. The U.S. Court of Appeals for the Ninth and Eleventh Circuits, respectively, upheld the bankruptcy court's decision in both *Affordable Media* and *Lawrence*.

TIMING CAN BE EVERYTHING

In too many cases, estate and asset protection plans miss key bankruptcy protections or ignore crucial facts that could jeopardize the plan itself. Again the bottom line is that the timing of an asset protection or estate plan is crucial to how it will fare in bankruptcy court.

For example, in *In re Agnew*,¹⁷ a farmer owned an undivided 1/5 interest in farmland along with some farming equipment; his mother, in trust, owned the remaining 4/5 undivided interest in the land. The farmer leased the 4/5 parcel from his mother for farming purposes and to live on. Before filing bankruptcy, the farmer transferred his 1/5 interest in the land and his farm equipment to his mother's trust, in exchange for the parcel of land on which he lived. Years before the transfer, the farmer and his mother had discussed making this transfer to ensure that his siblings would not evict him after his mother died.

At issue was whether this transfer should be defeated by Bankruptcy Code Section 522(o)(4), which authorizes the reduction of the amount claimed by a bankruptcy debtor as to homestead property in the amount of any such property that was disposed of in a 10-year period prior to the filing of the bankruptcy petition, if the transfer was made with the intent to hinder, delay, or defraud creditors. Fortunately for the debtor/farmer, the court found there was no intent to defraud creditors; the anticipated bankruptcy filing was not the reason for this transfer even though it was admitted to have been recommended by a bankruptcy consultant shortly before the bankruptcy filing.

Contrast this with *In re Lacounte*,¹⁸ where the court found that a husband and wife debtor did violate Bankruptcy Code Section 522(o) by selling assets to intentionally divert funds away from creditors. Anticipating bankruptcy, the debtor's daughter sought counsel of an attorney who advised the husband and wife to sell off what they did not need, and use the proceeds to pay down their home mortgage. The Debtors sold 3 family cars and the husband's future interest in his mother's 680 acre farm. They used the proceeds from these sales to pay down the mortgage on their home even though debtors had incurred more than \$180,000 in gambling debts on their credit cards. The debtors also transferred the wife's future interest in her mother's home back to her mother because they understood that in bankruptcy proceedings she would most likely lose this family asset to creditors.

179 F.3d 1228 (9th Cir. 1999).

¹⁶ *Lawrence v. Goldberg (In re Lawrence)*, 279 F.3d 129 (11th Cir. 2002).

¹⁷ *In re Agnew*, 355 B.R. 276 (Bankr. D. Kans. 2006)

¹⁸ *In re Lacounte*, 342 B.R. 809 (Bankr. D. Mont. 2005).

The court held that selling the assets and utilizing the proceeds to pay down the home mortgage was done solely to keep the assets out of reach of creditors. The court found this violated 522(o) and the debtor's homestead exemption was reduced by the amount they received as proceeds from sales of their assets.

Keep in mind that in each of the cited cases, the debtors chose to file voluntarily. In most cases, the debtor may very well be judgment proof and would not have to defend against a creditor with strong-arm powers, such as a trustee. If a debtor has implemented an estate plan with creditor protection features, it is logical to ask, why voluntarily file for bankruptcy?

The point is, often it will be best to "hunker down," live with a judgment and occasional depositions in aid of execution and continually attempt to settle as the years roll on. Keep in mind that as time passes, the statutes of limitation continue to click away.

If a planning or asset protection plan is implemented after a demand for payment by a creditor and/or entry of a judgment, a bankruptcy court will be more inclined to find that the plan was a fraudulent transfer.

Planners should advise clients that the risk of a bankruptcy court setting aside or disregarding an asset protection plan increases exponentially based upon (i) the timing of the plan and (ii) the existence of a creditor claim. While the burden is on the trustee in bankruptcy to prove that a transfer can be set aside as fraudulent, evidence other than the debtor's testimony, such as communication with third parties and lack of non-creditor planning reasons, may be used to determine if sufficient proof exists.

A court evaluating whether sufficient "badges of fraud" exist to demonstrate a fraudulent transfer may consider whether:

- 1) the transfer is to an insider¹⁹;
- 2) the debtor has retained control of the asset;
- 3) the transfer was concealed;
- 4) before the transfer, the debtor was sued or demand was made;

¹⁹ The definition of an insider can be found at 11 U.S.C. § 101(31), which reads as follows: The term "insider" includes (A) if the debtor is an individual - (i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control; (B) if the debtor is a corporation - (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor; (C) if the debtor is a partnership - (i) general partner in the debtor; (ii) relative of a general partner in, general partner of, or person in control of the debtor; (iii) partnership in which the debtor is a general partner; (iv) general partner of the debtor; or (v) person in control of the debtor; (D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor; (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and (F) managing agent of the debtor.

- 5) the transfer was of substantially all of the debtor's assets;
- 6) the debtor absconded;
- 7) the debtor removed or concealed assets; and
- 8) there was no reasonable equivalent value or consideration for the transfer.

Ideally, the Plan should be implemented before any creditor claim arises. Many times, the timing of the Plan cannot be controlled, but will be a significant factor.

Under the 2005 Bankruptcy Act, a debtor must maintain a domicile within a state for the two years (730 days) prior to filing a petition in order to have that state's exemption laws apply in the bankruptcy.²⁰ If the debtor's domicile was not located in a single state for that 730-day period, then it is necessary to determine where the debtor resided for the 180 days before those 730 days (days 731 through 910).²¹ In those situations the exemption laws of the state where the debtor was domiciled the greatest number of days between day 910 before filing and day 730 before filing will be the state law to apply in the bankruptcy.²²

LIMITING RISK:

As a threshold matter, the first decision is whether to file a voluntary bankruptcy petition. For many clients, there is no need to file a voluntary petition: their asset protection plan provides enough creditor protection and the non-bankruptcy forum appears to be more debtor-friendly since there are no "strong arm" powers such as the ones provided to a bankruptcy trustee. Outside of bankruptcy, there is no trustee and no strong-arm powers with which to contend.

When an estate planning strategy is put into place; the estate tax, income tax, and financial and family advantages of the arrangement should be emphasized. While important, creditor protection should not be the primary reason of an estate-planning strategy. Rather, estate tax, income tax and other financial considerations should be the motivating factors.

The age of the client, tax issues, current stage in life or business and family support factors are all important in fashioning and defending a legitimate plan. At every opportunity, the documents relating to the plan should contain "recitals" or specifically mention the non-creditor protection factors which result in the creation of the plan.

PAPER TRAIL

In defending any estate or asset protection plan, it is important to have a paper trail that justifies the estate-planning purposes behind the transfers. Again, assuming that the timing is in favor of the debtor, documentation that demonstrates adequate and reasonable non-creditor planning

²⁰ 11 U.S.C. § 522(b)(3)(A) (2007).

²¹ *Ibid.*

²² *Ibid.*

purposes for the transfers may provide a bankruptcy judge with sufficient ammunition to defeat efforts by a bankruptcy trustee to enforce a claim against the protected assets. For instance, if a debtor's medical condition is one factor that supports an estate or asset protection plan, it is wise to document the debtor's health and include letters from treating physicians.

LLCS AND FLPS

Limited liability companies (LLCs) and FLPs—integral parts of many estate plans—are popular vehicles to hold valuable family assets. Indeed, typical estate and gift tax planning recognizes the advantage of discounting that can occur for gift tax purposes, which often leads to transfers of partial interests in an LLC or FLP to family members and/or trusts for their benefit.

There are some state statutes that limit creditors of a debtor-limited partner. For example, 805 ILCS 180/30-20 safeguards the membership interest of an LLC owner or member by limiting creditors of a debtor-limited partner to a “charging order.” A charging order provides the creditor with the right to receive any distributions that may be paid to the debtor-limited partner, but does not allow the creditor to exercise any rights otherwise held by the limited partner.²³ In Illinois, a court may order a foreclosure of the lien on a distributional interest created by the charging order at any time. It is important to note that Illinois does not appear to treat single member and multi-member LLCs differently; in other words, it appears a court may order a foreclosure whether the LLC is single-member or multi-member. The purchaser at the foreclosure sale will acquire the rights of a transferee.²⁴

Unlike Illinois, some jurisdictions expressly prohibit the foreclosure of a charging order lien, which strengthens the protection afforded to a member. For example, Delaware law expressly provides “attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.”²⁵ Likewise, Nevada law provides that the charging order is the exclusive remedy “by which a member may satisfy a judgment out of the member’s interest of the judgment debtor, whether the limited-liability company has one member or more than one member” and “[n]o other remedy, including, without limitation, foreclosure on the member’s interest . . . is available to the judgment creditor . . . and no other remedy may be ordered by a court.”²⁶ This enhanced charging order protection is one reason planners will create entities in other jurisdictions. Due to complex choice of law issues, it is not clear, however, that such planning will be upheld under all circumstances. For example, if an Illinois resident creates an LLC in Nevada, will a judgment creditor in the debtor’s home state of Illinois be able to apply Illinois law to foreclose on the charging order lien, or will a court recognize Nevada law prohibiting foreclosure?

A charging order may turn the creditor into a partner for federal tax purposes, although the tax law is not clear on this. The one Revenue Ruling reaching this result involved a situation where

²³ 805 ILCS 180/30-10.

²⁴ 805 ILCS 180/30-20.

²⁵ 6 Del. C. § 18-703.

²⁶ N.R.S. § 86.401(2).

the debtor-limited partner voluntarily gave the creditor an assignment of the limited partnership interest. Many authorities believe that a creditor will not be subject to federal income tax by reason of merely holding a charging order.²⁷ If income is allocated but not distributed, then the creditor has the risk of being taxed on income that is never received.

One suggestion is to make an LLC or limited partnership agreement impose affirmative obligations on members and partners to make future capital calls and to be involved in partnership management.²⁸ This conclusion is based upon the Bankruptcy Court decision in *Ehmann*,²⁹ where a bankruptcy judge concluded that charging order protection does not apply once a limited partnership interest is subjected to the Bankruptcy Court's jurisdiction when the debtor-limited partner has filed or has been forced into bankruptcy if the partnership arrangement is non-executory. If executory, a trustee is bound by the operating agreement. LLC and FLP agreements should state that they are intended to be executory contracts, that is to say, a contract in which obligations exist on both sides that are unperformed.

There is very little case law addressing the question of whether a limited liability company's operating agreement is an executory contract. Although the Bankruptcy Code does not define the term "executory contract," legislative history and case law cite with approval Professor Vern Countryman's definition: "a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."³⁰ However, in *In re Warner*, the Bankruptcy Court held that operating agreements do not qualify as executory contracts.³¹ Another recent case, *In re Denman*,³² held that LLC operating agreements are not *per se* executory contracts under Tennessee law and, further, that the operating agreement in that case was not an executory contract under 11 U.S.C. § 365. However, a provision in the operating agreement granting members the option to purchase a bankrupt member's interest constituted an *ipso facto* clause that violated 11 U.S.C. § 541(c)(1)(B), which prohibits any provision that "effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property." As a result, the purchasing member did not have the automatic option to purchase the bankrupt member's interest.

Where a debtor is a limited partner in a limited partnership with no affirmative duties to the partnership, the contract may be considered non-executory, and thus not binding upon the trustee in bankruptcy. On the other hand, if a debtor, as limited partner, has affirmative duties to contribute money and to perform services for the partnership, then the partnership agreement may be considered executory, and may, therefore, receive charging order protection in bankruptcy.

²⁷ See *812-2nd Tax Mgmt. Est., Gifts & Tr. J.* IX.D.2 (2006).

²⁸ See Thomas O. Wells & Jordi Guso, *Business Law: Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member*, 81 Fla. Bar J. 34 (2007).

²⁹ This decision was subsequently vacated when the parties settled and the Court approved same. See *Movitz v. Fiesta Investments, LLC*, 337 B.R. 228 (Bank. D. Ariz. 2005).

³⁰ Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 Minn.L.Rev. 439, 460 (1973).

³¹ 480 B.R. 641 (Bankr. N.D.W. Va. 2012). An article about *In re Warner* can be found at: <http://www.llclawmonitor.com/tags/executory-contract/>.

³² 513 B.R. 720 (Bankr. D. W. Tenn. 2014).

From a planning perspective, there are several things one can do to bolster their argument that an operating agreement is an executory contract, including:

1. Draft the operating agreement so that the bankruptcy of a member does not cause a dissociation of the member or a membership termination triggering a monetization of the member's interest.
2. Eliminate a member's right to withdraw or dissociate from the LLC.
3. Make sure the agreement does not allow an assignee to become a member without the consent of all the other members, and perhaps also the manager (except permitted transferees)
4. Avoid *ipso facto* clauses, which are clauses that are conditioned on insolvency or financial condition of a bankrupt debtor prior to filing bankruptcy, the commencement of bankruptcy or the appointment of a bankruptcy trustee.
 - a. Draft the purchase price and terms the same regardless of the cause of the trigger.
 - b. Include legitimate reasons why you need buy-sell provisions (other than creditor protection) such as keeping ownership in the family or with employees.
 - c. Draft the provisions for the price and terms of a purchase fairly or based on an objective rationale (such as a longer period to pay if the trigger is due to unexpected circumstances and thus company cannot "plan ahead" for the repurchase obligation).
5. Clearly state the business purposes of the entity so that the bankruptcy court is less likely to disregard rights of non-debtor members.
6. Emphasize the personal service aspect as part of the ownership by:
 - a. restricting managers to family members of employees;
 - b. requiring owners to serve as managers and attend meetings;
 - c. requiring all owners to serve as managers and attend meetings;
 - d. Stating that services provided by each owner are critical and unique and failure to perform will excuse the obligation of other owners to perform;
 - e. Stating that family members have some experience or expertise that makes them uniquely suited to being the managers (but this may not actually apply to all family members);

- f. Requiring multiple generations to participate in management in order to transfer knowledge between family members;
 - g. Including a provision that automatically terminates an owner's voting and managerial rights upon the bankruptcy of that owner, which should be effective since based on personal trust, etc.; and
 - h. Imposing fiduciary duties on the members, such as a duty to provide the LLC with information obtained in the course of the member's business or affairs. However, be careful that this doesn't give the bankruptcy trustee a cause of action against the other members.
7. Use higher percentage or unanimous voting requirements, and also consider requiring consent of the manager of an LLC for actions such as distributions and liquidations.
 8. Make the buy/sell price favorable to the other owners. For example, the price is to be determined by a third party appraiser selected by the company, and based on the interest being purchased after taking into account all applicable discounts, and to be paid over 9 years bearing interest at the AFR with no security.
 9. If the agreement includes a mandatory purchase or a put, particularly for cash, this may be helpful to the bankruptcy trustee because it makes it easier to monetize the investment. This is a reason to avoid a mandatory purchase except on circumstances such as death.
 10. Is there a drag-along right, which in the hands of a trustee would let the trustee sell the entire company? If so consider eliminating this and rely on the sale of assets.
 11. Include a capital call provision that can be imposed on all owners. Making a call prior to the bankruptcy filing that the debtor member defaults on must be remedied by the trustee prior to assumption of the contract.
 12. Be careful not to exercise a forfeiture provision which could result in a voidable preference transfer or a fraudulent conveyance.
 13. Include a statement that the operating agreement is intended to be an executory contract under 11 U.S.C. § 365(a).

Moreover, LLC members and FLP partners should assume an active role in the management of the entity. Changes to the limited partnership statutes in many states permit participation of limited partners in the management of the entity without the loss of limited liability.³³

³³See, Thomas O. Wells & Jordi Guso, *Business Law: Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member*, 81 Fla. Bar J. 34 (2007).

Another example of bankruptcy court “interjection” in this area is the case of *In re Ashley Albright*,³⁴ where a Colorado bankruptcy court held that the trustee in bankruptcy, as the successor of the LLC that had been owned by a debtor, had the ability to provide consent to the transfer of a member interest in a single-member LLC, and could therefore exercise management control over the LLC and liquidate the assets of the LLC to realize the value as the sole member. The bankruptcy judge concluded that the purpose of the Colorado charging order statute was to protect other members, even though the language of the statute itself had no mention of the charging order protection only applying in a multiple member situation.

Many planners suggest that an LLC have multiple members, so that if one member ends up in bankruptcy, the presence of other members (hopefully) could strengthen the possibility of applying charging order protection.

Finally, given the discounting that can occur for gift tax measurement purposes, it will often be inconsistent with normal estate and gift tax planning not to transfer partial interests in an LLC to family members and/or trusts for their benefit.

FRAUDULENT TRANSFERS

A fraudulent transfer is defined under the Bankruptcy Code as a transfer that can be avoided by a trustee if the transfer was made with (1) the intent to actually defraud, hinder and delay creditors or (2) in exchange for less than reasonably equivalent value while the debtor was insolvent.³⁵

A fraudulent transfer also can be found to have occurred when a debtor has assumed a creditor’s obligation instead of making a transfer. If a debtor makes a transfer to a creditor and does not receive equivalent value,³⁶ a fraudulent transfer exists if

1. the debtor’s business (or impending business) held assets unreasonably low in value;
2. the debtor incurred or believed it would incur debts beyond what the debtor could repay;
or
3. at the time of the transfer, the debtor was either already insolvent or became insolvent as a result of the transfer.

There is a popular misconception that a “fraudulent transfer” is a transfer that involved defrauding one or more creditors in the bankruptcy court. Under debtor-creditor law, the term “fraudulent transfer” means a transfer made for the purpose of avoiding creditors, or in a situation where the transferor is undercapitalized when business operations and potential risk relating thereto is taken

³⁴291 B.R. 538 (Bankr. D. Co. 2003).

³⁵ 11 U.S.C. § 548(a)(1) (2007).

³⁶ Value is defined in 11 U.S.C. § 548(d)(2)(a) as property, or satisfaction or securing of a present or antecedent debt of the debtor. Thus, a promise to remain employed does not satisfy this definition and is not enough to prevent a fraudulent transfer.

into account. This is certainly different than “committing fraud,” which occurs when one party actively misleads another party.

Committing a “fraudulent transfer” in the debtor-creditor law context is generally not a crime, although some states have passed bar rules that prevent lawyers from being integrally involved in helping or advising clients to effectuate fraudulent transfers,³⁷ even though it may be unconstitutional, and seems at least distasteful by many to prohibit lawyers from advising their clients to take actions that are in the client’s best interests. At the least, a client has the right to know all potential actions and potential implications thereof.

Some transfers that are intended to defeat creditors may be illegal, such as transfers intended to evade collection of taxes by the Internal Revenue Service, under Internal Revenue Code Sections 7206(4) and 7201.³⁸

Any person who (1) conceals a debtor’s assets, (2) receives the debtor’s assets fraudulently, or (3) transfers or conceals assets on behalf of a corporation intending to defeat the Bankruptcy Code will find himself, and possibly his lawyer, in prison for up to five years.³⁹ Take for instance *U.S. v. Smithson*,⁴⁰ in which the debtor and his lawyer were both convicted and served jail time for a transfer made two days before filing bankruptcy.

Prosecutors also apply 18 U.S.C. § 371, which prohibits individuals from committing fraud on the United States. The government must prove

- 1) an agreement between two people;
- 2) a scheme to defraud the United States; and

³⁷See, for example, Connecticut Informal Opinion 91-23: “A lawyer may not counsel or assist a client to engage in a fraudulent transfer that the lawyer knows is either intended to deceive creditors or that has no substantial purpose other than to delay or burden creditors.” The opinion went on to say that the determining factor of impropriety was whether the lawyer knew that the transfer was intended to deceive, embarrass, delay or burden a creditor. *But see* South Carolina Bar Ethics Advisory Opinion 85-02, which specifically held that it was ethical for an attorney to transfer a client’s assets to protect against the potential claims of future creditors. There, the Committee held that if there was no immediate reasonable prospect of judgment against the client, to transfers to avoid future creditors was not a violation of the ethics code. The Florida Supreme Court in the case of *Freeman v. First Union Nat’l Bank*, 329 F.3d 1231 (2003), held that Florida’s fraudulent conveyance statute is only a creditor collection tool and is not a basis for damage claims against nontransferees such as third-party financial consultants or legal advisor.

³⁸Fines in the amounts of not more than \$100,000 (\$500,000 for corporations) and not more than 3 years in prison or both. See *U.S. v. Hook*, 781 F.2d 1166 (6th Cir. 1986), in which the court affirmed the conviction of the appellant under IRC Section 7201 for concealing assets from the IRS, by forming a corporation to hold stock and automobiles with his wife and daughter as the sole shareholders. He also conducted other transactions not in compliance with the tax code. In dicta, the court also discussed the effect of Section 7206(4) providing that any attempt to conceal assets after a tax assessment, notice and demand of payment, and refusal to pay is a felony under that statute. This case effectively states that some transfers and transactions intended to conceal assets for tax purposes prior to a tax deficiency assessment will be illegal under IRC Section 7201, and that any transfer or concealment of assets after an assessment will be illegal.

³⁹18 U.S.C. § 152. Punishment includes fines and/or up to 5 years in prison.

⁴⁰49 F.3d 138 (5th Cir. 1995). The case was remanded for re-sentencing.

3) an overt act committed in furtherance of the agreement.⁴¹

An attorney was convicted of conspiring to transfer the assets of one corporation to another in contemplation of bankruptcy under both 18 U.S.C. §§ 371 and 152.⁴² There, the attorney counseled the client to transfer some of the corporation's inventory to another company and then auction off the rest of the company's assets. The attorney, Switzer, set up the transactions and prepared confessions of judgment for some favored creditors. The transaction took place prior to the judicial sale for the trustee in bankruptcy's benefit. Switzer's conviction was upheld on appeal because he was found to have attempted, through his advice and participation in the transactions, to defeat the bankruptcy statutes, and thereby defraud the United States of the client's assets in bankruptcy.

PREFERENTIAL TRANSFERS

While most planners understand state fraudulent transfer rules, which are usually similar to the Bankruptcy Code fraudulent transfer statute, many planners are not familiar with the code's preferential transfer provisions. Transfers made to any party within 90 days of the filing of a bankruptcy petition may be set aside.⁴³ Moreover, transfers made to an insider⁴⁴ within one year of filing a bankruptcy petition may be set aside, notwithstanding whether the transfer would be considered a "fraudulent transfer" under fraudulent transfer rules.⁴⁵ Reasonable compensation paid for services actually rendered will not be considered to be a preferential transfer,⁴⁶ but dividends paid by a professional practice corporation to its owner or member can be considered a preferential transfer. In addition, repayment of shareholder loans may be set aside as a preference.

A case that deals with this insider creditor issue is *In re Halling*, 449 B.R. 911 (2011). Here, the debtor's son was a guarantor on a loan that was given to his mother. The mother made regular payments to the bank for this loan and eventually filed for bankruptcy. The trustee sought to avoid the transfers as preferential stating the son (as a guarantor) was an inside creditor and transfers made to the bank up to a year before bankruptcy were avoidable. The Court stated that guarantors are creditors within the bankruptcy code. The payments to the bank benefitted the son because each payment reduced his liability (as guarantor) to the bank. Thus, the Court allowed the trustee to recover from the son the transfers between 90 days and 1 year prior to filing because son was treated as an insider. Although not specifically stated in the case, presumably the trustee could recover from the bank for the transfers within 90 days.

Transfers also are illegal if asset protection planners intend to evade the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration Board's Comptroller

⁴¹ 18 U.S.C. § 371 (2007).

⁴² *U.S. v. Switzer*, 252 F.2d 139 (2nd Cir. 1958).

⁴³ 11 U.S.C. § 547(b)(4)(A) (2007).

⁴⁴ See footnote 19 for definition of an "insider".

⁴⁵ 11 U.S.C. § 547(b)(4)(B) (2007).

⁴⁶ *In re Double Eagle Const. Co.*, 188 B.R. 406 (Bankr. D. W. Mo. 1995).

of the Currency or the Director of the Office of Thrift Supervision⁴⁷ under 18 U.S.C. § 1032. In *U.S. v. Brown*,⁴⁸ the appellant's conviction for concealing property from the FDIC and the trustee in bankruptcy was affirmed. There, the appellant transferred his interests in a home, fitness center and a corporation to family members and friends. He did not reveal the transfers or his interests to the FDIC, to whom he owed \$2.4 million, to the bankruptcy trustee.

COMPETING CREDITORS

Oftentimes a debtor will want to settle or give a mortgage and/or lien on all assets to a “friendly creditor” to avoid the possible loss of those assets to one or more other creditors. If the friendly creditor is considered an insider, then actions taken that benefit such creditor may be set aside by the other creditors within one year of when they occur. On the other hand, an unrelated friendly creditor (i.e., a creditor who is not an insider) may be able to hold whatever liens or assets it has been given as part of an arms-length debt relief or workout arrangement as long as the debtor has not filed or been forced into bankruptcy within 90 days of the transfer.

DISTRIBUTIONS FROM “INSOLVENT” ENTITIES

Many accountants advise their clients to “keep wages low and dividends high,” but this advice often does not take into consideration fraudulent transfer and preferential transfer rules in the event the client finds himself in a bankruptcy.

Estate and financial planners also need to consider state laws concerning distributions made from a company under circumstances in which sufficient reserves have not been set aside to pay known or expected creditors. The board of directors of a company allowing such distributions can become liable to a creditor. The liability of the directors would be based upon the amount of monies or other assets that should have been left in the company as opposed to being paid out. For example, 805 ILCS 5/8.65(a)(1) provides “The directors of a corporation who vote for or assent to any distribution prohibited by Section 9.10 of this Act shall be jointly and severally liable to the corporation for the amount of such distribution.” Section 9.10(c) of the Illinois Statutes prohibits distributions that, after giving such distribution effect, would (1) result in the corporation being insolvent, or (2) would result in the net assets of the corporation being less than zero or less than the maximum amount payable at the time of distribution to shareholders having preferential rights in liquidation if the corporation were then to be liquidated.

10 YEAR RULE FOR ASSET PROTECTION TRUSTS

Asset protection trusts are arrangements whereby creditors of a beneficiary may not have access to trust assets, based on the law of the jurisdiction where the trust is formed and operated. Asset protection trust jurisdictions in the United States and abroad have proliferated.

The 2005 Bankruptcy Act makes transfers to self-settled trusts or similar devices subject to being set aside in bankruptcy when made within 10 years of filing. A self-settled trust is a trust

⁴⁷ 810-2nd Tax Mgmt. Est., Gifts & Tr. J. II.B.1 (2006). Punishment includes fines and/or up to 5 years in prison.

⁴⁸ 1999 U.S. App. Lexis 18225 (10th Cir. 1999).

established by an individual that allows for the trust assets to be held for the possible benefit of that individual. This 10-year set aside statute applies if the transfer was made with the “actual intent” to hinder, delay or defraud present or future creditors.⁴⁹ Bankruptcy Code Section 548(e)(1) applies to both domestic and offshore asset protection trusts.

In *Battley v. Mortensen*,⁵⁰ an Alaska Bankruptcy court voided the transfer of property to an Alaska asset protection trust because it found the trust was created with the intent to hinder, delay or defraud future creditors. Mr. Mortensen, an Alaska resident, created the Mortensen Seldovia Trust (an Alaska domestic asset protection trust) (the “Trust”) on February 1, 2005 and deeded real property in Seldovia, Alaska, worth approximately \$60,000 to the Trust. Mr. Mortensen’s mother also gave him \$100,000 to transfer to the Trust. At the time of the transfers, Mortensen was having financial problems, but was apparently solvent. The stated purpose of the Trust was to preserve the Seldovia property for family members and protect assets from creditors. In 2009, Mr. Mortensen became ill, incurred substantial credit card debt (over \$250,000), and ultimately filed for Chapter 7 bankruptcy.

The bankruptcy court found that Mr. Mortensen created a valid Alaska asset preservation trust because he was solvent at the time of the Trust’s creation. Consequently, the determinative issue in this case was whether Mr. Mortensen transferred the Seldovia property to the Trust “with actual intent to hinder, delay, or defraud” his creditors in violation of 11 U.S.C. § 548(e), which contains a 10 year limitation period for setting aside a fraudulent transfer to a self-settled trust. The bankruptcy court considered (i) the Trust’s stated purpose of protecting assets from a beneficiary’s potential future creditors, (ii) Mr. Mortensen’s low income relative to his expenses, and (iii) Mr. Mortensen’s speculative stock investments with the Trust’s cash assets, in concluding that Mr. Mortensen’s transfer of the Seldovia property and cash to the Trust constituted persuasive evidence of an intent to hinder, delay or defraud creditors. Consequently, the transfer of the Seldovia property to the Trust was voided by the bankruptcy court.

This case is notable for DAPT planning because it shows the impact that federal law can have on state law asset protection planning. The Trust likely would have been protected under Alaska state law, which has only a 4 year lookback period. However, federal law applied the 10 year lookback period under § 548(e), which voids any transfer made to a self-settled trust with the actual intent to hinder, delay or defraud present or future creditors. Although this seemingly creates a 10 year statute of limitations for a DAPT, it is important to point out that 548(e) applies only if the bankruptcy court finds actual intent to hinder, delay or defraud present or future creditors.

Another recent case highlights the choice of law issues that are apparent where a resident of one state creates a domestic asset protection trust in another state. In *Dahl v. Dahl*, 2015 WL 404521 (Utah 2015), the Supreme Court of Utah refused to enforce a choice-of law provision in a domestic asset protection trust designating Nevada law as controlling where the trust was created by a Utah resident. The Supreme Court of Utah found that applying Nevada law under the

⁴⁹ 11 U.S.C. § 548(e)(1) (2007).

⁵⁰ 2011 WL 5025249 (Bankr. D. Alaska May 26, 2011).

circumstances of the case would undermine Utah's strong public policy in favor of equitable distribution of marital assets in divorce cases. As a result, the Supreme Court of Utah applied Utah law, instead of Nevada law, to avoid violating Utah public policy.

Several bankruptcy court decisions have concluded that offshore asset protection trusts are either invalid, or that the debtors involved with offshore asset protection trusts can be jailed on contempt.⁵¹ A 2012 Illinois Supreme Court case, *Rush University Medical Center v. Sessions*⁵² held the adoption by Illinois of the Uniform Fraudulent Transfers Act ("UFTA") in 2006 did not supplant the state common law rule that DAPTs are not permitted.

In *Rush*, Mr. Sessions created an irrevocable self-settled spendthrift trust in 1994 that was governed by the laws of the Cook Islands (the "Trust"). Mr. Sessions transferred his 99% limited partnership interest in Sessions Family Partners, Ltd., a Colorado limited partnership, and real property in Illinois to the Trust. Mr. Sessions was a lifetime beneficiary and Trust Protector of the Trust. In 1995, Mr. Sessions made a pledge of \$1.5 million to Rush University Medical Center ("Rush U") for the construction of a Rush U presidential residence, which was later constructed even though no payments were made towards the \$1.5 million pledge. In 2005, Mr. Sessions was diagnosed with terminal cancer. He blamed the doctors at Rush U for not diagnosing his cancer early enough for treatment to be effective. As a result, Mr. Sessions amended his estate planning documents so that his pledge would not be satisfied at his death, which occurred on April 25, 2005. At the time of his death, Mr. Sessions had less than \$100,000 in his estate (not nearly enough to fulfill his pledge to Rush U), but the assets in the Trust were valued at approximately \$19 million, including over \$2.7 million of real property in Illinois. Consequently, Rush U sued the Trust alleging breach of contract and that the Trust should be voided based on the Illinois common-law that self-settled spendthrift trusts are deemed to be fraudulent and per se void, and their assets reachable by creditors of the settlor/beneficiary.

Although the opinion does not expressly state what assets of the Trust can be recovered by Rush University, presumably Rush University would be able to recover the real property located in Illinois. However, the Cook Islands courts are not bound by the decision of the Illinois Supreme Court, so it is unlikely the assets located offshore could be reached. It is important to point out that the Illinois court applied Illinois law to determine the validity of the transfers. The court did not apply Cook Islands law even though the trust was governed by Cook Islands law. This case, like the *Dahl* case, is indicative of what may happen if a resident in a non-DAPT jurisdiction creates a DAPT in another jurisdiction. The state of residence may apply the home state's law regarding creditor protection and disregard the law governing the trust, at least as to assets located in the state of residence.

The 10-year rule should not apply if the debtor forms an offshore trust for the benefit of the debtor's family, and not for the debtor himself. "Substantial de facto control," however, has been

⁵¹ For more information on asset protection see Barry S. Engel's *Asset Protection Planning Guide (3rd edition)*.

⁵² 980 N.E.2d 45 (Ill. 2012).

found to be sufficient for a court to find that the trust should be disregarded for creditor protection purposes.⁵³

BANKRUPTCY EXEMPTIONS: OPT IN VS. OPT-OUT STATES

The U.S. Bankruptcy Code establishes a list of exemptions under federal law relating to assets such as annuities, life insurance, retirement accounts and homestead. In addition, each state has its own set of exemptions under state law. Each state may determine whether state or federal law exemptions will be available to a debtor in a bankruptcy proceeding.⁵⁴ States that require debtors to use state law exemptions are known as “opt-out” states. States that permit a debtor to choose whether to apply the federal law exemptions or the state law exemptions are known as “opt-in” states. A majority of states, including Illinois, are “opt-out” states, which means that the exemptions under Illinois state law apply in bankruptcy proceedings.

ANNUITIES AND LIFE INSURANCE

Some states offer unlimited protection of life insurance and the cash values of annuity contracts. Some states only protect certain financial products if and to the extent that they are reasonably necessary for the support and/or retirement of a debtor. In Illinois, all proceeds payable because of the death of the insured and the aggregate net cash value of any or all life insurance and endowment policies and annuity contracts payable to a wife or husband of the insured, or to a child, parent, or other person dependent upon the insured, or to a revocable or irrevocable trust which names the wife or husband of the insured or which names a child, parent, or other person dependent upon the insured as the primary beneficiary of the trust (whether the power to change the beneficiary is reserved to the insured or not and whether the insured or the insured's estate is a contingent beneficiary or not) are exempt from creditors.⁵⁵

Is an annuity a “similar device” that would not be protected in bankruptcy, under the provision applying to asset protection trusts, where within 10 years of filing, a transfer is made into an annuity or life insurance product with the actual intent to hinder, delay or defraud present or future creditors?

The only case that has considered this question is *In re Portco*, a March 30, 2011 Bankruptcy Court decision, that held that Congress only intended to capture “a similar device [to an asset protection trust] that had the same effects as a self-settled trust, and that only an express trust was within that definition.” The court stated that the purpose of the Bankruptcy Code Section 548(e) was to thwart the protection of “domestic asset protection trust jurisdiction.” In this case a debtor

⁵³ See Steve Leimberg’s Asset Protection Planning Newsletter # 70 (Sept. 12, 2005) at www.leimbergservices.com, which discusses *Federal Trade Commission v. Ameridebt*, 373 F. Supp.2d 558 (D. Md. 2005) in which the debtor, under FTC investigation, transferred nearly \$24 million to offshore trusts and used other money to pay for lavish expenses.

⁵⁴ 11 U.S.C. § 522(b).

⁵⁵ 735 ILCS 5/12-1001(f) (2014).

company was entitled to receive real estate from a third party by contract, and instead allowed the real estate to go to a separate company owned by the same shareholder.⁵⁶

RETIREMENT ACCOUNTS

Federal bankruptcy law exempts traditional and Roth IRAs up to an aggregate cap of \$1,000,000 adjusted for inflation (currently \$1,245,475) excluding amounts rolled over from an exempt retirement account.⁵⁷ Under Illinois law, however, a debtor's interest in or right, whether vested or not, to the assets held in or to receive pensions, annuities, benefits, distributions, refunds of contributions, or other payments under a retirement plan is exempt from judgment, attachment, execution, distress for rent, and seizure for the satisfaction of debts if the plan is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986, as now or hereafter amended, or is a public employee pension plan created under the Illinois Pension Code, as now or hereafter amended, without any monetary limit.⁵⁸ The term “retirement plan” is defined broadly to include (1) a stock bonus, pension, profit sharing, annuity, or similar plan or arrangement, including a retirement plan for self-employed individuals or a simplified employee pension plan; (2) a government or church retirement plan or contract; (3) an individual retirement annuity or individual retirement account; and (4) a public employee pension plan created under the Illinois Pension Code, as now or hereafter amended.⁵⁹

Illinois law unequivocally protects any interest a debtor may have in the assets of a pension or retirement plan and any right to receive benefits, distributions, or other payments under such plan.⁶⁰ The specific language of the Illinois exemption for retirement plans does not exclude debtors who have come into their pension rights derivatively, as opposed to having earned them through their own labor.⁶¹ In *Clark v. Rameker*, 134 S. Ct. 2242 (2014), however, the Supreme Court settled a conflict among the circuits regarding whether federal exemption covers inherited IRAs. The Court held that funds held in an IRA that were inherited by a Chapter 7 debtor were not “retirement funds” as that term is used in the bankruptcy exemption statute. As a result, funds in an inherited IRA are not exempt under federal bankruptcy law. Some practitioners believe that, in light of *Rameker*, Illinois courts will not construe state law to exempt inherited IRAs for non-spouse beneficiaries, but an IRA inherited by a spouse should be exempt.

HOMESTEAD EXEMPTION

Under federal bankruptcy law, exemption of an interest in Homestead acquired within 1,215 (3 years and 4 months) days prior to filing a petition for bankruptcy is limited to \$125,000 adjusted for inflation (currently \$155,675).⁶² This cap will apply even if the debtor owned the homestead

⁵⁶ 447 BR 590 (Bankr. S.D.Ill. 2011).

⁵⁷ See 11 U.S.C. § 522(n) (2010).

⁵⁸ 735 ILCS 5/12-1006(a) (2014).

⁵⁹ 735 ILCS 5/12-1006(b) (2014).

⁶⁰ See *In re Lummer*, 219 B.R. 510 (Bankr. S.D. Ill. 1998).

⁶¹ *Ibid.*; See also 735 ILCS 5/12-1006(b) (2014).

⁶² 11 U.S.C. § 522(p) (2010); *but see* Steve Leimberg’s Employee Benefits and Retirement Planning Newsletter #75 (Dec. 9, 2005) at www.leimbergservices.com, discussing *In re Blair*, No. 05-35922-HDH-7 (Bankr. Ct. N.D. Texas)

for more than 1,215 days under certain circumstances (e.g., violation of federal or state securities laws, any criminal act, intentional tort or willful or reckless misconduct that causes serious injury or death to another in the preceding 5 years).⁶³ Federal homestead protection is denied to the extent that the value of a homestead is attributable to any non-exempt property transferred by the debtor in the 10 year period ending on the bankruptcy filing date *with the intent to hinder, delay or defraud a creditor*.⁶⁴

If debtor owned a homestead for more than 1,215 days, and then moved into a new homestead within the 1,215 day period immediately prior to filing bankruptcy, the federal cap will still apply, except that the proceeds applied to the new homestead from the sale of the former homestead will be exempt from the cap if the debtor's previous and current residences are in the same state.⁶⁵ Post-acquisition appreciation in value of homestead within 1,215 day period is exempt.⁶⁶

However, because Illinois is an opt-out state, the Illinois Homestead exemption, rather than the federal Homestead exemption, will apply. In Illinois, every individual is entitled to an estate of homestead to the extent in value of \$15,000 of his or her interest in a farm or lot of land and buildings thereon; a condominium, or personal property, owned or rightly possessed by lease or otherwise and occupied by him or her as a residence; or in a cooperative that owns property that the individual uses as a residence.⁶⁷ That homestead and all right in and title to that homestead generally is exempt from attachment, judgment, levy, or judgment sale for the payment of his or her debts or other purposes and from the laws of conveyance, descent, and legacy.⁶⁸ If two or more individuals own property that is exempt as homestead, the value of the exemption of each individual may not exceed his or her proportionate share of \$30,000 based upon percentage of ownership.⁶⁹

Although Illinois's homestead exemption is substantially less than the federal homestead exemption, other states, such as Florida and Texas, grant substantially larger, or even unlimited, homestead exemptions. Debtors who are domiciled in these states for 730 days preceding the bankruptcy filing can therefore claim the larger homestead exemption.⁷⁰ However, the federal cap will still apply in these jurisdictions in federal bankruptcy court if a debtor has owned the homestead for less than 1,215 days.⁷¹ The home to be protected does not appear to be required to be actually occupied as a *principal* residence for the 1,215 days.⁷² Many individuals will

in which an increase in the value of a debtor's homestead acquired more than 1215 prior to filing was not subject to the \$136,875 cap; however, the article cautioned that *irregular* mortgage payments may not be disregarded.

⁶³ 11 U.S.C. § 522(q) (2010).

⁶⁴ 11 U.S.C. § 522(o) (2010).

⁶⁵ 11 U.S.C. § 522(p).

⁶⁶ See *In re Rasmussen*, 349 B.R. 747 (Bankr. M.D. Fla. 2006); *In re Blair*, 334 B.R. 374 (Bankr. N.D. Tex. 2005).

⁶⁷ 735 ILCS 5/12-901.

⁶⁸ *Ibid.*

⁶⁹ *Ibid.*

⁷⁰ If a debtor is not domiciled in a single state for the 730 days prior to filing, then the law that applies is the place in which the debtor's domicile was located for 180 days immediately preceding the 730 period or for a longer portion of such 180 day period than in any other place. 11 U.S.C. 522(b)(3)(A).

⁷¹ 11 U.S.C. 522(p).

⁷² 11 U.S.C. § 522(p).

therefore be advised to acquire a second home in a homestead protective state such as Florida or Texas to start the 1,215-day period, and then move to such state 730 days before filing for bankruptcy.

CONCLUSION

Bottom line: Estate planners giving asset protection advice need to help make their client aware of the many pitfalls that can exist in the world of bankruptcy. We recommend consultation with a bankruptcy lawyer before undertaking planning steps that may someday be criticized by a bankruptcy judge and/or litigation counsel.