Hope for the Best but Plan for the Worst: What Estate Planners Should Know About Creditors' Rights and Asset Protection

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I. INTRODUCTION

A. Why Asset Protection Planning? Asset protection planning should be integrated into the overall financial and estate plan for the client, and should complement it. Structuring asset protection planning in this manner is not only sensible, but it also provides the best argument to rebut the suggestion that the planning was motivated by an intent to hinder, delay, or defraud creditors.

The law recognizes the right of individuals to arrange their affairs to limit their liability to potential future creditors. *In re Heller*, 613 N.Y.S. 2nd 809 (N.Y. Sur. Ct. 1994). This is analogous to Judge Learned Hand's famous opinion that everyone has a right to organize his affairs to minimize his taxes.

Clients want asset protection planning, and they want their professional advisors to have expertise in this area. Asset protection concerns cause anxiety for our clients in a variety of circumstances. Many of our clients are fearful of being targeted by an unfounded lawsuit in the future. Some of our clients worry that future circumstances may trigger a claim. And some of our clients are worried about a past circumstance which may have already caused a claim or which may cause a claim in the future. Asset protection strategies should plan against a possible future event that would result in economic and financial devastation to our client. Client debtors who have thoughtfully and aggressively pursued asset protection strategies, even late in the day "uglification" strategies, will be rewarded and will retain more assets and repay less of their debts. Reciprocally, those client debtors with exposed "low hanging fruit" who are not proactive in protecting themselves will retain less of their assets and income and repay a greater percentage of their debts.

Asset protection planning strategies should be routinely discussed with estate planning clients. As trusts and estates lawyers we should ask about client exposure to liability. With higher estate tax exemptions and with the opportunities for tax-oriented estate planning possibly shrinking, trust and estate planning lawyers and other financial service providers -- accountants, financial planners, investment advisors, and trust bankers -- have a strong motivation to increase their expertise in the asset protection area as the opportunity presents itself to find other profit centers in their practices.

B. How to Avoid a Claim that a Creditor Has Been Defrauded? The goal of asset protection is not to achieve 100% protection. Rather the goal is to change the creditors' economic analysis of the client's assets. How can the client (and we as the client's advisors) make it difficult for the creditor to reach the client's assets? Conveyances of property and retitling of assets should have a sound justification and business purpose other than creditor avoidance. Lawyers should discourage greed. Remember the saying "Pigs get fat, hogs get slaughtered." Lawyers should be satisfied to materially improve the client's situation and should discourage their clients from making unnatural transfers of too great a portion of their assets. Lawyers should resist pressure from clients for assistance in "borderline" transactions, whether the line is hiding assets, tax fraud, or bankruptcy fraud. To engage in asset protection planning, the lawyer must know his or her clients, screen them with some level of due diligence, and

sometimes obtain Affidavits of Solvency (discussed in more detail below) with satisfactory disclosure of details to ensure that the client is not engaged in a fraudulent conveyance.

Quite often, multiple asset protection strategies should be employed. A close analysis must be made of each client's circumstances. Is the client unmarried or married? What are the assets that the client wants to protect? Are there any legal entities involved (such as an LLC) that might provide any protection? What is the seriousness and size of the risk? What is the client's risk tolerance? Who is the creditor? Is it the IRS, a spouse, a third-party creditor, or a bankruptcy trustee? Does the client have liability insurance or umbrella coverage? What existing protections are allowed in the statutory and case law in the client's state of domicile? What is the timing of the planning?

Asset protection planning must be done as early as possible, before the liability the client is concerned about arises, or at least before it "ripens." When there is a judgment against a client, the creditor can use the judgment to go after client's assets, but the creditor cannot go after the assets the client does not own. So lawyers should consider what planning techniques exist to limit the client's ownership of the asset but allow the client to continue to use and enjoy the asset. Lawyers should be sure that their clients are taking advantage of available exemptions from creditors' claims. And in the creditors' rights and debtors' rights arenas, it is essential to have at least a rudimentary understanding of bankruptcy law and some of the important and ever-changing developments and ramifications.

C. Who are appropriate asset protection clients?

1. A physician concerned that he or she cannot have enough malpractice liability insurance to protect himself or herself from potential future claims, or who is considering going partially or totally "naked" (without liability insurance coverage) because of the prohibitively high cost of the premiums.

2. Another professional, such as an accountant, lawyer, architect or engineer, who has similar concerns.

3. A present or former outside member of a corporate board of directors who is concerned about potential directors' liability for which he or she may not be adequately insured or indemnified.

4. An individual with substantial net worth or notoriety who is concerned that his or her wealth or notoriety may make him or her a target for vexatious claims in our litigious environment.

5. A person engaged in a business from which personal liability could arise, or in a business representing the greater part of his or her net worth, where the inherent nature of the business is such that the potential for serious future claims is sufficient.

6. Someone seeking to avoid forced heirship provisions of state law, e.g., to limit the rights of a surviving spouse to inherit.

7. A married person concerned he or she may someday be facing divorce or alienation from his or her current spouse, seeking to posture his or her assets to limit his or her exposure to an expensive divorce property settlement in the event he or she may someday divorce.

8. An entrepreneur who has recently sold or expects to sell a closely-held business who is concerned to preserve the proceeds of sale from potential claims for indemnification by the buyer, who may be disappointed with the performance of the business.

9. Someone who presently owns or previously owned real estate with potential environmental liability associated, who is concerned that someday there could be a gigantic environmental liability imposed upon him or her.

Note that every new economic crisis and every new economic cycle in the U.S. creates new classes of potential asset protection clients. So be on the lookout – who will be tomorrow's debtors?

D. <u>Who are inappropriate asset protection clients?</u>

1. The individual, or his or her business, is bankrupt.

2. Bankruptcy of the individual or his or her business appears imminent.

3. Individuals for whom the financial picture is bleak: where there are substantial loan defaults, contract defaults with severe potential penalties, or apparent business tort liabilities.

4. Individuals who are, for all practical purposes, insolvent.

5. A lawsuit has been threatened or filed against the individual or his or her business, or an adverse judgment against the individual or his or her business is threatened.

6. The individual's net worth is negative.

7. A substantial judgment has been entered against the individual or his or her business.

II. METHODS OF PROTECTION AND PLANNING OPPORTUNITIES

A. <u>Outright Gifts</u>. A debtor client may transfer property by gift, typically to family members or others who are the "natural objects of their bounty."

1. <u>Federal Gift Tax</u>. Unlimited gifts to a spouse are permitted without gift tax consequences. I.R.C. § 2523. Up to $16,000/year per donee ($32,000 if donor's spouse elects to split the gift) is allowed for gifts to a non-spouse without any gift tax consequence. I.R.C. § 2503(b). Above those levels gifts to a non-spouse will use up the donor's estate tax exemption. In 2022 the estate tax exemption is $12.06 million, and that entire amount can be given away tax free during life. Once the $12.06 million exemption is exhausted by lifetime gifts, gifts are subject to Federal gift tax. I.R.C. § 2505. Federal Gift Tax Return Form 709 will be required for split gifts or gifts which take advantage of any portion of the Unified Credit. The return is due by April 15 of the year following the gift.

2. <u>Federal Estate Tax</u>. Property given away is removed from the donor's taxable estate. Future appreciation on the property avoids tax at the donor's death.

3. <u>Federal Income Tax</u>. Income earned on property given away is thereafter taxed to the donee who may be in a lower income tax bracket. With compressed income tax brackets (the "kiddie tax" basically taxes unearned income of a child to age 19 at the parents' rates), there is very little income tax savings from gifts to children or to trustee for children, but gifts to a child over 19 will save some income tax. Gifts carry over into the hands of the donee the donor's income tax basis. I.R.C. § 1015.

4. <u>Management Supervision</u>. Parents or other donors will frequently want to make gifts during their lives so they may evaluate the donee's ability to manage the property before deciding how to handle additional transfers to the same donee.

5. <u>Fraudulent Conveyance</u>. Assets gifted are immune from creditors' claims if the donor is not insolvent at the time of the gift, if the gift does not render the donor insolvent, and if the gift was not made with the intent to hinder, delay, or defraud creditors.

a. A gift given with intent to delay, hinder or defraud existing or subsequent creditors is voidable. Virginia Code § 55.1-400

b. Virginia Code § 55.1-401 makes voidable as presumptively fraudulent any gift made at a time there are existing creditors, regardless of the donor's actual intent, if the donor is insolvent. This section was expressly intended to defeat frauds perpetrated on existing creditors by the marriage of an insolvent debtor, accompanied by gifts to his or her spouse. *Hyman v. Porter*, 37 Bankr. 56 (Bankr. E.D. Va. 1984). Gift transactions between husband and wife are deemed fraudulent as to existing creditors as a matter of public policy. *Morrisette v. Cook & Bernheimer Co.*, 122 Va. 588, 95 S.E. 449 (1918).

c. A creditor's suit is required to void the gift under Virginia Code § 55.1-400 or § 55.1-401. Virginia Code § 55.1-402.

6. Legal Formalities. It is essential to follow legal formalities (e.g., in the case of real estate, execute and record a deed reflecting the change of title; in the case of corporate stock, cancel old certificate of donor, issue new smaller certificate to donor, new certificate to donee.)

7. Contributions to Virginia College Savings Plan. I.R.C.§ 529, which became law in 1998, authorized Qualified State Tuition Programs, and Virginia laws adopted such a program. Virginia Code § 23.1-701. Parents or grandparents may use this provision to establish college savings funds for children or grandchildren. Contributions to such funds may expand the annual gift tax exclusion by, in effect, accelerating five years of $16,000 annual exclusions to make a $80,000 contribution in one year for one child ($160,000 from a married couple). Virginia Code § 23.1-707.G.1. provides that prepaid tuition contracts, college savings accounts and ABLE accounts are exempt from creditors of purchaser, contributor or beneficiary (except state may reach assets remaining in ABLE account at beneficiary's death.)

8. Direct Tuition/ Medical Payments. In addition to gifts to 529 plans, donors may also make gifts by paying tuition and health care expenses directly to the provider under I.R.C. § 2503(e) or by establishing UTMA accounts for the benefit of young donees as provided under the Virginia Uniform Transfers to Minors Act (Virginia Code § 64.2-1900-1922).

B. Gifts to Irrevocable Trusts.

1. General. Gifts to irrevocable trusts are perhaps the most highly utilized and effective asset protection strategy available. A transfer by the settlor to an irrevocable spendthrift trust for the benefit of one other than the settlor is effective to avoid the claims of the beneficiary's creditors. Such a trust will provide the beneficiary with few or no rights to reach the trust assets; distributions to or for the benefit of the beneficiary will normally be at the trustee's discretion.

Most states have long recognized that an individual is free to establish a trust for the support and maintenance of a beneficiary which prevents the beneficiary from voluntarily or involuntarily assigning or alienating his interest. If the spendthrift trust is validly created, the creditors of a beneficiary will have no greater claim to the assets of the trust than the beneficiary could have. Accordingly, if the trust is a purely discretionary trust and the beneficiary has no right of withdrawal, the beneficiary's (beneficial) interest should be insulated from the claims of his creditors, and any attempt at alienating, pledging, or otherwise charging his beneficial interest in the trust should be void. *Baker v. Vermont Bank & Trust Co.*, 342 F.2d 12 (2d Cir. 1965).

2. Federal Gift Tax Law. Gifts to an irrevocable trust may be sheltered from gift tax by the $16,000/$32,000 annual gift tax exclusion; but as this exclusion is available only for gifts of a present interest, the trust must include appropriate Crummey withdrawal powers. I.R.C. § 2503(b). *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321.

Under I.R.C.§ 2041(b)(2), if a Crummey power grants a beneficiary the right to withdraw an amount larger than the greater of (a) $5,000 or (b) five percent (5%) of the aggregate value of the trust in the year in which the beneficiary dies, the balance of the amount subject to withdrawal in excess of the greater of $5,000 or Five Percent (5%) of corpus may be included in the beneficiary's taxable estate.

A gift to an irrevocable trust for the benefit of a spouse may be sheltered from gift tax by the unlimited marital gift tax exclusion, but only if the spouse's interest in the trust is not a "terminable interest." I.R.C. § 2523(b). In other words, the price of taking advantage of the unlimited gift tax marital deduction for a gift to a trust is that all trust assets will have to be treated as owned by the spouse for estate tax purposes, so that when the trust assets pass per the trust at her death, they will be deemed included in her taxable estate. If a gift in trust for a spouse is a terminable interest, it will be subject to gift tax unless subject to a Crummey withdrawal power in the trust which qualifies the gift for the annual gift tax exclusion.

In the absence of an appropriate Crummey power or qualification of a gift as a marital gift deductible under I.R.C. § 2523, a gift to an irrevocable trust may be sheltered from gift tax only by use of the donor's unified credit.

3. Federal Estate Tax Law. Effective gifts to an irrevocable trust remove property and its post-gift appreciation from the donor's taxable estate.

4. Federal Income Tax Law. Income earned on property given to an irrevocable trust is taxed to the trust as a separate taxpayer (assuming the trust is a non-grantor trust).

5. Probate Avoidance. Property held in an irrevocable trust is not subject to probate in the donor's or settlor's estates.

6. Management/Spendthrift. In addition to the income tax and probate avoidance advantages of a transfer to an irrevocable trust for the benefit of individuals other than the settlor (e.g., settlor's spouse or descendants) such a transfer has the additional benefit of affording management of the assets and discretion over distribution in the event beneficiaries are youthful or improvident.

7. For the Benefit of Settlor. As of July 1, 2012, Virginia enacted domestic asset protection trust legislation permitting a settlor to establish an irrevocable trust of which the settlor is a beneficiary and allowing the settlor to receive spendthrift protection against the claims of the settlor's creditors. For a more detailed discussion of the Virginia self-settled asset protection trust statute, refer to Paragraph J. below.

8. For the Benefit of a Third-Party Beneficiary. A transfer by the settlor to an irrevocable trust for the benefit of someone other than the settlor may be effective to avoid the claims of the settlor's creditors so long as the settlor was solvent before and after the gift and the other badges of fraud are avoided, i.e., so long as the transfer was not a fraudulent conveyance.

9. Inter Vivos Qtip Trust. Inter Vivos Qtip trusts can be an effective estate tax planning and asset protection planning tool.

a. Estate Tax Planning. For estate tax planning, if one spouse has sufficient assets to take advantage of the unified credit if he or she dies first but the other spouse does not, then during life the wealthier spouse may create a QTIP trust for the less wealthy spouse in an amount sufficient to utilize the less wealthy spouse's estate tax credit. Then the assets in the Qtip Trust will pass at the beneficiary spouse's death to the wealthy spouse's heirs tax-free.

Note however that that with the introduction of portability under I.R.C. § 2010, this type of planning may not be as necessary. Also note that the generation-skipping transfer tax exemption is not portable between spouses.

b. Asset Protection Planning. For asset protection planning, a lifetime Qtip trust might be an appropriate vehicle. A spouse will likely be hesitant to make an outright gift of assets to his or her spouse if the transferee spouse has creditor concerns. In such an instance, the transferor spouse can transfer assets to an Inter Vivos Qtip trust for the transferee spouse's benefit. Such a transfer would qualify for the unlimited marital deduction under I.R.C. § 2423(f).

As a potential further benefit, the trust might provide that at the transferee spouse's death, the remaining trust assets could be available for the benefit of the transferor spouse. The question arises whether a transfer back to the transferor spouse would cause the trust assets to be included in the transferor spouse's estate. Treas. Reg. § 25.2523(f)-1(d) expressly provides that the assets are includible in the transferee spouse's estate under I.R.C. § 2036 and § 2038, thus there are no estate tax concerns for the original transferor.

However there may be creditor concerns. If the assets pass back to the transferor spouse, the trust may be treated as a self-settled trust which might expose the trust assets to creditor claims. But many states, including Virginia, have enacted legislation to clarify that such trusts are not deemed to be self-settled trusts, with the result that such trust assets are exempt from the claims of creditors. VA Code § 64.2-747(B)(3). Perhaps the best solution is for the transferee spouse to be granted a testamentary power of appointment, allowing him or her to appoint the assets back to a trust for the transferor spouse's benefit.

For planning purposes, of course the transferee spouse of a lifetime Qtip trust must receive all income for life, and that income stream might be attached by a creditor, but the principal of the trust would be protected. This risk could be alleviated by the Trustee investing in assets that produce little or no income. Additionally, a transferor spouse contemplating such a gift should consider that the transferee spouse will continue to receive income for life, even in the event of divorce.

10. Spousal Lifetime Access Trust. As we as practitioners are aware, Spousal Lifetime Access Trusts ("SLATs") have become a commonly utilized estate planning tool in recent years amongst our high-net-worth clients. This increase in popularity is largely due to the scheduled decrease in estate tax exemption amounts in 2026. Transferring assets to a SLAT provides the same asset protection benefits as transferring assets to any irrevocable discretionary trust for the benefit of a child or grandchild or spouse. But of course a SLAT has the added benefit that the transferee spouse may use the trust assets for the benefit of both the transferee spouse and the transferor spouse, i.e. the marital unit.

Again, the transferor spouse must consider the risks of divorce and of the premature death of the transferee spouse. To address the risk of premature death, some practitioners suggest granting the transferee spouse a testamentary power of appointment and including the transferor spouse within the class of permissible beneficiaries.

11. Irrevocable Life Insurance Trust. Such a trust owns an insurance policy on the settlor's life and is also named as beneficiary of the policy. After the settlor's death, the proceeds may be held in further trust for family members or distributed. It may be used to provide liquid but untaxed assets for paying estate taxes. Such a trust can be effective and inviolable by the settlor/donor's creditors if it avoids the badges of fraud. Unfortunately for the settlor, its most effective use is to convert and leverage relatively small transfers during settlor's lifetime in the form of premium payments, into a much larger death benefit available free of settlor's creditors to settlor's heirs. For a client suffering from creditor woes, use of life insurance trusts may be a way of assuring his heirs will have the financial security which he could not enjoy while alive.

a. Life insurance proceeds retained under the terms of a policy establishing a spendthrift trust are not assignable by the beneficiary or susceptible to claims of the beneficiary's creditors except to the extent the premiums have been paid by the beneficiary. Virginia Code § 38.2-3118.

b. Estate taxes are avoided only if the settlor survives at least three years after transferring existing policies to the trust. That fact suggests the desirability of contributing cash to the trust so that the trustee may purchase the policies. Policies initially purchased by an irrevocable trust will be outside of the settlor's taxable estate regardless of how long the settlor lives after funding the trust.

12. Bankruptcy Issues. Note that federal bankruptcy law gives bankruptcy trustees a 10-year look-back period in connection with alleged fraudulent transfers to self-settled trusts and "other similar devices," presumably including GRITS, GRATS, GRUTS, QPRTS, CRTS, CLTS, ILITS, FLPs/FLLCs (11 U.S.C. § 548(e)).

13. Who Should Serve as Trustee. A trust as a transferee from a debtor will have the best opportunity to survive attempts by creditors to recapture the assets if at least one trustee is an independent third party unrelated to the settlor or the beneficiaries. For income, estate and gift tax reasons it is also desirable for the settlor to avoid serving as trustee. No beneficiary serving as co-trustee should have fiduciary power over distributions to himself or herself; these must be reserved to independent trustees. Under Bankruptcy Code § 541(d) any property in which the bankrupt debtor holds legal title, arguably including title as trustee, becomes property of the bankruptcy estate.

C. Gifts to Charity. A debtor client may make outright gifts or irrevocable trust gifts to charity. In general, creditors cannot reclaim the gift unless it was a fraudulent conveyance. Note also that the charities will fight creditor claims.

1. Federal Gift and Estate Tax. There are allowed unlimited deductions from gift tax (I.R.C. § 2522) and estate tax (I.R.C. § 2055) for outright gifts to qualified charitable organizations.

2. Federal Income Tax. There is allowed a limited deduction from income tax (I.R.C. § 170) for outright gifts to qualified charitable organizations.

3. Retained Life Estate/Remainders. There are special tax rules and tables for valuing the gift tax, estate tax, and income tax charitable deductions where the settlor retains for herself or a family member a life interest or a remainder interest in property given to charities. Using such a technique, i.e., a charitable remainder trust, a donor can maintain a generous guaranteed income stream for as long as she lives. For instance, if a client has anxiety about a prospective future creditor, she

might diminish her net worth by making a charitable lead gift with a remainder to her children or grandchildren free of creditors' claims.

4. Note that the annuity on a Charitable Remainder Trust may be attached and the remainder of a Charitable Lead Trust may be attached.

5. For such transfer to avoid the claims of the transferor's creditors, the general rules for fraudulent conveyance relating to gifts must be complied with.

D. Sale of Asset to Child or Trust for Child. If such a sale is made for a full and adequate consideration, creditors cannot challenge the sale unless they can show fraudulent intent. Obviously, fraudulent intent will be more difficult to prove where fair consideration is received.

1. Frustrating Creditors by Using Illiquid Consideration.

   a. Private annuity payable by purchaser/child or trust to parent/seller bearing long fixed term or for life.

   b. Note payable by purchaser/child or trust to parent/seller bearing long fixed term.

This is an example of "uglifying" an asset (discussed in more detail below), which may be as effective or more effective an asset preservation technique than giving the asset away.

2. Sales of Limited Partnership Interests in Real Estate or Closely-Held Stock or Tech Stock to Children or Trusts for Children. For real estate developers/investors and owners of closely-held stock or tech stock expected to appreciate very substantially wishing to shift some future income and asset appreciation to children for both estate tax savings and asset preservation reasons, the sale of limited partnership interests in a family partnership to children or trusts for children presents a significant opportunity.

   a. At the inception of an investment or development venture there is frequently an opportunity to fairly sell a significant interest in the venture for relatively nominal consideration, e.g., limited partnership interests in a limited partnership of which the transferor is the general partner to trusts for transferor's children. The transferor may give liquid assets to such trust in anticipation of this opportunity, so that the trust will have its own funds to invest.

b. Such an arrangement must be structured very carefully to comply with the rigorous Family Partnership rules of I.R.C. § 704(e) and to avoid the Estate Freeze rules of I.R.C. § 2701.

E. Tenancy by the entirety. A debtor client may transfer property into tenancy by the entirety with his/her spouse or retain property held in that form of ownership. A creditor of one spouse cannot attach property held in tenancy by the entirety, thus making such property immune from the claims of the creditors of one spouse. A tenancy by the entirety is defined by the following characteristics:

(i) Five unities: marriage, title, estate, time, and possession.
(ii) Each spouse has an undivided one-half interest in the asset.
(iii) Neither spouse may sever the tenancy unilaterally. Both must sign on any conveyance.
(iv) The property automatically passes outright at the death of the first spouse to the surviving spouse.

1. Federal gift tax. There is no federal gift tax consequence when spouses transfer property, even previously separately owned property, into tenancy by the entirety, or from tenancy by the entirety into separate ownership. I.R.C. § 2523.

2. Federal estate tax/income tax. Tenancy by the entirety property passes at death tax-free to a surviving spouse who is a U.S. citizen. I.R.C. § 2056. It is worth remembering that the surviving spouse will take tenancy by the entirety property with an income tax basis that is only stepped-up to fair market value at date of death as to fifty percent (50%) of the property. I.R.C. § 2040(b). In contrast, property owned completely by one spouse which is inherited by the other spouse receives a stepped-up income tax basis at date of death as to one hundred percent (100%) of the property in the hands of the inheriting spouse. I.R.C. § 1014.

3. Virginia. Tenancy by the entirety property may be created in many but not all states. In Virginia, spouses may own real or personal property as tenants by the entirety for as long as they are married. Joint ownership by spouses is not deemed to constitute tenancy by the entirety. Rather the tenancy by the entirety form of ownership must be clear and explicit. Virginia Code § 55.1-136.

In addition, Virginia Code § 55.1-136(C) confirms that property held as tenants by the entirety will not lose its immunity from the claims of their separate creditors if they convey it to their joint revocable or irrevocable trust or in shares to their separate revocable or irrevocable trusts, so long as (i) they continue to be married to each other, (ii) the trusts continue to hold title, and (iii) it continues to be their property. Importantly, this statute resolves the tension between the desire to protect the home or any other assets from claims of a creditor of one spouse and the desire to divide title for estate tax planning purpose and to fund the

spouses' respective applicable credit amount bypass trusts. Now both goals may be accomplished.

Property held as tenants by the entirety passes automatically to the surviving spouse at death, avoiding probate. Avoidance of probate may be cited as a legitimate motive for the transfer and as evidence that it was not intended to defraud creditors. Note importantly that the protection afforded by tenants by the entirety is only effective while both parties are living and married to each other. Upon divorce, the tenancy is severed and the creditor protection is lost, and at the first death, the property passes to the survivor, and thus is exposed to the survivor's creditors.

4. Tenants By the Entireties in Bankruptcy. Under the Bankruptcy Code, a debtor may exempt "any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety…to the extent that such interest as a tenant by the entirety…is exempt from process under applicable nonbankruptcy law." 11 U.S.C. § 522(b)(2)(B). In other words, a debtor can exempt their interest in property owned as a tenancy by the entirety to the extent such interest could not be reached by a creditor under state law.

In Virginia, a tenancy by the entirety is a form of property ownership created when property is transferred to or acquired by spouses under certain circumstances. In order for property to be owned as a tenancy by the entirety, it must be acquired with five unities: marriage, title, estate, time, and possession. *In re Bunker,* 312 F.3d 145, 151 (4th Cir. 2002). Tenancy by the entireties enjoys the right of survivorship. *Id.* A tenancy by the entireties can only be severed by the consent of the spouses or by divorce, in which case the ownership becomes a tenancy in common. *Id.* Finally, property owned as a tenancy by the entirety cannot be encumbered by the debts of just one spouse; both spouses must be liable for the debt for a creditor to collect against the property. *Id.*

When only one spouse files for bankruptcy protection, then the property held as a tenants by the entireties is exempt from the bankruptcy estate to the extent that a creditor only has a claim against that spouse. When both spouses file individually, the property held as a tenancy by the entirety is likewise exempt from the bankruptcy estates of the debtors. When the spouses file as joint debtors, the property held as a tenancy by the entirety is exempt from their estates to the extent that they are not joint debtors on the same debt. *In re Bunker*, 312 F.3d 145, 154 (4th Cir. 2002).

The proceeds of a sale of property held as a tenancy by the entirety remain exempt from a debtor's bankruptcy estate absent an "agreement or other indicia of the [debtor and spouse's] intent to sever the entireties tenancy upon the sale of the [property]." *In re Ballard*, 65 F.3d 367, 370 (4th Cir. 1995).

5. Planning Opportunities. Where only one spouse is facing a potential liability, and the marriage is secure, consider shifting property (including

personality) owned jointly or by the spouse facing the potential liability into tenancy by the entirety. In the case of real estate, there is no need to go through a "straw man;" the conveyance may be from the fee owner spouse directly to himself or herself and his or her spouse as tenant by the entirety with common law rights of survivorship. To put themselves in a position to use this opportunity, clients should strive to avoid having their spouses assume joint liabilities with them, e.g., to the extent possible avoid having spouse co-sign loans, loan guarantees, performance bonds, contracts, etc.

But note a potential planning dilemma: if the client would not otherwise give his property at death to his or her spouse outright, the use of tenancy by the entirety distorts the client's estate plan, for instance if the client would otherwise leave the property to the spouse in trust or to his children or other family members. Moreover, putting separately owned property into tenancy by the entirety makes it much more likely the other spouse will be awarded a substantial interest in such property in the event of divorce.

While creation of tenancies by the entirety in personal property is legal in Virginia, there are significant practical hurdles to doing so. For instance, bank and brokerage signature cards typically do not provide for that option, offering only a joint property designation. The employees charged with opening accounts at banks and brokerages are likely to be totally unfamiliar with the designation "tenants by the entirety with common law rights of survivorship" and its legal significance and are not likely to be flexible about opening an account with such an "odd" designation. It may be necessary to insist that the point of contact employee "check upstairs" with more senior management to confirm the propriety of tenants by the entireties accounts. And some institutions may, as a matter of policy, refuse to establish such accounts.

And consider, if a tenancy by the entireties bank or brokerage account is opened whereby either tenant may withdraw all funds -- an "either/or account" -- can such an entireties account be protected from the creditors of either tenant who has complete power to liquidate the account? Possibly not. The safest, albeit more cumbersome, practice will be to require both parties to evidence their consent to withdrawals or redemptions from an entireties account in intangible personality. As a result, it may not be worth titling a couple's basic checking account as tenants by the entirety, so long as the balance is kept to a relatively low level. This requirement should not be a substantial imposition for accounts holding medium- and long-term investment assets.

6. <u>Interesting Case Law</u>.

a. Tenancy by the entirety property is immune from creditors of either owner, e.g., on contract or tort liability of either, but obviously NOT immune from creditors of both. *Allen v. Parkey*, 154 Va. 739, 149 S.E. 615 (1929); *Vasilion v. Vasilion*, 192 Va.

735, 66 S.E.2d 599 (1951); *Ragsdale v. Genesco*, Inc., 674 F.2d 277 (4th Cir. 1982); *In re Sefren* (Maryland), 41 B.R. 747 (Maryland 1984); *State v. One 1984 Toyota Truck*, 533 A.2d 659, 311 Md. 171 (1987); *Warman v. Strawberry* (D.C.), 587 F.Supp. 109 (1983). Proceeds of sale of tenancy by the entirety property is also held as tenants by the entirety. *Bruce v. Dyer*, 524 A.2d 777, 309 Md. 421 (1987); *Potts v. U.S.*, 408 S.E.2d 901 (Va. 1991).

b. In Virginia a deed which conveys a marital home to husband and wife "as joint tenants with full common law right of survivorship" created a tenancy by the entirety, and proceeds from the sale of the property are exempt from claims of non-joint creditors in Bankruptcy Court under § 522(b)(3)(B). *In re Zella* (Mitchell), 196 B.R. 752, aff'd 202 B.R. 712 (1996).

c. Conversion to tenants by the entirety on the eve of bankruptcy may be characterized as a fraudulent conveyance. *In Re White*, 28 B.R. 240 (Bankr. E.D. Va. 1983).

d. In *Oliver v. Givens* (204 Va. 123, 129 S.E.2d 661 (1963)), the Court found that the sale proceeds of tenants by the entirety property continues to be held by as tenants by the entirety, and continues to be immune from the claims of one spouse's creditors. The transfer of the property by the husband to the wife of his interest in the proceeds was not a fraudulent conveyance. The Trustee in bankruptcy acquired no rights in the husband's interest in the proceeds of the sale of the property and was not entitled to recover of the defendant wife a judgment for the husband's share which she had received.

e. In *Rogers v. Rogers*, 257 Va. 323, 512 S.E.2d 821 (1999), the Virginia Supreme Court, in refusing to permit a creditor with separate judgments against husband and wife to levy on real estate held by them as tenants by the entirety, noted its previous statements, made "clearly and without equivocation," that entireties property is exempt from the claims of creditors who do not have joint judgments against the husband and wife. Separate judgments against each do not qualify.

f. A 4th Circuit opinion (*Estate of Reno v. C.I.R.,* 916 F.2d 955 (1990)), interpreting Virginia's apportionment statute to allow a testator to direct that the entire burden of estate taxes be placed on a co-tenant by the entirety was thought by commentators and many members of the Bar to indicate a breach in the doctrine cited above. The decision was widely criticized by many, including the Virginia Bar Association, which at the suggestion of the Wills,

Trusts and Estates Section of the Virginia Bar Association, filed an amicus curiae brief in support of a petition for rehearing.

In an en banc review, the 4th Circuit reversed the panel decision and held that under Virginia law a decedent's will cannot apportion all estate taxes against tenancy by the entirety property. *Estate of Reno v. C.I.R.*, 945 F.2d 733 (4th Cir., 1991). The Court held that Virginia law unequivocally forbids a testator from alienating entireties property by will, and that apportioning the taxes to this property would be the "functional equivalent" of this. In effect the Court refused to permit Mr. Reno from impairing at his death entireties property he could not have impaired during his lifetime.

g. Rent proceeds held in a couple's joint bank account cannot be reached by the husband's creditor, when those proceeds came from property owned by the couple as tenants by the entirety. Rental proceeds are no different in character from sales proceeds from land held by the entireties. Putting the rental proceeds into a bank account held by the couple as joint tenants does not change the character of the proceeds. *Kenbridge Building Systems v. David W. Love*, (VLW 91-H-320, Circuit Court of Richmond). The decision did not indicate whether funds had been commingled in the joint account.

F. <u>Creation and Transfer of Interests in Family Partnerships and LLCs</u>.

1. <u>Family Limited Partnerships/Family LLCs</u>. The use of a family limited partnership and family limited liability companies has the following advantages:

a. Simplifies annual giving, particularly of assets which are not easily susceptible of division into $16,000/$32,000 units. Partnership units or LLC interest may be given.

b. To keep assets within the family by use of buy-sell provisions, restrictions on alienation, including assignments to creditors.

c. Unlike an irrevocable trust, a family partnership or LLC agreement may be amended, so it is a more flexible vehicle.

d. Business judgment rule, rather than the stricter prudent man rule which governs trustees, applies to managing general partners.

e. Arbitration can be required to resolve internal disputes, whereas beneficiaries may not be required to arbitrate disputes with trustees.

To most effectively preserve the partnership's assets from the creator's creditors, because the law is not completely settled in the area, a trusted family member who is not the creator or the creator's spouse should serve as general partner. The creator may be a limited partner.

Where the limited partnership contains only liquid investment assets such as marketable securities, it is important to be able to demonstrate credible non-creditor avoidance business purpose to feel secure behind the "charging-order-only" shield and a credible non-tax business purpose to be able to claim a valuation discount. (Probably only a modest valuation discount, if any, will be available for partnerships holding only marketable securities.)

2. Why Is A Family Limited Partnership/Family LLC the “Holy Grail” of Estate, Tax and Financial Planning?

a. Using an FLP/FLLC, clients can give away assets for income and estate tax purposes but keep control over the assets. The parent or other donor may be general partner or may create an entity to be general partner/managing member over which the donor has direct or indirect control.

This contrasts with the normal tax rule, whereby the “price” of getting income off of your income tax return and an asset out of your taxable estate requires abandonment of control. Our clients almost always want to keep control over their assets, and loss of control frequently discourages them from giving assets away where the gift would otherwise make good estate planning, tax planning, and financial planning sense. In this respect -- that they may give away assets for tax purposes but keep control -- our clients may have their cake and eat it too using an FLP/FLLC.

b. Using an FLP/FLLC clients can leverage lifetime gifts using the annual gift tax exclusion or gift tax applicable credit amount by taking discounts on partnership interests given, where they could not take discounts giving the assets held by the partnership.

c. Using an FLP/FLLC, clients may leverage testamentary gifts at death using the estate tax applicable credit amount by taking discounts on the partnership/membership interests remaining in their names at death. Even majority partnership/LLC membership interests held by the managing partner/managing member may be discounted. If the donor, through lifetime gifts gets to a minority position, greater discounts may be taken. If, during his life, the donor gives up control, greater discounts may be taken. So a donor gets discounts on both partnership interests gifted during life and on partnership interests retained and passing at death. The IRS “invented” the minority discounts in this area when it issued Revenue Ruling 93-12, which held that minority discounts could be appropriate even for interests in a family-controlled entity.

d. Assets held in an FLP/FLLC are generally protected from creditors. Under the Uniform Partnership Act and the Uniform Limited Partnership Act and under the

LLC and LLLP statutes, creditors with a judgment against a partner in a partnership or member of an LLC have NO RIGHT to

1. become substituted partner
2. compel the general partner to make distributions
3. compel the general partner to liquidate and distribute the partnership assets.

Even if a creditor obtains a judgment against a debtor partner, a partnership or LLC membership interest may not be a very attractive asset for the creditor to go after. The only remedy of such a creditor is to get a “charging order” instructing the general partner/managing member, if the general partner/managing member makes a distribution with respect to the interest subject to the order, to pay it instead to the judgment creditor. This principle of Virginia law was reaffirmed in a 1994 Fairfax County case, *First Union Bank v. Allen Lorey Family Ltd*., VLW 094-8-328, which held that a creditor with a charging order does not have standing to ask a court to dissolve the partnership. (But see *Crocker National Bank v. Jon R. Perreton*, 208 Cal. App. 3d.1, 255 Cal. Rpts. 794 (1989), which held that a creditor was not limited to a charging order and was able to attack and sell the debtor’s limited partnership interest.) If the debtor has the ability to see to it that no distributions will be made from the partnership, and the creditor knows it, the partnership interest will be an unappealing target for the creditor.

But in a family context, why would a general partner choose to make a discretionary distribution to a family member subject to a charging order? He would not. In fact, it is even worse for the creditor: the IRS has ruled that a creditor with a charging order gets the K-1, and must report and pay income tax on the income not distributed to him. (Rev. Rul. 77-137) So, to a creditor, a partnership is an ugly asset.

There is an important distinction in the state LLC statutes between the 43 states whose statutes might be said to have “broad charging order” authority which might permit a court to control the activities of the partnership or LLC and appoint a receiver where there is a charging order against a partner or member, and the “Magnificent Seven” states which restrict the court’s authority. In this view asset protected LLCs should be established in one of seven states to have maximum asset protection against charging order remedies. These seven states with optimal statutory language are Alaska, Florida, New Jersey, South Dakota, Delaware, Virginia, and Texas.

There is a second risk asset protection attorneys worry about, the risk of “judicial foreclosure” on a partnership or LLC subject to a charging order. The Magnificent Seven states are ideal in that regard as well.

Moreover, because uniform partnership laws import certain concepts from other laws, and LLC statutes do not, it is the considered opinion of experts giving close scrutiny to the matter that LLCs in the Magnificent Seven States may benefit from more thorough asset protection, in general, than partnerships.

e. A partnership or LLC is a great vehicle for joint investments among friends, siblings, older parents and adult children, grandparents or parents and trusts for younger children. It is a great way for parents to teach children in their 20s and 30s how to invest, and to encourage active participation in the research, analysis, and investment process.

3. New Tax Issues for FLPs. Recently the IRS has stepped up and broadened its attacks on discounted transfers to and through FLPs. Some court rulings favorable to the IRS have caused new concern.

a. In *Strangi v. Commissioner*, T.C. Memo. 2003-15 (2005), the IRS argued that minority discounts were not available because of substantial retained interests by the donors.

b. In *Powell v. Commissioner*, 148 T.C. No. 18 (2017), the Tax Court held that assets of a limited partnership could be pulled back into the gross estate of a decedent who held only a limited partnership interest.

While these cases are concerning, family partnerships and LLCs are still incredibly valuable tools. These cases suggest that practitioners should be careful in drafting partnership agreements and operating agreements to minimize the risks raised by these cases.

One of the key issues is control. There is no question if the person whose assets are going into the FLP is willing to give up control of the FLP and permit someone else to serve as managing partner (or in the case of an LLC, as managing member), the risks of inclusion of FLP or LLC assets in his or her estate are substantially diminished. In certain cases this will work fine and the transferring party will be willing to permit someone else to serve as manager, perhaps an entity, such as another LLC, in which he or she may have a controlling interest. In cases where it is not realistic or acceptable to the person transferring assets to the partnership or LLC to give up control, perhaps the party can be the managing partner or managing member, and if circumstances change in the future in any way which suggest it is undesirable for that person to be the manager, whether because further tax cases make it clear that such control causes a problem or because that party becomes subject to creditor claims, at that time the manager may resign and the operating agreement or partnership agreement should contain language permitting the succession to management by someone other than the transferring party, someone or an entity which is not related or subordinate to the transferring party. The agreement could also delegate certain powers, particularly the power to make distributions, to liquidate, and to dissolve the entity to a "Special Manager" to address the concerns highlighted in the *Powell* case. The entity should also have a non-tax business purpose to avoid scrutiny.

G. Disclaimers. In Virginia, a "disclaimer" is the "refusal to accept an interest in or power over property." Virginia Code § 64.2-2600. A disclaimer can be made by a person "in whole or in part" and the person can disclaim "any interest in or power over property,

including the power of appointment" and "the interest or power even if its creator imposed a spendthrift provision or similar restriction on transfer or a restriction or limitation on the right to disclaim." Virginia Code § 64.2-2603(A). A person can likewise disclaim a right of survivorship in jointly held property. Virginia Code § 64.2-2605.

In order to properly disclaim an interest, the disclaimer must "be in writing or other record, declare the disclaimer, describe the interest or power disclaimed, be signed by the person making the disclaimer, and be delivered or filed in the manner provided in § 64.2-2610." Virginia Code § 64.2-2603.

The effect of a valid disclaimer is that the "interest passes according to any provision in the instrument creating the interest providing for the disposition of the interest, should it be disclaimed, or of disclaimed interests in general" and is deemed effective "as of the time the instrument creating the interest becomes irrevocable or, if the interest arose under the law of intestate succession, as of the time of the intestate's death." Virginia Code § 64.2-2604(B). If the instrument granting the interest does not provide for a successor to the interest, and the disclaimer is an individual, the "disclaimed interest passes as if the disclaimant had died immediately before the time of distribution." Virginia Code § 64.2-2604(B)(3). If the disclaimer is for an interest in a right of survivorship, then the right "passes as if the disclaimant predeceased the holder to whose death the disclaimer relates" and is effective "as of the death of the holder of jointly held property to whose death the disclaimer relates." Virginia Code § 64.2-2605.

Disclaiming an interest in nontestamentary instruments, such as beneficiary benefits from an insurance policy, is treated in the same manner. Virginia Code §§ 64.1-191; 64.1-192; 64.1-193.

Analyzing a disclaimer of an interest in nontestamentary instruments, the Supreme Court of Virginia has found that by virtue of the disclaimer being effective as of the date of the interest, the disclaiming person could not be said to have held an interest that could be transferred, and thus the disclaimer did not constitute a fraudulent transfer under Virginia law. Interestingly, the nontestamentary instrument disclaimer statute has no specific language regarding transfers, unlike the testamentary disclaimer statute. *Compare* Virginia Code § 64.1-193 and Virginia Code § 64.2-2603(G) ("A disclaimer made under this chapter is not a transfer, assignment, or release"). This suggests that a disclaimer of a testamentary interest is even more protected from fraudulent transfer law in Virginia by both Supreme Court precedent and by statute.

As it relates to asset protection, when a disclaimer is effectively made, the disclaimant is treated to have predeceased the transfer and therefore the disclaimant is deemed to have never obtained an interest in the disclaimed property that could be attached by a creditor. As such, creditors of the disclaimant do not have a claim against either the disclaimant or against the disclaimant's estate. *Nat'l City Bank of Evansville v. Oldham*, 537 N.E.2d 1193 (1989).

When a beneficiary is confronting creditor problems, either existing or anticipated, the beneficiary might disclaim assets to avoid creditor attachment of those

assets. A disclaimer of an interest in an estate valid under state law may preserve the assets within the family unit while protecting the assets from the creditors of the disclaiming party. In 1997, the Supreme Court of Virginia held in *Abbott v. Willey*, 253 Va. 88 (1997) that by virtue of the disclaimer being effective as of the date of the interest, the disclaiming person could not be said to have held an interest that could be transferred, and thus the disclaimer did not constitute a fraudulent transfer under Virginia law. In this case, Mrs. Willey, confidant of President Clinton, while liable on a note, disclaimed her entitlement to her husband's life insurance and let it pass to her children. The creditor claimed the disclaimer was a fraudulent conveyance, but the Supreme Court held that a disclaimer could not be set aside on those grounds. Many commentators found this to be a surprising result. A Colorado court similarly held in *Colacci v. United Bank of Boulder*, 549 P.2d 1096 (1976). The disclaimer was held to cause the disclaimed assets to pass directly from the decedent's estate to the ultimate beneficiaries.

If there is no transfer from the disclaimant, efforts to assert a fraudulent transfer should be unsuccessful. A testator/settlor might anticipate potential creditor problems on the part of beneficiaries by planning in contemplation of disclaimers by specifying to whom the disclaimed property would go. The well-planned will or trust document will provide a contingent trust for alternate takers in the event the primary beneficiary disclaims.

Another way in which a disclaimer could be used in the context of asset protection is to provide for the contingent funding of a trust for the benefit of a beneficiary instead of an outright gift to the beneficiary. This would be valuable when the beneficiary does not presently have any current creditor concerns, but the settlor wants the beneficiary to be able to disclaim assets into a trust for the beneficiary's benefit if future creditor concerns arise. Consider, however, that in order for the disclaimer to be a qualified disclaimer for federal transfer tax purposes under I.R.C. § 2518(b)(4), the transfer must be made to a spouse.

There are some exceptions to the asset protection benefits of disclaimers. For example, some states prevent valid disclaimers if the disclaimer is insolvent. Many states do not recognize valid disclaimers when the disclaimant is made by a person attempting to qualify for Medicaid benefits. Virginia considers disclaimers by persons attempting to gain or retain Medicaid eligibility as an uncompensated transfer resulting in a period of ineligibility. Virginia Code § 32.1-325.02. Disclaimers are also not effective against a federal tax lien. The United States Supreme Court held in *Drye v. United States*, 528 U.S. 49 (1999) that the federal government could reach disclaimed assets to satisfy a federal tax lien against the disclaimant.

There is a split of authority as to whether a disclaimer can be used to avoid creditors with many states holding that such is an act to defraud creditors. See, e.g., *Stein v. Brown*, 480 N.E.2d 1121 (Ohio 1985) citing California decision, *In Re. Kalt's Estate*, 16 Cal 2nd 807, 108 P.2d 401 (1940), which was subsequently overruled by statute (Cal. Prob. Code Sec. 283). See also, Hoesley v. State, 243 Neb. 304, 498 N.W.2d 571 (1993).

The Bankruptcy Code provides avenues for avoiding certain transfers that go beyond the scope of the state fraudulent transfer laws. Courts, analyzing statutes similar to Virginia's have found that the pre-petition disclaimer of an interest is not a voidable transfer that can pursued by a bankruptcy trustee under the Bankruptcy Code. *See, e.g. In re Patow*, 632 B.R. 195, 204-05 (B.A.P. 9th Cir. 2021) (finding that disclaimer of an interest in a trust was not a voidable transfer under 11 U.S.C. § 544 and California state law); *In re Simpson*, 36 F.3d 450, 452-53 (5th Cir. 1994) (finding that disclaimer was not a fraudulent transfer under 11 U.S.C. § 548). However, courts have been less likely to find that a post-petition disclaimer is safe from being avoided. *In re Schmidt*, 362 B.R. 318, 321-25 (Bankr. W.D. Tex. 2007) (finding that a post-petition disclaimer was a recoverable transfer under 11 U.S.C. § 549); *In re Farrior*, 344 B.R. 483, 485-87 (Bankr. W.D. Va. 2006) (finding that a debtor in chapter 7 could not make an effective disclaimer post-petition as the interest was property of the estate under the control of the appointed trustee); *see also Drye v. United States*, 528 U.S. 49 (1999) (finding that a disclaimer did not relieve disclaiming person for tax liabilities incurred on the disclaimed property).

H. Powers of Appointment and Powers of Withdrawal.

1. General. In the context of asset protection, the distinction between a General Power of Appointment and a Nongeneral (or Limited) Power of Attorney is a crucial one because property subject to a General Power of Appointment may be subject to the claims of the donee's creditors whereas property subject to a Nongeneral Power of Appointment is not.

According to Black's Law Dictionary, a power of appointment is "a power created or reserved by a person having property subject to disposition, enabling the donee of the power to designate transferees of the property or shares in which it will be received…" Black's Law Dictionary (10th ed. 2014). There are two types of powers of appointment: general powers of appointment and non-general (or special or limited) powers of appointment.

> a. A general power of appointment is a "power of appointment by which the donee can appoint – that is, dispose of the donor's property – in favor of anyone at all, including oneself or one's own estate." Black's Law Dictionary (10th ed. 2014).
>
> b. A limited power of appointment is a "power of appointment that either does not allow the entire estate to be conveyed or restricts to whom the estate may be conveyed; esp., a power by which the donee can appoint to only the person or class specified in the instrument creating the power, but cannot appoint to oneself or one's own estate." Black's Law Dictionary (10th ed. 2014).

In Virginia, a general power of appointment means a power of appointment exercisable in favor of the powerholder, the powerholder's estate, a creditor of the powerholder, or a creditor of the powerholder's estate. A nongeneral power of

appointment means a power of appointment that is not a general power of appointment. Virginia Code § 64.2-2700.

2. Nongeneral Power of Appointment. Creditors cannot reach property that is subject to a nongeneral power of appointment. The donee has no beneficial interest in the property because the donee cannot appoint the property in favor of herself or her estate. Some state statutes expressly provide that property subject to a nongeneral power of appointment is immune from the claims of creditors.

Notably, under federal bankruptcy law, the bankruptcy estate does not include "any power that the debtor may exercise solely for the benefit of an entity other than the debtor." Bankruptcy Code § 541(b)(1)

In Virginia, property subject to a nongeneral power of appointment is exempt from a claim of a creditor of the powerholder or the powerholder's estate. However, property subject to a nongeneral power of appointment is subject to a claim of a creditor of the powerholder or the powerholder's estate to the extent that the powerholder owned the property and transferred the property with the intent to delay, hinder, or defraud creditors. Virginia Code § 64.2-2738

3. General Power of Appointment. Creditors may be able to reach property that is subject to a general power of appointment. There are two types of general powers of appointment: (a) presently exercisable powers of appointment and (b) powers of appointment exercisable at a future date, for example a testamentary general power of appointment.

In general, property subject to a general power of appointment cannot be reached by the powerholder's creditors before the time that the power is exercised, unless the power was created by the powerholder. However, some states have enacted statutes which provide that the powerholder's creditors can reach property that is subject to an unexercised general power of appointment.

Notably, under federal bankruptcy law, the bankruptcy estate does include "all legal or equitable interests of the debtor in property as of the commencement of the case." Bankruptcy Code § 541(a)(1) Consequently a donee's general power of appointment exposes the property to a donee's creditors in a bankruptcy proceeding.

In Virginia, property subject to a general power of appointment is not protected from the claims of creditors. Virginia Code § 64.2-747(B). There is a distinction in the Virginia Code between when the general power is created by the powerholder and when the general power is not created by the powerholder.

a. General power created by powerholder

1. Property subject to a general power of appointment created by the powerholder is subject to creditors' claims to the extent the

power was exercised with the intent to hinder delay, hinder, or defraud creditors. Virginia Code § 64.2-2735(B).

2. Property subject to a general power of appointment created by the powerholder is not subject to creditors' claims to the extent that the powerholder irrevocable appointed the property in favor of a person other than the powerholder or the powerholder's estate. Virginia Code § 64.2-2735(C).

3. Property subject to a general power of appointment created by the powerholder is subject to creditor's claims of (a) the powerholder if the power is presently exercisable and (b) the powerholder's estate if the estate is insufficient to satisfy the claims and subject to the right of a decedent to direct the source from which liabilities are paid, if the power is exercisable at the powerholder's death. Virginia Code § 64.2-2735(D).

b. General power not created by powerholder

1. Property subject to a presently exercisable general power of appointment created by a person other than the powerholder is subject to creditors' claims only to the extent that the powerholder's property is insufficient. Virginia Code § 64.2-2736(A).

2. Property subject to a general power of appointment exercisable at the powerholder's death is not subject to creditors' claims of the powerholder or the powerholder's estate except to the extent that the power is exercised in favor of the powerholder's estate. Virginia Code § 64.2-2736(B).

3. A power of appointment created by a person other than the powerholder which is subject to an ascertainable standard is treated as a nongeneral power. Virginia Code § 64.2-2736(C).

4. Powers of Withdrawal. Powers of withdrawal are presently exercisable general powers of appointment. Some powers of withdrawal are unlimited, and some are limited, both in time and in amount. Obvious examples of a limited power of withdrawal include a five and five power and a Crummey power. A five and five power refers to a beneficiary's power to withdrawal the greater of five percent or $5,000 referenced in I.R.C. § 2514(e) and 2041(b). A Crummey power refers to the annual exclusion under I.R.C. § 2503(b), or $16,000 or $32,000 if the donor is married.

Many states treat a power of withdrawal as the equivalent of a power of revocation because the two powers are functionally identical. (Restatement (Second) of Trusts § 156). It is well accepted that the property of a revocable trust is subject to the

claims of the settlors' creditors. If the power of withdraw is unlimited (such as is the case with a revocable trust), the subject property is fully available to the claims of the powerholder's creditors. Virginia Code § 64.2-747(A). If the powerholder retains the power until death, the property subject to the power may be liable for claims and statutory allowances to the extent the power holder's probate estate is insufficient to satisfy those claims and allowances. Virginia Code § 64.2-2735.

In addition, during the period that the power of withdrawal may be exercised, the holder of the power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power. Virginia Code § 64.2-747(B). This of course means that property subject to a power of withdrawal is not protected from the claims of creditors. Importantly, however, like many states, Virginia created an exception for trust property that is subject to a five and five power or a Crummey Power. Upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greatest of (i) five and five power, (ii) the annual exclusion amount ($16,000), or (iii) double the annual exclusion amount ($32,000) if the donor was married at the time of the transfer to which the power of withdrawal applies. Virginia Code § 64.2-747(B)(2). This subsection of the code consequently limits the creditor to the five and five amount or the annual exclusion amount.

5. Planning Considerations.

a. Clients should beware that giving a trust beneficiary a power of withdrawal, including a Crummey power or a five and five power, or giving a beneficiary a general power of appointment, may imperil the asset protection benefits afforded to the trust. Clients must consider whether the tax benefits and flexibility offered by the granting of such powers outweigh the potential exposure of the assets to creditors.

b. The parent of a client with creditor concerns may consider granting a special power of appointment to the spouse of the child, allowing the spouse to exercise the power in favor of any of the parent's descendants, i.e. the child with the creditor concerns.

c. In states in which an unexercised general power of appointment does not expose the property to the claims of the donee's creditors, instead of transferring property outright to the donee, the donor might grant a general power of appointment to the donee, who could then exercise the power to herself in the future if she has no creditors.

I. Decanting. Decanting permits the trustee of an irrevocable trust to change certain provisions of the trust by appointing or decanting income and/or principal of a trust into a new trust with modified terms. Decanting might be helpful to correct drafting errors, to resolve ambiguous trust language, or to fix administrative issues such as changing the

trust situs or the governing law or the trustee provisions. Importantly, decanting can also be used to enhance the asset protection benefits of the trust.

In 2012 Virginia first adopted legislation permitting a trustee to decant trust assets. In 2016 Virginia adopted the Uniform Trust Decanting Act which provided a detailed statutory framework for Trustees to exercise the decanting power. (Article 8.1 of the Virginia Code.) The Act divides the decanting power into two categories: (1) trustees who may decant under expanded distributive discretion and (2) trustees who may decant under limited distributive discretion. A Trustee that has expanded distributive discretion means the Trustee has complete discretion to distribute income or principal of the trust to any one or more of the current beneficiaries, meaning their discretionary power of distribution that is not limited to an ascertainable standard or a reasonably definite standard. Conversely, a Trustee with limited distributive discretion may only distribute income or principal by an ascertainable standard or a reasonably definite standard. Virginia Code § 64.2-701.

A Trustee with expanded distributive discretion has much greater flexibility in modifying a trust than a Trustee with limited distributive discretion, and consequently has more ability to achieve asset protection benefits through the act of decanting. For example, a trustee with expanded distributive discretion may:

1. add or enhance spendthrift provisions
2. eliminate current beneficiaries or remainder beneficiaries
3. decant trust assets to a special needs trust for a disabled beneficiary
4. change the distribution standards
5. change trustee or trustee succession provisions
6. change the powers of a trustee
7. change the jurisdiction of a trust
8. change the state law governing the trust
9. add trust protectors and/or investment advisors

Any of these modifications might be used to enhance the protection of the trust assets from attacks by potential creditors. Of course, a trustee is governed by the general principles of fiduciary duties, but decanting to protect trust assets would seem well within the duties of loyalty and care.

Importantly under Virginia Code § 64.2-779.24, a debt, liability, or other obligation enforceable against the property of a first trust is enforceable to the same extent against the property when held by the second trust after exercise of the decanting power.

J. Domestic Self-Settled Asset Protection Trusts. A domestic asset protection trust (commonly referred to as a "DAPT") is typically an irrevocable trust with an independent

trustee who has complete discretion to make distributions to class of beneficiaries including the settlor of the trust. The assets of the trust are protected from the general creditors of the settlor, provided, however, that the transfer to the trust must of course not be a fraudulent transfer intended to shelter assets from an existing creditor, or to hide assets or evade U.S. or foreign taxes. The settlor of a DAPT (or a OAPT discussed below) must be very careful to avoid transfers to domestic or foreign trusts which could be seen to be a fraudulent conveyance under state, Federal Bankruptcy, or foreign situs law. Failure to fully disclose and turn over all assets belonging to the settlor is a ground for not obtaining a bankruptcy discharge. 11 U.S.C. § 727.

The first DAPT statute was passed in Alaska in 1997. As of the current date, 19 states, including Virginia, have adopted domestic asset protection trust statutes. It seems clear that the trend is moving to encourage the protection of assets from prospective future creditors, and that public policy in the U.S. has shifted in favor of debtor defendants. Importantly there is still very little case law on DAPTs.

This trend should cause lawyers who at one time believed that asset protection planning was "shady" to ask themselves this question: If 19 state legislatures and governors representing all areas of the country have effectively encouraged asset protection planning, how shady can it be? Nearly 40% of the states have officially sanctioned asset protection planning as appropriate public policy.

The authors recommend David Shaftel's twelfth ACTEC comparison of the Domestic Asset Protection Trust Statutes Updated Through August 2019.

The authors also note that a detailed discussion and analysis of Domestic Asset Protection Trusts is beyond the scope of this outline, but there is extensive material available for those interested in this topic.

1. <u>Virginia's Self-Settled Asset Protection Trust Statute</u>. As of July 1, 2012, Virginia amended its implementation of the Uniform Trust Code to allow settlors to establish an irrevocable trust of which the settlor is a beneficiary and allowing the settlor to receive spendthrift protection against the claims of the settlor's creditors. These new code sections can be found in Virginia Code § 64.2-745.1 and § 64.2-745.2.

There are a number of statutory requirements outlined in Virginia Code § 64.2.745.2 that must be met in order for a trust to come within the protection of the statute.

a. The trust is irrevocable;

b. The trust is created during the settlor's lifetime;

c. There must be, at all times when distributions could be made to the settlor pursuant to the settlor's qualified interest, at least one beneficiary other than the settlor;

d. The trust has at all times at least one qualified trustee, who may be, but need not be, an independent qualified trustee;

e. The trust instrument expressly incorporates the laws of the Commonwealth to govern the validity, construction, and administration of the trust;

f. The trust instrument includes a spendthrift provision that restrains both voluntary and involuntary transfer of the settlor's qualified interest; and

g. The settlor does not have the right to disapprove distributions from the trust.

Transfers to the trust may not render the settlor insolvent, and fraudulent transfers are excepted from the asset protection coverage afforded by the Virginia DAPT statute. (Virginia Code § 64.2.745.1(C)). The burden of proof to assert the fraudulent transfer is clear and convincing evidence. *Bruce v. Dean*, 140 S.E. 277, 149 Va. 39 (1927); *Mills v. Miller Harness Co., Inc.,* 326 S.E.2d 665, 229 Va. 155 (1985); *In re Coleman*, 185 B.R. 892 (2002). Creditors that existed at the time the trust was funded have five years to bring a claim. (Virginia Code § 64.2.745.1(D)). This period is longer than the period in other domestic asset protection trust states. Many commentators have noted that Virginia's DAPT statute is more conservative than other states. In addition to the five-year period for existing creditors to bring a claim (compared to two years in other states), Virgina's statute also has a more restrictive definition of who can serve as a Trustee or party responsible for making distribution decisions, and in Virginia the settlor cannot retain a power to disapprove distributions from the trust, whereas this power is common in other states with DAPT statutes.

Of course there are limitations to the effectiveness of a DAPT in protecting assets. The Virginia DAPT statute provides an exception for a child support claim under § 64.2-744(A). There is no spendthrift protection against a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust (§ 64.2-744(B)), against the United States, the Commonwealth of Virginia, any city, county or town, §64.2-744(C)), or claims under a statute or regulation of the United States or the Commonwealth that requires a beneficiary to reimburse the Commonwealth or any agency or instrumentality thereof, for public assistance such as Medicaid. (§ 64.2-745(A)).

Importantly, Virginia Code § 64.2-745.1(E) provides protection for attorneys, trustees, trust advisors, trust directors, and others involved in counseling, drafting, preparing, and administering a Virginia self-settled spendthrift trust.

2. <u>Conflict of Law Issue</u>: A DAPT is an asset protection technique that may be successfully used by residents of states that have adopted DAPT statutes. But it seems unclear whether nonresidents of DAPT states may establish a DAPT under a DAPT state's laws and enjoy the desired asset protection and tax benefits offered by the DAPT. This interesting and vital issue involves the area of conflict of laws. The issue is whether a forum court in a state without a DAPT statute which has jurisdiction over the settlor of a DAPT created under the laws of a state that has a DAPT statute can apply the law of the forum state rather than that of the DAPT state. Thus far, the analysis seems to focus on the Restatement (Second) of the Law, Conflict of Laws, Section 273 and 270(a). Section 273 addresses when the creditors of a beneficiary can reach the trust assets and directs

that this issue is governed by the law of the state chosen by the settlor in the trust document. Section 270(a) focuses on whether the nonresident's state of residence has a strong public policy against DAPT asset protection. It is an unsettled issue whether the law of the DAPT state should apply to the creditors' claim, or whether the law of the debtor's residence should apply. (David Shaftel's twelfth ACTEC comparison of the Domestic Asset Protection Trust Statutes Updated Through August 2019).

K. Offshore Self-Settled Asset Protection Trusts. An offshore self-settled asset protection trust ("OAPT") is an alternative to a domestic self-settled asset protection trust. In an OAPT, the settlor irrevocably transfers assets to an independent fiduciary under the laws of the foreign jurisdiction. If the trust is established offshore, because the trust is designed so that no U.S. court will exercise primary jurisdiction over the administration of the trust, and because U.S. trustees do not have authority to control all substantial decisions of that trust (which are reserved to offshore trustees), the trust will be considered a "foreign" trust for U.S. tax purposes. I.R.C. § 7701(a)(30)(E) and (31)(B).

The authors note that a detailed discussion and analysis of Offshore Asset Protection Trusts is beyond the scope of this outline, but the authors wanted to address them briefly as they are an extremely effective asset protection planning tool, and assets held in an OAPT are nearly impenetrable by a creditor in the United States. The authors are not aware that there has ever been a case where assets have been successfully repatriated to the U.S. from an offshore trust, even when the creditor is the United States federal government. The authors also highly suggest Duncan Osborne's and Elizabeth Schrug's treatise "Asset Protection, Domestic and Internal Law and Tactics" for extended resources on offshore asset protection trusts.

There are some advantages of foreign asset protection trusts over domestic asset protection trusts which are discussed below. As a general comment, there are substantial set up costs and administrative costs, including the ongoing complex tax reporting requirements, associated with the establishment of an OAPT, and a client would be well-advised to not consider establishing an OAPT unless the client intends to put at least $2-$3 million of seed funding into the trust.

1. Characteristics of Favorable Asset Preservation Jurisdictions. A person concerned about potential future claims or creditors may arrange to transfer or establish the situs for some of his or her assets in another country, for instance through an asset preservation trust in that jurisdiction. While the location of the assets and the existence of the trust will be discoverable in a creditor collections proceeding or in bankruptcy (unless the settlor is prepared to perjure or expatriate himself or herself -- and under the latest tax law changes expatriation has its own tax consequences), a state court in which a judgment is awarded against the settlor has no jurisdiction to enforce the judgment against assets in another jurisdiction. And while a federal bankruptcy court has national jurisdiction, it cannot enforce its judgments in an overseas jurisdiction. The judgments of U.S. courts will have to be perfected and enforced, if that is possible, in the foreign jurisdiction where the assets are located, which will involve time delay, trouble and expense in the form of local counsel fees, among others. Although a U.S. court may

exercise jurisdiction over a U.S. settlor, the settlor, having established an irrevocable discretionary trust with an independent institutional trustee offshore, will be powerless to regain control of the assets which he or she has placed in trust.

A favorable foreign asset preservation jurisdiction will have three particular characteristics: (1) it will not recognize or enforce U.S. judgments, or it will be reluctant to; (2) it will countenance spendthrift trusts for the benefit of a settlor; and (3) it will have less stringent fraudulent conveyance laws than the U.S. There are summaries available which compare the laws of asset protection jurisdictions for those interested. It is virtually impossible to stay current on the laws of multiple offshore jurisdictions, or even one, because these laws are constantly evolving and changing to seek competitive advantage over rival jurisdictions. So U.S. lawyers really need to rely on local counsel for the current state of the law.

2. <u>An Asset Preservation Jurisdiction Does Not Recognize or Enforce U.S. Judgments, or Is Reluctant To Do So</u>. The courts of many foreign jurisdictions recognize U.S. judgments obtained by U.S. creditors against U.S. debtors and, as a matter of comity, will permit such judgments to be filed, recorded and enforced against assets of the U.S. debtor located in the foreign jurisdiction. In such a jurisdiction the U.S. creditor will not have to prove his case again in the foreign jurisdiction. The only action necessary in such a foreign court is, in effect, a collection action on debt which is deemed by the foreign court to have been finally established. Assets held by a U.S. debtor in his own name in such a foreign jurisdiction may be seized by the U.S. creditor if it succeeds in the prosecution of the collection action, which should not be difficult. Normally the creditor's biggest problem will be locating the foreign assets, not obtaining the foreign court order to seize them.

Examples of such a jurisdiction are Bermuda, The Bahamas, the Cayman Islands, which recognizes U.S. judgments but requires a local action to enforce them. The creditor will, however, have to raise any claim to the assets in a trust sitused in such jurisdiction in the courts of such jurisdiction. For instance, if the creditor wants the trustee to disburse assets to the creditor, and the trustee refuses -- e.g., because the trust is an irrevocable discretionary spendthrift trust -- or if the creditor argues that assets in the trust were transferred to the trustee in fraud of such creditor's rights, the creditor will have to file suit against the trust or trustee in the court of the host jurisdiction. The host jurisdiction will apply its own trust law -- e.g., regarding the effectiveness of a spendthrift trust held for the benefit of the settlor and the use of a trust protector to delete the settlor from the class of permissible beneficiaries of the trust -- and its own law of fraudulent conveyance and its own burden of proof. But it should be recognized that jurisdictions that theoretically will enforce foreign judgments may in practice be reluctant or slow to do so and reluctant to let foreign creditors successfully attack trusts in their jurisdictions.

In certain other jurisdictions, like the Cook Islands and Nevis, the local courts by law will not recognize foreign judgments in general, so that a judgment obtained in a U.S. court against a U.S. debtor has no legal consequence in such jurisdictions. In such jurisdictions there would have to be two legal proceedings, one to prove the settlor of the

trust had a liability to the creditor, and a second to prove that the transfer to the trust was a fraud on the creditor under local law, so that the creditor should have access to trust assets to satisfy the liability. If the U.S. debtor (or a trust established by the debtor) has assets in the foreign jurisdiction which the U.S. creditor wants to attach, the creditor must bring the entire principal case de novo in the courts of the foreign jurisdiction. In other words, the creditor must engage local counsel, file suit on the merits, bring evidence and witnesses to the foreign jurisdiction, and deal with the procedural rules and substantive laws of the foreign jurisdiction, for instance as to causes of action and burden of proof, possibly deal with a foreign language and unfamiliar legal system, which may make it much more difficult to obtain the desired judgment against the debtor than it was or would have been in the U.S. This burden is in addition to whatever further problems the creditor will have in collecting on the judgment against assets in the foreign jurisdiction in the event he is able to obtain a favorable judgment from the foreign court on his underlying theory of claim.

Bringing the cause of action in a foreign jurisdiction obviously presents a daunting financial burden. In addition to other difficulties, there may be language barriers, concern over hostile judicial attitudes to foreign plaintiffs, and an exotic -- i.e., non-common law -- legal system. Needless to say, the intimidating burden of having to bring a cause of action de novo in a foreign jurisdiction may give the debtor much greater leverage in dealing with the creditor to avoid the claim altogether or compromise the claim favorably.

3. An Asset Preservation Jurisdiction Has Less Stringent Fraudulent Conveyance Law. Certain foreign jurisdictions, especially a number of small island jurisdictions, take a more narrow view of what is a fraudulent conveyance than do U.S. jurisdictions and use certain objective tests to cut off rights of certain parties alleging fraudulent conveyance. In 1989 the Cook Islands adopted the world's first Asset Preservation Trust ("APT") Statute. There are now more than 60 offshore jurisdictions which have adopted some sort of asset protection trust statute, and numerous other jurisdictions are considering such legislation.

Asset preservation trusts may be particularly immune from creditor claims of fraudulent conveyance. Foreign jurisdictions seek to establish a hospitable environment for asset protection trusts with U.S. and other foreign-domiciled settlors by enacting specific APT legislation, the principal precepts of which may include:

a. allowance of recovery by a creditor only if the creditor's obligation existed at or before the time of the settlor's absolute disposition in trust;

b. creation of a malicious intent (to defeat creditors) test with respect to the debtor settlor;

c. elimination of the void ab initio concept with respect to the insolvent settlor's trust in favor of a voidable concept;

d. preservation of the rights of trustees and non-collusive beneficiaries to costs and benefits enjoyed in advance of a set-aside; provided, in the case of the trustee, that it acted prudently in establishing the solvency of the settlor; and

e. limitation of any set-aside to the amount of the debtor's disposition necessary to satisfy the obligation of the petitioning creditor.

Foreign Jurisdictions With Favorable Asset Protection Trust Legislation include Anguilla, Antigua, Bahamas, Barbados, Belize, Bermuda, Cayman Islands, Cook Islands, Cyprus, Gibraltar, Labuan, Marshall Islands, Mauritius, Nevis, Niue, St. Vincent, St. Lucia, Seychelles, Turks and Caicos Islands. These jurisdictions recognize the validity of irrevocable spendthrift trusts of which the settlor is a beneficiary as a shield from creditors of the settlor who did not exist and were not contemplated when the trust was established. The Channel Islands (Jersey & Guernsey) and the Isle of Man have statutes that permit self-settled spendthrift trusts, and are sometimes used, but they do not have elaborate asset protection trust statutes.

For example, the law of the Bahamas permits allegedly defrauded creditors to assail a trust for only two years after the trust's creation. U.S. statutes of limitation are generally longer than those in offshore asset protection trust jurisdictions. It will normally take a creditor more than two years to find out the debtor has put any money in a Bahamian trust. The laws of the Cook Islands in the South Pacific (near New Zealand) and Nevis in the Caribbean permit creditors to allege fraudulent conveyance, but impose a criminal burden of proof -- beyond a reasonable doubt -- on the creditors to show that the trust was funded or established with principal intent to defraud that creditor and that the establishment of or disposition to the trust made the settlor insolvent or without property by which that creditor's claim (if successful) could have been satisfied. Nevis also requires every creditor initiating proceedings against a trust to deposit a $25,000 bond with the Ministry of Finance. Gibraltar has adopted legislation encouraging asset preservation trusts of which the settlor may be a beneficiary, and permits no challenge after recordation of the fact of the trust by creditors alleged to have been defrauded so long as the settlor who established the trust was not insolvent immediately after the transfer to the trust.

Care must be given to selecting an appropriate foreign jurisdiction, and the evaluation of the attractiveness of a situs as an asset preservation jurisdiction must take into account whether the jurisdiction has asset preservation trust legislation and the type of liability sought to be avoided and the contemplated means of avoidance. The selection of the "right" offshore jurisdiction in which to establish an asset protection trust in a given set of circumstances is an art, not a science. In practice, US professionals typically get comfortable with two or three jurisdictions, perhaps with different virtues, with their laws, their lawyers, their banks and trust companies, and use and re-use those jurisdictions, lawyers and banks, over and over.

L. Trust Protectors.

1. Offshore. Trust protectors have long been used in offshore asset protection trusts. One of the mechanisms by which the settlor of an OAPT "controls" the irrevocable and discretionary trust is through the trust protector. In order to obtain the creditor protector that an offshore trust provides, the settlor cannot retain any rights which might subject the trust assets to creditor claims. The settlor should therefore not have the right to revoke the trust, should not have the right to remove and appoint trustees, to change the trust situs, or to change the trust beneficiaries. Instead, the settlor can appoint in the trust document a trust protector and grant to the trust protector these powers. The settlor may view the trust protector as his alter ego, who may add or delete beneficiaries and change the Trustee and the jurisdiction of the trust. If the trustee does not do what the settlor wants, a new trustee can be appointed.

The Trust Protector can be any trusted person who would not be seen as "subordinate" to the settlor. An appealing choice for a trust protector would be someone the settlor trusts who is domiciled outside of the U.S., even better if the trust protector is a non-citizen of the U.S. Certainly if a U.S. claim ever arises, a U.S.-based trust protector should be replaced with an offshore protector to insulate the protector from U.S. court process. In order to address potential claims and changed circumstances in the future, the trust should contain a mechanism to replace trust protectors.

In a typical offshore trust, the trust protector may discharge and replace the Trustee and move the trust assets to another trust company whenever the settlor likes. The trust protector can also change the situs of the trust and its governing law to another jurisdiction in the event of unexpected developments. The trust protector may add to or delete from the class of beneficiaries if the settlor requests.

2. Domestic. The use of trust protectors in domestic trusts is a relatively recent development. Clients have always been eager to achieve flexibility in irrevocable trusts and in dynasty trusts. They want to accommodate for future unexpected circumstances by maintaining a level of control over the Trustee. Settlors have long used different types of third parties to exercise this control and for certain trustee functions, such as the power to direct the investments of the trust and the power to manage a closely-held business interest owned by the trust. Sometimes these third parties are known as "trust directors" or "trust advisors." The use of "trust protectors" as a third-party has increased in popularity in recent years.

While trust protectors can certainly be useful in long-term irrevocable trusts, their role is not clearly defined. Broadly stated, the role of a trust protector is to supervise the trustee, to perform and modify administrative and tax-oriented tasks, to protect and carry out the interests of the settlor, sometimes even to modify a trust to change (add or eliminate) trust beneficiaries, terminate the trust, or veto trust distributions.

The powers of a trust protector can be outlined in the trust instrument itself, and also sometimes in state law. Importantly, only some states have statutes regarding trust protectors. And case law on the topic of trust protectors is sparse.

Many states that have adopted the Uniform Trust Code ratify the use of trust protectors, even if the term "trust protector" is not expressly used in state statute. For example, Virginia enacted a directed Trustee statute in 2012 and Virginia Code § 64.2-779.27 provides that:

> "1. If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust.
>
> 2. The terms of a trust may confer upon a trustee or other person a power to direct the modification or termination of the trust.
>
> 3. A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty."

There is great debate in the United States as to whether trust protectors are a fiduciary. Of course this issue is critical because it affects the standard of care that the trust protector owes to the beneficiaries, and it also affects the trust protector's potential exposure to liability for breach of fiduciary duty. Note that Virginia law presumes that a third party acting in such a role is a fiduciary. Note also that Virginia Code § 64.2-779.32 provides that a directed trustee is not liable for any actions taken to comply with a trust director's exercise or nonexercise of a power of direction.

Just as a trust protector is a useful tool in an offshore asset protection trust as a means by which the settlor can exercise control, a trust protector may also be a useful asset protection tool in any irrevocable, dynastic domestic trust. The trust protector could alter a beneficiary's interest in a trust, add or remove beneficiaries, grant, modify, or revoke a beneficiary's power of appointment, change the distribution standard, remove and replace trustees, and even terminate a trust. All of these powers might be employed to address any concerns raised by unanticipated future creditors of the trust beneficiaries. Lawyers drafting trust protector provisions into a trust must exercise caution. They must research state law (which is inconsistent and unclear, at best) to ensure that the role of the trust protector complies with state law. They must be clear in the trust instrument itself as to what powers the trust protector has. And they must be clear as to how the powers of the trust protector relate to the powers of the settlor, the trustee, and other third party decision makers.

M. Insurance.

1. Life Insurance. A debtor client may purchase life insurance on her life or on the life of another payable to a third party.

a. If premiums are paid or a policy is transferred with intent to defraud creditors of the insured, the cash value of the policy may be liable to that extent to the claims of creditors.

b. Premiums paid in fraud of creditors may be recovered by creditors. Virginia Code § 38.2-3122.

c. Upon the demise of the insured, even if fraudulent conveyance may be proven by creditors of the insured as to the payment of the insurance premiums, they would have no claim to the life insurance death benefit except to recover the value of the premiums fraudulently paid. *White v. Pacific Mutual*, 150 Va. 849 (1928); Virginia Code § 38.2-3122.

d. If the owner insured makes an irrevocable beneficiary designation, the cash value and the proceeds should be exempt from claims of creditors except in cases of and to the extent of transfers with intent to defraud the creditors. Virginia Code § 38.2-3122.

e. I.R.C. §2206 apportions the federal estate tax against the beneficiaries of life insurance to the extent of the portion of the taxable estate represented by the policy unless the decedent relieves the recipients of life insurance proceeds from the apportionment. *Baptiste v. Commissioner* (63 T.C.M. 2653 (1992)) provides further that any amount of unpaid federal estate tax owed by the insured's estate can be collected from the beneficiary of a life insurance policy includible in the decedent's estate, as a transferee. I.R.C. § 6324(a)(2). Estate tax liability may not be apportioned to or collected from life insurance that is not included in the insured's taxable estate, for instance, insurance originally owned by an irrevocable trust or transferred to such a trust more than three (3) years before the insured's death.

However, the I.R.S. cannot assert a claim against life insurance proceeds if state law exempts life insurance proceeds from claims of insured's creditors, unless the lien was filed during the insured's lifetime. *Stern v. Commissioner*, 357 U.S. 39 (1957); *Hampton v. Commissioner*, 30 T.C. 708 (1958). If a lien is filed during the lifetime of the insured owner, the government is limited to collecting the cash value of the policy at the time of the insured's death. The difference between the total proceeds and the cash value escapes the I.R.S.'s claim. *United States v. Bess*, 357 U.S. 51 (1957).

f. It is possible to buy life insurance in certain offshore jurisdictions, such as the Bahamas and Caymans, where the cash value is expressly not susceptible to claims of creditors of the insured.

2. Business and Liability Insurance. It is frequently overlooked in a business setting that adequate levels of comprehensive insurance coverage may be essential to the long term viability of the business endeavor by protecting the business assets from unexpected and onerous claims which occur too frequently in our litigious society. General insurance coverage clients might consider include

a. Property Insurance/Fire and Extended Coverage
b. Business Interruption
c. Comprehensive (general liability with adequate limits)
d. Products/Completed Operations coverage (products liability)
e. Excess Liability Umbrella
f. Business Auto Insurance
g. Workmen's Compensation
h. Appropriate Specialty Insurance for the Business and Industry
i. Fidelity Bond (for employee theft)
j. Bailee's Coverage

3. Umbrella Insurance. All high-net-worth clients should consider having a substantial umbrella insurance policy as an additional layer of protection from general liability. Umbrella insurance is a type of personal liability insurance that covers claims in excess of homeowners', auto, or watercraft policy coverage. This insurance is particularly important for clients who own automobiles, boats, and rental properties (but be certain that the umbrella policy covers rental properties). This product is typically inexpensive

N. Premarital and Marital Agreements. Premarital and Marital Agreements are an effective estate planning and asset protection tool. Clients want to protect their assets in the event of divorce and preserve their ability to freely dispose of their assets at death. As we approach what will be the largest wealth transfer in history, those transferring the wealth and those receiving the wealth will be increasingly focused on protecting gifted and inherited assets.

1. Premarital Agreements. Premarital Agreements in Virginia are governed by the Virginia Premarital Agreement Act, Title 20, Chapter 8 of the Code of Virginia. A Premarital Agreement is defined as "an agreement between prospective spouses made in contemplation of marriage and to be effective upon marriage." Virginia Code § 20-148. In order to be valid, the Agreement must be in writing and signed by both parties, and the agreement becomes effective once the parties get married. Virginia Code § 20-149. To be enforceable, the Agreement must be voluntarily executed, the Agreement must not be "unconscionable" when executed, and each party must make a fair and reasonable disclosure of his or her property and financial obligations prior to its execution, or if there was not disclosure, the party who did not receive disclosure must voluntarily and in

writing waive the right to disclosure. Virginia Code § 20-151. The issue of unconscionability hinges on the intrinsic fairness of the terms of the Agreement. It is worth noting that Virginia is a very contract friendly state and Premarital Agreements are rarely overturned as unenforceable.

Parties to a Premarital Agreement may contract with respect to any of the following: (1) the rights and obligations of each in the property of either or both of them whenever and wherever acquired or located; (2) the right to manage and control property; (3) the disposition of property upon separation, marital dissolution, death, or any other event, (4) spousal support, i.e. alimony, (5) making a will, trust, or other agreement; (6) ownership rights in and disposition of the death benefit from a life insurance policy; (7) choice of law; and (8) any other matter that is not in violation of public policy or criminal statute. Stated more broadly, Premarital Agreements address what happens when a marriage ends, either because of divorce or death. Importantly, parties to a Premarital Agreement may not contract to any terms addressing child custody or child support. Such issues are always under the jurisdiction of the Court and are subject to modification.

A Premarital Agreement is a useful asset protection tool for a variety of client circumstances. If there is a large discrepancy in income or net worth between the parties, the economically advantaged party wants to limit or eliminate spousal claims in the event of divorce. If one party owns a particularly valuable asset such as a closely-held business or a piece of real property, she wants to maintain her ownership of that asset in the event of divorce. Similarly, if one party anticipates receiving a significant gift or inheritance during her life, she wants to protect that asset in the event of divorce and may want to leave inherited assets back to her own family members at death, circumventing the spousal share requirements at death under state law. Property received by gift or inheritance might be deemed to be separate property in some states and marital property in other states, so even if gifted or inherited property is maintained in a separate account in the name of one spouse, such property might be subject to division in the event of divorce. A Premarital Agreement could provide that gifted and inherited property is expressly deemed to be separate property not subject to division in the event of divorce. If the parties are of similar economic means, a Premarital Agreement can also be useful. The parties may have built their wealth prior to marriage and they both want to ensure that their pre-marital assets remain separate property. One or both of the parties may have children from a prior marriage for whom they wish to provide. A Premarital Agreement will allow both parties to limit obligations to their spouse at death to an amount less than the spousal share as required under state law, i.e. the elective share in Virginia. Both parties can also waive their spousal rights guaranteed under federal law to receive certain types of retirement plans so that each party can leave these assets directly to their own children. Another prime reason that parties seek Premarital Agreements is to limit legal fees, court costs, and the stress involved in negotiating a divorce settlement. They want to clarify what is separate property and what is marital property, especially untitled tangible personal property, and they want to determine what happens to those categories of assets in the event of divorce or death without subjecting such division to Court supervision and without incurring substantial legal fees.

2. Alternatives to Premarital Agreements: Discipline, Irrevocable Trusts, and (Post) Marital Agreements. It is a universal concern amongst wealthy clients that their children will lose their inheritances in the event of divorce. A Premarital Agreement can alleviate this concern. But what if their inheriting child, or the intended spouse of their inheriting child, refuses to enter into a Premarital Agreement? Tell your wealthy clients to counsel and implore their child to keep inherited assets segregated in his or her own name (or separate revocable trust). Generally, one does not need a Premarital Agreement to protect such assets from a divorce claim. Divorce courts typically do not divide gifted or inherited assets; these are not part of the "marital estate." But if the recipient puts such assets in joint name with a spouse and then gets divorced, the ex-spouse may walk away with 50%. It is important to note that keeping gifted or inherited assets separate is an effective strategy in the event of divorce but not at death. Absent a waiver of spousal inheritance rights in a Premarital Agreement, the surviving spouse has a claim to some portion of the gifted or inherited assets.

Another option available to parents who are concerned about their children losing assets in the event of divorce is to leave assets to their children in lifetime discretionary spendthrift trusts rather than outright. Assets held in an irrevocable discretionary trust by an independent Trustee for the benefit of a child are completely immune for the claims of the child's creditors, the most common creditor being the child's spouse. This arrangement has the added benefit of providing for protection at the child's death because the parent setting up the trust can dictate that any principal remaining at the child's death passes to the child's children, their grandchildren, so the child cannot disrupt this plan by leaving the assets to his or her spouse.

If one party is eager to negotiate a Premarital Agreement but the other party refuses, an option available to the eager party is to set up a self-settled asset protection trust, either domestically or offshore before the marriage. As discussed above, Virginia law now permits self-settled spendthrift trusts.

Finally, if a married couple neglected to sign a Premarital Agreement but wishes to negotiate spousal rights after-the-fact, there is another option: a Marital Agreement.

3. Marital Agreements. The Virginia Premarital Agreement Act also allows for agreements between married individuals. The relevant code provision provides that "[m]arried persons may enter into agreements with each other for the purpose of settling the rights and obligations of either or both of them, to the same extent, with the same effect, and subject to the same conditions, as provided in Virginia Code § 20-147 through 20-154 for agreements between prospective spouses, except that such marital agreements shall become effective immediately upon their execution." Virginia Code § 20-155

Marital Agreements are an effective shield not only against spousal claims, but also a shield against unrelated creditors. They are particularly useful for business owners. If a spouse wishes to be protected from liabilities of a spouse's business, e.g., from liability on performance bonds in the spouse's construction business or from any kind of co-guarantee of a business loan, a Premarital or Marital Agreement may assure the spouse freedom from such potential liability. More specifically, such an agreement may

provide the uninvolved spouse with contractual assurance that the family home held as tenants by the entirety will be held by the spouses free and clear of encumbrance associated with the spouse's business. Having an Agreement in place will often permit the spouse operating the business to secure financing without the other spouse's involvement and/or without pledging the family home as collateral, whereas a bank or lending company will always try to obtain the home as collateral or get the spouse to co-sign.

Needless to say, it may also be in the spouse's best interest to protect the family home from contingent liability, to insulate the spouse's assets from potential creditor claims. Where a business owner and spouse have a Marital Agreement and structure title to their assets shrewdly, the business owner may well be able to secure adequate business credit while protecting his family home and his spouse's assets from exposure to potential liabilities arising out of the business. Bonding companies and banks will frequently extend credit without spousal guarantee or the home as collateral where there exists a Marital Agreement along the lines described above, and its terms are disclosed from the beginning of credit negotiations.

In *Eure v. Jefferson National Bank*, (VLW 094-6-111), a unanimous Virginia Supreme Court held that a wife could void her liability on a guarantee of a loan made to her husband's company. Both husband and wife guaranteed the loan. She raised the defense of 15 U.S.C. § 1691, et seq., the Equal Credit Opportunity Act, which makes it illegal to discriminate against anyone during a credit transaction on the basis of marital status. The wife demonstrated to the Court's satisfaction that she had been required to sign the guarantee "solely on the basis of her marital status as the wife of [the company owner]." She held no interest in the company, was not a joint applicant for credit, and the bank made no inquiry regarding her credit standing. At the time of the loan her husband was worth more than $2 million. One of the terms of the loan, pursuant to common bank practice, was that the wife would be a guarantor.

O. <u>"Uglifying" Assets</u>.

As stated in the introduction, the goal of asset protection in estate planning is not to achieve 100% protection of all of the client's assets. Rather the goal is to change the creditor's economic analysis of the client's assets. Asset protection planning is an endeavor to make it difficult for the creditor to get at the client's assets. Thus, clients should consider how to "uglify" their assets, i.e. how to make otherwise attractive assets unattractive to creditors.

1. If one facing the possibility of creditor problems owns an unencumbered asset that might be an attractive target for her potential creditor, e.g., a marketable home, the anxious client might want to borrow a substantial amount of the equity out of the house to facilitate:

a. Gifts of cash to family members.
b. Investment in "ugly" assets unattractive to creditors.

c. Purchase of cash value life insurance with irrevocable beneficiary designation to take advantage of the bankruptcy exemption.
d. Contribution to qualified retirement plan exempt from creditors.
e. Invest in offshore asset preservation trust.

2. Cash may be invested in an asset less susceptible to a creditor's attack. For example, cash owned by one spouse with potential creditor problems may be used to invest in or pay down a mortgage on tenancy by the entirety property or to invest in stock of a closely-held corporation. Cash could be invested in exempt property such as qualified retirement plans or life insurance with an irrevocable beneficiary designation.

3. Real estate, closely-held business interests and other valuable assets may be "uglified" by any of the following techniques:

a. Contribution to family limited partnership or LLC.
b. Charitable remainder gifts, retaining income interest.
c. Installment sale or private annuity sale, e.g., to a child.
d. Sale or remainder, e.g., to child.
e. GRITs, GRATs, GRUTs.

P. Planning For Claims Against Client's Estate. The claims of creditors against an estate are superior to the rights of persons taking by intestate succession or under a Will and/or Revocable Trust. First the validity of claims must be determined, if necessary at a Debts and Demands hearing. Virginia Code § 64.2-556. Once debts are determined, if the estate is not adequate to pay all creditors, they are paid according to statutory sequence. Virginia Code § 64.2-528.

1. If the Will does not establish the order in which specific assets are used to satisfy the debts, state law will.

2. If assets have not been protected from the client's creditors before he dies, they will be vulnerable to claims of his creditors against his estate.

3. The Virginia Code authorizes certain allowances and exemptions which have priority over all claims against the estate.

4. Relief of Liability for Executor or Administrator. By calling a debts and demands hearing and following that up by filing a petition to show cause why the estate should not be distributed to beneficiaries and the personal representative discharged, the personal representative may be allowed to distribute the residue of an estate to the beneficiaries without personal liability for the claims of creditors. The personal representative may also avoid personal liability for the claims of creditors by distributing no sooner than six (6) months after appointment and by obtaining proper refunding bonds from the beneficiaries.

5. Beneficiaries' Transferee Liability. Beneficiaries of an estate may remain liable for up to five years for claims of creditors who were not parties to the debts and demands and show cause proceedings. Beneficiaries may be liable as transferees for unpaid estate tax, and not just for the portion attributable to their shares. *Estate of Baptiste v. Commissioner*, T.C. Memo 1992-198.

6. Tenancy by the Entireties Property. The Will of a decedent cannot apportion estate taxes against tenancy by the entirety property. *Estate of Reno v. C.I.R.*, 945 F.2d 733 (4th Cir., 1991) Creditors of one tenant may not obtain satisfaction from the entireties property in the hands of the surviving tenant by the entirety.

7. Mortgages on Real Estate.

a. Recourse. Recourse mortgages may be paid by the executor. Owen v. Lee, 185 Va. 160 (1946).

b. Nonrecourse. Nonrecourse mortgages may not be paid by the executor unless he is specifically directed to do so in the will.

c. Joint. If the liability is joint and several with a deceased joint tenant, a creditor can look to the personal representative for part or full payment.

8. Real Estate as a Source for Payment of Unsecured Debts. Real estate may be subject to the payment of debts. Virginia Code § 64.2-532. However, the personal estate is the primary source of payment. Virginia Code § 64.2-526. Any transfer of the real estate by an heir or devisee within one year of the decedent's death is not valid against the creditors of the decedent. Virginia Code § 64.2-538. For that reason, such real estate will not be insurable by a purchaser within that period unless the title insurance company holds the proceeds of sale in escrow and subject to creditors' claims for the one-year period.

9. Settlors' Creditors' Rights Against Revocable Trusts. The rights of creditors of deceased revocable trust settlors are uncertain in many states. However, it is generally recognized that a settlor's transferring his resources into a revocable trust should not impair the rights of the deceased settlor's creditors. See *State Street Bank and Trust Co. v. Reiser*, 389 N.E.2d 768, 771 (Mass. App. Ct. 1979). Statutory developments likely will clarify such creditors' rights against revocable trust assets. In Virginia, property held in a revocable trust while the settlor is alive is subject to the claims of the settlor's creditors, and after the death of the settlor, the trust property is subject to the claims of the settlor's creditors. Virginia Code § 64.2-747.

Q. The Internal Revenue Service as a Creditor.

1. Assessment.

a. General. The I.R.S. may not initiate collection action against a taxpayer until (1) the tax has been assessed, (2) the I.R.S. has given notice and made demand for payment of the tax, and (3) the taxpayer has refused to pay the tax. I.R.C. § 6303 and § 6331

b. Assessment Authority. The I.R.S. is authorized to make inquiries, determinations, and assessments of all taxes which have not been paid. I.R.C. § 6201(a)

1. The I.R.S. may immediately assess all taxes disclosed on tax returns prepared by the taxpayer. I.R.C. § 6201(a)(1)

2. The I.R.S. may immediately assess mathematical or clerical errors appearing on the return and certain overstated credits. I.R.C. § 6201(a)(3)

3. The I.R.S. may not assess a deficiency determined by the I.R.S. until the taxpayer has been provided with a notice of deficiency and an opportunity to file a petition with the Tax Court. I.R.C. § 6212(a)

   After the I.R.S. has conducted an audit of the taxpayer and determined that tax was understated, the I.R.S. will send a notice of proposed deficiency to the taxpayer. The notice of proposed deficiency (i.e., a 30-day letter) offers the taxpayer 30 days in which to file a protest letter with the Appeals Office of the I.R.S. If an agreement is reached with the I.R.S. at the appeals level, and a settlement of the tax owed is agreed upon, the I.R.S. may assess the tax.

   If the taxpayer ignores the 30-day letter or an agreement is not reached in appeals, the I.R.S. is required to issue a statutory notice of deficiency (i.e., a 90-day letter) which grants the taxpayer the option of agreeing with the deficiency or filing a petition with the Tax Court within the 90-day period. The statutory notice of deficiency must be sent by either registered or certified mail to the last known address of the taxpayer. I.R.C. § 6212(a) If the taxpayer agrees with the deficiency, the I.R.S. may immediately assess the amount. If the taxpayer ignores the 90-day letter, the I.R.S. may assess the deficiency at the end of the 90-day period.

If the taxpayer files a petition with the Tax Court and the Tax Court determines the amount of the deficiency, then the I.R.S. may immediately assess the entire amount of the determined deficiency. I.R.C. § 6215(a)

c. Method of Assessment.

1. The I.R.S. assesses the tax (including assessable penalties) owed by the taxpayer by recording the liability in a summary record that contains the identification number of the taxpayer, the character of the liability assessed, the tax period, and the amount of the assessment. I.R.C. § 6203.

2. The date of the assessment is the date the summary record is signed by an assessment officer. § 301.6203-1 of the Regulations.

3. The taxpayer may request a copy of the record of assessment. I.R.C. § 6203; § 301.6203-1 of the Regulations.

d. Notice and Demand for Tax. The I.R.S. must give written notice to the taxpayer within 60 days after making an assessment of tax stating the amount of tax owed and demanding payment. I.R.C. § 6303(a)

2. Offer in Compromise.

a. The I.R.S. is authorized to compromise the amount of the liability in certain situations. I.R.C. § 7122; § 301.7122 of the Regulations. Because an offer in compromise creates a contract between the taxpayer and the Treasury, the following elements must be present: the agreement must have a subject matter, the parties must have legal capacity to contract, there must be mutual assent (i.e., offer and acceptance), there must be consideration, there must be legal authority, and the parties must intend to be bound. Furthermore, the entire process must be in writing. *Big Diamond Mills v. U.S.*, 51 F.2d 721 (8th Cir. 1931).

b. The I.R.S. may only consider offers in compromise which are based on (1) doubt as to liability, and (2) doubt as to collectability. The I.R.S. may not consider hardship, sympathetic or appealing facts, or equity as a basis for an offering compromise. Opinions of the Attorney General of the United States, October 24, 1933, and October 2, 1934, O.A.G. 6, 7, XIII-2 C.B. 442, 445.

c. The taxpayer is required to reveal the amount and location of his assets to the I.R.S. on a detailed financial statement. If the I.R.S. rejects the offer in compromise, it may use the financial statement as a "road map" to access the taxpayer's assets.

d. The I.R.S. may ask the taxpayer to enter into a collateral agreement in connection with the offer in compromise.

3. Collateral Agreements.

a. The I.R.S. may, prior to accepting an offer in compromise, require a taxpayer to enter into a collateral agreement. The purpose of a collateral agreement is to provide the I.R.S. with additional payments out of the taxpayer's future net cash flow. Internal Revenue Manual 5.8.6.

b. The collateral agreement is often expressed as a percentage of the taxpayer's "annual income." Annual income is generally defined as adjusted gross income increased by bad debt deductions, long term capital losses, net operating losses, and worthless stock deductions. "Annual income" may also include nontaxable income.

4. Trust Fund Taxes.

a. General. Employers are required to withhold social security, Medicare, and income taxes from their employees' wages. I.R.C. § 3102 and § 3402. These amounts are held in trust for the government. I.R.C. § 7501(a). The I.R.S. must credit the employee for withheld taxes even if the employer fails to remit the "trust fund" taxes to the government. See *U.S. v. Huckabee Auto Co.*, 783 F.2d 1546 (11th Cir. 1986). The I.R.S. may collect taxes from responsible persons (e.g., officers of the employer) if the employer fails to remit the withheld taxes. I.R.C. § 6672.

b. Collection from Responsible Persons. When a corporate employer files a petition under Chapter 11 of the Bankruptcy Act, it may propose a plan of repayment for any unpaid taxes over a period not to exceed 6 years. § 1129 (a)(9)(C) of the Bankruptcy Code. If the plan is approved, the I.R.S. may (1) receive the payments over time, including interest or (2) attempt to collect the trust funds taxes from the responsible persons. There is no requirement that the I.R.S. first attempt to collect from the corporation. It is the I.R.S.'s stated policy to seek collection from responsible persons whenever trust fund taxes cannot be immediately collected from the corporation. I.R.S. Policy Statement 5-14

5. Tax Lien on "All Property Rights." As soon as the taxpayer neglects to pay taxes, a lien in favor of the U.S. arises on "all property and rights to property of a taxpayer." I.R.C. § 6321, § 6322 and § 6331. The tax lien need not be filed to take priority over the taxpayer and most third-party claimants. Virginia Code § 58.1-908 provides the proper place for filing the tax lien against all forms of property in Virginia. If the lien is validly perfected before the bankruptcy filing, the I.R.S. is entitled to payment as a judgment creditor, not merely as a priority creditor.

6. Discretionary Trust Rule. If, however, the taxpayer has a beneficial interest in a trust that is subject to the trustee's discretion, the tax collector can reach only what the trustee elects to distribute. *First Northwestern Trust Co. v. Internal Revenue Service*, 622 F.2d 387 (8th Cir. 1980).

7. In Virginia, tenancy by the entirety property is not subject to an I.R.S. claim or levy upon one spouse. *Moore v. Glotzbach*, 188 F.Supp. 267 (E.D. Va. 1960). *Estate of Reno v. C.I.R.*, 945 F.2d 733 (4th Cir., 1991

8. Gifts made before any tax problems arise should not be subject to challenge by the I.R.S. under fraudulent conveyance laws, i.e., Virginia Code § 55-1-400.

9. The exemptions that may be claimed against creditors generally are not operative against the Government. *United States v. Bess*, 357 U.S. 51 (1958). I.R.C. § 6334 sets forth the minimal exemptions permitted. As a result, for example, ERISA plan assets which are exempt under *Patterson v. Shumate* (discussed below) from claims of other creditors, are subject to claims from the IRS. I.R.C § 6334(c).

10. An I.R.S. levy on a joint bank account for taxes owned by one joint depositor is effective against the entire account because the taxpayer had an unlimited right to withdraw from the account. *U.S. v. National Bank of Commerce*, 472 U.S. 713 (1985).

11. Not discharged in bankruptcy are:

    a. income or gross receipts tax liabilities arising within three years (from the date a return was last due to the date of bankruptcy filing): 3-Year Rule. (Recall that the normal statute of limitations for tax collection is 10 years under I.R.C. § 6502(a)(1).)

b. income or gross receipts tax liabilities assessed within 240 days prior to filing: 240-Day Rule. (This could include tax liabilities arising outside the 3-Year Rule, but such older taxes could be made dischargeable by waiting out the 240-day period before filing for bankruptcy.)

c. withholding taxes for which debtor is liable in any capacity.

d. tax due when no return has been filed.

e. tax due where a fraudulent return has been filed.

f. tax liabilities debtor willfully attempted to evade.

The Bankruptcy Court has jurisdiction under 11 U.S.C. § 505 to determine tax matters and to adjudicate tax liability unless the liability has been adjudicated by another court of competent jurisdiction. The I.R.S. may not levy under I.R.C. § 6331 or § 6332 during the pendency of a bankruptcy proceeding.

In *In re Abernathy*, 1993 Bankr. LEXIS 238, 93-1 U.S. Tax Cas. (CCH) P. 50108 (Bankr. N.D. Ill. 1993) a U.S. bankruptcy court granted a couple's motion for summary judgment in their request for attorney's fees, finding that the I.R.S. behavior in continuously attempting to collect discharged taxes was outrageous and completely unjustified. The court likened the I.R.S. to a "rogue elephant."

III. EXEMPT ASSETS

When confronted with a client who has severe financial problems or just planning for a possibility of a future financial problem, one of the first questions to be addressed is what assets can be protected from creditors and retained in the event that a bankruptcy is filed. Exemptions are available under both federal and Virginia law. Pursuant to Virginia Code § 34-3.1, Virginia has “opted out” from the standard federal exemptions contained in Section 522 of the Bankruptcy Code (11 U.S.C. § 522). Thus, a debtor in Virginia must look to other federal exemptions and the Virginia exemptions for protection.

A. <u>Tenants by the Entireties</u>. While not titled as an “exemption”, the ability to hold property as tenants by the entireties is perhaps the exemption of greatest value to Virginia residents. Property held as tenants by the entireties is subject only to the joint debts of spouses. In a typical situation, spouses own a house on which there is joint debt secured by a deed of trust, but which has significant equity above the amount of the deed of trust. One of the spouses has incurred significant debt as the result of a failed business. While other assets owned by the indebted spouse, including future earnings, may be subject to creditor process, the house is protected from sale by the indebted spouse’s creditors as any judgment against the indebted spouse does not constitute a lien against the house.

This exemption is only available to spouses while they are married. Once the couple is divorced or the non-indebted spouse dies, the exemption is extinguished and the creditor of the indebted spouse can collect against one-half of the value of the property or, in the event of the death of the non-indebted spouse, on the whole value of the house. For example, a recorded judgment against the indebted spouse would become a lien upon the house immediately upon a divorce. If one spouse is deemed liable for the debts of the other spouse pursuant to the doctrine of necessaries, that debt will be joint debt that can be a lien against property held as tenants by the entireties. Virginia Code § 55.1-202.

Both real and personal property can be held as tenants by the entireties and the tenancy by the entireties is not destroyed by conveyance to joint or separate revocable or irrevocable trusts. Virginia Code § 55.1-136. See Virginia Code § 46.2-622 regarding owning a vehicle as tenants by the entireties. However, as to personal property, it must be "manifest" that the property is intended to be owned in a tenancy by the entirety. It is not necessary to use the magic "tenant by the entireties" language so long as the owners are described as spouses and take the personal property with right of survivorship. *In re Potter*, 274 B.R. 224 (Bankr. E.D. Va. 2002). The law of the state in which property is located rather than the state of residence of the spouses wife determines whether tenants by the entireties property is exempt. The exemption for entireties property is also contained in § 522(b)(2)(B) of the Bankruptcy Code (11 U.S.C. § 522(b)(2)(B)).

Pursuant to 11 U.S.C. § 363(h), a bankruptcy trustee is permitted to sell entireties property if certain conditions exist. However, the trustee cannot sell entireties property if the proceeds will go only to separate unsecured creditors of the husband and the wife. In In re Bunker, 312 F.3d 145 (4th Cir. 2002) two married couples filed joint Chapter 7 petitions. In both cases, their only joint debt was the mortgage on their homes and both couples had significant equity in their homes. The debtors claimed the equity as exempt and the trustee challenged their exemptions. The Fourth Circuit held, despite the fact that one of the couples had their cases substantively consolidated because they had intermingled their finances, the equity in the homes to be totally exempt from individual creditors under Virginia law.

The United States Supreme Court has held, in *United States v. Craft*, 535 U.S. 274 (2002), that a federal tax lien against one spouse could be enforced against property held in a tenancy by the entireties. This decision has not affected the sanctity of tenants by the entireties exemptions as to other debts.

B. <u>Retirement Plans</u>.

1. <u>General</u>. Virginia's exemption for retirement plans is found at Virginia Code § 34-34. Section 34-34 defines "retirement plan" as "a plan, account, or arrangement that is intended to satisfy the requirements of I.R.C. § 401, 403(a), 403(b), 408, 408A, 409 (as in effect prior to repeal by United States P.L. 98-369), or § 457." Under *Patterson v. Shumate*, 504 U.S. 753 (1992), a debtor's interest in an ERISA qualified retirement plan, for example a 401(k) plan, due to its anti-alienation provisions, is treated as being fully exempt from creditor attack. In addition, amounts in ERISA qualified retirement plans are not treated as being a part of the bankruptcy

estate created by § 541 of the Bankruptcy Code. Thus, the exemption available under an ERISA qualified plan even though it is defined as a retirement plan by § 34-34 is not determined by § 34-34. Rather, all amounts in any ERISA qualified retirement plan are fully exempt. 11 U.S.C. § 522(b)(3)(C).

IRAs and Roth IRAs are exempt, but not fully exempt.11 U.S.C. § 522(n). However, the amount of the exemption for IRAs and Roth IRAs is currently $1,362,800 which means that the vast majority of these accounts are also protected in full from creditor attack.

2. Inherited Retirement Accounts in Bankruptcy. Section 522(d)(12) of the Bankruptcy Code provides an exemption for "Retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986." Those sections of the Internal Revenue Code cover:

- IRC § 401: a qualified pension, profit-sharing and stock bonus plan created under a trust established by an employer for the exclusive benefit of employees or beneficiaries.

- IRC § 403: qualified annuity plans that are established by an employer for an employee under IRC § 404(a)(2) or § 501(c)(3).

- IRC § 408: individual retirement accounts (IRA), meaning "a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries," provided that the trust meets the requirements of that statute.

- IRC § 408A: a "Roth" IRA.

- IRC § 414: other retirement plans for controlled groups of employees, including predecessor employers, partnerships or proprietorships, governments and churches.

- IRC § 457: eligible deferred compensation plans established and maintained by eligible employers.

- IRC § 501(a): retirement plans established and maintained by defined tax-exempt organizations.

While the Bankruptcy Code is clear when it comes to a debtor's retirement accounts, it does not provide guidance on inherited retirement accounts. Predictably, courts produced a variety of findings on the treatment of inherited retirement accounts in bankruptcy. The Supreme Court in *Clark v. Rameker*, 573 U.S. 122 (2014) finally provided some clarification. In *Clark*, the debtor inherited an individual retirement account from her deceased mother pre-petition. 573 U.S. at 125-26. After filing for bankruptcy, the debtor claimed the inherited IRA as exempt pursuant to 11 U.S.C. §

522(b)(3)(C)[1]. *Id.* at 126. The chapter 13 trustee and the debtor's unsecured creditors objected. *Id.* After an extensive review of the Bankruptcy Code and the Internal Revenue Code, the Supreme Court found that funds in inherited IRAs "are not objectively set aside for the purpose of retirement" and thus were not "retirement funds" that are exempt under 11 U.S.C. § 522(b)(3)(C). While the Supreme Court did not review 11 U.S.C. § 522(d)(12) in *Clark*, the language in section 522(d)(12) is identical and would most-likely lead to the same result. As noted by some observers, unlike the Seventh Circuit, whose opinion the Supreme Court was reviewing on appeal, the Supreme Court did not differentiate between IRAs inherited from deceased spouses and those inherited from non-spouses.

Notably, some states do offer protection for inherited IRAs.

C. Homestead Exemption. Virginia's primary statutory exemption is the homestead exemption established by Virginia Code § 34-4. Every "householder" is permitted to exempt $5,000 in property and an additional $500 for each dependent. There is also an additional exemption to a parent if the parent's income is less than $1,750 per month. Virginia Code § 34-4.2. Virginia Code § 34-1 defines "householder" as a resident of Virginia. If the householder is 65 years of age or older there is an additional $10,000 exemption. These exemptions can be claimed against equity in real property or against personal property (cash, checking accounts, cars, etc.). In addition, there is a $25,000 exemption per householder for equity in real or personal property which is used as the householder's or the householder's dependents principal residence. For example, a married couple under the age of 65 with two children would have a homestead exemption of $11,000.00 and $50,000 exemption in their house assuming it is owned jointly.. Assuming their house was worth $250,000 and was subject to a deed of trust with a balance due of $200,000.00, they could exempt the $50,000.00 of equity in the house and use the remaining $11,000.00 to protect money in their checking account or value in a car.

In order to claim the exemption for real property, the householder must file a homestead deed in the city or county where the home is located. If the real property is located outside of Virginia, then the homestead deed must be filed in the city or county in which the householder resides. Virginia Code § 34-6. In order to claim the exemption for personal property, the householder must file a homestead deed, in the city or county where he or she resides. Form homestead deeds for real property and personal property appear in Virginia Code §§ 34-6 (real property) and 34-14 (personal property). However, if the householder files bankruptcy, the filing of the Schedule of Property Claimed as Exempt is all that is needed to exempt the real and property. Virginia Code §§ 34-6 and 34-14.

A person may waive his or her homestead exemption in writing in the instrument that creates the debt. Virginia Code § 34-22 sets out language sufficient to make a waiver of the

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[1] "Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection…. (3) Property listed in this paragraph is—(C) retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986."

homestead exemption effective. However, § 522(e) of the Bankruptcy Code (11 U.S.C. § 522(e)) renders such waivers ineffective in bankruptcy. Further, none of the exemptions of Title 34 apply to creditors collecting secured debts. Virginia Code § 34-1 (exemptions of Title 34 are from "creditor process" and "creditor process" is defined as methods of collecting unsecured debts).

Also, none of the exemptions apply to debts for the purchase price of property or to spousal or child support obligations. Virginia Code § 34-5.

D. Poor Debtor Exemptions. Under the so-called "poor debtor's exemptions" established by Virginia Code § 34-26, every resident is permitted to exempt certain miscellaneous items without filing a homestead deed. The "poor debtor exemptions" are available to every resident of Virginia regardless of the existence of any other assets. The major exemptions here include the exemption for tools of the trade, which permits someone to exempt, up to $10,000 in value of, "[t]ools, books, instruments, implements, equipment, and machines, including motor vehicles, vessels, and aircraft, which are necessary for use in the course of the householder's occupation or trade." Virginia Code § 34-26(7).

Also of importance is a total exemption of $6,000 in motor vehicles. Virginia Code § 34-26(8).

A security interest on personal property claimed to be exempt under the "tools of the trade" exemption or the motor vehicle exemption takes priority over the claimed exemption.

A debtor may also exempt "[f]amily portraits and family heirlooms not to exceed $5,000 in value." Virginia Code § 34-26(2).

A debtor's wedding and engagement rings are exempt without regard to value. Virginia Code § 34-26(1a).

Finally, with the exception of statutory liens, all causes of action for personal injury and wrongful death or the proceeds in settlement thereof are exempt from creditor process. Virginia Code § 34-28.1.

E. Other Exemptions. There are a number of other exemptions created by Virginia and Federal law. Few of these exemptions are likely to be applicable to the typical client. However, for reference, a list of these exemptions is attached.

F. Conclusion. In many instances the proper use of exemptions can protect most of your client's assets. Counsel should pay particular attention to evaluating the types and values of any retirement accounts and should review the Virginia Code carefully to insure that homestead deeds are properly filed, if they are needed.

G. List of Federal Exemptions.

1. Federal Civil Service Retirement Benefits - 5 USC § 8346.

2. Armed Forces Personnel and Survivors - Deposits by Overseas Personnel - 10 USC § 1035; Retirement Annuities - 10 USC § 1440; Military Survivor Benefits and Annuities; 10 USC § 1450.

3. Seventy-Five Percent of Disposable Earnings or the Amount by which Disposable Earnings for a Week Do Not Exceed 30 times the Federal Minimum Hourly Wage - 15 USC § 1673.

4. Benefits and Annuities Payable to Survivors of Foreign Service Employees - 22 USC § 4060(c).

5. Annuities to Survivors of Federal Judges - 28 USC § 376(n).

6. Black Lung Benefits - 30 USC § 931(b)(2)(f) & 932(a) (through reference to 33 USC § 916).

7. Benefits to Widows of Lighthouse Service Personnel - 33 USC § 775.

8. Longshoremen and Harbor Workers Compensation and Benefits - 33 USC § 916.

9. Veterans' Benefits - 38 USC § 5301.

10. Social Security and Supplemental Security Income - 42 USC § 407.

11. Compensation for Injuries or Death Resulting from a War Risk Hazard - 42 USC § 1717.

12. Retirement and Supplement Annuities Pursuant to the Railroad Retirement Act - 45 USC § 231m.

13. Railroad Unemployment Benefits - 45 USC § 352(e).

14. Seaman's, Master's or Fisherman's Wages - 46 USC § 11109.

15. Seaman's Clothing - 46 USC § 11110.

H. List of Virginia Exemptions.

1. Growing Crops - Virginia Code § 8.01-489.

2. Compensation for Victims of Crime - Virginia Code § 19.2-368.12. Other than expenses from the injury.

3. Prepaid Tuition Contracts and Savings Trust Agreements - Virginia Code § 23-38.81F.

4. Property of Disabled [more than 40%] Veterans (an additional $10,000 homestead exemption) - Virginia Code § 34-4.1.

5. Cemetery or Burial Lots or Funds - Virginia Code §§ 34-26 & 38.2-4021.

6. Wedding/engagement rings - Virginia Code § 34-26(la). The debtor's wedding and engagement rings, without regard to value, are exempt.

7. Family heirlooms - Virginia Code § 34-26(2). Each debtor may exempt family portraits and heirlooms not exceeding $5,000 in value.

8. Wearing apparel - Virginia Code § 34-26(4). A debtor may exempt wearing apparel, not exceeding $1,000 in value.

9. Firearms - Virginia Code § 34-26(4b). A debtor may exempt firearms not exceeding $3,000 in total value.

10. Child Tax Credit and Earned Income Tax Credit - Virginia Code § 34-26(9).

11. Certain Farm Implements of Persons Actually Engaged in Agriculture - Virginia Code § 34-27.

12. Spousal and Child Support - Virginia Code § 34-28.2.

13. Emergency federal relief payments related to the COVID epidemic are exempt - Virginia Code § 34-28.3.

14. Seventy-Five Percent of Disposable Earnings For One Week or the Amount by which Disposable Earnings for a Week Do Not Exceed 30 Times the Federal Minimum Hourly Wage - Virginia Code § 34-29.

15. Spendthrift Trust Property - Virginia Code §§ 38.2-3118, 38.2-3119 & 55-19.

16. Proceeds from Life Insurance Policies and Annuity Contracts - Virginia Code §§ 38.2-3122 and 38.2-3122.1. But not if policy or annuity purchased within 6 months of bankruptcy filing, and if policy or annuity was purchased with the intent to defraud creditors, the premiums paid are not exempt.

17. Group Life Insurance Policy and Proceeds - Virginia Code § 38.2-3339.

18. Proceeds from Accident and Health Insurance - Virginia Code § 38.2-3406.

19. Proceeds from Industrial Sick Benefits Insurance - Virginia Code § 38.2-3549.

20. Proceeds from Cooperative Life Insurance - Virginia Code § 38.2-3811.

21. Burial Society Benefits - Virginia Code § 38.2-4021

22. Fraternal Benefit Society Benefits - Virginia Code § 38.2-4118.

23. Health savings account under sections 220 or 223 of the Internal Revenue Code are exempt from creditor process to pay any debt of the participant or the beneficiary. Virginia Code § 38.2-5604.

24. Uniforms, arms, and equipment required of persons in the Virginia National Guard and the Virginia Defense Force are exempt. Virginia Code § 44-96.

25. Benefits Accrued or Accruing from the Virginia Supplemental Retirement System except for child or spousal support- Virginia Code §§ 51.1-124.4 and 51.1-510.

26. Pre-need Funeral Trust Property - Virginia Code § 54.1-2823.

27. Approved Assignments of Salary and Wages (for the benefit of creditors) – Virginia Code § 55-165.

28. Unemployment Compensation Benefits - Virginia Code § 60.2-600.

29. Public Assistance Payments - Virginia Code § 63.2-506.

30. Family Allowance for Surviving Spouse and Minor Children - Virginia Code § 64.2-309 ($24,000; priority over all other claims against the estate).

31. Exempt Property of a Decedent's Estate - Virginia Code § 64.2-310 ($20,000.00; priority over all other claims against the estate).

32. Homestead Allowance from Decedent's Estate - Virginia Code § 64.2-311 ($20,000.00; priority over all other claims against the estate).

33. Workers' Compensation Benefits - Virginia Code § 65.2-531.

34. Prepaid tuition contracts, college savings accounts (529 plans) and ABLE accounts – Virginia Code § 23.1-707(G)(1) and § 23.1-707(I). Except state may reach assets remaining in ABLE account at beneficiary's death.

IV. BASICS OF BANKRUPTCY

1. United States Constitution

Article 1, Section 8, Clause 4 of the United States Constitution authorized Congress to establish uniform laws on the subject of bankruptcy.

The goal of bankruptcy is to give an honest debtor a "fresh start" not a "head start."

Bankruptcy laws are designed to discourage a "race to the courthouse" by creditors.

Bankruptcy is also critical to entrepreneurship and innovation. Without the ability to fail and then start over again, business people would be less willing to take risks and move the economy forward. Milton Hershey is a classic example of someone who filed multiple bankruptcies before he became a success.

2. Types of Bankruptcy

A. Chapter 7

Chapter 7 bankruptcy is a liquidation proceeding. In a Chapter 7 case, a trustee is appointed to collect and liquidate (sell) all of the debtor's unencumbered, non-exempt property to pay the claims of the debtor's creditors. Individuals and corporations can file under Chapter 7, but a corporation does not get a discharge of its debts in Chapter 7.

B. Chapter 11

Chapter 11 bankruptcy is a reorganization proceeding. Chapter 11 can be used by individuals and corporations. Many times Chapter 11 is used as a vehicle to sell assets of a corporation. Individuals use Chapter 11 when they cannot qualify for Chapter 13 because they have too much debt.

There are special provisions for small business debtors who qualify under Subchapter V of Chapter 11. Introduced in 2020, Subchapter V of Chapter 11 allows for a quicker and less expensive reorganization process for small businesses and individuals whose debts exceed the limits of Chapter 13, but whose reorganization is not as complex as is required by a normal Chapter 11 case. Subchapter V is a mix of Chapter 11 and Chapter 13 wherein a trustee is appointed, the Debtor proposes a plan, and if the Debtor's creditors consent to the

plan, the Debtor makes payments under that plan. If the creditors do not consent, then the Debtor makes payments to the trustee who in turn distributes the payments to the creditors.

C. Chapter 13

Chapter 13 is a used for reorganization of individuals. A Chapter 13 Trustee is responsible for reviewing a debtor's plan of reorganization and monitoring and distributing payments made under the Chapter 13 plan.

Chapter 13 permits individuals with regular income to rehabilitate their financial affairs. Chapter 13 cases usually take longer than Chapter 7 cases and may last as long as three to five years before they are completed. The Chapter 13 Trustee's primary function is not to liquidate property, but to disburse to creditors monies that are paid by the debtors. In a Chapter 13 case, a debtor is permitted to reinstate home mortgages or vehicle loans which have become delinquent and to change the terms on which certain secured debts are paid, to enable the debtor to retain these properties, and to treat the creditors in a manner which is permitted by statute. Customarily, unsecured creditors receive some payment on their claims (unlike most Chapter 7 cases), although this payment may be delayed until the middle or end of the plan period.

D. Chapter 12

Chapter 12 is similar to Chapter 13, but is available only to family farmers.

E. Chapter 15

Chapter 15 sets our procedures for dealing with insolvencies of foreign debtors.

F. Voluntary and Involuntary

In addition to a debtor voluntarily filing bankruptcy, creditors of a debtor can file an involuntary bankruptcy petition and force a debtor into bankruptcy. If a debtor has less than 12 creditors, it takes only one creditor to file an involuntary petition. If a debtor has 12 or more creditors, it take 3 creditors to file an involuntary petition. The creditors' claims must not be contingent or subject to a bona fide dispute.

3. Automatic Stay

A. Effect of Stay

The automatic stay is an automatic statutory injunction which goes into effect for the debtor's benefit at the time a bankruptcy case is filed. 11 U.S.C. § 362(a).

The stay immediately stops all pre-bankruptcy collection actions against the debtor in bankruptcy, including suits, garnishments, foreclosures, demands, attachments, offsets and the like. It stays all pending civil actions and the enforcement of any pre-petition judgment. It prevents lien perfection or other efforts by creditors to improve their position.

The automatic stay goes into effect upon filing of the petition regardless of whether a creditor is aware of the filing. If a creditor has taken an action, innocently or otherwise, which violates the automatic stay, immediate action should be taken to reverse that action. If the automatic stay has been violated, it is possible to have the stay annulled.

Although it is broad, the stay is limited by statute as to duration and scope. The stay ends immediately when the bankruptcy case is closed, dismissed, or when a discharge is granted to an individual under Chapter 7 or is otherwise granted or denied under Chapters 11 or 13. Further, the stay of acts against estate property ceases when the property "is no longer property of the estate . . . ." 11 U.S.C. § 362(c)(1). For example, if estate property is sold, abandoned or exempted, the stay ends, unless when the property leaves the estate it becomes the debtor's property and thus, subject to the stay of 11 U.S.C. § 362(a)(5).

The automatic stay is further limited when the debtor has a history of seeking bankruptcy protection:

> (a) The automatic stay will expire 30 days after the filing of a case if the debtor had been in another case within one year and that prior case had been dismissed. The court could extend the stay, after a hearing that must be completed within the 30 days after the filing of the petition, if the filing of the second case is held to be in good faith. There is a presumption of a lack of good faith if the debtor was in more than one prior case within the year, if the debtor failed to file documents in the earlier case, failed to provide adequate protection, failed to perform under a confirmed plan or there was not a substantial change in the debtor's circumstances. (Section 362(c)(3)).
>
> (b) No automatic stay would arise at all if the debtor filed a case and was a debtor in two cases within the previous year. In such case, upon request of any party, the court shall promptly enter an order confirming that no stay is in effect. Within 30 days of the filing of the petition, any party can request the court to impose a stay if the party demonstrates that the filing is in good faith. There is a presumption that the filing is not in good faith if the debtor was in two previous cases, the debtor failed to file required documents, failed to pay adequate protection payments, or failed to comply with the terms of a confirmed plan. The debtor must demonstrate that there has been a substantial change in the debtor's circumstances in order for the court to impose the stay. (Section 362(c)(4)).

The automatic stay enjoins:

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the bankruptcy case, or to recover a claim against the debtor that arose before the commencement of the bankruptcy case;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the bankruptcy case;

(3) any act to obtain possession of property of the bankruptcy estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor; and;

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning a corporate debtor's tax liability.

11 U.S.C. § 362(a).

B. Exceptions to Automatic Stay

The scope of the automatic stay is also limited by statute, as set forth in 11 U.S.C. § 362(b). There are numerous express exceptions to the stay, which are not all listed below. The most frequently applicable exceptions are that the filing of the petition does not stay:

1. Criminal proceedings (Section 362(b)(1)).

2. The enforcement of alimony, maintenance or support rights from property other than estate property (Section 362(b)(2)).

3. Acts to perfect lien interests to the extent permitted by § 546(b) or § 547(e)(2), (Section 362(b)(3)) (for example, the filing of a memorandum of mechanic's lien, but not the filing of the suit to perfect the mechanic's lien).

4. Enforcement of police and regulatory power (Section 362(b)(4).

5. A governmental unit's issuance of a tax deficiency notice (Section 362(b)(9)).

6. Any act by a landlord under a lease of nonresidential real property which terminated pre-petition to obtain possession of the property (Section 362(b)(10)).

7. Eviction action by a landlord where a judgment for possession was entered before the bankruptcy was filed (Section 362(b)(22)).

C. Other Matters Regarding the Automatic Stay.

1. The stay terminates as to personal property if the debtor fails to file a statement of intention in a timely fashion and fails to take action to implement to statement of intention within the time prescribed - 30 days after the first date set for the meeting of creditors. Upon motion of the Trustee, made within the 30-day period after the meeting of creditors, the court may prevent the automatic termination of the stay. The debtor must either surrender the collateral, redeem the collateral, or reaffirm the secured debt. (Section 362(h))

2. The debtor can no longer retain the property and require the creditor to go to state court to gain possession of its collateral.

3. The stay is also lifted if the Statement of Intention does not indicate the debtor's intention as to the creditor's collateral.

4. The Trustee must file a motion before the period in Section 521(a)(2) to prevent the stay from being terminated. For the stay not to be terminated, the court must find that the property is of consequential value to the estate, the creditor must be provided with adequate protection and the property must be delivered to the trustee. If the court does not make these determinations, the stay is terminated as of the conclusion of the hearing.

5. Section 521(a)(2) requires the debtor to perform under the Statement of Intention within 30 days of the first date set for the meeting of creditors rather than from the date the Statement of Intention is filed. The Statement of Intention is still required to be filed 30 days after the petition is filed.

6. The automatic stay would not apply with respect to the withholding of income that is property of the estate or property of the debtor for the payment of a domestic support obligations, which would include support obligations accruing both before or after the filing. (Section 362(b)(2)(C))

7. The automatic stay would not impair the creation or perfection of a statutory lien for ad valorem taxes on personal property or special tax or special assessment upon real property when a governmental unit assesses the taxes after the filing of the petition. (Section 362(b)(18))

8. The court may grant *in rem* relief from the automatic stay as to real property, thus precluding the application of the stay in any subsequent bankruptcy case, if the bankruptcy were filed as part of a scheme to hinder, delay or defraud creditors which also included the unauthorized transfer of the real estate or involved multiple bankruptcy filings. Such an order would be effective for two years as to a subsequent bankruptcy filing unless the debtor can show changed circumstances. The order granting *in rem* relief should be recorded in the Clerk's Office where the property is located. (Sections 362(d)(4) and 362(b)(20))

9. The automatic stay would not apply in any action to enforce a lien against real property if the petition were filed by an ineligible debtor, Section 109(g), or where such a filing were made in violation of a court order that prohibited the filing. (Section 362(b)(21))

10. The automatic stay would not prevent the enforcement of an order for possession obtained prepetition by a landlord. However, the debtor can keep possession if the debtor certifies that there are circumstances under state law which would permit the debtor to cure the arrearage, deposits with the clerk of the court the rent due for the 30 days after filing, and within 30 days after filing certifies that the entire monetary default has been cured. (Section 362(b)(22) and 362(l))

A bankruptcy filing is likely to be no impediment to a landlord with a possession order obtaining possession of the property. It is extremely unlikely that a debtor would be able to cure all of the arrearages within 30 days.

11. Creditors are protected from the imposition of punitive sanctions if the creditor acts in a good faith belief that the automatic stay has been terminated due to the failure of a debtor to perform his or her Statement of Intention. (Section 362(k)(2))

12. The stay is not violated by a lessor contacting and negotiating with a debtor relative to the debtor's proposed assumption of a lease of personal property. (Section 365(p)(2)(C))

D. Actions to Administratively "Freeze" Deposit or Checking Accounts

The Bankruptcy Code expressly preserves the right of creditors to "offset" mutual debts owing to a bankrupt debtor against debts owed to the creditor, so long as the parties are identical, the debts are both pre-petition and mutual and any other state requirements for offset have been followed. An "offset" is a taking of the debtor's property, and is expressly stayed by the automatic stay discussed above.

The United States Supreme Court, *Citizens Bank of Maryland v. Strumpf*, 516 U.S.16 (1995), has held that a creditor may temporarily suspend or "freeze" activity on a deposit or other eligible account, notwithstanding the automatic stay, to enable it to promptly file a motion to lift stay to permit the offset of the account against mutual unpaid debt. If a "freeze" is put into effect, the debtor (and his counsel) should promptly be notified of the hold and that any outstanding items will be returned "refer to maker." At the same time, the creditor should have its counsel promptly move to lift the stay to permit the offset to be accomplished.

Note that a creditor cannot offset post-petition deposits (deposits received after bankruptcy) against pre-petition liabilities. Offset is only permitted where the debts are mutual and both arose pre-petition.

The ability of a creditor to setoff is controlled by § 553. Prepetition setoffs may be subject to partial attack by the Trustee if the difference between what the debtor owes the creditor and what the creditor owes the debtor (the "insufficiency") is less than what the insufficiency was 90 days before the filing of the petition or the first date after 90 days before the filing on which there was an insufficiency. Before making a setoff, a creditor should review the past history of the accounts between the debtor and the creditor so that the setoff can be made at a time when it will not be subject to attack if a bankruptcy petition is filed after the setoff. *In re Koch*, 224 B.R. 572 (Bankr. E.D. Va. 1998).

The recent decision of the U.S. Supreme Court in *Fulton v. City of Chicago* provided that holding a vehicle which had been impounded for parking violations was not a violation of the automatic stay. Despite *Fulton,* creditors should be cautious of violating the automatic stay.

E. Foreclosures

As stated above, a bankruptcy filing automatically stays a foreclosure sale. Therefore, a trustee foreclosing on a piece of real property should check the bankruptcy court's website to see if the person who is the subject of the foreclosure sale has filed bankruptcy. This check should be done before any foreclosure notices are sent and then again before the trustee gets in the car to go to the sale. The first check is to insure that

the trustee is not violating the automatic stay or the discharge injunction in sending out the foreclosure notice which contains a demand for payment. The second check is to be sure that you don't waste a trip when a bankruptcy is filed the morning of the foreclosure sale.

Because the automatic stay does not go into effect until the bankruptcy case is filed, it is important to note down the time on which the foreclosure sale was completed. For example, if the foreclosure sale was completed at 10:04 a.m. and the bankruptcy was not filed until 10:05 a.m., the automatic stay would not stay the effect of the foreclosure sale.

Sometimes, despite a person's best efforts a bankruptcy can be filed before a foreclosure sale and the trustee is not aware of the filing and conducts the foreclosure sale. Such sale is void. However, the trustee could petition the bankruptcy court to annul the stay. If the stay is annulled (i.e. it is treated as if the stay never went into place), the foreclosure sale will be effective.

4. The Role of the Trustee

Section 544 of the Bankruptcy Code provides that a Bankruptcy Trustee has the rights and powers of a judgment lien creditor and a bona fide purchaser of real property and may avoid any transfers that are avoidable by such a creditor or BFP.

The Bankruptcy Trustee may also avoid any transfer that is avoidable under applicable law (i.e. state law).

The Bankruptcy Code provides for the appointment of a trustee in several circumstances; however, a trustee's duties vary depending upon the type of case filed or the circumstances of their appointment.

A. United States Trustee

In Virginia and all but two other states, the United States Trustee serves as a government oversight function generally for the protection of the rights of unsecured creditors. In addition, the United States Trustee has several duties imposed upon them by the Bankruptcy Code, such as:

1. Appointing and supervising private trustees who administer Chapter 7, 12, and 13 bankruptcy estates (and serving as trustees in such cases where private trustees are unable or unwilling to serve);

2. Taking legal action to enforce the requirements of the Bankruptcy Code and to prevent fraud and abuse;

3. Referring matters for investigation and criminal prosecution when appropriate;

4. Ensuring that bankruptcy estates are administered promptly and efficiently, and that professional fees are reasonable;

5. Appointing and convening creditors' committees in Chapter 11 business reorganization cases;

6. Reviewing disclosure statements and applications for the retention of professionals; and

7. Advocating matters relating to the Bankruptcy Code and rules of procedure in court.

B. Chapter 7 Trustee

Chapter 7 trustees are private attorneys who are appointed by the United States Trustee to oversee administration of a chapter 7 estate. 11 U.S.C. § 701; 11 U.S.C. § 322. Chapter 7 trustees are statutorily required to:

1. collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest;

2. be accountable for all property received;

3. ensure that the debtor shall perform his intention as specified in Section 521(a)(2)(B) of this title;

4. investigate the financial affairs of the debtor;

5. if a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper;

6. if advisable, oppose the discharge of the debtor;

7. unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest;

8. if the business of the debtor is authorized to be operated, file with the court, with the United States trustee, and with any governmental unit charged with responsibility for collection or determination of any tax arising out of such operation, periodic reports and summaries of the operation of such business, including a statement of receipts and disbursements, and such other information as the United States trustee or the court requires;

9. make a final report and file a final account of the administration of the estate with the court and with the United States Trustee;

> 10. if with respect to the debtor there is a claim for a domestic support obligation, provide the applicable notice specified in subsection (c);
>
> 11. if, at the time of the commencement of the case, the debtor (or any entity designated by the debtor) served as the administrator (as defined in section 3 of the Employee Retirement Income Security Act of 1974) of an employee benefit plan, continue to perform the obligations required of the administrator; and
>
> 12. use all reasonable and best efforts to transfer patients from a health care business that is in the process of being closed to an appropriate health care business that—
>
>> (A) is in the vicinity of the health care business that is closing;
>>
>> (B) provides the patient with services that are substantially similar to those provided by the health care business that is in the process of being closed; and
>>
>> (C) maintains a reasonable quality of care.

11 U.S.C. § 704(a). As part of their duties, chapter 7 trustees are also entitled to bring causes of action held by the estate against other parties (including the debtor), including but not limited to fraudulent transfers and preferences that will be discussed in detail below.

C. Chapter 11 Trustee

There is no automatic appointment of a trustee in a chapter 11 case, except in Subchapter V cases,; instead, debtors remain in possession of the estate unless and until a trustee is appointed. Any party in interest can request the appointment of a chapter 11 trustee before confirmation of a plan. 11 U.S.C. § 1104(a). However, appointment of a chapter 11 trustee is only made in two circumstances:

> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
>
> (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

11 U.S.C. § 1104(a). The Fourth Circuit has made it clear, though, that the appointment of a chapter 11 trustee is an “extraordinary remedy” that is “the exception rather than the

rule." *In re Fraidin*, 1994 WL 687306, at *1 (4th Cir. 1994). Once a chapter 11 trustee is appointed, they are statutorily required to:

> 1. perform the duties of the trustee, as specified in paragraphs (2), (5), (7), (8), (9), (10), (11), and (12) of section 704(a);
>
> 2. if the debtor has not done so, file the list, schedule, and statement required under section 521(a)(1) of this title;
>
> 3. except to the extent that the court orders otherwise, investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
> 4. as soon as practicable—
>
> > (A) file a statement of any investigation conducted under paragraph (3) of this subsection, including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate; and
> >
> > (B) transmit a copy or a summary of any such statement to any creditors' committee or equity security holders' committee, to any indenture trustee, and to such other entity as the court designates;
>
> 5. as soon as practicable, file a plan under section 1121 of this title, file a report of why the trustee will not file a plan, or recommend conversion of the case to a case under chapter 7, 12, or 13 of this title or dismissal of the case;
>
> 6. for any year for which the debtor has not filed a tax return required by law, furnish, without personal liability, such information as may be required by the governmental unit with which such tax return was to be filed, in light of the condition of the debtor's books and records and the availability of such information;
>
> 7. after confirmation of a plan, file such reports as are necessary or as the court orders; and
>
> 8. if with respect to the debtor there is a claim for a domestic support obligation, provide the applicable notice specified in subsection (c).
> 11 U.S.C. § 1106(a).

D. Chapter 13 Trustee

Generally, the United States Trustee appoints one or more standing trustees to act as trustees in chapter 13 cases filed in their regions pursuant to 11 U.S.C. § 1302. Unlike chapter 7 trustees, whose duties are to liquidate the debtor's estate, a chapter 13 trustee's

main goal is to facilitate the confirmation of a plan and, assuming a successful confirmation, disburse funds to a debtor's creditors pursuant to the confirmed plan. Chapter 13 trustees are statutorily required to:

> 1. perform the duties specified in sections 704(a)(2), 704(a)(3), 704(a)(4), 704(a)(5), 704(a)(6), 704(a)(7), and 704(a)(9) of this title;
>
> 2. appear and be heard at any hearing that concerns—
>
> > (A) the value of property subject to a lien;
> > (B) confirmation of a plan; or
> > (C) modification of the plan after confirmation;
>
> 3. dispose of, under regulations issued by the Director of the Administrative Office of the United States Courts, moneys received or to be received in a case under chapter XIII of the Bankruptcy Act;
>
> 4. advise, other than on legal matters, and assist the debtor in performance under the plan;
>
> 5. ensure that the debtor commences making timely payments under section 1326 of this title; and
>
> 6. if with respect to the debtor there is a claim for a domestic support obligation, provide the applicable notice specified in subsection (d).

11 U.S.C. § 1302(b).

5. Preferences

A. What is a Preference?

A preference is a transfer to or for the benefit of a creditor, on account of an antecedent debt, made while the debtor was insolvent, within 90 days of the date of the filing date (one year for transfers to insiders) that enables the creditor to receive more than the creditor would receive if the case was under Chapter 7 and the payment had not been made. Section 547(b). The typical case is a creditor being sued by the debtor to recover payments on an open account made in the 90 days before the debtor filed for bankruptcy. The goal of the preference system is to provide a level playing field, to prevent the race to the courthouse, and provide for equal treatment of similarly situated creditors.

B. There are three defenses to preference cases that have the most applicability in a typical preference case: 1) Providing "new value" to the debtor; 2) Contemporaneous exchange, and; 3) Transactions made in the "ordinary course" of business.

1. In most cases the first time you will hear about a preference claim will be in a letter from an attorney for the debtor or the trustee. How do you respond to the letter?

i. Verify the information in the letter carefully. Debtor's records are often not very accurate. You will see demands for payments made to other parties, payments made well outside the 90 days, demands for cash payments, and other basic problems.

ii. Review any sales to the debtor in the 90-day preference period that have not been paid. If you delivered goods or services after a payment was made, this is new value and a credit against the amount they are seeking.

iii. Review your records regarding the invoice dates and the date you were paid for at least 15 months. The relevant date for payment is when the check from the debtor cleared the bank. You may not know that date, but you can come close with the date of receipt of payment. Compare the debtor's pre-preference period history of payments with the history of payments during the preference period. If payments were being made in the same range during the preference period, you have a strong ordinary course of business defense.

C. BAPCPA made several changes to the defense to preference actions that will help you if you received payments from a bankrupt person or company.

1. The most significant change is a small alteration to § 547(c)(2) and the "ordinary course of business" defense.

i. Under the old law, a defendant relying on the ordinary course of business defense was required to show **both** that the transfer was in the ordinary course of business between the debtor (plaintiff) and creditor (defendant), a subjective test, **and** that the transfer was made according to ordinary business terms, an objective test.

ii. BAPCPA changed the "and" in this section to "or." Now a creditor will only be required to show one of the two.

2. Section 547(c)(9) provides that transfers where "the aggregate value of all property that constitutes or is affected by such transfer is less than $6,825" are not recoverable as preferences in "a case filed by a debtor whose debts are not primarily consumer debts." In other words, in a business case, transfers of less than $6,825 cannot be recovered.

3. 28 U.S.C. 1409(b) provides that any action seeking recovery of a money judgment or property of less than $25,000 brought by a trustee or debtor-in-possession must be brought in the defendant's home district. This does not apply to claims against insiders. Also, courts have determined that this does not apply to preference actions.

6. <u>Fraudulent Transfers</u>

Section 548 of the Bankruptcy Code provides that the Bankruptcy Trustee may avoid any transfer made within two years of the bankruptcy filing that was made with the actual intent to hinder, delay, or defraud any entity to which the debtor was indebted or any transfer for which the debtor did not receive reasonably equivalent value and either the debtor was insolvent at the time of the transfer or was made insolvent by the transfer; was engaged in a business with unreasonably small capital; believed that the debtor would incur debts beyond the debtor's ability to pay; or made the transfer to an insider.

Generally, the Bankruptcy Trustee has two years from the filing of a bankruptcy case to bring a fraudulent transfer action.

Section 550 of the Bankruptcy Code provides that the Bankruptcy Trustee may recover the avoided transfer from the initial transferee and any immediate or mediate transferee.

Transfers of a charitable contribution by a debtor to a charitable organization are not recoverable by a Bankruptcy Trustee if the contribution was not more than 15% of the debtor's annual gross income of the debtor for the year in which the transfer was made or if the transfer was consistent with the practices of the debtor in making charitable contributions.

A Trustee also has the ability to avoid transfers that could be avoided under State law or in different time periods such as that afforded to the IRS. Notably, Virginia Code Section 55.1-400 (transfers to hinder or delay existing creditors) and Virginia Code Section 55.1-401 (voluntary transfers). The statute of limitations on voluntary transfers in Virginia is 5 years.

Bankruptcy Code § 548 provides that:

> (a)(1) The trustee may avoid any transfer…of an interest of the debtor in property, or any obligation…incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily--
>
> > (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
> > (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
> > (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
> > (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
> (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

11 U.S.C. § 548(a).

The general rule is that "obligations incurred by a debtor solely for the benefit of a third party are treated as not supported by a reasonably equivalent value." *In re Renegade Holdings, Inc.*, 457 B.R. 441, 444 (Bankr. M.D.N.C. 2011); 5 Collier on Bankruptcy ¶ 548.05[2][b] (16th ed. rev. 2011). However, modern courts have adopted an expanded view of "reasonable equivalent value" where value can be found in indirect benefits to the debtor. The seminal case in the Fourth Circuit regarding "indirect benefits" and avoidance actions is *In re Jeffrey Bigelow Design Grp., Inc.*, 956 F.2d 479 (4th Cir. 1992). In *In re Jeffrey Bigelow*, the Fourth Court largely adopted the view of the Second Circuit's *Rubin v. Manufacturers Hanover Trust Co.* decision that: "'If the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor, then the debtor's net worth has been preserved, and [the statute] has been satisfied—provided of course, that the value of the benefit received by the debtor approximates the value of the property or obligation he has given up.'" *Jeffrey Bigelow*, 956 F.2d at 485 (quoting *Rubin*, 661 F.2d 979, 991-92 (2d Cir. 1981)). Thus, "the focus is whether the net effect of the transaction has depleted the bankruptcy estate" as section 548 is designed to preserve the value of the estate of its unsecured creditors. *Id.*

Virginia statutory law provides similar relief that can be utilized under 11 U.S.C. § 544(b)(1)[2]. Under Virginia law, every (i) gift, conveyance, assignment, or transfer of, or charge upon, any estate, real or personal, (ii) action commenced or order, judgment, or execution suffered or obtained, and (iii) bond or other writing given with intent to delay, hinder, or defraud creditors, purchasers, or other persons of or from what they are or may be lawfully entitled to shall, as to such creditors, purchasers, or other persons or their representatives or assigns, be void. § 55.1-400.

To come within the scope of Virginia Code § 55.1-400, the transfer or act assailed must be done with intent to hinder, delay or defraud. 9A M.J., *Fraudulent and Voluntary Conveyances,* § 12 (Repl.Vol.1977). Because of the difficulty of establishing "actual intent", evidence of fraud may be, and generally must be, circumstantial. *Fowlkes v. Tucker,* 164 Va. 507, 180 S.E. 302, 305 (1935); *Hutcheson v. Savings Bank of Richmond,*

[2] 11 U.S.C. § 544(b)(1) provides: "Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title."

129 Va. 281, 105 S.E. 677, 680 (1921); *Witz, Biedler & Co. v. Osburn,* 83 Va. 227, 2 S.E. 33 (1877). Consequently, without differentiating between delaying, hindering or defrauding, courts have relied historically upon presumptions of fraud, known also as "badges of fraud," which consist of facts and circumstances which the law admits to be the signs of fraud; and from which the fraudulent intent may be inferred. *See, In re Decker,* 295 F. Supp 501 (W.D.Va.1969), *aff'd sub nom. Woodson v. Gilmer,* 420 F.2d 378 (4th Cir.1970); *Herring v. Wickham,* 70 Va. (29 Gratt.) 628 (1878).

The badges of fraud have been stated to include: (1) retention of an interest in the transferred property by the transferor; (2) transfer between family members for allegedly antecedent debt; (3) pursuit of the transferor or threat of litigation by his creditors at the time of the transfer; (4) lack of or gross inadequacy of consideration for the conveyance; (5) retention or possession of the property by transferor; and (6) fraudulent incurrence of indebtedness after the conveyance. *See Hutcheson v. Savings Bank of Richmond,* 129 Va. 281, 105 S.E. 677 (1921). *See generally, Enforcement of Judgments and Liens in Virginia,* § 7.3 at 315 (Rendleman ed. 1982).

The party seeking to avoid a fraudulent conveyance may shift the burden of proof by establishing a *prima facia* case of fraud. *First National Bank of Bluefield v. Pressley,* 176 Va. 25, 10 S.E.2d 526, 527 (1940). Moreover, a prima facia case is established by demonstrating a badge of fraud. *Temple v. Jones, Son & Co.,* 179 Va. 286, 19 S.E.2d 57, 62 (1942).

The trustee must initiate an avoidance action under 11 U.S.C. §§ 544 or 548 within the earlier of

> (1) the later of--
> (A) 2 years after the entry of the order for relief[3]; or
> (B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or
> (2) the time the case is closed or dismissed.

11 U.S.C § 546(a).

Once a trustee completes a successful avoidance action under sections 544 or 548, the trustee may seek to recover for the benefit of the estate from the initial transferee and any subsequent transferee the property that was transferred or the value of such property, with certain exceptions. 11 U.S.C. § 550.

[3] The entry of the order for relief occurs on the petition date in voluntary cases. 11 U.S.C. § 301(a); 11 U.S.C. § 302(a). In an involuntary bankruptcy, the order for relief is entered pursuant to 11 U.S.C. § 303(h). The date for entry of order for relief is not affected by a later conversion of the case. 11 U.S.C. § 348(a).

7. Cramdown.

Cramdown is the bankruptcy term of art used to describe where a debtor under a Chapter 13 or Chapter 11 plan proposes to pay a secured creditor only the value of the secured party's collateral rather than the entire amount owed to the secured creditor. For example, a Chapter 13 debtor owns a 3 year old Cadillac. Friendly Bank has a lien upon the Cadillac for amounts due under an Installment Note. The balance due on the note is $35,000. The debtor says that the value of the Cadillac is $20,000. The loan is "upside down". Upside down is another descriptive term used when the value of the collateral is less than the amount owed on the obligation secured by the collateral. Under the debtor's Chapter 13 plan, the debtor proposes to pay Friendly Bank $20,000 over 5 years with interest at 5%. The Installment Contract provides for interest at 12%. The unpaid balance of $15,000 would be treated as an unsecured claim and Friendly would be paid only a portion of this deficiency claim. A 20% payment on a deficiency claim would be considered a good result.

Chapter 13 and Chapter 11 provide that a debtor can engage in such a cramdown, but there are certain exceptions and defenses. The first is the value of the collateral. Not surprisingly, the debtor will attempt to value the collateral as low as possible. The Supreme Court decision in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), provides that starting point for the value of the collateral should be its retail value, not the liquidation value or the value to the debtor. For cars, trucks, trailers, and mobile homes which have a recognized guide value such as NADA the starting point is the NADA retail value. The debtor can then reduce that value by showing excess mileage or use. As a practical matter, counsel for debtors and creditors many times agree on a value which half-way between NADA retail and NADA wholesale to avoid the time and expense of having to prove the value of the collateral.

In *Till v. SCS Credit Corporation*, 541 U.S. 465 (2004), the Supreme Court held that the appropriate rate of interest to be paid on the value of the collateral was not the contract rate, but a rate which added several points to the prime rate. Assuming the prime rate was 3.0% a rate of 5.0 could be the interest rate on the $20,00 secured claim to be paid to Friendly Bank.

The debt on some collateral cannot be crammed down. In a Chapter 13 case, debt secured only by a lien on real property which is the debtor's principal residence cannot be crammed down. 11 U.S.C. § 1322(b)(2). Thus, if a debt owed to you by a Chapter 13 debtor is secured only be a lien on the debtor's home, then the debtor cannot modify that debt in Chapter 13. However, if you had a lien on the debtor's car as well as his home to secure repayment of the same debt, you could be crammed down because your debt was not secured only by a lien on the home. The definition of debtor's principal residence is a residential structure, including mobile or manufactured home or a trailer without regard of whether the structure is attached to real property. Thus it appears that an obligation secured only by a mobile home may not be crammed down in a Chapter 13 plan.

Another exception to cramdown can be found in the famous "hanging paragraph" of section 1325(a). It is called the "hanging paragraph" because it appears at the end of Section 1325(a) without any numerical identification. The "hanging paragraph" provides that a Chapter 13 debtor cannot cramdown any debt where the creditor has a purchase money security interest on an automobile that was purchased within 910 days of the bankruptcy filing or where a purchase money security interest that was obtained on any other type of collateral purchased within one year of the bankruptcy filing.

8. <u>Whose Property Is It?</u>

When a bankruptcy case is commenced all of the debtor's interest in property becomes property of the debtor's estate. The debtor's estate is a separate entity from the debtor. In a Chapter 7 case, the Chapter 7 trustee is charged with administering the property of the debtor's estate. In a Chapter 7 case, the property of the estate includes all of the property of the debtor as of the filing date, but not any property acquired by the debtor after the filing date except for property acquired by inheritance, as a result of a property settlement or a divorce decree, or as a beneficiary of a life insurance policy within 180 days of the bankruptcy filing.

In a Chapter 13 case, the property of the estate also includes all property that the debtor acquires during the pendency of the Chapter 13 case. The confirmation of a Chapter 13 plan vests all of the property of the estate in the debtor.

In a Chapter 7 case, the property of the estate remains under the control of the trustee until the trustee abandons the property. Any property not administered by the trustee when the case is closed is abandoned to the debtor.

In a Chapter 11 case, the debtor serves as the debtor in possession and property remains in possession of the bankruptcy estate until the Chapter 11 plan is confirmed at which time it vests in the debtor.

Thus, real property owned by a debtor would be subject to the control of a trustee in the Chapter 7 case from the time that the bankruptcy case is filed until the property is abandoned by the Chapter 7 Trustee. Similarly, in a Chapter 13 case and a Chapter 11 case, real property of the debtor is under the control of the Chapter 13 trustee or the Chapter 11 debtor in possession until the Chapter 11 plan or the Chapter 13 plan is confirmed. During these periods the debtor does not have the power to convey any real property without an order of the bankruptcy courts. As will be discussed later, while a Chapter 13 case is pending any sale or refinance of real property must be approved by the Bankruptcy Court.

Sometimes property of the debtor may be excluded form property of the estate. ERISA qualified plans, such as 401(k), 457 and 403(b) plans, are generally excluded, but IRAs depend on state homestead exemption law for protection.

In the business context, financial matters are generally more complicated. For example, a standby letter of credit has been held to be property of the estate, after an examination under Section 542 of the rights and obligations under the contract. If it "unambiguously" shows an intent to insure loss relating to amounts to be paid under a contract, it may be held not to be property of the estate, and the landlord could recover from the letter of credit. See *Two Trees v. Builders Transport Inc*. (*In re Builders Transport*), 11th Cir., No 05-15900, 12/5/06, cert. denied, 127 S. Ct. 2112 (U.S. 2007). The treatment of letters of credit in the commercial leasing context is further complicated by the section 502(b)(6) cap on landlords' claim for non-residential leases rejected by the bankrupt tenant as part of the tenant's rights under bankruptcy law. Landlords, for the time being, should not rely on a standby letter of credit as full security under a commercial lease. A case from the 5th Circuit provides hope that landlords who are fully secured by their letter of credit may be able to evade the cap on rejected leases by abstaining from filing a claim and simply drawing on the letter of credit. In re Stonebridge Technologies, Inc., 430 F.3d 260, 45 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 80389 (5th Cir. 2005). However, this may backfire, in that savvy debtors could file the claim on the landlord's behalf and thus put the cap into play.

9. Consensual Liens

Consensual liens such as those created be a deed of trust pass through bankruptcy unaffected.

A chapter 7 debtor cannot stripdown a partially secured deed of trust lien. *Dewsnup v. Timm*, 502 U.S. 410 (1992). For example, a home is worth $150,000. The first deed of trust is in the amount of $140,000 and equity line deed of trust is in the amount of $30,000. A Chapter 13 debtor cannot treat $10,000 of the equity line deed of trust as secured and the remainder, $20,000, as unsecured.

A chapter 7 debtor also cannot stripoff a wholly unsecured secured deed of trust lien. *Bank of Am. V. Caulkett*, 135 S.Ct. 1995, 1999 (2015); *Ryan v. Homecomings Financial Network*, 253 F.3d 778 (4th Cir. 2001). For example, the home is worth $150,000. The first deed of trust is in the amount of $140,000. The second deed of trust is in the amount of $20,000 and the equity line deed of trust is in the amount of $30,000. A Chapter 13 debtor cannot treat the $30,000 of the equity line deed of trust as unsecured.

Chapter 13 debtors, however, have a tool not available to chapter 7 debtors: 11 U.S.C. § 1322(b). Section 1322(b)(2) provides that a chapter 13 plan may "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of any class of claims." While the statute bars modification of a secured ***claim*** of a claimant whose security interest is in the principal residence of the debtor, the Fourth Circuit has found that section 1322(b)(2) does not bar the modification of the ***rights*** of creditors. In *Burkhart v. Grigsby*, 886 F.3d 434 (4th Cir. 2018), the Fourth Circuit determined that a partially "underwater" lien falls within the so-called "anti-modification" language of section 1322(b)(2), but a "nominally secured

creditor with an entirely underwater lien" did not fall within the "anti-modification" clause and thus should be viewed as holding an unsecured claim. Id. at 437-38. As such, the rights afforded to creditors, i.e. holding a lien that survives the bankruptcy process and would entitle the creditor to foreclose on the collateral, can be modified or avoided through section 1322(b)(2). Id. at 440-41. In other words, if the senior liens do not entirely capture the value of the property, then the rights of the junior lienholder cannot be modified when the lien is secured only by the debtor's principal residence. However, if the senior liens completely cover the value of the property, leaving nothing for a junior lienholder in the event of a liquidation, the junior lienholder's claim can be modified and treated as an unsecured claim.

Furthermore, the "anti-modification" clause applies only to liens "secured only by a security interest in real property that is the debtor's principal residence." If the obligation is secured by something in addition to the real property, such as a debtor's bank account, then the debtor can modify the terms of that obligation.

10. Avoidance of Judicial Liens

Pursuant to section 522(f) of the Bankruptcy Code, a debtor may avoid a judicial lien other than a judicial lien for a domestic support obligation which impairs an exemption. Under section 34-4 of the Code of Virginia, a debtor is entitled to a $25,000 exemption which may be claimed in the debtor's equity in her home. To the extent that a judicial lien impairs that exemption it may be avoided to the extent of the impairment. Here are some examples:

Value of home	$150,000
Deed of Trust	$125,000
Judgment	$ 25,000
Homestead	$ 25,000

In this case the full amount of the judgment can be avoided because the deed of trust and the $25,000 homestead equal the value of the home.

Value of home	$150,000
Deed of Trust	$110,000
Judgment	$ 25,000
Homestead	$ 25,000

In this case $10,000 of the $25,000 judgment can be avoided. $15,000 of the judgment would remain as a lien against the home.

Value of home	$150,000
Deed of Trust	$ 90,000
Judgment	$ 25,000
Homestead	$ 25,000

In this case none of the judgment lien can be avoided because the total of the deed of trust, judgment, and homestead is less than the value of the home.

Relief under 522(f) is brought on by a motion not by an adversary proceeding. However, care needs to be exercised to insure that the motion is properly served on the entity holding the judgment lien. See Bankruptcy Rule 7004(h) for special service rules on insured depository institutions. The motion should state the value of the home, the prior consensual liens, the amount of the homestead exemption which was identified in the homestead deed filed in the local land records and the amount of the judicial lien. Many times the entity holding the judicial lien will not contest the avoidance of its lien. If the person holding the judicial lien files an objection a hearing is held. Most times the hearing centers on the value of the home. Hypothetical costs of sale of the home are not considered in determining its value. The value of the home for lien avoidance purposes is determined as of the date of the bankruptcy filing.

Assuming that the debtor is successful in having the judicial lien avoided an order will be entered by the Bankruptcy Court. This order should then be docketed in the land records where the property is located. The Order should contain a complete legal description of the subject property. The Order should also reflect that service of the motion to avoid the lien was properly given and state the basis for avoiding the lien. Once the lien is avoided, it cannot be asserted later if the home increases in value. Sometimes a Chapter 7 case will be filed without having a title search done and a discharge will be granted. Later the debtor will discover that there was an old judgment lien on the home. In this situation, the debtor can petition the Bankruptcy Court to reopen the old Chapter 7 case and then file a motion to avoid the judicial lien.

Judicial liens can also be avoided as preferences if they become effective against real property within 90 days of the bankruptcy filing. Likewise, a deed of trust recorded within 90 days of a bankruptcy filing can be avoided as a preference if it was given to secure payment of an antecedent debt.

11. Sales and Refinances in Bankruptcy

A. Sales

1. Chapter 7

In Chapter 7, the trustee can sell real property of the debtor if there is equity that can be realized for the benefit of the creditors. This does not happen all that frequently as a debtor with equity in a home will usually file Chapter 13 and save the home rather than have it sold.

The Chapter 7 Trustee can also sell property where the debtor has only a partial interest in the real estate such as that of a tenant in common, a joint tenant, or a tenant by the entirety provided that certain conditions set forth in section 363(h) are met. In this case, the trustee will sell the property and pay the co-owner the value of his interest.

However, when the trustee seeks to sell the property which has a co-owner the sale must be approved by use of an adversary proceeding. Bankruptcy Rule 7001(3). If the property is subject to partition, the trustee can bring a partition action and then sell the portion of the property partitioned to the Chapter 7 debtor.

In the situation where the proceeds of sale will not be sufficient to pay all of the liens on the real property, the property can still be sold under section 363(f) free and clear of all liens which might be against the real property. This usually occurs in a Chapter 11 case. In this situation, one of the elements of section 363(f) must be proven. Otherwise the sale free and clear of liens is the same as a sale of real property where the proceeds of sale are sufficient to satisfy all of the liens. While the motion brought by the Chapter 7 Trustee will sometimes be identified as a sale free and clear of liens, the Chapter 7 Trustee will usually only sell property where the proceeds of sale are sufficient to pay all lienholders.

2. Chapter 13

The Chapter 13 debtor may sell her real property while she is in Chapter 13. The Chapter 13 debtor will file a motion with the Bankruptcy Court asking the court to approve the sale of the property and the terms of the contract of sale. The motion should identify the liens against the property and indicate that such liens will be satisfied from the proceeds of sale. As with the order which avoids a judicial lien, the order approving the sale of real property should contain a complete description of the subject property. The order should also identify the amounts that are being paid to the Chapter 13 Trustee. Finally, the order should approve the terms of the real estate contract and authorize the payment of the real estate commission and the payment of other costs customarily associated with a real estate closing such as the cost of deed preparation and the payment of the settlor's tax. It is good practice to reference the approval of the sale by the Bankruptcy Court in the deed and attach the Order of the Bankruptcy Court approving the sale to the deed.

B. Refinances

Refinances are similar to sales in that they are accomplished by a motion and an order of the Bankruptcy Court. The motion to approve the refinance should describe the subject property and the terms of the refinance.

In both sales and refinances in Chapter 13 cases, all existing liens should be handled at the closing just as they would be handled in any normal real estate transaction. A lien payoff amount should not be sent to the Chapter 13 Trustee under the belief that the Chapter 13 Trustee will pay off the lien holder. If the Chapter 13 Trustee was making payments under the Chapter 13 plan to a creditor whose lien was paid off as a result of a sale, the Chapter 13 Trustee will make the appropriate changes to the distribution schedule under the Chapter 13 plan after the closing.

C. Payoff of the Chapter 13 Plan

If the Chapter 13 debtor has been paying under the Chapter 13 plan for 36 months, then the Chapter 13 debtor can pay the remainder of plan commitment amount (i.e. the balance due under the plan to the unsecured creditors). If the Chapter 13 plan has been in place for less than 36 months, the Chapter 13 Trustee will usually require the Chapter 13 debtor to pay 100% of the allowed claims. It is important to note the distinction between paying off the debtor's obligations under a Chapter 13 plan and paying all of the claims filed in a Chapter 13 case. In a Chapter 13 case, a debtor may list $30,000 in unsecured claims. Only those creditors that file a proof of claim get to participate in the distribution from the Chapter 13 plan. Let's assume that only $20,000 worth of claims are filed. Under the chapter 13 plan, the debtor proposes to pay 20% of each of these claims. Thus, at the end of the Chapter 13 plan the debtor would have paid $4,000 to his unsecured creditors. If the debtor satisfies his obligations under the plan from the proceeds of his refinance he would pay $4,000. If the debtor has to pay all the filed claims, he would have to pay $20,000.

Once confirmed, plans are not easily disturbed, but it can be done. The Fourth Circuit has held that the doctrine of res judicata prevents modification of a Chapter 13 plan unless the party seeking modification demonstrates that the debtor experienced a "substantial and unanticipated post-confirmation change in his financial condition." *Murphy v. O'Donnell* (*In re Murphy*), 4th Cir., No 05-1637, 1/18/07. *See also O'Donnell v. Goralski* (*In re Goralski*), 4th Cir., No 05-1844, 1/1807. In the latter of this pair of cases, the 4th Circuit contrasted the situations of a condominium owner who, at the time of his filing, valued the condo at $155,000 with a $121,000 lien. 11 months later he sold it for $235,000 – a greater than 50% increase in value. The bankruptcy court allowed the trustee's motion for modification. In the former, modification was denied where the debtor husband and wife executed a cash-out refinance to mitigate difficulty making plan payments because the husband's income had been reduced.

12. After Acquired Property

In a chapter 7 case, a debtor typically receives a discharge of her obligations. Thus, a judgment lien that was recorded prior to a debtor filing Chapter 7 would not be a lien on property acquired by the debtor after the Chapter 7 case was filed. Of course, if the Chapter 7 was dismissed or the debtor was denied a discharge, then the judgment lien would remain effective against any real property the debtor later acquired.

After the debtor receives a discharge in Chapter 13, the situation is the same as in Chapter 7. A judgment lien arising prior to the date of filing of the Chapter 13 bankruptcy case would not be not effective against property acquired after the Chapter 13 bankruptcy was filed assuming that the Chapter 13 case was not dismissed and the Chapter 13 debtor receives a discharge.

Typically, the order of discharge which a debtor receives is not docketed in the local land records. Thus, in the situation of after acquired property it is incumbent upon the person searching title to confirm that a debtor received a bankruptcy discharge subsequent to the docketing of the judgment lien.

13. Proofs of Claim and Pacer System

A. When to file a proof of claim.

1. Chapter 7 – You are only permitted to file a claim when told to do so. In "No Asset" cases, there is no need to file a claim. Most individual Chapter 7 cases are filed as "No Asset" cases and originally noticed that way. If the Trustee discovers assets, she will re-notice the case as an asset case. Typically, this will happen after the creditor's meeting/341 meeting.

2. Chapter 13 – You should always file a proof of claim as there is almost always some payment to creditors in Chapter 13 cases.

3. Chapter 11 -- In Chapter 11, debtor must file a list of creditors and amounts owed. This is referred to as the "scheduled" amount. If you are happy with the amount and the claim is not scheduled as contingent, unliquidated or disputed, then you do not need to file. However, it is dangerous to rely on the debtor's schedules as they might be amended later so the better course of action is to file your own proof of claim. If the scheduled amount is incorrect or the claim is scheduled as contingent, unliquidated or disputed, then you need to file.

Creditors must watch the applicable bar date closely. The bar date is usually set by the Court after the case is underway, meaning it will not appear on the initial notice that a case has been filed. All creditors should be notified of the bar date when set. Bar dates may vary depending on the type of claim.

B. How to file a proof of claim.

1. Typically, the Court will send a proof of claim form with the notice indicating you need to file. The forms are available at most Bankruptcy Court websites. They are available at the website for the Western District of Virginia Bankruptcy Court's website at www.vawb.uscourts.gov. That is a revisable PDF form.

2. Claims must be filed in the appropriate Clerk's Office or with a private claims processor in larger cases. The notice of filing will give the location.

C. Additional Claim Issues.

1. A creditor does not have to receive formal notice from the Bankruptcy Court of a case in order for their debt to be discharged. Creditors have obligation to take reasonable steps to investigate whether bankruptcy has been filed if they receive information that debtor has filed for bankruptcy. Debts can be discharged even if creditor gets no formal notice, if it fails to investigate. However, in "No Asset" cases, the debt will be discharged even if creditor got no notice.

2. You are required to attach supporting documents that support your claim. For example, a copy of the title showing the lien if you have a secured claim on a vehicle or a copy of the account statement for an open account. If you fail to attach supporting documents, the Trustee will probably object to your claim on the basis of lack of documentation.

3. Claims can be amended, so it is better to file something than nothing, even if you are not sure of the exact amount owed or you do not have the attachments.

4. Amount of claim is the amount that is owed as of the date the petition is filed. This amount includes interest through the petition date, attorney's fees and court costs. Any amounts owed after that date will be dealt with differently as administrative claims.

5. Administrative claims must be sought by filing a Request for Allowance of Administrative Claim with the Court in the form of a Motion. You must have a statutory basis for an Administrative Claim, which are listed at § 503(b). In some larger cases, the Court will establish a procedure similar to the proof of claim procedure for common types of administrative claims such as § 503(b)(9) claims.

D. PACER System

1. All Bankruptcy Courts use electronic filing that is similar to U.S. District Court system. All bankruptcy courts follow a standard pattern for the names of their websites. www.vawb.uscourts.gov is the site for the Bankruptcy Court for the Western District of Virginia.

2. Go to http://pacer.psc.uscourts.gov/ to register for a PACER number. You do not have to be an attorney to register for a PACER number.

3. You can review all of the documents filed in a case on system. Searches are available by debtor's name or case number. Using the system, you can review the debtor's schedules and other filings, check deadlines and check the status of claims filings.

14. Planning for a Customer to File

A. What to do when bankruptcy is on the horizon.

1. Check your contracts, invoices, and other documents. Your invoices should provide for attorney's fees and interest. They should disclaim consequential damages.

2. Confirm that security documents are correct before there is problem.

i. Check that the information on the titles to vehicles is correct and that you have the titles.

ii. Check that financing statements are filed in the correct name and correct place. Be exceptionally careful with names. In *The Official Committee of Unsecured Creditors for Tyringham Holdings, Inc. v. Suna Bros., Inc. (In re Tyringham Holdings, Inc.)*, 354 B.R. 363 (Bankr. E.D. Va. 2006), Judge Tice held that a financing statement filed in the name "Tyringham Holdings" did not create a security interest when the debtor's correct legal name was "Tyringham Holdings, Inc." If you are filing in a hurry, Virginia Code Ann. § 8.9A-516(b) sets out a list of what must be included in a financing statement and § 8.9A-520(a) states that the SCC must refuse to accept a filing that fails to comply with that subsection. The § 8.9A-516(b) list includes organizational identification number for corporate debtors.

iii. Confirm that judgments and deeds of trust are filed in the right jurisdiction. Make sure that your General District Court judgments have been filed in the Circuit Court Clerk's office (they should be filed in the Circuit Court of the location where you got the judgment and any Circuit Courts where the defendant owns property). If General District Court judgments have not been filed in Circuit Court, they will not be a lien on real property. See Virginia Code Ann. § 8.01-458.

iv. Make sure the proper person(s) have signed critical documents. Make sure personal guarantees have been signed. Consider checking open accounts on a regular time frame to be sure that you have personal guarantees signed by the proper person(s). Remember to give consideration for any new guarantees.

B. When bankruptcy is imminent.

1. If bankruptcy is looming, remember that the preference period is 90 days (assuming you are not an "insider" of the debtor). If you need to correct one of the problems listed above, consider extending the debtor additional credit or withholding collection activity to take your action past the 90 day deadline. Actions taken 91 days before the filing date are immune from attack as preferences.

2. Pull and review your payment history for ordinary course of business defense purposes. Consider applying a payment to the newest invoice instead of the oldest if this would help your ordinary course of business defense. Of course, you must honor directions from the debtor regarding payment.

3. Remember that COD transactions are going to be immune from a preference challenge as the payment is not on an antecedent debt.

4. Our advice is to take the money, even if you think that the customer is going to file for bankruptcy. It is better to have the money now and possibly give some percentage of it back two years later than not getting the payment.

C. If a bankruptcy case is filed.

1. File a notice of appearance or monitor the case on PACER.

2. In Chapter 13 cases, file a proof of claim. You are probably best off filing a claim in a Chapter 11 case. In a Chapter 7 case, monitor the case closely for an asset notice and if one is issued, file your proof of claim.

3. Consider whether you have an administrative claim.

4. If the debtor is continuing to operate (probably in Chapter 11), assuming you do not have a contract with the debtor, you are free not to sell to the debtor. Commonly people will put the debtor on cash only terms. Any post-petition sales will be an administrative claim if not paid, but many cases are administratively insolvent, so you should watch your A/R closely. Absent Court approval, such as "critical vendor" status, the debtor cannot pay pre-petition invoices.

5. If the debtor needs your goods or services and cannot pay cash, there is the opportunity to obtain some benefit from the debtor. Consider offering terms in exchange for a settlement with the debtor whereby your preference liability is eliminated. Consider seeking Court approval for the debtor to pay your pre-petition debt first while you continue to sell to it. This converts an unsecured claim to an administrative claim.

6. If the case is a Chapter 13 and you are being paid on a secured obligation such as a house or car, monitor the debtor's performance under Chapter 13 Plan closely. If problems develop, file Motion for Relief early.

7. Post-petition interest on unsecured and undersecured claims generally cannot be collected under Section 502. Secured claims generally can collect interest only to the extent it comes from the collateral's equity cushion. Applying payments to interest first and then preserving the remainder to claim as principal outstanding was denied in the 4th Circuit. *National Energy & Gas Transmission, Inc. v. Liberty Electric Power (In re National Energy & Gas Transmission Inc.*), 4th Cir., No 06-1459, 7/10/07.

15. Bankruptcy Planning

A. Bankruptcy planning encompasses many complex financial and legal decisions in order to maximize the benefit of the bankruptcy process to the debtor while not prejudicing the rights of creditors under applicable law. Debtors who engage in overly aggressive last-minute planning, such as eve of bankruptcy

purchases may find their case dismissed for abuse. *See, e.g., In Re O'Brien*, (concerning eve of bankruptcy home and car purchase in bad faith due in part to falsified information in loan documents)., N.D. Ohio, No 07-30825, 6/25/07. The Supreme Court held that a Chapter 7 debtor's bad faith impacts the right to convert the case to Chapter 13. *Marrama v. Citizens Bank of Massachusetts*, U.S., No. 05-996, 2/21/07. Likewise, a transfer of assets by a prospective debtor to a self-settled trust or to a third party beneficiary trust while the prospective debtor is in financial difficulty has little chance of not being avoided in a bankruptcy case.

1. In *De Feliece v. US Airways, Inc.*, (4th Cir., No. 06-1892, 8/1/07), the Fourth Circuit upheld a lower court decision that the airline did not breach its fiduciary duties when it allowed its employees to continue to invest in its corporate stock in the Section 401(k) plan in the time period leading up to the company's filing for Chapter 11 protection. The Court looked to the "prudent man" investment standard and noted that the option was disclosed as high risk and was one of many investment options available. In order to determine whether a fiduciary with discretion to select and maintain such investment options breached its duties, the "totality of the circumstances" must be considered – including the plan structure and goals, disclosures made to participants, and challenges facing the company.

2. In *Beck v. PACE International Union* (U.S., No. 05-1448, 6/11/07), the Court issued a narrow opinion that a bankrupt employer did not breach its fiduciary duties when, rather than following the union's suggestion of investigating whether it should merge its single-employer plans with a multiemployer pension fund, the employer instead decided to annuitize the plans as a method of terminating them. The straightforward reasoning was that there could be no breach because merger of a single-employer plan into a multi-employer plan is not a permissible method of terminating single-employer plans. Even though the impact of the case is narrow, employers may want to consider, given the opinion's recognition that ERISA serves as a guide as to merger and termination options, how their plan language provides termination options. In footnote three, the Court noted ERISA requires any method of termination must be "in accordance with provisions in the plan" and that the employer could have drafted its documents to limit available termination methods and thus permit merger.

3. Upon filing, "known creditors" are entitled to specific notice of the bankruptcy. Known creditors is a broadly construed term, and includes, e.g., the administrator of an estate where no wrongful death suit had yet been filed, but whose identity as a potential claimant was known to the debtor. *Zurich American Insurance Co. v. Tessler*, 4th Cir., No. 06-1834, 6/26/07).

4. A corporation also should remain cognizant of shareholder rights as they relate to the bankruptcy process. In a 2006 Delaware chancery case, a telecommunications company was prohibited from selling the majority of its assets in bankruptcy without a shareholder vote, even though a shareholder vote was prohibited by federal securities law at that time for failure to file annual reports. Federal preemption and Constitutional Supremacy Clause arguments by defendant directors were rejected. The court focused on the two inequities that would result – the "unfair" expansion of preferred stockholders' rights under the intricacies of the Bankruptcy Code and the denial of the common shareholders' right to vote. It was "anticipated" by the Chancellor that the directors would have to turn to the SEC for relief against the prohibition on voting. *Esopus Creek Value LP v. Hauf*, Del. Ch., No 2487-N, 11/29/06.

16. Reclamation

A. Outside of bankruptcy a creditor's right to reclaim goods is governed by Section 2-702 of the Uniform Commercial Code.

§ 8.2-702. Seller's remedies on discovery of buyer's insolvency.

(1) Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under this title (§ 8.2-705).

(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser or lien creditor under this title (§ 8.2-403). Successful reclamation of goods excludes all other remedies with respect to them.

If you learn that a buyer is insolvent immediately try to stop delivery of any goods to the buyer. If the goods have been delivered, immediately send a reclamation notice. If there is a creditor with an existing lien on inventory, that creditor's lien on inventory will prevail over your right to reclaim the goods. If the goods have been incorporated into other products, you will not be permitted to reclaim your goods. If you are going to move to reclaim, you should also have someone go to the buyer's place of business and physically identify and tag your goods.

B. When a bankruptcy is filed Section 546(c) is the exclusive reclamation remedy. *See Flavo-O-Rich, Inc. v. Rawson Food Serv., Inc. (In re Rawson Food Serv., Inc.),* 846 F.2d 1343, 1346 (11th Cir. 1988).

To make reclamation demand under § 546(c)(1) the goods must have been sold in the ordinary course of the seller's business. The goods must have been delivered while the debtor was insolvent. A debtor is insolvent under the Bankruptcy Code definition when its liabilities exceed its assets. (Under the UCC a debtor is insolvent if it cannot pay its debts as they become due or its liabilities exceed its assets.) The seller must discover insolvency after delivery of the goods. The debtor must have received the goods within 45 days before the bankruptcy was filed. The seller must make a timely written reclamation demand not later than 45 days after the receipt of the goods or not later than 20 days after bankruptcy filing date. A seller's right to reclaim is subject to the rights of secured creditors with a lien on inventory.

In almost all Chapter 11 bankruptcy cases, a lender has a prior lien on all of the debtor's inventory and that lender is usually undersecured. This means that in most cases there is no realistic chance of a seller reclaiming its goods. However, a seller of goods is entitled to an administrative claim for the cost of goods delivered to the debtor in the 20 days before the bankruptcy filing and which have not been sold as of the date of the bankruptcy filing.§503(b)(9). An administrative claim is the highest priority of unsecured claims and is paid after secured claims and before other unsecured claims including claims of employees and taxes. Thus, it would appear that a creditor who delivered goods within the 20 day window would be in a good position to be paid for those goods. However, many times a Chapter 11 debtor is administratively insolvent. This means that the value of its lien free assets is less than the amount of its administrative debt.

17. Avoidance Powers and Trusts

Section 541 of the Bankruptcy Code defines what property is included in a debtor's bankruptcy estate. As a general matter, funds held by a debtor in trust for another are not considered property of the estate. 11 U.S.C. § 541(d). Thus, when the debtor makes a transfer of funds held in trust for another, as opposed to when a debtor makes a transfer of her own assets, that transfer cannot be avoided pursuant to the trustee's avoidance powers.

But what about when the debtor is the beneficiary of a trust? According to section 541(c)(1)(A) of the Bankruptcy Code, "an interest of the debtor in property becomes property of the [bankruptcy] estate ... notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—(A) that restricts or conditions transfer of such interest by the debtor...." However, section 541(c)(2) provides an exception to this rule for an interest in a trust that is subject to a valid spendthrift provision: "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." In other words, a debtor's beneficiary interest

in property held in trust becomes property of the estate absent a valid spendthrift provision. *In re Salahi*, 2012 WL 1438213, at *2-3 (Bankr. E.D. Va. 2012).

While a valid spendthrift provision may offer protection of the debtor's interest in the trust property, that protection is not absolute. In Virginia, if the trust is self-settled, then bankruptcy courts have found that the property should be included within the property of the bankruptcy estate. *In re Salahi*, 2012 WL 1438213, at *4. Furthermore, Section 548(e) of the Bankruptcy Code provides that

> (e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if--
>
> (A) such transfer was made to a self-settled trust or similar device;
> (B) such transfer was by the debtor;
> (C) the debtor is a beneficiary of such trust or similar device; and
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

11 U.S.C. § 548(e). Thus, transfers made by the debtor within 10 years to self-settled trusts where the debtor is a beneficiary are avoidable if the trustee can show such transfer was made "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted."

18. <u>Trustee Powers and Limited Liability Companies</u>

A membership interest in a limited liability company is personal property in Virginia. Virginia Code § 13.1-1038. As such, if a member of a limited liability company files for bankruptcy, that member's interest will become property of the bankruptcy estate pursuant to 11 U.S.C. § 541(a). *In re Virginia Broadband, LLC*, 498 B.R. 90, 94 (Bankr. W.D. Va. 2013).

"Under Virginia law, members of a limited liability company are dissociated upon the filing of a bankruptcy petition." *In re Johnson*, 2021 WL 5496731, at *4 (Bankr. E.D. Va. 2021); Virginia Code § 13.1-1040.1(6)(a). Disassociated members retain their membership interest, but only have the powers of an assignee. Virginia Code § 13.1-1040.2(A). Disassociation does not trigger automatic dissolving of LLC. Virginia Code § 13.1-1040.2(B). Assignees get to "receive, to the extent assigned, only any share of profits and losses and distributions to which the assignor would be entitled" but do not get to "participate in the management and affairs of the limited liability company or to become or to exercise any rights of a member." Virginia Code § 13.1-1039. Thus, the effect of filing a bankruptcy petition is that the bankrupt member is divested of all rights as a member to participate in the management or operation of the LLC but "does not forfeit the

value of his ownership interest." *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 704 (Bankr. E.D. Va. 2000).

So what happens, then, when an individual who is a sole member of a limited liability company files for bankruptcy? By operation of the Virginia Limited Liability Company Act, they should become a disassociated member who can only exercise the rights of an assignee. If that were the case, then no one would have the power to actually manage the limited liability company as an assignee has no management power or vote power to get more members or assign a manager.

That would be an unfortunate result that would render the limited liability company rudderless and thus decrease the value of the interest for the estate of the debtor. Thus, bankruptcy courts have sought various solutions to the conundrum. *In re Modanlo*, 412 B.R. 715 (Bankr. D. Md. 2006); *In re First Protection, Inc.*, 440 B.R. 821, 830 (B.A.P. 9th Cir. 2010). The general solution appears to be to ignore the state law regarding rights of an assignee and instead to allow the trustee to manage the assets of the limited liability company. *See In re Modanlo*, 412 B.R. at 727-28; *In re Albright*, 291 B.R. 538 (Bankr. D. Col. 2003). In essence, the courts have analyzed the policy considerations behind the statutes limiting assignee powers and found that, while serving a purpose in multi-member limited liability companies by not forcing the other members to involuntarily to share governance responsibilities with someone they did not choose, it serves no such purpose in sole-member limited liability companies. *In re Modanlo*, 412 B.R. at 730.

Disregarding the state law and allowing the trustee to operate or liquidate the a sole member limited liability company is not the only solution. In a case from 2011, Judge Huennekens in the Eastern District of Virginia ordered that a limited liability company without a member qualified to serve as a manager would be liquidated after the appointment of a liquidating trustee. *In re Williams*, 455 B.R. 485, 502-03 (Bankr. E.D. Va. 2011) (finding that two debtors in separate cases held membership interests in limited liability company, but could not liquidate limited liability company as they were both disassociated members under Virginia law).

As discussed earlier, for multi-member LLCs of which a bankrupt Chapter 7 debtor is a member, the Chapter 7 trustee would receive the share of the profits and losses to which the bankruptcy member is entitled. But the trustee need not sit idle; even as an assignee, the trustee still has the power to transfer or sell the debtor's LLC membership interest pursuant to the Bankruptcy Code's sale provisions of 11 U.S.C. § 365. *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 707-08 (Bankr. E.D. Va. 2000).

V. ATTACKING THIRD PARTY TRUSTS

The use of third party trusts serve as an important asset protection vehicle for estate and trust lawyers. For our purposes, a third party trust is a trust established by a settlor for the benefit of another. The core issue with the use of third party trusts for asset protection is the right of a creditor to reach an asset to collect a debt against a beneficiary. In the ever increasing litigious nature of our society, the ability of trusts to withstand creditor attacks is more and more important.

In general, to the extent that a third party trust is protected by a spendthrift clause, a creditor of a beneficiary may not reach the beneficiary's interest until distribution is made by the trustee to that beneficiary.

Under Virginia law, the impact of creditor's claims against a beneficiary's interest in a trust are governed by Virginia Code §§ 64.2-742 – 64.2-749, all of which are based upon §§ 501 – 507 of the Uniform Trust Code (2000) ("UTC"). Virginia passed the UTC effective as of July 1, 2006 with minor revisions. There has been little case law in Virginia since the implementation of the UTC informing the contours of Virginia's version of the UTC. In light of limited governing case law, the UTC Comments can provide significant insight into the meaning of the Virginia UTC.

With our transient society, the laws of other states could impact the asset protection characteristics of the trusts written in Virginia. As lawyers, we cannot be certain where individuals will ultimately reside and which laws will apply to a creditor attack against a trust. Although the UTC has been passed in some form in 36 states, most states have made state-specific changes to their versions. In fact, state law on the ability to protect trust's assets from creditors continues to be fluid and asset protection characteristics vary from state to state.

In this section, we will analyze (a) current Virginia law on the ability of creditor to attack a third party trust; (b) creditor remedies against a third party trust; (c) risks to third party trusts found in other states; (d) planning opportunities to consider in drafting trusts to enhance creditor protection; and (e) planning opportunities to enhance creditor protection for a trust beneficiary by modifying trusts whether by nonjudicial settlement agreements, decanting or use of trust protectors/trust directors.

This section does not cover the myriad of issues relating to self-settled trusts.

A. Virginia Law.

1. Rights of beneficiary's creditor or assignee.

a. The rights of a beneficiary's creditor or assignee are circumscribed by Virginia Code § 64.2-742 which is based upon UTC § 501:

> "To the extent a beneficiary's interest is not subject to a spendthrift provision, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means. The court may limit the award to such relief as is appropriate under the circumstances."

b. In the comments to Section 501, the Uniform Law Commissioners ("ULC") noted that a creditor can reach the interest of a beneficiary when there is no valid spendthrift clause. This section does not mean that the creditor can necessarily collect all distributions made to the beneficiary and it does not prescribe the procedures for reaching a beneficiary's interest. "The section does clarify, however, that an order obtained against the trustee, whatever state procedure may have been used, may extend to future distributions whether made directly to the beneficiary or to others for the beneficiary's benefit. By allowing an order to extend to future payments, the need for the creditor periodically to return to court will be reduced." UTC Comment 501.

c. In describing potential collection provisions, the ULC opined that "[a] creditor typically will pursue a claim by serving an order on the trustee attaching the beneficiary's interest. Assuming that the validity of the order cannot be contested, the trustee will then pay to the creditor instead of to the beneficiary any payments the trustee would otherwise be required to make to the beneficiary, as well as discretionary distributions the trustee decides to make. The creditor may also, in theory, force a judicial sale of a beneficiary's interest." UTC Comment 501.

d. In exercising its discretion to provide remedy to a beneficiary's creditor, a court may appropriately consider the support needs of a beneficiary and the beneficiary's family. See *Restatement (Third) of Trusts* Section 56 (cmt. e) 2003. UTC Comment 501.

2. <u>Spendthrift provision.</u>

a. The impact of a spendthrift clause is delineated in Virginia Code § 64.2-743 as based on UTC § 502:

> "A. A spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest.
>
> B. A term of a trust providing that the interest of a beneficiary is held subject to a "spendthrift trust," or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.
>
> C. A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this article, a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary."

b. In the comment to Section 502 of the UTC, the ULC explains that "a settlor has the power to restrain the transfer of a beneficiary's interest, regardless of

whether the beneficiary has an interest in income, in principal, or in both. Unless one of the exceptions under this article applies, a creditor of the beneficiary is prohibited from attaching a protected interest in a trust and may only attempt to collect directly from the beneficiary after a distribution is made." UTC Comment 502.

c. The ULC further notes that "[f]or a spendthrift provision to be effective under this Code, it must prohibit both the voluntary and involuntary transfer of the beneficiary's interest, that is, a settlor may not allow a beneficiary to assign while prohibiting a beneficiary's creditor from collecting, and vice versa. A spendthrift provision valid under this Code will also be recognized as valid in a federal bankruptcy proceeding. See 11 U.S.C. Section 541(c)(2)." UTC Comment 502.

3. Exceptions to spendthrift provision.

   a. The exceptions to spendthrift protection are found in Virginia Code § 64.2-744 based upon UTC § 503:

      "A. In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another state.

      B. Even if a trust contains a spendthrift provision, a beneficiary's child who has a judgment or court order against the beneficiary for support or maintenance, or a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust, may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary.

      C. Subject to the limitations of § 64.2-745, no spendthrift provision shall operate to the prejudice of the United States, the Commonwealth, or any county, city, or town.

      D. A claimant against which a spendthrift provision cannot be enforced may obtain from a court an order attaching present or future distributions to or for the benefit of a beneficiary. The court may limit the award of such relief as is appropriate under the circumstances."

   b. This section exempts the claims of certain categories of creditors (sometimes referred to as exception creditors, exception creditors or preferred creditors) from the effects of a spendthrift restriction.

   c. As described by the ULC, the impact of this exception is to permit a creditor for unpaid support to attach present or future distributions that would otherwise be made to a beneficiary. Distributions subject to attachment include distributions required by the express terms of the trust, such as

mandatory payments of income, and distributions the trustee has otherwise decided to make, such as through the exercise of discretion. This section does not authorize, on its face, a claimant to compel a distribution from the trust. UTC Comment 503.

d. The exception for a creditor who has provided services for the protection of a beneficiary's interest in the trust allows a beneficiary of modest means to overcome an obstacle preventing the beneficiary's obtaining services essential to the protection or enforcement of the beneficiary's rights under the trust. See *Restatement (Third) of Trusts Section 59 cmt. d (2003)* UTC Comment 503.

e. In describing this code section, the ULC states "[s]ubsection (c), which is similar to *Restatement (Third) of Trusts Section 59 cmt. a (2003),* exempts certain governmental claims from a spendthrift restriction. Federal preemption guarantees that certain federal claims, such as claims by the Internal Revenue Service, may bypass a spendthrift provision no matter what this Code might say. The case law and relevant Internal Revenue Code provisions on the exception for federal tax claims are collected in *George G. Bogert & George T. Bogert, The Law of Trusts and Trustees Section 224 (Rev. 2d ed. 1992);* and *2A Austin W. Scott & William F. Fratcher, The Law of Trusts Section 157.4 (4th ed. 1987).* Regarding claims by state governments, this subsection recognizes that States take a variety of approaches with respect to collection, depending on whether the claim is for unpaid taxes, for care provided at an institution, or for other charges. Acknowledging this diversity, subsection (c) does not prescribe a rule, but refers to other statutes of the State on whether particular claims are subject to or exempted from spendthrift provisions." UTC Comment 503.

f. Unlike the *Restatement (Third) of Trusts* and *Restatement (Second) of Trusts*, the UTC does not create an exception to the spendthrift restriction for creditors who have furnished necessary services or supplies to the beneficiary. Most of these cases involve claims by governmental entities, which the drafters concluded are better handled by the enactment of special legislation. The drafters also declined to create an exception for tort claimants. "For a discussion of the exception for tort claims, which has not generally been recognized by statutes, see *Restatement (Third) of Trusts Section 59 Reporter's Notes to cmt. a (2003).* For a discussion of other exceptions to spendthrift restrictions in other states, see *George G. Bogert & George T. Bogert, The Law of Trusts and Trustees Section 224 (Rev. 2d ed. 1992);* and *2A Austin W. Scott & William F. Fratcher, The Law of Trusts Sections 157-157.5 (4th ed. 1987)*." UTC Comment 503.

g. Virginia altered UTC § 503 in certain ways by (a) removing a beneficiary's spouse or former spouse who has a judgment or court order against the beneficiary for support or maintenance as preferred creditor and (b) adding Section D permitting a creditor to reach present or future distributions.

4. <u>Certain claims for reimbursement for public assistance.</u>

a. The impact of certain claims for reimbursement for public assistance are found in Virginia Code § 64.2-745 as follows.

> "A. Notwithstanding any contrary provision in the trust instrument, if a statute or regulation of the United States or Commonwealth requires a beneficiary to reimburse the Commonwealth or any agency or instrumentality thereof, for public assistance, including medical assistance, furnished or to be furnished to the beneficiary, the Attorney General or an attorney acting on behalf of the state agency responsible for the program may file a petition in the circuit court having jurisdiction over the trustee requesting reimbursement. The petition may be filed prior to obtaining a judgment. The beneficiary, the guardian of his estate, his conservator, or his committee shall be made a party.
>
> B. Following its review of the circumstances of the case, the court may:
>
> 1. Order the trustee to satisfy all or part of the liability out of all or part of the amounts to which the beneficiary is entitled, whether presently or in the future, to the extent the beneficiary has the right under the trust to compel the trustee to pay income or principal to or for the benefit of the beneficiary; or
>
> 2. Regardless of whether the beneficiary has the right to compel the trustee to pay income or principal to or for the benefit of the beneficiary, order the trustee to satisfy all or part of the liability out of all or part of any future payments that the trustee chooses to make to or for the benefit of the beneficiary in the exercise of discretion under the trust.
>
> C. A duty in the trustee under the instrument to make disbursements in a manner designed to avoid rendering the beneficiary ineligible for public assistance to which he might otherwise be entitled, however, shall not be construed as a right possessed by the beneficiary to compel such payments.
>
> D. The court shall not issue an order pursuant to this section if the beneficiary is a person who has a medically determined physical or mental disability that substantially impairs his ability to provide for his care or custody, and constitutes a substantial handicap."

b. This section is not found in the UTC.

5. Discretionary trusts; effect of standard.

   a. The effect of a discretionary distribution standard in a trust can be found in Virginia Code § 64.2-746 (as based on UTC § 504) as follows:

      > "A. In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another state.
      >
      > B. Except as otherwise provided in subsection C and § 64.2-745, whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if:
      >
      > 1. The discretion is expressed in the form of a standard of distribution; or
      >
      > 2. The trustee has abused the discretion.
      >
      > C. To the extent a trustee has not complied with a standard of distribution or has abused a discretion:
      >
      > 1. A distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child; and
      >
      > 2. The court shall direct the trustee to pay to the child such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion.
      >
      > D. This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution.
      >
      > E. A creditor may not reach the interest of a beneficiary who is also a trustee or co-trustee, or otherwise compel a distribution, if the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard."

   b. This section addresses the ability of a beneficiary's creditor to reach the beneficiary's discretionary trust interest, whether or not the exercise of the

trustee's discretion is subject to a standard. Further, this provision is similar to the *Restatement (Third) of Trusts*, eliminates the distinction between discretionary and support trusts, unifying the rules for all trusts fitting within either of the former categories. See *Restatement (Third) of Trusts Section 60 Reporter's Notes to cmt. a (2003)*. UTC Comment 504.

c. Critically, this provision has limited application. Pursuant to UTC § 502 and Virginia Code § 64.2-743, the effect of a valid spendthrift provision, where applicable, is to prohibit a creditor from collecting on a distribution prior to its receipt by the beneficiary. This section is relevant only if the trust is not protected by a spendthrift provision or if the creditor falls within one of the exceptions to spendthrift enforcement created by UTC § 503 and Virginia Code § 64.2-744.

d. UTC § 504 and Virginia Code § 64.2-746 establishes the general rule that a creditor cannot compel a distribution from the trust, even if the trustee has failed to comply with the standard of distribution or has abused a discretion, except for the preferred creditors described in subsection (C). Under Subsection (D), the power to force a distribution due to an abuse of discretion or failure to comply with a standard belongs to the beneficiary. Under Virginia Code § 64.2-776A, a trustee must always exercise a discretionary power in good faith and with regard to the purposes of the trust and the interests of the beneficiaries. UTC Comment 504.

6. <u>Overdue distribution.</u>

a. In general, the impact of a spendthrift clause is to insulate a beneficiary's interest in a trust until a distribution is made and received by a beneficiary.

b. Under Virginia Code § 64.2-748 (based upon UTC § 506) an overdue distribution is impacted as follows:

> "A. In this section "mandatory distribution" means a distribution of income or principal that the trustee is required to make to a beneficiary under the terms of the trust, including a distribution upon termination of the trust. The term does not include a distribution subject to the exercise of the trustee's discretion even if (i) the discretion is expressed in the form of a standard of distribution or (ii) the terms of the trust authorizing a distribution use language of discretion with language of direction.
>
> B. Whether or not a trust contains a spendthrift provision, a creditor or assignee of a beneficiary may reach a mandatory distribution of income or principal, including a distribution upon termination of the trust, if the trustee has not made the

distribution to the beneficiary within a reasonable time after the designated distribution date."

c. As noted in the comment to UTC § 506, "[w]hether a trust contains a spendthrift provision or not, a trustee should not be able to avoid creditor claims against a beneficiary by refusing to make a distribution required to be made by the express terms of the trust. On the other hand, a spendthrift provision would become largely a nullity were a beneficiary's creditors able to attach all required payments as soon as they became due."

B. <u>Creditor Remedies against a Third Party Trust in Virginia</u>.

1. <u>Invasion of Trust.</u>

a. As described above in Virginia Code § 64.2-745 (B) (1), under certain circumstances, a court can order a trustee to reimburse the state of Virginia for public assistance furnished from amounts the beneficiary is entitled to receive, whether currently or in the future.

b. In addition, a court may order a distribution for the support of a beneficiary's child, if a trustee has not complied with a distribution standard or has abused discretion under Virginia Code § 64.2-746 (C).

2. <u>Garnishment of Distributions.</u>

1. Under Virginia Code §§ 64.2-744 (B) and (D), present or future distributions can be attached for child support or for a judgment creditor who has provided services for the protection of a beneficiary's interest in a trust.

2. The United States, Virginia or any city, county or town may seek garnishment of trust distributions (whether present or future) under Virginia Code §§ 64.2-744 (C) and (D).

C. <u>Creditors Risks to Third Party Trusts Observed in Other States</u>.

1. <u>General</u>

Courts in other jurisdictions have taken a wide variety of positions on the ability to attack spendthrift trusts for the benefit of third party beneficiaries. In fact, the asset protection characteristics of trusts is evolving year to year. The location of the beneficiary, the trustee, the settlor, the forum of the dispute or the trust assets could impact the ability of a creditor to attack a trust.

Often, in attacking third party trusts, creditors are hoping to invalidate spendthrift protection on account of excess control and dominion over the trust by a debtor-beneficiary.

2. <u>What are some exceptions (or potential exceptions) to spendthrift protection in other states?</u>

    a. There are a variety of statutory and common law exceptions to spendthrift protections based upon the nature of the claim. The theory in exempting certain creditors is that attachment does no injustice to trust purpose while avoiding unjust enrichment of the beneficiary. These preferred creditors may have rights to broach spendthrift provisions by statute or case law. Some states have no exceptions while others may have many or may otherwise limit the impact of a spendthrift clause. In addition, some states (a) limit the scope of spendthrift protection (no matter the type of creditor) (b) subject trusts to creditor attacks if a beneficiary debtor is a trustee (c) permit trustee of the trust under a broader set of fact patterns or (d) permit indirect attacks on trusts.

    b. Virginia has three preferred creditors (child support claimant, governmental entity and judgment creditor who provides services for the protection of a beneficiary's interest in the trust) under Virginia Code § 64.2-744.

    c. Spousal Support Claims.

       Many states include an exception to spendthrift protection for spousal support claims as it is included with UTC § 503. This exception was not incorporated into the Virginia UTC. Examples of state laws invalidating spendthrift clauses for spousal support claimants include Florida (Florida Statute § 736.0504); Georgia (O.C.G.A. § 53-12-80-D); New York (CPLR 5203 (c) 4); and Pennsylvania (20 Pa. C.S. § 7743 (b) (2).

    d. Services or supplies provided for necessaries.

       (i) A variety of states (and prominent commentators) hold that exception creditors should include those claimants who provide necessary services or furnished necessary supplies to a beneficiary. See *Restatement (Third) of Trusts § 59 (2003).*

       (ii) According to the commentary to the *Restatement (Third) of Trusts*, "failure to give enforcement to appropriate claims of this type would tend to undermine the beneficiary's ability to obtain necessary goods and assistance; and a refusal to enforce such claims is not essential to a settlor's purpose of protecting the beneficiary." *Restatement (Third) of Trusts §59 cmt. c (Am. Law Inst. 2003).* Examples of this exception can be found in Kentucky (KRS § 386 B.5-020 (6) (a)); Louisiana (La. R. S. § 9:2005 (2)); and Oklahoma (60 O.S. § 175.25).

e. Statutory Limitation on Scope of Protection Provided by a Spendthrift Trust.

Unlimited spendthrift protections for third party trusts is not available in all states. For instance, in California, although a creditor cannot compel a distribution from a spendthrift trust, 25% of a distribution is subject to the claims of the beneficiary's creditors. *See* Cal. Prob. Code §15306.5(f); *Carmack v. Reynolds,* 391 P.3d 625 (Cal. 2017). Further, in Oklahoma, although a creditor cannot compel distributions, distributions to a beneficiary in excess of $25,000 per annum are subject to creditor claims. Okla. Stat. Ann. title 60, §175.25(B)(2).

f. Government Claims.

(i) Governmental claims are also excepted from spendthrift trust protections because of the primacy of such claims on public policy grounds and federal law pre-exception. Among other cases, the types of claims may relate to environmental liability, income tax or securities laws violations. Virginia has permitted this exception under Virginia Code § 64.2-744 C. The contours of the preference for the government has been subject to varied litigation with uncertain outcomes.

(ii) In considering the access a government entity may have to a third party trust, the key issue is whether a beneficiary has an enforceable right to a distribution from the trust. An interest in a discretionary trust may not qualify as an attachable property right for the government creditor. *First Northwestern Trust Co. of South Dakota v. IRS, 622 F 2d 387 (8th Circuit 1980).* On the other hand, an ascertainable standard distribution standard has been held to be an attachable property right. *United States v. Taylor, 254 F. Supp. 752 (N.D. Cal 1966); Duckett v. Enomoto, 117 A.F.T.R. 2d 2016-1358 (D. AZ 2016).* Further, a trust has been held to be discretionary (and not attachable) where the distribution standard was for the beneficiary's "support, comfort and welfare." *First of America Trust Co. v. U.S. 93-2 U.S.T.C. ¶ 50, 507 (C. D. Ill 1993).*

g. Tort Claimants.

(i) Another preferred class of creditors is that of tort claimants. Under the *Restatement (Third) of Trusts § 59 cmt. (a) 2 (2nd 2003),* an exception may be generated where the nature or a pattern of tortious conduct by a beneficiary may on policy grounds justify a court's refusal to allow spendthrift immunity to protect the trust interest and the lifestyle of that beneficiary, especially one whose willful or fraudulent conduct or persistency reckless behavior causes serious harm to others.

(ii) In *Sligh v. First National Bank of Holmes County (*704 So. 2d 1020 (1997)), the Mississippi Supreme Court allowed the creditor to collect against the trusts by concluding that spendthrift protection should not extend to judgments for "gross negligence and international torts." This case was later repealed by state statute.

(iii) Notwithstanding the fact that legal commentators seem to favor such an exception, the exception for involuntary tort creditors is extremely rare and currently only one state, Georgia (GA Code § 53-12-28), provides for such an exception from spendthrift trust protections. See *BNA Portfolio 810-4th: Asset Protection Planning, VI. Trusts, F. Protective Trust Provisions*.

h. Other Public Policy Exceptions.

(i) The *Restatement (Second) of Trusts § 157* and *Restatement (Third) of Trusts § 59* indicate that the situation in which the interest of a beneficiary of spendthrift trust may be reached in other types of cases if considerations of public policy so requiring evaluating the situation in a case by case basis. It may be appropriate to have an interest of a beneficiary who receives funds from a trust (by advance, loan or breach of trust) to have his or her share in a spendthrift trust be reallocated to other beneficiaries. *Restatement (Third) of Trusts § 59 cmt a (2003).*

(ii) For instance, in *Chaford v. Overcross* 179 Cal App 4th 1098 (2009) a trustee-beneficiary committed a breach of trust and the trust was made whole from such trustee-beneficiary's share of the trust, despite the presence of spendthrift clause. The beneficiaries were able to enforce the surcharge against the trustee-beneficiary's interest in the trust.

i. Reciprocal Trust Rights.

It is possible, as described in a prominent legal resource, that "reciprocal" or "crossed" trusts (also sometimes called a "parallel" trusts) argument may defeat spendthrift trust protections where the settlor of one trust is a beneficiary of another trust and vice versa. As we know, the reciprocal trust doctrine has developed as a tax construct for the purpose of preventing a form over substance avoidance of the gift or estate tax. See *BNA Portfolio 810-4th, Asset Protection Planning, VI. Trusts. F. Protective Trust Provisions.*

3. <u>When does a trust constitute a spendthrift trust outside of the UTC definition?</u>

a. The definition of what constitutes a spendthrift trust can vary from state to state.

b. Under common law, no specific language is required to create a spendthrift trust and a spendthrift trust can be created by a mere demonstration of the settlor's intent that the beneficiary's trust interest should not be subject to either voluntary or involuntary alienation. See *Restatement (Third) of Trusts § 58 cmb (3) (2003)*. In some jurisdictions, the spendthrift trust exists by implication or default. See *N.Y. Est. Powers and Trusts Law § 7-1.5 (a) (1)*. See *BNA Portfolio 810-4th: Asset Protection Planning, VI. Trusts, F. Protective Trust Provisions*.

4. Expanded possibility of trust invasion.

Some states permit a creditor to invade a trust if a trustee has not complied with a standard of distribution or has abused discretion for a broad set of fact patterns including in Kentucky (KRS 386B.5-030 (3), Nebraska (Neb. Rev. State. § 30 – 3849 (c) and North Carolina (N.C. G. S. § 36C-5 – 504 (d).

5. Indirect Attacks.

a. In fact, even absent an exception to spendthrift protections, it is possible that a court will make trust subject to a claim for practical purposes. A beneficiary's interest in a trust may be impacted even if there is no direct attack on a spendthrift provision. *In re Balanson,* 25 P. 3rd 28 (Colo. 2001)*,* Colorado Supreme Court held that the beneficiary's interest in the trust constituted property for purposes of property division in a dissolution of marriage. Although not invaded or garnished, the trust interest was taken into account in determining equitable division of marital assets. In another example, a Vermont court has had a similar result where the economic value of the trust was relevant to the property division in divorce. See *Clark v. Clark*, 779 A, 2nd 42 (Vt. 2001)).

b. Further, in the divorce context, it is possible that trust distributions to a spouse can be considered income for purposes of calculating spousal support. *Tannen v. Tannen,* 3 A. 3rd 1229, 1246 (N.J. Sup. 2010).

6. What is impact if the beneficiary is a trustee of the trust?

a. Under Virginia Code § 64.2-746 E, Virginia law protects a spendthrift trust if a beneficiary is the trustee, as long as the distribution standards for the trustee-beneficiary are limited by the ascertainable standard.

b. On the other hand, the *Restatement (Third) of Trusts § 60 cmt g* states that creditors of a trustee-beneficiary should reach the maximum amount of trust funds that the trustee could distribute to himself or herself.

c. Spendthrift provisions have been held to be ineffective in instances where the beneficiary is a trustee as the debtor has ability to access funds, control the timing and manner of distribution. *Hawley v. Simpson (Bankruptcy*

Court CD IL, No. 03-83674, 2004); Dollinger v. Bottom, 176 B.R. 950 (N.D. 1994). Case law has upheld spendthrift clause protection where the debtor-beneficiary was a co-trustee on account of fiduciary duties. *In Re Schwann 240 B. R. 754 (Minn 1994); McCauley v. Hersloff, 147 B.R. 262 (MD 1992).*

d. Certain courts have invalidated spendthrift protections where a debtor-beneficiary has explicit or implicit control over a trustee. *In Re Baldwin (Bankruptcy Court, Ohio No. 2-88-05792 (1992)),* a court invalidated spendthrift protection where the beneficiary was deemed to have the indirect authority to appoint himself as trustee. In *Richardson v. McCullough 259 B. R. 509 (R.I. 2001)* the court held that the spendthrift clause was invalidated as the debtor-beneficiary exercised practical control of the actions of the trustee.

7. Selected Litigation and Lessons Learned.

Litigation and controversy provide a window into the impact on the way the law works and the risks and opportunities our clients face. The following provide a window into what happens in the litigation context.

a. *In re Trawick*, 497 B.R. 572 (Bankr. C.D. Ca. 2013). A debtor was a beneficiary and trustee of trust set up by his parents. The trust contained a spendthrift clause. Bankruptcy occurred in California but trust governed by North Carolina law. North Carolina law specifically did not limit enforceability of spendthrift provisions in trusts where trustee is also a beneficiary. Trustee had the ability to make distributions not limited by ascertainable standard and, therefore, the trust was not protected from beneficiary's creditors. Lesson: The choice of Trustee may impact the creditor protection characteristics of a third party trust.

b. *In re Hilgers*, 371 B.R. 465 (B.A.P. 10th Cir. 2017) aff'd Fed. Appx 662 (10th Cir. 2008). In this case, a debtor's interest in a trust was to be distributed to him upon the death of his parents. The court determined that spendthrift provisions were not effective upon the termination of the trust. The UTC requires in these instances that trustee must expeditiously distribute trust property. Lesson: Not surprisingly, the assets in a trust which are payable outright to a beneficiary are subject to the creditors of a beneficiary. Virginia law provides that an "overdue distribution" is subject to creditors and distribution must be made promptly. Often, litigation in this area involves whether a distribution is actually overdue.

c. *In J.B. Hunt LLC v. Thornton*, 432 S.W. 3d 8 (Ark 2014). In this case, the debtors were the trustees and life beneficiaries of charitable reminder trusts. The creditor, J.B. Hunt, commenced an action to attach future distributions. The court held, that although a creditor may reach future

distributions from a trust under UTC § 501, the creditor may not reach a contingent interest of a debtor (relying on comments to UTC). Lesson: The more uncertain or contingent an interest in a third party trust, the more likely a trust will survive an attack by the creditor of a beneficiary.

d. *In re Marcato (*2009 WL 1856578, Bkrtcy. M.D. Ala. June 29, 2009*).* The debtor had an interest in a trust set up by his mother where the trustee was given broad discretion to retain trust assets and sell the trust assets. At such time as the trustee deemed appropriate, then the trust was to be distributed. Bankruptcy court stated that interests in a spendthrift trust are excluded from a debtor's bankruptcy estate to the extent that they are protected from creditors under applicable state law. The court held that the trust had not terminated at the mother's death and found that the termination was within the discretion of the trustee and had not occurred and, as a result, the assets are protected so long as the assets were held by the trustee. Lesson: Pure discretionary and ongoing trust shares provide significant asset protection for a beneficiary.

e. *In re Salahi (*2012 WL 148213*, (*Bankr. E.d. VA April 25, 2012*).* In this case, bankruptcy trustee sought termination of trust where debtor was co-settlor and sole beneficiary. Under Virginia Code § 64.2-747, where the beneficiary retains control of disposition and use of the trust assets, the trust is treated as a revocable trust despite terms that indicate it is an irrevocable trust. Lesson: This case is one of the few Virginia matters that exist in this area of law. The question here was whether the trust was revocable or not.

f. *In re Skubitz,* 2014 Bankr. 2014 WL 2321-3 (Bankr. D. KAN. January 21, 2014*).* The debtor was the trustee and beneficiary of a trust established by her late husband. Bankruptcy court held Kansas UTC (a) prevented creditors from attaching a beneficial interest that is exercisable only in the trustee's discretion and (b) Kansas adopted 2004 amendment to UTC clarifying that a creditor could not reach a discretionary interest of a beneficiary trustee whose discretion is subject to an ascertainable standard. Lesson: This result mimics Virginia Code § 64.2-746 E and displays the ability of a beneficiary to be a trustee of trust fund for his or her benefit and retain creditor protection.

g. *In re Wiley,* 2012 WL 6705416 (Bankr. N. M. December 26, 2012)*,* the key question was whether a spendthrift clause existed under the New Mexico UTC. Although the clause lacked specific language for voluntary, involuntary or spendthrift provisions, then the clause satisfied the requirements of a spendthrift clause as the intent of the provision clearly limited to voluntary and involuntary transfers. Lesson: Magic language is not always required to trigger spendthrift protection. Nevertheless, I

would suggest all spendthrift clauses we draft include "involuntary", "voluntary" and "spendthrift" to solidify spendthrift protection.

h. *In Re Levitan v. Rosen*, 124 N.E. 3rd 148 (Mass App Ct 2019). In this case the sole beneficiary of a spendthrift trust established by a parent had the right to withdraw 5% of the corpus annually and the trustee had the right to distribute income and principal to her. The court held asset was subject to equitable distribution as the beneficiary's interest was not speculative and more than a more expectancy. Lesson: A clear non-discretionary right to a distribution will be subject to a creditor attack.

D. <u>Ability to Alter Trust Provisions in Order to Enhance Asset Protection</u>.

There are a variety of mechanisms trusts and estates lawyers should consider to protect the wealth of our clients by altering existing provisions of irrevocable trusts. The ability to amend irrevocable trust is valuable given the uncertainty of the law of asset protection and the changing circumstances that a beneficiary may be facing. Amendments could be advisable if the existing trust has inefficiencies or potential creditor exposure.

The core mechanisms available to amend and modify an irrevocable trust are (a) use of trust protectors; (b) settlement agreements under the UTC; and (c) decanting.

The types of valuable trust amendments could include (a) extending the trust term in cases where it would otherwise expire at a point in time; (b) inserting an independent trustee in order to avoid trustee-beneficiary powers being controlled by a creditor; (c) revising the beneficial interests of a trust to include the removal of mandatory distribution, even to the extent of excluding a beneficiary or adding a beneficiary; (d) providing for broader discretion to a trustee in terms of making distributions; (e) inserting a trust protector to make future amendments to the trust; (f) permitting a trustee to acquire assets of the trust for the use of a beneficiary in lieu of making distributions of trust property to that beneficiary; (g) adding a duress type clause which could alter or suspend beneficial interests of a debtor-beneficiary under certain circumstances; and (h) inserting a more robust spendthrift clause.

Certain amendments to a trust may or may not be acceptable to a beneficiary as the primary types of amendments would limit a beneficiary's rights and benefits in a trust. Further, any amendment raises fiduciary liability issues for a trustee.

Please note that there are a variety of tax issues (whether income, gift, estate and generation skipping) which must be considered prior to amending any trust. This outline does not cover the myriad of tax issues involved with amendments.

The following section of the outline will provide a cursory description of mechanisms of amendment along with a description of hold-up or duress trust clauses.

1. Trust Protectors.

   a. A trust protector (or its equivalent "trust director", "special independent trustee", etc.) may be provided authority in the trust document to alter an irrevocable third party trust to permit a trust to better withstand an attack from a creditor of a beneficiary. [Refer to Section II, Paragraph L of this outline for more information on Trust Protectors]

   b. The term "trust protector" generally means whatever the trust instrument says it means. A trust protector with amendment power should generally be independent and can potentially have broad range of authority. The relevant types of authorities a trust protector could have includes the (a) power to modify and amend the trust including beneficial interests; (b) authority to change principal place of administration or governing law of the trust; (c) authority to direct a trustee to take certain acts; and (d) authority to veto certain actions to be taken by a trustee.

   c. The authority granted to a trust protector could be in the original agreement or be inserted by settlement agreement under Virginia Code § 64.2-709 (based upon UTC § 111).

2. Settlement Agreements.

   a. Judicial or nonjudicial settlement agreements are a well-known mechanisms of modifying an irrevocable trust under Virginia Code § 64.2-709.

   b. An example of the use of this type of agreement in asset protection can be seen *In re Korma, 2012 WL 256246 Bankr. (Bank D. Md June 28, 2011)*. The issue in this case was whether the debtor's right to receive distributions was an asset of the bankruptcy estate. The spendthrift provision was deemed enforceable under nonbankruptcy law, and, as a result, the beneficiary interest in the trust was not property of the bankruptcy estate. Originally, the trust term was to terminate upon the death of the three income beneficiaries but prior to that distribution date the trust had been modified by settlement agreement (as approved by the court) to continue as an ongoing trust after such distribution date. The modification was implemented by consent of the beneficiaries and approved by the state court. Bankruptcy court did not substitute its judgment for that of the state court.

c. The various tax issues and mechanisms of amendment are beyond the scope of this outline.

3. Decanting.

a. An irrevocable trust which has a variety of defects or inefficiencies for creditor protection purposes may be able to have those defects or inefficiencies corrected by means of decanting. [Refer to Section II, Paragraph I of this outline for more information on Decanting]

b. A recent example of the mechanism in use can be seen in *Ferri v. Powell-Ferri,* 476 Mass 651 (2017). In that case, the beneficiary had a right to withdraw assets from a third party trust at certain moment in time. The trust had in excess of $75,000,000 in assets. The trustee decanted the trust into a new trust with different terms after the date the beneficiary's wife filed for a divorce. At the time of the decanting, the beneficiary had an immediate exercisable right to withdraw a portion of the trust. The right of withdrawal was removed from the second trust. The court held that the decanting was based upon a valid exercise of authority and that the beneficiaries did not participate (nor did he have knowledge) of the actual decanting. The decanted trust was honored in part during the divorce proceedings. The Connecticut Supreme Court, in a related case, adopted the opinion of the Massachusetts Court that the decanting was proper. (*Ferri v. Powell-Ferri, SC 19432)*

c. Any decanting that alters a beneficiary's rights could create fiduciary liability for the trustee or a variety of tax consequences whether gift tax, estate tax, generation-skipping tax or income tax. For more information on the myriad of issues with decanting, see *BNA 871 T. M., Trust Decanting – State Law and Federal Considerations.*

d. One issue with decanting and asset protection can be found in Section 27 of the Uniform Trust Decanting Act ("UTDA"). Section 27 states that a debt that is enforceable against the first trust is enforceable to the same extent against the property held by the second trust following the decanting. Virginia passed this section of the UTDA in Virginia Code § 64.2-779.24. In analyzing this section, commentators have noted that the UTDA subjects the receiving trust to the debts of the decanted trust, even though distributions in other situations would lead to different results. There is some uncertainty on the issue and its impact on asset protection. See *Debt in the Context of Decanting: The Surprising Impact of Section 27 of Uniform Trust Decanting Act, Paul Hattenhauer, Estate Planning (May 2020); What's So Surprising? Decanting is not an Asset Protection Technique for Trusts. Susan T. Bart, ACTEC Asset Protection Committee, 10/21/2020.*

e. UTDA § 27 only applies to a debt, liability or other obligation that is in existence and enforceable against the property of the first trust at the time of decanting. UTDA § 27 Comment.

f. Despite uncertainty, the ULC states there are a number of ways that decanting can provide additional creditor protection for beneficiaries. Decanting can be used to add a spendthrift provision, to eliminate or postpone a right to mandatory payment or a right of withdrawal, to eliminate a general power or to create a special needs trust. UTDA Comment § 27.

4. <u>Duress Provision.</u>

a. One type of dispositive provision (by amendment or otherwise) in a trust which can be beneficial to a debtor-beneficiary is a duress clause, otherwise known as a hold-up clause or standby trust clause. These types of clauses have a lot of variety but generally involve triggering new dispositive provisions by shifting terms, purposes and beneficial interests upon occurrence of an event, such as disability of a beneficiary or bankruptcy of a beneficiary. A hold-back or extension provision often permits an independent trustee to have the authority to create an ongoing discretionary trust at a moment in time when an outright trust distribution would otherwise have been made. These types of clauses could include a suspension of a right of beneficiary to receive a distribution upon an event and the beneficiary's interest could be reinstated after the disqualifying event has passed. The authority of the independent trustee could utilize a "best interests" evaluation of the beneficiary's situation to include when a beneficiary has been (a) named a defendant in serious litigation; (b) separated or in the process of a divorce; (c) determined to have a serious gambling, alcohol or drug addiction; (d) involved in bankruptcy proceedings; (e) determined to have significant financial or nonfinancial difficulty; and (f) determined to have a significant disability.

b. Hold-up or duress clauses have had some success in litigated cases. *In Re Fitzsimmons,* 896 F 2d 373 (9th Cir 1990)*,* the court held that a debtor-beneficiary's beneficial interest which terminated in favor of another beneficiary in the event the debtor-beneficiary became insolvent was effective to withstand a federal tax claim.

In *Domo v. McCarty,* 612 N.E. 2d 706, 710 (Ohio 1993), the court held that a trust withstood a creditor attack after it converted (by its terms) from an absolute right to income and principal to a trust which had to be administered as a purely discretionary trust for the debtor-beneficiary and descendants upon the trust interest being subject to creditor claims. The protective provision in question was as follows:

> "Protective Provision. No interest of my wife or of any lineal descendant of mine in income or principal shall be anticipated, encumbered or assigned. No such interest shall be subject to claims of such person's creditors, spouse or divorced spouse or others. If any part or all of any such interest, but for this provision, would vest in or be enjoyed by any other individual or entity, other than by disclaimer or release, such interest shall terminate. Thereafter the Trustees from time to time may, in their discretion, but shall not be obligated to, pay to or expend for such person, any dependent of his or any other lineal descendant of mine, such amounts of the income or principal comprising such interest as the Trustees in their discretion deem proper."

E. <u>What are some planning ideas to consider in light of varied state laws and avenues of attacks of trusts?</u>

There is a lot of uncertainty in predicting challenges to third party trusts over time. Asset protection laws vary from state to state and evolve over time. Litigation outcomes are uncertain and bad facts can make bad law. Judges do not tend to have a background in trust and estates which can often lead to unpredictable outcomes in creditor attacks on trusts. Debtors do not tend to be popular defendants and judges could be tempted to use result-oriented jurisprudence.

As family advisors, we need to balance our clients' potentially competing objectives of asset protection and beneficiary control and autonomy.

Attacks on third party trusts start with an attempt to defeat a spendthrift clause, whether by preferred creditor status, limited state spendthrift protection, existence of a deficient spendthrift clause, or the beneficiary being deemed to have excess control over a trust and is followed by an attempt to garnish trust distributions or invade the trust. In some states and on a limited basis in Virginia, creditors of a debtor-beneficiary can compel distributions under certain circumstances. Outside of a spendthrift clause, the best mechanism for asset protection in a trust is the existence of a discretionary distribution standard which will limit a creditor's ultimate remedy to attach trust funds.

A key issue many courts consider is whether a debtor-beneficiary has excessive control or dominion over a trust by serving as trustee, by having effective control of a trustee or by having rights to distribution.

What are some planning concepts to consider as we draft trusts and advise trustees administering trusts?

The optimal asset protection framework for a trust is the use of an independent trustee with pure discretionary distribution standards in that trust. Of course, this

framework is not likely to meet the objectives of an average client who wishes to provide his or her beneficiary with control over their inheritance. As planners trying to solve issues for our clients, we have to consider a spectrum of distribution standards and trusteeship provisions as we accomplish competing objectives, beneficiary control and asset protection. In that connection, we should look at the following ideas:

1. Consider drafting (or amending existing trusts) to:

   a. Incorporate spendthrift clauses with (a) specific references to "involuntary", "voluntary" and "spendthrift" in order to clearly trigger UTC definition of a spendthrift clause and (b) specific exclusion of spousal claims for equitable distributions and alimony from assignment.

   b. Consider naming a Co-Trustee if a beneficiary is a trustee as some case law collapses third party trusts when a debtor-beneficiary is a trustee. The use of a co-trustee serves to limit control by the beneficiary.

   c. Consider use of independent trustee (or trust protector/trust director provision) to limit ability of a creditor to assert that a debtor-beneficiary has excessive dominion and control over the trust administration.

   d. Consider including broad discretionary distribution standards in trusts as it is the safest format from a creditor protection point of view. The impact of discretionary distribution provisions is to limit the extent of a beneficiary's interest in a trust so it sufficiently indeterminate to avoid it being an attachable property right. The obvious concern as a planner is whether the broadening discretion defeats the settlor's objective to provide for his or her beneficiary. The discretion could be coupled with a standard such as "best interests" and a non-binding statement of intent from the settlor.

   e. In drafting discretionary provisions to be exercisable by a trustee in our trusts, consider using term "may" not "shall" in order to limit the risk of a compelled distribution by a creditor. Some case law has relied on "shall" as a mechanism for trust interests to be attached.

   f. Consider avoiding mandatory distributions in our trusts. Many trust distribution provisions require an outright distribution at the death of the settlor, staggered distributions at certain age milestones, five and five withdrawal rights, or income to be paid annually. Mandatory payments of income or principal (or unlimited rights to income and principal) will be subject to claims of creditors. For asset protection purposes, we should consider advising clients to leave property in ongoing trusts for maximum extent possible or, at least, lengthening the term of a trust. In doing so, we need to balance access and control in a

beneficiary along with the ability to protect assets from creditors. Marital deduction trusts must pay all income to a spouse to preserve the marital deduction.

g. Consider altering trust beneficial interests to add an additional beneficiaries. In that regard, "spray" or "sprinkle" trusts permitting distributions among a class of beneficiaries offer some additional asset protection as the debtor-beneficiary is not sole recipient of the trust.

h. Incorporate "hold-back", "duress" or other standby type provisions permitting an independent person (trustee, trust protector or trust director) to alter beneficial provisions upon the occurrence of certain events in order to avoid a claim by a creditor of a debtor-beneficiary. These clauses, among other things, could modify mandatory distribution rights or alter beneficial interests to provide for a discretionary trust to be implemented upon the occurrence of a triggering event such as insolvency, disability, separation, divorce or bankruptcy of a beneficiary. The issue with these types of provisions is whether a settlor desires an independent person to have significant control over a beneficiary's inheritance. One variation for this type of clause is to have a suspension of rights where distributions are inoperative during any period when such distribution would be subject to enforceable claims of a beneficiary.

i. Consider robust trust protector clause, which would permit an independent person to amend the trust in the future to limit creditor attacks on trusts. These types of provisions permit a flexible approach to an uncertain future. This kind of flexibility risks defeating a settlor's objectives to provide definitive benefits to their loved ones.

j. Due to case law where a trustee's authority has been attributed to debtor-beneficiary, we should consider limiting powers of a beneficiary to remove and replace a trustee to the constraints of Revenue Ruling 95-58, 1995-2 C.B.

2. Advise Trustee to avoid administering an existing trust as an alter-ego of beneficiary. The trustee should not follow all directions made by a beneficiary or the trust may not be honored. Some case law has held that a trust may not to be respected for creditor's rights purposes if practical control of trust administration is in the debtor-beneficiary or if trust administration formalities are not followed.

3. Advise Trustees to consider moving jurisdiction of the trust to one more favorable for creditor protection purposes. The Trustee could change the trust's governing

law or situs if the current situs/governing law is detrimental to the trust beneficiary or if there is law in another state which is more appealing than the current governing law. South Dakota and Nevada are considered to be favorable jurisdictions for asset protection purposes.

4. Consider recommending that a beneficiary resign as Trustee upon the occurrence of creditor issues in order to limit avenues of attack. One idea is to have the removal/resignation automatically triggered by the terms of the trust.

5. Trustee should consider making "on behalf of" distributions for a beneficiary rather than direct payments in order to avoid creditor attachment.

6. As real estate in trust is generally governed by law of the situs of the land, a trustee should consider transferring trust real estate to an entity (such as LLC) in order to shift governing law of that asset away from the law of the situs of the land, if advantageous to do so.

7. Trustee should consider purchasing assets for personal use of beneficiary if permissible under the trust. The trustee should retain those assets in trust and maintain asset protection over those assets. The terms of the trust should specifically authorize this course of action.

8. Where there is a mandatory income interest in trust, the trustee could consider transferring assets into an entity in order to limit and control the amount of net income payable to an income beneficiary under the definition of legal accounting income. Any such transaction should weigh estate tax marital deduction and fiduciary duty issues.

9. Consider trust amendment by means of settlement agreements and trust decanting in order to implement more optimal asset protection characteristics. Any amendment must weigh trustee fiduciary duty constraints and tax considerations.

F. Resources.

For more information relating to the issues surrounding the attack of third party trusts, please see below.

(1) *Case law under the Uniform Trust Code, David M. English, Scot W. Boulton and Dana G. Fitzsimmons (2016).*

(2) *Asset Protection Planning: Kicking the Tires Sixteen Years after Domestic Asset Protection Trusts made their Public Debut in 1997, Charles D. Fox 2013, Virginia Advance Estate Planning and Administration Seminar (Virginia CLE).*

(3) *Estate Planning in a World of Creditors and Predators: Asset Protection for Every Estate Planning Client, Michael Barton, Kristin Frances Hager, Stephen W. Murphy and William I. Sanderson, 2015, Virginia Annual Trusts and Estates Seminar (Virginia CLE).*

(4) *How Courts Unravel Asset Protection Strategies and Protecting Your Trust, Louis S. Harrison and Beth Fox, ACTEC Asset Protection Committee Meeting, 10/21/2017.*

(5) *Court-Created Exceptions to Spendthrift-Trust and Other State Law Protections, Richard Nenno, ACTEC Asset Protection Committee Meeting, 6/16/2017.*

(6) *The Perfectly Modern Trust: Flexibility, Creditor Protection and Beneficial Enjoyment, Heidi C. Freeman, 58 Tax Management Memorandum 159, 4/3/2017, Bloomberg BNA.*

(7) *Drafting Trusts for Maximum Protection from Creditors, Dennis Sandoval, Estate Planning (May 2003).*

(8) *Protecting Trusts from Claims of Alimony or Child Support, Barry Nelson, Trusts & Estates (March 2014).*

(9) *US Government as Creditor versus Spendthrift/Discretionary Trust Protections, Nancy Schmidt Roush and Daniel S. Rubin, ACTEC Asset Protection Committee Meeting, 10/22/2017.*

VI. CONFLICTS OF LAWS ISSUES

1. <u>What is the governing law of a trust?</u>

   a. Virginia Code § 64.2-705, based upon UTC § 107, defines governing law of a trust as follows:

      "The meaning and effect of the terms of a trust are determined by:

1. The law of the jurisdiction designated in the terms unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue; or
2. In the absence of a controlling designation in the terms of the trust, the law of the jurisdiction having the most significant relationship to the matter at issue."

b. UTC Comment § 107.

Again, the ULC provides significant guidance as to the meaning of our Virginia UTC code sections. In Comment to § 107, the ULC states that:

> "Paragraph (1) allows a settlor to select the law that will govern the meaning and effect of the terms of the trust. The jurisdiction selected need not have any other connection to the trust. The settlor is free to select the governing law regardless of where the trust property may be physically located, whether it consists of real or personal property, and whether the trust was created by will or during the settlor's lifetime. This section does not attempt to specify the strong public policies sufficient to invalidate a settlor's choice of governing law. These public policies will vary depending upon the locale and may change over time."
>
> "Paragraph (2) provides a rule for trusts without governing law provisions – the meaning and effect of the trust's terms are to be determined by the law of the jurisdiction having the most significant relationship to the matter at issue. Factors to consider in determining the governing law include the place of the trust's creation, the location of the trust property, and the domicile of the settlor, the trustee, and the beneficiaries. See *Restatement (Second) of Conflict of Laws* §§ 270 cmt. c and 272 cmt. d (1971). Other more general factors that may be pertinent in particular cases include the relevant policies of the forum, the relevant policies of other interested jurisdictions and degree of their interest, the protection of justified expectations and certainty, and predictability and uniformity of result. See *Restatement (Second) of Conflict of Laws* § 6 (1971). Usually, the law of the trust's principal place of administration will govern administrative matters and the law of the place having the most significant relationship to the trust's creation will govern the dispositive provisions."

c. A principal place of administration is provided in Virginia Code § 64.2-706 (based upon UTC § 108) and is defined as follows:

> "A. Without precluding other means for establishing a sufficient connection with the designated jurisdiction, terms of an inter vivos trust designating the principal place of administration are valid and controlling if:

a) A trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction;

b) A trust director's principal place of business is located in or a trust director is a resident of the designated jurisdiction; or

c) All or part of the administration occurs in the designated jurisdiction.

B. Without precluding the right of the court to order, approve, or disapprove a transfer, the trustee of an inter vivos trust may transfer the trust's principal place of administration to another state or to a jurisdiction outside of the United States that is appropriate to the trust's purposes, its administration, and the interests of the beneficiaries.

C. When the proposed transfer of a trust's principal place of administration is to another state or to a jurisdiction outside of the United States, the trustee shall notify the qualified beneficiaries of the proposed transfer not less than 60 days before initiating the transfer. A corporate trustee that maintains a place of business in the Commonwealth where one or more trust officers are available on a regular basis for personal contact with trust customers and beneficiaries shall not be deemed to have transferred its principal place of administration if all or significant portions of the administration of the trust are performed outside the Commonwealth. The notice of proposed transfer shall include:

1. The name of the jurisdiction to which the principal place of administration is to be transferred;
2. The address and telephone number at the new location at which the trustee can be contacted;
3. An explanation of the reasons for the proposed transfer;
4. The date on which the proposed transfer is anticipated to occur; and
5. The date, not less than 60 days after the giving of the notice, by which the qualified beneficiary shall notify the trustee of an objection to the proposed transfer.

D. The authority of a trustee under this section to transfer a trust's principal place of administration to another state or to a jurisdiction outside of the United States terminates if a qualified beneficiary notifies the trustee of an objection to the proposed transfer on or before the date specified in the notice.

E. In connection with a transfer of the trust's principal place of administration, the trustee may transfer some or all of the trust property to a successor trustee designated in the terms of the trust or appointed pursuant to § 64.2-757.

F. The court, for good cause shown, may transfer the principal place of administration of a testamentary trust to another state or to a jurisdiction outside of the United States upon such conditions, if any, as it may deem appropriate."

d. UTC Comment § 108

(1) In describing the meaning of this section, the ULC states "[t]his section prescribes rules relating to a trust's principal place of administration. Locating a trust's principal place of administration will ordinarily determine which court has primary if not exclusive jurisdiction over the trust. It may also be important for other matters, such as payment of state income tax or determining the jurisdiction whose laws will govern the trust. See Section 107 comment."

(2) "Because of the difficult and variable situations sometimes involved, the Uniform Trust Code does not attempt to further define principal place of administration. A trust's principal place of administration ordinarily will be the place where the trustee is located. Determining the principal place of administration becomes more difficult, however, when cotrustees are located in different states or when a single institutional trustee has trust operations in more than one state. In such cases, other factors may become relevant, including the place where the trust records are kept or trust assets held, or in the case of an institutional trustee, the place where the trust officer responsible for supervising the account is located." UTC Comment § 108.

(3) "Under the Uniform Trust Code, the fixing of a trust's principal place of administration will determine where the trustee and beneficiaries have consented to suit (Section 202), and the rules for locating venue within a particular state (Section 204). It may also be considered by a court in another jurisdiction in determining whether it has jurisdiction, and if so, whether it is a convenient forum. A settlor expecting to name a trustee or cotrustees with significant contacts in more than one state may eliminate possible uncertainty about the location of the trust's principal place of administration by specifying the jurisdiction in the terms of the trust. Under subsection (a), a designation in the terms of the trust is controlling if (1) a trustee is a resident of or has its principal place of business in the designated jurisdiction, or (2) all or part of the administration occurs in the designated jurisdiction. Designating the principal place of administration should be distinguished from designating the law to determine the meaning and effect of the trust's terms, as authorized by Section 107. A settlor is free to designate one jurisdiction as the principal place of administration and another to govern the meaning and effect of the trust's provisions." UTC Comment § 108.

(4) "Subsection (b) provides that a trustee is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries." UTC Comment § 108.

(5) "Ordinarily, absent a substantial change or circumstances, the trustee may assume that the original place of administration is also the appropriate place of administration. The duty to administer the trust at an appropriate place may also dictate that the trustee not move the trust." UTC Comment § 108.

(6) While transfer of the principal place of administration will normally change the governing law with respect to administrative matters, such a transfer does not normally alter the controlling law with respect to the validity of the trust and the construction of its dispositive provisions. See 5A Austin W. Scott & William F. Fratcher, *The Law of Trusts* Section 615 (4th ed. 1989). UTC Comment § 108.

2. Conflicts of Laws and Asset Protection in Trusts.

a. General.

(1) A major issue with the asset protection characteristics of a trust is when two or more states have concurrent jurisdiction over the affairs of a trust. *Charles E. Rounds, Jr. and Charles E. Rounds, III, Loring and Rounds, A Trustee's Handbook,* § 8.5 (hereafter "*Loring and Rounds*"). It is possible state laws may be contradictory when it comes to the construction of terms and the rights, duties and obligations of creditors. *Jeffrey A. Schloenblum, Multi State and Multi National Estate Planning*, § 17.05 (1991).

(2) The conflicts of laws issue may be determined by the law of place of administration, the situs of the property, the settlor's domicile, the beneficiaries' domicile, the trustee's domicile and/or the forum of the court handling the matter. *Loring and Rounds* § 8.5.

(3) Unfortunately, the conflicts of laws analysis relating to trust administration may lead to contradictory and uncertain outcomes in evaluating which state law will be applicable to creditors' rights controversies.

b. Basic Concerns.

(1) In general, the law of situs of land generally governs most questions relating to a parcel of land in a trust. *7 Scott & Ascher on Trusts* § 46.5.

(2) As a general proposition, the meaning and legal effect of the terms of a trust are determined by the laws of the jurisdiction selected in the governing instrument unless such selection violates a strong public policy in a jurisdiction with the most significant relationship to the matter at issue. *Loring and Rounds* § 8.5; UTC § 107; *7 Scott & Ascher* § 45.3.1 N 8.

(3) As a rule of thumb and in the absence of controlling provisions in the trust instrument or local law, the law of principal place of administration will govern administrative matters and the law of the place having the most significant contacts to the trust's creation will govern the construction of dispositive provisions. *Loring and Rounds* § 8.5.

(4) UTC § 202 (b) provides that the beneficiaries of a trust are subject to the jurisdiction of the courts of the state regarding any matter relating to the trust. *Loring and Rounds* § 8.5

c. Creditor's Rights and Spendthrift Clauses.

(1) The enforceability of a trust spendthrift provision will ordinarily be governed by the situs of the trust. *Loring and Rounds* § 8.5. It should generally be immaterial where the beneficiary is domiciled, where the creditor or assignee is domiciled, where the debt was incurred or the assignment was made or where the suit has venue. *7 Scott & Ascher* § 45.7.3.

(2) The enforceability of a spendthrift trust of movables is ordinarily governed by the law of the place the settlor expressly provided or by implication fixed or if not, fixed the settlor's domicile. *7 Scott & Ascher* § 45.7.1.1. *Restatement (Second) of Conflicts of Laws* § 273.

(3) For land in trust, the impact of a spendthrift provision is ordinarily governed by the law of the situs of the land. *Loring and Rounds* § 8.5; *7 Scott & Ascher* § 45.7.1.3.

(4) As a general proposition, the state law designated in a trust agreement will determine whether (or not) a creditor can reach an interest of a debtor-beneficiary in trust. *Restatement (Second) of Conflicts of Laws § 273 (1971).* In the event there is no substantial relationship between a trust and the state law delineated in the agreement, the designated state law may not be applicable and, even if there is a substantial relationship, a court may disregard the situs provision under certain circumstances where public policy exceptions are relevant. *See Restatement (Second) of Conflict of Laws § 270 cont. b (1971).*

(5) An example of a thorough analysis of choice of law analysis for a spendthrift trust can be found *In Re Zukerhorn* 484 B.R. 182 (B.A.P. 9th Cir. 2012).

VII. ETHICAL AND MALPRACTICE ISSUES FOR ATTORNEYS

The general ethical rule governing lawyers practicing in asset protection following the law of fraudulent conveyance is that if a client has no current or

"contemplated" creditors but is only concerned about potential future creditors, it is clearly perfectly ethical to assist.

A. Evolution of Perception of Legal Ethics in Asset Protection.

The legal practice of asset protection arose out of the nationwide collapse of the value of commercial real estate in 1989-1992. When Denver's real estate collapsed, a Denver lawyer with clients in trouble, Barry Engel, approached the Cook Islands and suggested the adoption of the world's first asset protection trust statute. When it was adopted in the Cook Islands, Mr. Engel set up such trusts for many of his Denver clients and other offshore jurisdictions soon followed suit and developed similar statutes.

Initially, most lawyers were very uncomfortable with the ethics of helping clients "hide" assets from creditors. Over the years, 60 plus offshore jurisdictions and 19 U.S. states have adopted asset protection trust statutes, and it seems indisputable that asset protection is now comfortably within the public policy mainstream and can hardly in that light be seen as unethical.

Moreover, such luminaries as Duncan Osborne, who has chaired the International Planning Committee of the American College of Trust and Estate Planning, and Gideon Rotschild, who has chaired the ABA Special Committee on Asset Protection, have authored articles suggesting not only is it not unethical to do asset protection planning, but it may also be civilly negligent – i.e., legal malpractice – not be recommend asset protection planning to clients for whom it is obviously appropriate.

Certain areas of asset protection planning are certainly thorny and require close examination and analysis. If a client asks you to help him avoid a child support claim, are you comfortable assisting morally or unethically? Some states permit it under certain circumstances. What about helping a client protect assets in the event of future divorce? Consider, has the other spouse been a client of yours? Is the property sought to be protected community property? Has a divorce action been initiated, is filing contemplated? What if the assets sought to be protected were earnings during the marriage in a non-community property state, where the spouse's interest in inchoate?

BEWARE: In the case of insolvent clients or clients with a clear intent to hinder, delay or defraud existing creditors, it may be unethical for an attorney to counsel or assist a client in a conveyance which perpetrates a fraud on the client's creditors. As an example, See Virginia Rule for Professional Conduct, Rule 1.2 and Disciplinary Rule 1-102(A)(4) and 7-102(A)(7)

B. Federal and Virginia Ethical Rules. The primary source of federal rules is the American Bar Association's Model Rules of Professional Conduct. At the state level, the relevant rules can be found in each state's code of professional conduct. In Virginia, the sources are primarily the Virginia Rules of Professional Conduct, the Virginia Code of Professional Responsibility, and legal ethics opinions.

According to Disciplinary Rule 7-102(A)(7), a lawyer shall not counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent. To do so would not only expose the attorney to censure or disbarment, but also to suit for fraud as a co-conspirator or in malpractice.

Under Virginia Rule 1.2(c), a lawyer may not counsel or assist a client in conduct that is criminal or fraudulent. Under Virginia Rule 1.6(c), a lawyer must reveal such information if the crime is reasonably certain to result in substantial injury to the financial interests or property of another.

Moreover, according to Disciplinary Rule 4-101(D), a lawyer must reveal the intention of his client, as stated by his client, to commit a crime or information which clearly establishes that his client has perpetrated a fraud related to the subject matter before the tribunal with respect to which the lawyer is representing the client. If the client acknowledges to the attorney that he has committed a fraud, that clearly establishes it. Not to make the required revelation could subject the attorney to censure or disbarment.

Under Disciplinary Rule 4-101(C)(3) a lawyer may reveal information which clearly establishes that his client has, in the course of the representation, perpetrated upon a third party a fraud related to the subject matter of the representation. Recognizing the risk that the lawyer may well be sued as a co-conspirator in the fraud or for malpractice, the lawyer may want to avail himself of this opportunity, in which he is excused from breaching the attorney-client privilege.

If a client has committed a fraud using his attorney's services without the attorney's prior knowledge, the attorney may reveal his client's fraud to a damaged third party without breach of attorney-client privilege to protect himself from implication.

On the other hand, if a client consults with his attorney for advice as to whether an activity he engaged in without the attorney's involvement was illegal or fraudulent, and the attorney advises him that it was, and he thanks the attorney and terminates the professional engagement, the attorney's advice is clearly privileged, and the attorney may not disclose any information obtained in the engagement. The attorney is not thereby implicated in the illegal or fraudulent act.

C. Planning Attorney's Liability. Attorneys engaging in asset protection planning have certain unique liability issues of which they must at all times be mindful.

1. Civil Liability. In a federal case applying New Jersey law, *Morganroth & Morganroth v. Norris, McLaughlin & Marcus*, P.C., 331 F. 3rd 406 (3rd Circuit 2003), the Court held that persons -- lawyers -- who assist fraudulent transfers may have liability for various common law wrongs, even if they do not receive the property in question, and even if they commit no overt acts in support of the conspiracy. These common law liabilities may include the tort of creditor fraud, aiding and abetting, and civil conspiracy to commit creditor fraud.

a. And consider *McElhanon v. Hing*, 151 Az. 386, 728 P.2d 256 (Ct. App. 1985), aff'd. in part and vacated in part, 151 Az. 403, 728 P.2d 273 91986), cert. denied 107 S. Ct. 1956 (1987), which involved an attorney who was held liable ($286,120 in damages) for participating in a conspiracy to defraud a client's judgment creditor. The facts of this case are rather egregious and illustrate the point made above that while attorneys have the ethical obligation to zealously represent their clients, they should not be foolish. A disgruntled creditor may very well allege fraud by the planning attorney for a number of reasons, including as a means of obtaining discovery from the attorney. The good news for lawyers engaged in asset protection planning today is that creditors have historically been reluctant to sue planning attorneys. Sooner or later, that may change. But see *Bosak v. McDonough*, 549 N.E.2d 643 (111.App. 1st Dist. 1989), in which the Court found that absent evidence that the attorney counseled the debtor to defraud the lender or agreed to participate in any fraud, the attorney is not liable for conspiracy. Another "good" case refusing to find a lawyer liable is *Nastro v. D'Onofrio*, 263 F. Supp 2d 446 (D. Conn. 2003), in which a Court refused to hold a lawyer civilly liable to a creditor of a client for whom the lawyer created an offshore spendthrift trust, citing the strong public policy of Connecticut in not imposing a liability on lawyers to third parties. As to a claim that an estate planning lawyer might have "aided and abetted" a tort, the seminal case is *Haberstam v. Welch*, 705 F. 2d 472 (D.C. Cir 1983, decided by a 3-judge panel including Judges Scalia and Bork).

b. The other extreme involves the possibility of an attorney being sued by an estate planning client, or his heirs, successors and beneficiaries after his death, when the client or his estate subsequently suffers a judgment. The claim might be asserted that the attorney was delinquent in that techniques were in fact available to protect the estate during the client's lifetime, but the attorney negligently failed to raise or otherwise explore them with the client in the estate planning process. See "What ACTEC Fellows Should Know About Asset Protection," an article by Duncan Osborne and Elizabeth M. Schurig published in 25 ACTEC NOTES. See also Gideon Rothschild's article in the September 2003 issue of Trusts & Estates, Asset Protection Planning Ethical? Legal? Obligatory?

c. Consider also *F.D.I.C. v. Porco*, 552 N.Y.S. 2d 910 (Ct. App. 1990), wherein the New York Court of Appeals held that "under long-standing New York law, a creditor has no cause of action against a party who merely assists a debtor in transferring assets where, as here, there was neither a lien on those assets nor a judgment on the debt."

d. Also, in the matter of *In re Young* (2020 WL 5548742, C.D.Cal., September 15, 2020), an attorney was suspended from practicing before the U.S. Bankruptcy Court for the Central District of California for a minimum of five years for assisting a client with hindering and delaying a creditors' rights. The facts in this case are egregious: the attorney's long-time client incurred substantial debt and the attorney represented the client in the bankruptcy proceedings. At some point during the proceedings, the client transferred his property to the attorney's wife, who was also a paralegal at the attorney's law firm. The Court found that the purpose of the transfer was to hinder and delay the bankruptcy sale. In addition to violating ethics rules from the Federal Rules of Bankruptcy Procedure and the California Rules of Professional Conduct, the attorney also might face ramifications under California law. In an attempt to deter fraudulent transfers, California has enacted a criminal statute which subjects not only the party making the transfer to criminal prosecution, but also anyone who participants with the transferring party, including the attorney.

2. Criminal Liability. It goes without saying that an attorney assisting a client in asset preservation planning must scrupulously avoid conduct which could implicate the attorney himself in possibly criminal activity. See, for example, 11 USC § 152, the Crime Control Act of 1990, Bankruptcy Crimes, and I.R.C.§ 7206, as well as:

a. Racketeering Influenced and Corrupt Organization ("RICO") statute, 18 U.S.C. § 1961 et seq.

b. Bankruptcy Crimes

(1)18 U.S.C. § 152 for anyone "knowingly and fraudulently concealing from a trustee ... any property belonging to the estate of a debtor."

(2) 18 U.S.C. § 157 for anyone "having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme files a [bankruptcy petition] or makes a fraudulent representation in a [bankruptcy] proceeding."

c. I.R.C.§ 7212(a) for anyone who "corruptly endeavors to ... impede any officer of the United States or obstructs or impedes the administration [of the tax law.]" See United States v. Popkin, 943 F.2d 1535 (11th Cir. 1991) in which Mr. Popkin, an attorney, was convicted for assisting a client in disguising the source of undeclared funds being repatriated from offshore.

d. Money Laundering Control Act, 18 U.S.C. § 1956 and 1957.

e. Conspiracy to Defraud the U.S., 18 U.S.C. § 371.

f. Mail and Wire Fraud, 18 U.S.C. § 1341.

g. The Patriot Act signed into law by President Bush on October 25, 2001 designed to thwart the financial underpinning of terrorism.

3. No Available Malpractice Insurance. Attorneys should be advised that virtually every legal malpractice policy excludes fraud from the scope of its coverage. If a lawyer knowingly gives advice that assists his client in perpetrating a fraud, he is liable to suit for fraud or malpractice without benefit of insurance coverage.

4. Planner Due Diligence is Required to Avoid Civil, Criminal or Ethical Liability. Many commentators and asset protection planning legal experts have suggested that a lawyer engaged in estate planning may have a duty to clients to advise on asset protection planning in addition to more traditional trust and estate and tax planning advice. While there are risks in giving asset protection advice, you may be "damned if you do, damned if you don't." Duncan Osborne recently framed the matter in this way:

> "The debate between advocates of creditors' rights and advocates of asset protection cannot … turn on whether asset protection planning is proper. Rather, the only meaningful debate is the determination of the lawful and proper scope of asset protection planning … Nowhere is it written that an individual must preserve his assets for the satisfaction of unknown future claims and claimants. The focus on causality -- a causal link between an asset transfer and the injury allegedly suffered by a creditor -- provides a means to distinguish between the actions that operate directly to prejudice a particular creditor and those actions that in some remote, not foreseeable way, have after the passage of time or the occurrence of an intervening cause, compromised a creditor's financial interest."

5. Use of Affidavit of Solvency. Attorneys consulting with and advising clients with regard to domestic or foreign asset protection trusts or other asset protection strategies involving donative transfers of assets should consider the use of an Affidavit of Solvency. Where the issue of asset protection arises in an engagement, obtain such an Affidavit from the client. In the Affidavit the client should represent, state and affirm that he or she has no pending or threatened claims; that he or she is not presently under any investigation of any nature, and that he or she is not involved in any administrative proceedings; that no situation has occurred which the client has reason to believe will develop into a legal problem in the future; that following any transfers the client intends to remain solvent and able to pay his or her reasonably anticipated debts as they become

due; and that none of the assets which the client may transfer were derived from any of the "specified unlawful activities" under the Money Laundering Control Act of 1986. To the extent any legal disputes or other problems exist, they should be disclosed in the Affidavit and the Affidavit should provide that either sufficient assets will be retained with which to satisfy any liability arising from the problem, or the documents should be drafted with provisions requiring that any liability resulting from the disclosed problem(s) be satisfied by the asset protection trust if the liability is finally and legally established and not otherwise satisfied.

The internet affords the opportunity for lawyers to do additional due diligence investigation of new asset protection clients, for instance lexis searches for judgments, liens, pending litigation.

The asset protection lawyer should maintain a file containing a memorandum explaining the facts of each case which the lawyer has refused to take. This may prove helpful someday if the integrity of the lawyer and the types of cases accepted are challenged. A sample Affidavit of Solvency is attached as an Exhibit.

6. Asset Preservation for Attorneys Themselves. Can an attorney ethically engage in asset protection planning to protect his or her personal assets against the potential of an act of malpractice?

a. In general nothing appears in the Code Of Ethics which would either prohibit the attorney from personal planning of this nature, nor does anything exist in the Code to insure clients that their counsel will have assets against which they could proceed if something goes wrong. There is, for example, no ethical prohibition against an attorney filing for bankruptcy protection.

b. Rule 1.8(h) prohibits a lawyer from attempting to exonerate himself or herself, or from limiting his or her liability to the client, for acts of malpractice.

1. This prohibition is aimed toward attorneys using release forms or like means of limiting liability.

2. There is no requirement of practice that an attorney have an attractive balance sheet. Virginia Bar rules do not require malpractice coverage.