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Alan Gassman and Mike Markham are to be commended for having written and compiled an excellent reference source for any legal practitioner involved with bankruptcy law, debtor/creditor issues, asset protection and any other related litigation. Mr. Gassman and Mr. Markham are colleagues who have labored in the legal trenches for many years. Their insight and experience will be invaluable to any practitioner involved in representation relating to this area of law and Gassman & Markham on Florida and Federal Asset Protection Law will be a leading reference source for years to come.

- Al Gomez, Esq., Litigation and corporate bankruptcy attorney and Shareholder with Morse & Gomez, P.A.;
Tampa, Florida

This guide to Florida and Federal Asset Protection Law should be on every Florida estate planning attorney's bookshelf. It will soon be regarded as the go-to reference guide of its kind, similar to how Natalie Choate's retirement account guides are thought of. If you are planning a client's estate and not considering asset protection issues, you're only doing half the job. This reference tool quickly points you to the answers you need.

- Craig R. Hersch, Board Certified Wills, Trusts & Estates Attorney, CPA, Founding Shareholder and Director of
Investor's Security Trust Company; Fort Myers, Florida

Alan Gassman has long had a reputation for being a solid asset protection planning attorney who focuses on the technical issues of the subject, doesn't get carried away with the latest flavor-of-the-day planning hype, and provides solid and dependable services to his clients. This book should aid lawyers and other advisors immensely in understanding both the basic and complex issues involved in Florida asset protection planning-with the refreshing absence of the marketing hype that is otherwise so prevalent in this field.

- Jay D. Adkisson, Nationally-known collection attorney and co-author of the bestselling "Asset Protection: Concepts & Strategies".

Alan Gassman is a leader in the asset protection field and is nationally-known for his abilities and experience. Anything he writes is a must-read by anyone, including both practitioners and prospective clients. If my own family member needed an asset protection attorney, Alan is one of the very few attorneys in our industry who would be on my short list to do the work. His knowledge and dedication to making sure the Florida law is well understood and used by those who live and practice there is to be commended."

- Steve Oshins, Nationally Known and Respected Estate and Creditor Protection Expert

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GASSMAN & MARKHAM ON FLORIDA & FEDERAL ASSET PROTECTION LAW

*Includes state and federal
statutes and other resources*

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INTRODUCTION

Florida has a unique body of creditor protection planning laws that come from a number of different sources, and a number of different practice areas. The laws can be found in the Florida Constitution and Florida Statutes, and many stem from common law principles. This book seeks to explain these principles in a clear and simple manner, so that advisors can tailor asset protection plans to each client's needs.

Chapter 1 focuses on what creditor protection is, who qualifies, and the key rules that apply.

Chapter 2 discusses tenancy by the entireties, originally a common law protection for a husband and wife, which has been codified in the Florida Statutes. Tenancy by the entireties, or "TBE," provides strong protections for married couples that title property and assets as such.

Chapter 3 discusses annuities and annuity contracts, and how Floridians can protect their assets through permanent life insurance and cash value annuities.

Chapter 4 gives an in depth review of life insurance policies as described in Florida Statutes Section 222.

Chapter 5 discusses the vast homestead protections offered under Florida law. This chapter explains the relevant case law and recommended methods for protecting an individual's homestead and homestead proceeds from creditors.

Chapter 6 is regarding wages and wage accounts – which are protected under the head of household exemption of the Florida Statutes in Section 222 – and can be a valuable asset protection tool for families.

Chapter 7 is on disability insurance and proceeds, which are exempt from creditor claims. This chapter reviews the relevant statutes and case law.

Chapter 8 on pension plans, IRAs, and other qualified retirement plans, presents the current case law on these subjects. To date, there is not a settled consensus among courts as to whether such funds can be withdrawn for personal interests. The chapter also provides the relevant IRS provisions.

Chapter 9 provides a brief discussion on five subsidiary types of asset protection, including alimony rights, unemployment compensation benefit rights, Florida Prepaid Tuition Fund and 529 Plans, hurricane savings accounts, and physical asset exemptions.

Chapter 10 reviews the federal non-bankruptcy exemptions, including survivor benefits and retirement plans.

Chapter 11 is on Asset Protection Trusts, particularly Domestic Asset Protection Trusts (DAPTs). This chapter provides an in-depth look at minimizing the impact of the Medicaid tax and Florida's rules for lifetime QTIP Trusts.

Chapter 12 looks at Asset Protection Trusts overseas, and includes the famed Oshin's State Ranking Charts for categories such as best states to decant a trust and best states for Domestic Asset Protection Trusts.

Finally, Chapter 13 briefly touches on one of the newest entrants to the asset protection and estate planning game: non-charitable foundations.

CHAPTER 1

IMPORTANT RULES AND STRATEGIES AFFECTING CREDITOR PROTECTION

LEGAL INTERPRETATION.

When planning to use exemptions, it is important to read all applicable statutes, case law and legal articles, so as to become familiar with the general definitions.

While Florida and Federal courts are not uniform or necessarily predictable in determining how various exemption rules will be applied, under Florida law, exemptions are to be liberally construed in favor of providing the benefits of the exemptions to debtors.¹ When reviewing creditor protection statutes, courts look at the plain language of the statute first.² If the language of the statute is clear and unambiguous, courts must enforce the statute according to its plain meaning.³ However, if the court finds that the statute's language is not clear, it must turn to other sources, like legislative history and case law, to determine the intent of the statute.

Readers should keep in mind that oftentimes bankruptcy court decisions are not reviewed on appeal and may be "standing bad law" until the decision itself is appealed or overturned by a subsequent decision. One bankruptcy court judge does not have to follow the published decisions of another, so the decisions rendered by bankruptcy courts are often inconsistent. Many decisions are based upon very small dollar amounts or situations where a judge strongly disfavored or favored a creditor or debtor, resulting in misplaced opinions. Even the Florida Supreme Court has misunderstood creditor protection rules and released opinions that have caused more confusion than clarity, such as when it ruled that a transfer of the proceeds of the sale of a homestead to other exempt assets besides homestead would be a fraudulent transfer.⁴ There is therefore a good degree of uncertainty in many areas, and unpleasant surprises can be common.

HOW CAN AN INDIVIDUAL RECEIVE FLORIDA'S CREDITOR PROTECTIONS?

A debtor can use the Florida creditor exemptions when he or she is domiciled in Florida. A debtor is considered domiciled starting on the first day he or she lives in Florida, with the intention of making Florida his or her home.

CAN MOVING TO FLORIDA BE A FRAUDULENT TRANSFER?

¹ *Havoco of Am., Ltd v. Hill*, 790 So. 2d 1018 1021 (Fla. 2001) quoting *Milton v. Milton* 63 Fla. 533 (Fla. 1912)).

² *U.S. v. DBB, Inc.*, 180 F.3d 1277, 1281 (11th Cir. 1999).

³ *In re Griffith*, 206 F.3d. 1389, 1393 (11th Cir. 2000) (citing *Caminetti v. United States*, 242 U.S. 470, 485 (1917)).

⁴ *Orange Brevard Plumbing & Heating Co. v. La Croix*, 137 So. 2d 201 (Fla. 1962).

Generally, Florida's bankruptcy courts have found that moving to Florida to use Florida's statutory exemptions to protect assets from creditors is not a fraudulent transfer.⁵ However, the United States District Court, Middle District of Florida, has found that moving to Florida for the sole purpose of taking advantage of its generous exemptions so as to avoid creditors in other states can result in the debtor being limited only to the exemptions allowed from his or her state of origin.⁶

IMPORTANT BANKRUPTCY RULES.

A book about creditor protection and bankruptcy would be twice as long as this book is, and also more difficult to read and understand. The following pages provide significant information on bankruptcy, but certainly not everything that a planner would need to know if he or she purported to be competent in both creditor protection planning and bankruptcy law. Consultation with qualified bankruptcy counsel is therefore called for on many occasions.

Federal bankruptcy law can have a significant impact on planning for a debtor, and Alan Gassman's 2017 outline on What Estate Planners (And Others) Need to Know About Bankruptcy can be received by emailing agassman@gassmanpa.com.

While a full discussion of bankruptcy is outside of the purview of this book, advisors who are not well versed in that area should be aware of the following, and review the definitions and articles that follow.

Under the 2005 revisions to the Bankruptcy Code, Section 522(b)(3)(A), a debtor must maintain domicile within a state for 730 days (2 years) prior to filing a bankruptcy petition, in order to enjoy the exemption laws of that state.⁷ If the debtor did not live in a single state for the 730-day period, then it is necessary to determine where the debtor resided for the 180 days preceding the 730-day period (days 731 through 910) and the exemption laws of the state where the debtor was domiciled the greatest number of days during such 180-day period. For example, if an individual moves to Florida and files bankruptcy 729 days after the move, then the bankruptcy law to apply will be for the state where the individual resided for the longest period of time during the 180 days preceding the 730 days before filing.

Notwithstanding the 180 days required above, a 1,215-day rule applies to qualify for protection of a Florida homestead in bankruptcy. Pursuant to 11 U.S.C. § 522(p), a debtor cannot exempt any amount of the homestead property value in excess of the current cap of \$170,350 that is acquired during the 1,215 days before the bankruptcy filing. As a result of the above rules, a non-Floridian might want to purchase a Florida residence, move to Florida and make it their homestead 485 days after the purchase, and then the 1,215 days and 730 days will be completed at the same time. For homestead tax purposes, the \$50,000 exemption and 3% cap can begin to apply on the January 1st after the move in date, provided that an appropriate application is made with the County Property Appraiser on or before March 1st of the calendar year following when the residence becomes the homestead of the client.

The 730-day rule does not apply to property protected by reason of tenancy by the entireties status under state law where one spouse files bankruptcy (as further discussed in the Tenancy by the Entireties

⁵ *In re Hill*, 163 B.R. 598, 601 (Bankr. N.D. Fla. 1994).

⁶ See *In re Coplan*, 156 B.R. 88 (Bankr. N.D. Fla. 1993).

⁷ 11 U.S.C. § 522(b)(3)(A).

section of this book), Bankruptcy Code Section 522(b)(3)(B) provides for an exemption from creditors' claims of "any interest in property in which the debtor had, *immediately before the commencement of the case*, an interest as tenant by the entirety . . . to the extent that such interest as tenant by the entirety assets are exempt from process under applicable non-bankruptcy law."⁸ (Emphasis added.) Under Florida law, tenancy by the entirety property is exempt from process to satisfy debts owed to individual creditors of either spouse, since the property belongs to neither spouse individually.⁹ A creditor owed by both spouses would be able to seize tenancy by the entirety property. Therefore, residents of other states may take advantage of this protection, despite the fact that the couple never resides in Florida.¹⁰

Clients moving from community property states to Florida should be careful to ensure that the former community property is converted into non-community property under the transmutation rules, which will vary based upon the client's state of origin. The specific rules that apply for California, Nevada, Texas, and Wisconsin are discussed in further detail in Chapter 2, Section V.

More important bankruptcy points are as follows:

1. Florida is an "opt-out" state, meaning that individuals who have Florida law apply to their bankruptcy are required to utilize the Florida creditor exemption laws, in lieu of the bankruptcy exemptions that can apply for residents of "opt-in" states, as explained below. If a state is an "opt-in state", then its residents are able to decide to claim either the state law exemptions or the federal law exemptions.

Although Floridians do not have the ability to use the federal law exemptions that apply for opt-in state residents, all individuals, no matter what their state law says, are able to exempt the following two items in bankruptcy:

a. Pension and other qualified plan accounts, which are more thoroughly described in Sections 401, 403, 408, 408A, 414, 457 and 501(c)(18) of the Internal Revenue Code.

b. IRAs, but subject to a contributory IRA limitation that at the time of publication is \$1,362,800. This will increase with the Consumer Price Index every three years. Assets held under IRAs that have been rolled over from qualified pension accounts are not counted under this limitation.

In *Clark v. Rameker*, the United States Supreme Court held that inherited IRAs do not qualify for this exemption because they are not "retirement accounts." This limitation will not apply to debtors who are able to use the state law exemptions that protect inherited IRAs.

⁸ See *In re Smith*, 8:15-BK-01469-KRM, 2016 WL 675806 at *1 (Bankr. M.D. Fla. Feb 18, 2016) (citing 11 U.S.C. § 522(b)(3)(B); see also *In re Schwartz*, 362 B.R. 352 (ruling that the *real property* held in tenancy by the entirety is exempt from creditors in bankruptcy under Florida common law, even where the debtor was not domiciled in the state for 730 days prior to the filing of the bankruptcy); *In re Robedee*, 367 B.R. 901 (finding that *personal property* held in tenancy by the entirety was exempt from creditors under Florida common law, even where the debtor was not domiciled in the state for 730 days prior to the filing of the bankruptcy).

⁹ *Id.*

¹⁰ *In re Cauley*, 374 B.R. 311 (Bankr. M.D. Fla. 2007) (extending tenancy by the entirety protection to Florida property in a Delaware bankruptcy, even though the debtors were not Florida residents).

c. As mentioned above, assets held by a married couple as tenants by the entirety pursuant to the law of the state that is controlling will be protected.

2. The rules of evidence in bankruptcy court are different than the Florida law rules of evidence. Most notably, there is no CPA client privilege under the federal rules of evidence, but a lawyer may hire an accountant to assist in giving legal advice while maintaining communications privileged under the lawyer accountant communications.

The U.S. Supreme Court has opined that under certain circumstances the “crime fraud exception” to the attorney/client privilege will allow a creditor to receive lawyer file materials and testimony that would otherwise be privileged where a crime, fraud, or certain “fraudulent transfer” activity has occurred, with the active assistance of the lawyer, regardless of whether the lawyer was aware of the applicable wrongful or other conduct.

In a corporate bankruptcy, or where an independent trustee is appointed to serve in an individual Chapter 11 bankruptcy, the trustee in bankruptcy will own and be able to waive the attorney/client privilege. This may go hand-in-hand with pursuing a cause of action against the law firm that helped the debtor, if the services it rendered resulted in the award of assets to creditors, or the court finds that the result would have been more favorable but for the negligence or misconduct of the law firm. This can be a double benefit for creditors who receive not only assets that were unprotected as the result of lawyer malpractice, but also damages against the law firm in the same amount if the malpractice suit is successful.

3. A debtor who files bankruptcy within one year after making a transfer for the primary purpose of avoiding a creditor (a “fraudulent transfer”) will permanently lose the ability to discharge all indebtedness owed at the time that bankruptcy is filed. The same result applies if the debtor has been concealing an asset from creditors and does not report it as an asset on the bankruptcy schedules that will be available to creditors in the bankruptcy.

4. Additionally, it may not be possible for a “transferee” who has knowingly received a “fraudulent transfer” from another debtor who was in bankruptcy to bankrupt out transferee liability. This was the result in the case of *Elliott v. Kieseewetter*, where the husband transferred assets to his wife for the purpose of avoiding creditors. The court found that the fraudulent transfer rules applied to make the wife liable, because she knowingly cooperated. The bankruptcy court held that she could not bankrupt out the liability because of the application of Bankruptcy Code §523(a)(2)(A), which provides that an individual debtor is not discharged from any debt for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud.¹¹

5. Dishonesty with respect to the filing or administration of a bankruptcy estate, or intentional destruction of records to obfuscate pertinent information can also result in the loss of the right to a discharge and criminal prosecution.

¹¹ 391 B.R. 740 (Bankr. W.D. Pa. 2008).

Malicious or willful misconduct, breaking of certain laws, and a number of actions or inactions can result in the indebtedness resulting therefrom from not being dischargeable in bankruptcy, notwithstanding that other indebtedness may be dischargeable.

6. While an individual may receive a discharge of all debt in a successful Chapter 7 bankruptcy, a corporation or other entity will not. Thus, non-individual debtors, like companies and partnerships, normally do not file bankruptcy, but instead simply share their assets with creditors in an appropriate manner, or file for state court supervision thereof under an “assignment for the benefit of creditors” (“ABC”) to help assure that there will not be fiduciary exposure for failure to properly administer assets for creditors.

7. Individuals with more than 50% of their debt characterized as “consumer debt” and who have income exceeding a certain amount available, which generally corresponds to the mean income for individuals with similarly sized families residing in their region, will normally be required to have a Chapter 13 five-year payment plan of a certain portion of their post-filing income to be shared ratably among the creditors.

8. While the Bankruptcy Code only has a two-year fraudulent transfer statute, courts may also choose to enforce the state law fraudulent transfer statute. In Florida, this is either four (4) years, or in some cases, within the later of four (4) years from the transfer or one (1) year from when the creditor knew about the transfer. The “one year from when the creditor knew about the transfer” exception that can benefit a creditor will not apply in bankruptcy.

9. The 2005 Bankruptcy Act provides exceptions to the ability to protect a homestead in bankruptcy. This was a reaction to Florida’s unlimited homestead exemption, and the Florida Supreme Court’s 2001 decision in *Havoco of Am., Ltd. v. Hill* that the homestead protection laws trump the fraudulent transfer statute, unless ill-gotten gains are transferred into the homestead.

10. An individual or a married couple who file bankruptcy will therefore lose all equity above \$170,350 for a single owner or \$340,700 for a married couple owning a homestead if they have not owned the property or a previously qualifying exchanged residence for 1,215 days or more before filing bankruptcy, or to the extent that they have made fraudulent transfers into the homestead by purchase, improvements and/or debt reduction within ten (10) years before filing a bankruptcy.

A creditor can force an individual into bankruptcy, but if that individual has twelve (12) legitimate qualified creditors, it would take three (3) of them to file together to force an involuntary bankruptcy. Many Floridians therefore have eleven (11) or twelve (12) friendly creditors and a large home that is the mainstay of their continuing creditor protection until ten (10) years has passed from the date of acquisition of the homestead. A ten (10) year rule also applies for self-settled irrevocable “asset protection trusts” if funded with the intent to hinder, delay or “defraud” creditors.

11. Bankruptcy statutes include not only preferential transfer rules, which enable the trustee in bankruptcy to recoup distributions made to owners and creditors, but also claw back provisions which may enable creditors who received “more than their fair share”, as defined under the Bankruptcy Code, to refund such excess amounts.

The above summary no doubt oversimplifies a number of items, but does point out important information that should at least be known.

The following definitions have been written to give the reader a background in basic bankruptcy terminology and methodology. It may be useful to read these before proceeding through the outline, and to refer back when helpful.

1. Bankruptcy and “The Fish bowl” – The federal law and process that permits debtors to adjust creditor situations and receive a “fresh start” under the separate bankruptcy court system.

Bankruptcy itself is often referred to by bankruptcy lawyers as “the fish bowl” and a place for “trial by fire” because so much non-privileged information about a client and their past conduct must be disclosed and may be subject to discovery in sworn hearings, depositions and bankruptcy trials which are often conducted swiftly and with less time to prepare or delay than compared with the state court jury system. At the same time, creditors often feel that the bankruptcy rules and many bankruptcy judges are debtor friendly, which is sometimes the case, when debtors have acted honorably and have simply been unfortunate or perhaps unwise as opposed to being conniving, unreasonably careless, dishonest or unethical.

2. Chapter 7 Bankruptcy
- A process that provides for the appointment of an independent trustee to liquidate the non-protected assets of a debtor as pre-bankruptcy debts are discharged if certain requirements are met.

DISCUSSION/CONSIDERATIONS: *In an individual Chapter 7 Bankruptcy, all debts may be discharged (eliminated) while exempt assets are retained and businesses may be sold at arm's-length to related parties in court approved sales. This will be a home run for many unfortunate, but well-advised, debtors. No payment plan is required if the debt is mostly "business debt," as opposed to being mostly consumer debt. You can advise clients of the importance of this ratio. Further discussion of the implications of Chapter 7 Bankruptcy planning is provided below.*

3. Bankruptcy Estate
- Upon filing bankruptcy, non-exempt assets of a debtor become property of the bankruptcy estate, and are then under the control of the trustee in bankruptcy or the debtor in possession, pursuant to 11 U.S.C. § 541. For example, an individual filing bankruptcy who owns a creditor-exempt annuity contract and a bank account will retain ownership of the annuity and lose the bank account. The bank account will become part of the bankruptcy estate.

4. Discharge
- The actual order that results in debt being cancelled under a Chapter 7 bankruptcy, or upon completion of a successful Chapter 11 or Chapter 13 bankruptcy plan. No discharge is issued to non-individual entities (such as corporations and partnerships) under the Bankruptcy Code.

5. Loss of Discharge
- What occurs when a debtor in bankruptcy is denied the right to discharge debt by reason of pre-bankruptcy or post-bankruptcy conduct which causes the debtor to never be entitled to receive a discharge of debt then existing, leaving the debtor in "debtor purgatory" for the lifetime of any applicable judgment or obligation.

DISCUSSION/CONSIDERATIONS: *loss of discharge may occur when the debtor is not truthful or accurate with respect to disclosing assets, or makes a "fraudulent transfer" within one year before filing bankruptcy. Get any "fraudulent transfers" over well before needing to file bankruptcy, if they are legal to make in the first place (which is one reason that many debtors move to Florida—other reasons are discussed throughout this presentation.)*

6. Chapter 13 – A payment plan arrangement that individual debtors in bankruptcy meeting certain requirements must comply with under payment plan rules in order to adjust their debts.

DISCUSSION/CONSIDERATIONS: *Normally, this applies when there is mostly consumer debt and results in a five-year payment plan. Chapter 13 is only available to individuals (not corporations or other business entities). To be eligible to receive a Chapter 13 payment plan in 2020, an individual or married couple had to have unsecured debt of less than \$419,275, and secured debt of less than \$1,257,850. Chapter 13 repayment plans are for three to five years and are funded by the debtor's disposable income. Once the plan is approved by the court, the Chapter 13 trustee receives and administers payments. In exchange for compliance with a Chapter 13 plan, the debtor can keep his or her assets and a discharge of all debts is received when all payments have been made.*

7. Consumer Debt – An individual or married couple that would otherwise desire to discharge debt in a Chapter 7 bankruptcy may be required to have a Chapter 13 or 11 payment plan normally consisting of five years if most of their debt is “consumer debt,” which does not include debt that is the result of typical negligence, such as automobile accidents caused by a debtor. It is therefore often best to borrow for business purposes, and not personal purposes, if there is a choice.

8. Means Testing – The term denoting the criteria by which a debtor who would file a Chapter 7 bankruptcy may be required to instead enter into a Chapter 13 bankruptcy, with a payment plan, or a Chapter 11 bankruptcy, as applicable. Under these rules families with more than the median income based upon an applicable index will have to pay creditors over time based upon the excess of their available income over the applicable mean.

9. Net Disposable Income – The amount that a debtor in a Chapter 13 repayment plan can be expected to pay overtime in order to satisfy plan requirements.

- 10. Chapter 11 – A reorganization bankruptcy that will typically apply for bankruptcy businesses, investment entities, and individuals having large amounts of indebtedness or otherwise not qualifying for a Chapter 13 bankruptcy.
- 11. Subchapter V – **DISCUSSION/CONSIDERATIONS:** *The 2020 CARES Act added the term “Subchapter V” to definitions under Chapter 11 Bankruptcies whereby an individual or business entity having no more than \$7,500,000 in debt may request reorganization and reduction of indebtedness without the need to have any one or more creditors approve the debtor’s plan of reorganization. This is a temporary provision that can be applicable for bankruptcies filed on or before March 27, 2021, it is set to expire so as to not apply to bankruptcies filed after March 27, 2021. A debtor filing a Chapter 11 bankruptcy must affirmatively elect to have “Subchapter V” apply, and a great many bankruptcy lawyers have not yet navigated the waters of this new debtor friendly playing field. Please note that the “V” is a Roman Numeral V, meaning that this is pronounced “Subchapter Five”.*
- 12. Prepackaged Chapter 11 – A Chapter 11 bankruptcy where there is advance agreement between the debtor and a sufficient number of creditors to allow for debt to be reduced in a bankruptcy proceeding in order to have the ability to avoid federal income tax on debt discharge or adjustment, and state law documentary, intangible and other transfer taxes that may not apply when transitions and transactions occur in bankruptcy.
- 13. Debtor in Possession – A debtor with the right to maintain ownership and control of assets and activities in a Chapter 11 bankruptcy. The debtor in possession is a fiduciary and maintains operating control of the day-to-day business of the company. If the debtor in possession does not follow the rules or acts dishonestly the court can appoint an independent trustee to replace the debtor in possession.

- 14. Bankruptcy Schedules – The schedules that must be completed accurately under penalty of perjury and filed with the Bankruptcy Court for a debtor to file a bankruptcy proceeding.
- 15. Involuntary Bankruptcy – A bankruptcy proceeding filed by creditors to force a debtor into a Chapter 7 or Chapter 11 bankruptcy. This must be done in good faith, after reasonable negotiations, and will require three creditors to join in the petition if the debtor has twelve or more legitimate creditors.
- 16. Exempt Assets – An asset that will not be accessible to creditors and may be retained by a debtor under state law or federal bankruptcy law, such as state law protection that may apply to homestead, life insurance and annuity contracts in many states, and federal bankruptcy law exemptions for IRAs, 401(k) plans and tenancy by the entireties. State exemptions do not apply unless the debtor satisfied the 730 day or 180 day rule described in definition 18 below.
- 17. Non-Exempt Assets – Assets which are subject to creditor claims and become assets of the bankruptcy estate upon the filing of a bankruptcy petition. Non-exempt assets cannot be converted into an exempt asset because this may be considered to be a fraudulent transfer. A debtor who files bankruptcy within one year of making a fraudulent transfer risks permanent loss of the ability to discharge any and all debts then existing.
- 18. 730 Day or 180 Day Rule – A debtor will need to reside in the state where the bankruptcy is filed (to have the exemption laws of that state apply) for at least 730 consecutive days before filing. If the debtor does not meet the 730-day requirement, then the Bankruptcy Court will apply the exemptions of the state where the debtor resided for a majority of the 180 days immediately preceding the 730 day period. For example, if a debtor moves to Florida and has been living there for 729 days and someone forces them into bankruptcy, then the law of the state where the debtor resided for most of the 180 days before the 730 days will apply. What a difference a day makes!

19. Automatic Stay – An automatic stay prohibits creditors from taking action to collect on debts owed by a debtor once the bankruptcy has been filed. The creditor may petition the court to have the stay “lifted.” The automatic stay will not apply to certain federal agencies, such as the EPA. For example, it does not prevent certain federal agencies from taking action against a debtor. Debtors often make motions to “lift the stay” in order to protect collateral or prevent undue delay in the bankruptcy court.
20. Adequate Protection – Refers to the ability of a creditor to have protection of collateral where mortgage or security agreements exist and other requirements are satisfied.
21. Suggestion of Bankruptcy – A document filed in a state court proceeding or federal court civil case to indicate that one of the parties has filed bankruptcy. This will normally stop or delay the state court proceeding, and may move trials from state court to bankruptcy court, which can allow the debtor to avoid a jury trial and have a judge in bankruptcy who may view the survival of the business as a primary consideration and purpose.
22. “Attorney / Client” and Work Product Privileges – The two common privileges which prevent a lawyer’s file and work product from being accessible to parties who are adverse to a client.
23. Privilege Log – A schedule that must be disclosed to the debtor’s counsel and court when the attorney/client privilege is asserted which lets the opposing party know basic information about each item in the attorney’s file for which the privilege is claimed.
24. Crime Fraud Exception – Federal and state laws which prevent the assertion of the attorney/client privilege if the lawyer’s actions constitute the perpetration of a crime, defraudment, or in some situations communications with respect to a planned transfer to avoid creditors or concealment of assets. This can cause a debtor and the debtor’s lawyer to have to turn over otherwise protected attorney client privileged file materials, even if no crime or fraud occurred.

25. Core Proceedings – These are legal adversary proceedings where the Bankruptcy Court holds trial and makes determinations that would normally occur in state or federal court if the debtor were not in bankruptcy. These may include matters that would have otherwise been subject to arbitration.
26. Non-Core Proceedings – Litigation that occurs outside of the Bankruptcy Court that involves a debtor and may impact the outcome of a bankruptcy proceeding.
27. Adversary Proceedings – Proceedings similar to separate litigation within the bankruptcy case that is adjudicated by the Bankruptcy Court as if this were separate litigation outside of bankruptcy.
28. Income From the Discharge of indebtedness – Under Internal Revenue Code Section 108, a debtor may recognize taxable income when debt is reduced or discharged, which may be limited to the value of assets that will be owned after the discharge occurs, or which may not apply whatsoever if the discharge occurs in a bona fide bankruptcy proceeding.
29. Fraudulent Transfer – There are two types of fraudulent transfers. An “actual” fraudulent transfer is a transfer of an interest or obligation that is made with the intent to hinder, delay, or defraud any creditor. A “constructive” fraudulent transfer is a transfer of an interest or obligation by an insolvent or soon-to-be insolvent entity, without receiving reasonably equivalent compensation in exchange. Such transfers may cause loss of the ability to receive a bankruptcy discharge, if it has occurred within one year before the debtor files bankruptcy, or which may be set aside or subject a transferee to liability if it has occurred within two years before the filing of bankruptcy under the federal Bankruptcy Code, or for whatever longer period of time may apply under state law.
30. Preferential Transfer – A transfer that occurs when a debtor makes a payment or other transfer of property during the 90-day period prior to bankruptcy filing to one or more unsecured creditors not within the “ordinary course of business” and not to others of the same class. Such transfers are deemed voidable by the Bankruptcy Code. If the creditor is an “insider” (e.g., a family member, friend, business partners, or person or entity with a special connection to the debtor), the standard 90-day lookback period increases to one year.
31. Insider – An Insider that receives payments or assets from a debtor may have to repay such payments or assets to the bankruptcy court,

and this often occurs in unexpected situations. if the debtor is an individual, an “insider” is a (i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control. If the debtor is a corporation, an “insider” is a (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor. If the debtor is a partnership, an “insider” is a (i) general partner in the debtor; (ii) relative of a general partner in, general partner of, or person in control of the debtor; (iii) partnership in which the debtor is a general partner; (iv) general partner of the debtor; or (v) person in control of the debtor.

- 32. Doctrine of Successor Liability
 - State law which provides that the successor owner of a business or active real estate investment arrangement will be responsible for the liabilities of the previous owner if there is a required degree of commonality of related ownership, business identity, customers, and business assets. This is usually inescapable under state law, and often not realized by legal counsel. A Bankruptcy Court approved “363” sale is often the sole method of avoiding the imposition of this doctrine.

- 33. Assignment for the Benefit of Creditors (ABC) – A statutory state law proceeding where the state court will oversee the sale or distribution of corporate assets and payment of expenses and liabilities so that creditors are fairly treated, and officers, directors and managers of the debtor entity can avoid liability for fiduciary duties owed to creditors if the ABC plan is approved and carried out. An ABC plan does not discharge debtors in most states or avoid application of the Doctrine of Successor Liability.

- 34. Executory Contract – A contract between the debtor and third parties that may be binding upon the trustee in bankruptcy or debtor in possession, because there are contractual obligations on the part of both the debtor and the third party. This can be very important, particularly in the following situations:
 - a. Where the debtor owns LLC member or limited partnership interests and wishes to limit the creditor to having charging order protection in a jurisdiction that provides for this to be the sole remedy. A Limited Partnership Agreement or Operating Agreement may be executory when each partner or member has an obligation to make capital contributions, provide significant services, guarantee indebtedness, or carry out other material responsibilities.
 - b. A trustee in bankruptcy or debtor in possession may “reject” a non-executory contract, and thus not have legal responsibility, other than as to the damages that might be sued for by the other party.

For example, a trustee may choose not to pay a promissory note or to continue with an Operating Agreement where the payee or other party has no affirmative obligations. On the other hand, an Operating Agreement where both the debtor and third parties have affirmative obligations to make capital calls, provide management services, and to guarantee obligations should be characterized as an executory contract, making charging order protection possible, if applicable under state law.

35. Opting-In or Opting-Out – Every state in the United States has the ability to pass laws which require residents to use only the creditor exemptions provided under state law or to allow its residents to choose between the state law or federal law exemptions. A state can therefore “opt-out” of the federal exemptions, or a debtor residing in some states may “opt-in” to the state exemptions.
36. Super Creditors – These are creditors that can break through the exemptions. Super Creditors presently consist of the IRS, the Federal Trade Commission, the Securities Exchange Commission, Medicare (for penalties), federal agencies for penalties, restitution owed to the government as the result of criminal conduct, and the Federal Deposit Insurance Company in some circumstances. The Small Business Association also has special collection rights, as discussed in Chapter 9.
37. Tenancy by the Entireties – A special status of property reserved for married couples who live in states that recognize this type of ownership, and which may be immune from creditors of either spouse depending upon state law. It is possible that debtors living in a non-tenancy by the entireties state will be able to protect assets held as tenants by the entireties in a state where this is recognized where only one spouse owes the creditor. This specifically includes real estate and has been held to include tangible personal assets by at least one Florida case. Tenancy by the entireties may protect homestead property even where it would not otherwise be protected because of the homestead protection exceptions that were passed in 2005.

The six unities that are required to exist simultaneously for tenancy by the entireties to apply are as follows:

- a. Possession;
- b. Interest;
- c. Title;
- d. Time;
- e. Survivorship; and
- f. Marriage.

38. U.S. Trustee’s Office – A federal criminal enforcement agency office in Bankruptcy Court buildings which investigates and prosecutes bankruptcy fraud and associated matters, as more thoroughly described in Footnote 1 below.

39. Contempt of Court – An equitable remedy that may be applied by a bankruptcy judge to force a debtor to go to jail in order to induce conduct with respect to making assets available to the trustee in bankruptcy under circumstances where the debtor is believed to have control over the assets or a third party in possession of the assets, or has inappropriately created an impossibility with respect thereto.
40. Homestead Protection Exceptions – At present, a homestead exceeding \$170,350 in value (or \$340,700 for a married couple in bankruptcy if owned jointly), and otherwise exempt under state homestead creditor protection law, will be accessible to the trustee in bankruptcy to the extent of such excess net value if one of the following exceptions applies:
- a. the home was acquired or its equity value was enhanced by one or more “fraudulent transfers” within ten years of bankruptcy being filed, with the exception to apply to the extent of equity attributable to such fraudulent transfers;
 - b. the homestead was acquired less than 1,215 days before bankruptcy is filed; or
 - c. one of the “bad conduct” exceptions under Bankruptcy Code Section 550(a)(1) applies. See the case of *Martinez Hutton (In re Harwell)*, 628 F.3d 1312, 1314 (11th Cir. 2010) discussed in the materials that follow.
41. Strip Down – Where a mortgage or other collateralized loan is reduced in a Chapter 11 or 13 bankruptcy to the value of the collateral. The excess indebtedness becomes unsecured, and a payment plan may provide for satisfaction of the collateralized debt over time - commonly five years with interest based upon a 30-month amortization schedule. Sorry, there are no hot tubs or parties involved with this definition.
42. Cram-down – Where a judge requires creditors to be owed less monies, or under different payment terms, notwithstanding the creditor’s objections thereto.
43. Concealment – The felony of misleading the Bankruptcy Court and creditors by having substantive ownerships and benefit from assets that are not reported as assets of the debtor on a bankruptcy schedule.

44. Net Operating Losses (NOLs) — These are tax losses which may be used in subsequent years by related parties or purchasers of a business entity, depending upon federal tax law.

The following is a somewhat updated version of the article *AVOID CATASTROPHE: Know the Bankruptcy Code to Ward Off Devastating Surprises to an Estate Plan* by Alan S. Gassman, Esq. and Alberto F. Gomez, Esq., which was first published in *Trust & Estates*, October 2007.

AVOID CATASTROPHE: Know the Bankruptcy Code to Ward Off Devastating Surprises to an Estate Plan

EXECUTIVE SUMMARY:

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

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

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

FACTS:

THE BASICS

Any estate planning client could end up in a bankruptcy proceeding, whether voluntarily or involuntarily. In many cases, it is unlikely that a client would choose to file a voluntary bankruptcy petition. Often, a client may be forced into a bankruptcy proceeding on an involuntary basis.¹² Since the implementation of the 2005 Bankruptcy Abuse Prevention and Creditor Protection Act (2005 Bankruptcy Code), there are more stringent requirements imposed on consumer debtors that must be met for them to be eligible to file a petition.

Sometimes clients will represent physicians and health care related businesses or executives that will have necessary interaction associated with debtor/creditor situations and the Bankruptcy Code. Adding to this complexity is the probability of your client either having to file a bankruptcy petition or the client being a target for recovery by a debtor, bankruptcy trustee or creditors committee. Having a working knowledge of bankruptcy law will assist the practitioner in representing their client and hopefully assist in steering the client away from some common bankruptcy related pitfalls.

¹² 11 U.S.C. § 303.

These materials are meant to provide a basic overview of bankruptcy law and are not exhaustive.

In general, there are three types of bankruptcy:

Chapter 7 is essentially a liquidation mechanism.

Chapters 11 and 13 contemplate a full or partial repayment plan based upon ability to pay and statutory requirements.

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

A court may dismiss a case that is filed under Chapter 7 of the Bankruptcy Code when the debts are primarily consumer based.¹³ The term “consumer debt” is defined as a debt incurred by an individual primarily for personal, family, or household purposes.¹⁴ A business debt is one where the individual would expect some profit from the acts that led to the judgment.¹⁵ A Court will use a means based test that will force certain consumer debtors out of Chapter 7 liquidation and into Chapter 13, based upon assets and income testing.¹⁶ A tort liability judgment is not considered to be a consumer debt.¹⁷

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

Chapter 13 is only available to individuals (not corporate or other business entities). To be eligible to file a Chapter 13, an individual must have unsecured debts of less than \$419,275, and secured debts of less than \$1,257,850.¹⁸ Chapter 13 repayment plans are for three to five years and are funded by the debtor’s disposable income. In exchange for paying under a Chapter 13 plan, a debtor keeps his or her assets. Chapter 13 is prospective as opposed to the snapshot concept of Chapter 7. The Chapter 13 trustee administers payments under a plan once a court confirms the plan. At the conclusion of the plan, after payments are made, the debtor obtains a discharge.

Chapter 11 is used primarily for business entities, but individuals with significant assets or who do not meet the debt limits for Chapter 13, may file a Chapter 11 Bankruptcy. Instead of a trustee, the debtor

¹³ 11 U.S.C. § 707(b)(1).

¹⁴ 11 U.S.C. § 101(8).

¹⁵ *In re Peterson*, 524 B.R. 808, 812 (Bankr. S.D. Ind. 2015).

¹⁶ David Gray Carlson, Means Testing: The Failed Bankruptcy Revolution of 2005, 15 Am. Bankr. Inst. L. Rev. 223, 228 (2007).

¹⁷ *In re Peterson*, 524 B.R. 808, 812 (Bankr. S.D. Ind. 2015).

¹⁸ 11 U.S.C. § 109(e) (2010).

becomes the debtor-in-possession (DIP) and is afforded an opportunity to propose a plan. The DIP remains in possession and control of her assets. Chapter 11 requires the debtor to obtain the vote of creditors in order to confirm the plan, unless the debtor is able to “cramdown” the plan as authorized by the Code. The cramdown rules allow the bankruptcy judge to approve the debtor’s plan over the objections of dissenting creditors. The cramdown is only permitted if the plan does not discriminate unfairly and is fair and equitable to the dissenting classes.

The Subchapter V Bankruptcy was added to the Bankruptcy Code effective March 27, 2020 to enable individual and entity borrowers with no more than \$7,500,000 of debt to be able to have such debt restructured, and possibly reduced, by determination of the bankruptcy court judge, without the consent of other creditors. Debtors filing bankruptcy after March 27, 2020 and before March 27, 2021 are therefore in a much better position to negotiate with creditors, or to receive a reorganization order that will enable debtor to save the business or associated investments.

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

Moreover, the application of the attorney/client privilege differs depending on whether a client files for Chapter 7, 11, or 13. When a Chapter 7 bankruptcy petition is filed, the Chapter 7 trustee may become the owner of the attorney/client privilege, as well as all client files for purposes of asserting or waiving the privilege. There is a split of authority on this point.¹⁹

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

INVOLUNTARY BANKRUPTCY

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

A creditor cannot be counted in the three-or-more-creditor requirement if it holds a lien on the debtor’s property, unless its claim exceeds the value of the property lien by at least \$12,300. Generally, employees and “insiders” are not counted as creditors in determining whether 12 creditors exist. Because of the stricter bankruptcy rules, which are now applicable, more clients with large judgments against them will

¹⁹ *Community Futures Trading Comm’n v. Weintraub*, 471 U.S. 343 (1985), held that a trustee may waive the attorney/client privilege for a corporate Chapter 7 debtor, but it did not extend its holding to individual debtors. See *Miller v. Miller*, 247 B.R. 704 (Bankr. D. Ohio 2000), discussing the split of authority.

be rendered insolvent, yet will attempt to avoid or delay bankruptcy while maintaining their creditor exempt assets. Creditors may respond by utilizing the involuntary option.

There have been many notable decisions, including one by the U.S. Court of Appeals for the Fifth Circuit in *Denham v. Shellman Grain Elevator*,²⁰ where the Bankruptcy Court refused to count small and recurring claims as “countable” under the 12 creditors requirement. One Florida bankruptcy case, *In re Smith*, cited *Denham* and excluded creditors holding de minimis claims of up to \$275.²¹ Other cases have permitted claims of \$65 and \$10 to be countable under the Section 303 requirement that the aggregate claims must equal or exceed \$12,300.

Courts that have chosen not to follow *Denham*, and to instead allow small and recurring claims to count, have dismissed the de minimis exception based upon the premise that Congress has not explicitly ruled out small and/or recurring debt, so the statute²² should be applied literally.²³ Some courts, however, such as the court in the *Matter of Runyan*, have indicated that a \$25 debt would not be sufficient, and will evaluate the claims on a case-by-case basis.²⁴

While there is no bright-line rule to determine which creditors are “legitimate creditors,” in every situation involving an involuntary bankruptcy proceeding, the table below may help to provide some general guidelines.

Filing an involuntary petition is an aggressive creditor strategy and there are serious and costly consequences if the petition is dismissed. A creditor who files for an involuntary bankruptcy “in bad faith” can be forced to pay the debtor’s fees, costs and actual and punitive damages.²⁵ In *In re Cannon Express Corporation*,²⁶ the U.S. Bankruptcy Court for the Western District of Arkansas awarded compensatory damages and punitive damages where three creditors filed involuntary bankruptcy proceedings against debtor and the court found them to be in bad faith.

²⁰ *Denham v. Shellman Grain Elevator*, 444 F.2d 1376 (5th Cir. 1971), the debtor listed 18 creditors with an aggregate indebtedness of only \$467.13, all but one of whom were owed less than \$100, to defeat an involuntary petition for bankruptcy filed by one of *Denham*’s very large creditors. The court found that all of the debts were open and unliquidated as opposed to claims reduced to judgments, and that small recurring debts cannot qualify creditors to be counted toward the necessary amount required to initiate a petition.

²¹ See *In re Smith*, 123 B.R. 423 (M.D. Fla. 1990).

²² 11 U.S.C. § 303(b)(2) (2017).

²³ See *In re Okamoto*, 491 F.2d 496 (7th Cir. 1974) which allowed eight debts, all of which were below \$65 each, to count toward the 12 creditor threshold and stated that most courts abandon *Denham* because *Denham* refused to acknowledge Congressional intent by specifically differentiating between large and small debts and removing a prior provision excluding debts below \$50; See *Matter of Rassi*, 701 F.2d 627 (7th Cir. 1983) which prevented the petitioner from forcing the debtor into an involuntary bankruptcy by allowing two claims, both \$10 or less; See also 11 U.S.C. § 548(e); See also Steve Leimberg’s Estate Planning Newsletter Number 485 by Alan S. Gassman.

²⁴ *Matter of Runyan*, 832 F.2d 58 (Tex. Court App. 1987).

²⁵ 11 U.S.C. § 303(l)(2007).

²⁶ 280 B.R. 450 (Bankr. D.W. Ark. 2002).

The decision was based on a combination of five tests identified in *In re Landmark Distributors, Inc.*²⁷ The *Cannon* court combined²⁸ and restated the tests, finding that:

- (1) the claims were not well grounded in fact because the creditors did not speak with an attorney, talk to other creditors or attempt to collect the money from the debtor directly;
- (2) the creditors could have advanced their own interests in a different forum by using a collections agency or setting up a payment system with debtor or other forum, instead holding that using bankruptcy courts is an improper use of judicial resources;
- (3) the creditors used the bankruptcy proceedings to gain a disproportionate advantage over other creditors because the creditors, who were unsecured, testified that they thought filing involuntary bankruptcy proceedings would put them ahead of the other unsecured creditors, thus gaining priority; and
- (4) the creditors were motivated, the court held, by an improper use because the creditor “knew that he was not going to be paid” but thought filing would force the debtor to make payment. Finally, the court held no other reasonable person would have filed the same or similar claim without first investigating whether or not the debtor was paying its debts on time or attempting to collect the debts in some other fashion. For the improper filing, the court awarded for than \$14,000 compensatory damages and \$35,000 in total punitive damages. Had the debtor proven losses in sales by preponderance of the evidence, the court would have awarded these damages as well, which were to be \$2,768,288 according to the debtor.

In re Adell, 321 B.R. 561 (Bankr. D. Fla. 2005) is a good example of an involuntary bankruptcy filing that backfired on the petitioning creditor and resulted in a creditor becoming a debtor! In *Adell*, a bankruptcy court in Michigan dismissed an involuntary petition which was filed by Mr. Adell against his former builder. The Court awarded sanctions in the amount of \$6,413,230.68 against Adell. Adell then quickly moved to Naples, Florida and filed a Chapter 11 bankruptcy petition. Substantial litigation ensued resulting in the conversion of the Chapter 11 case to a Chapter 7, and ultimately the dismissal of the Chapter 7 case for substantial abuse. The court discussed that the damages awarded in the Michigan case constituted sanctions for a bad faith filing, and were therefore warranted pursuant to 11 U.S.C. § 303(i) of the Bankruptcy Code.

PROPERTY OF THE ESTATE

A bankruptcy filing will affect your client whether your client is a debtor, a recipient of a transfer from a debtor, or has an interest in a debtor. In general, upon filing a bankruptcy, assets of a debtor become property of the estate under 11 U.S.C. Section 541. Some assets are specifically excluded, such as an interest

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

²⁸ Those five tests are: (1) the improper use test which finds bad faith if a creditor files involuntary bankruptcy to gain a disproportionate advantage for himself over other creditors; (2) the improper purpose test which finds bad faith if creditor's motivation for filing is ill will, malice or harassment; (3) the objective test which asks if a reasonable person would have also filed involuntary bankruptcy; (4) the subjective test which looks at the subjective motivation of the creditor (almost identical to the improper purpose test); and (5) the two part test which combines the subjective and objective tests. *Cannon* at 453.

in a spendthrift trust, as defined in 11 U.S.C. Section 541(c)(2) or social security or veteran's benefits under 11 U.S.C. Section 522(d)(10)(a) and (b). If your client is a debtor, a recipient of a transfer from a debtor, or has an interest in a debtor, then bankruptcy law can dramatically affect the estate plan.

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

Also, courts may be sympathetic to situations in which debtors have lost "sacrificial lambs" as a part of their bankruptcy filings.²⁹ Judges may be more lenient in looking at fraudulent transfer and other issues with debtors who lose some assets upon filing bankruptcy, as compared to clients who have moved all of their assets to the exempt category and at filing show no assets going into the bankruptcy estate.

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

JUDICIAL POWERS

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

As a matter of bankruptcy law, a trustee is the equivalent of a hypothetical judgment creditor, and the trustee can step into the shoes of creditors to exercise statutory strong-arm powers to set aside and recover transfers deemed to be fraudulent or preferential. For instance, § 548 provides for a two-year reach back to pursue fraudulent transfers of property. Under 11 U.S.C. § 544, the bankruptcy trustee can utilize state fraudulent transfer statutes and extend the reach back period consistent with the statute (i.e. 4 years under Florida law).

There are many bankruptcy cases in which courts have disregarded transfers that were ostensibly motivated by estate-planning purposes. In most of these cases, the court's decisions were fact-specific,

²⁹ A common refrain from bankruptcy lawyers regarding this topic is that "pigs get fat and hogs get slaughtered." Leaving a sacrificial lamb may tip the scales more favorably towards a debtor since the perception of treating creditors fairly increases. Also, there is a much better chance that a settlement will result, especially with a Chapter 7 trustee. The Chapter 7 trustee is a court fiduciary who is required to promptly convert assets and disputes to cash, unlike some litigants, who pursue litigation out of principle or some ulterior motive.

involving transactions that occurred when the creditor claim was known or should have been known by the debtor. One of the critical factors considered by courts is the “timing” of the specific transfers.

Lesson learned: Get your client’s estate and income tax plan underway early and document your client’s business, estate, tax, family, and other legitimate motives to ensure that a bankruptcy court will not dismantle legitimate planning that occurs before a bankruptcy petition is filed.³⁰

Bankruptcy judges often apply substance over form and rely on equitable principles in rendering decisions, which often favors the trustee and creditors. For example, in *In re Larry Portnoy*,³¹ the bankruptcy court ignored the law of the applicable offshore jurisdiction and applied the law of the jurisdiction where the bankruptcy court resided, to determine that offshore trusts were not effective creditor protection devices. In *FTC v. Affordable Media*³² and in *Lawrence v. Goldberg*,³³ debtors were held in contempt and jailed for not turning over offshore assets. The U.S. Court of Appeals for the Ninth and Eleventh Circuits, respectively, upheld the bankruptcy court’s decision in both *Affordable Media* and *Lawrence*.

TIMING CAN BE EVERYTHING

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

For example, in *In re Agnew*,³⁴ a farmer owned an undivided 1/5 interest in farmland along with some farming equipment; his mother, in trust, owned the remaining 4/5 undivided interest in the land. The farmer leased the 4/5 parcel from his mother for farming purposes and to live on. Before filing bankruptcy, the farmer transferred his 1/5 interest in the land and his farm equipment to his mother’s trust, in exchange for the parcel of land on which he lived. Years before the transfer, the farmer and his mother had discussed making this transfer to ensure that his siblings would not evict him after his mother died.

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

³⁰ For bankruptcy cases dealing with estate planning issues, see *In re Kossow*, 325 B.R. 478 (S.D. Fla. 2005); *In re Jennings* 332 B.R. 465 (M.D. Fla. 2005); *In re Ludwig*, 345 B.R. 310 (Bankr. D. Colo. 2006); *Joseph J. Luzinski v. Peabody & Arnold, LLP and Joel Reinstein, P.A. (In re Gosman)*, Adv. No. 03-3228-BKC-SHF-A (S.D. Fla. 2007).

³¹ *In re Larry Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

³² *Federal Trade Commission v. Affordable Media, LLC, Denyse Lindaalyce Anderson and Michael K. Anderson*, 179 F.3d 1228 (9th Cir. 1999).

³³ *Lawrence v. Goldberg (In re Lawrence)*, 279 F.3d 129 (11th Cir. 2002).

³⁴ *In re Agnew*, 355 N.R. 276 (Bankr. D. Kans. 2006).

In contrast, in the case *In re Lacounte*,³⁵ the court found that a husband and wife debtor did violate Bankruptcy Code Section 522(o) by selling assets to intentionally divert funds away from creditors. Anticipating bankruptcy, the debtor's daughter sought counsel of an attorney who advised the husband and wife to sell off what they did not need, and use the proceeds to pay down their home mortgage. The Debtors sold 3 family cars and the husband's future interest in his mother's 680-acre farm. They used the proceeds from these sales to pay down the mortgage on their home even though debtors had incurred more than \$180,000 in gambling debts on their credit cards. The debtors also transferred the wife's future interest in her mother's home back to her mother because they understood that in bankruptcy proceedings she would most likely lose this family asset to creditors.

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

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

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

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

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

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

1.) the transfer is to an insider;
2.) the debtor has retained control of the asset;
3.) the transfer was concealed;
4.) before the transfer, the debtor was sued or demand was made;
5.) the transfer was of substantially all of the debtor's assets;
6.) the debtor absconded;
7.) the debtor removed or concealed assets; and
8.) there was no reasonable equivalent value or consideration for the transfer.

³⁵ *In re Lacounte*, 342 B.R. 809 (Bankr. D. Mont. 2005).

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

Under the 2005 revisions to the Bankruptcy Code, a debtor must maintain a domicile within a certain state for the two years (730 days) prior to filing a petition in order to have that state's exemption laws apply in the bankruptcy.³⁶ If the debtor's domicile was not located in a single state for that 730-day period, then it is necessary to determine where the debtor resided for the 180 days before those 730 days (days 731 through 910).³⁷ In those situations the exemption laws of the state where the debtor was domiciled the greatest number of days between day 910 before filing and day 730 before filing will be the state law to apply in the bankruptcy.³⁸

Further, as discussed below, a 1,215-day rule applies to qualify a "non-fraudulent transfer into a homestead" for full protection in bankruptcy, even where the state fraudulent transfer rules would not cause a set aside to occur (such as in Florida).³⁹ A ten-year statute, as described below, will provide for loss of equity in homestead attributable to fraudulent transfers made into the homestead within ten years of filing bankruptcy.

LIMITING RISK

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

When an estate planning strategy is put into place; the estate tax, income tax, and financial and family advantages of the arrangement should be emphasized. While important, creditor protection should not be the primary reason of an estate planning strategy. Rather, estate tax, income tax and other financial considerations should be the motivating factors. For example, if a family were to choose between having an offshore protection trust or a domestic family limited partnership (FLP) to hold significant long-term assets, the FLP may be more desirable, if discounts for tax purposes, greater control, and expense are important considerations.

On the other hand, offshore asset protection trusts arrangements may be more advantageous when there are significant business reasons for their use. For example, if there are family marital agreements in place in which each spouse agrees to allow premarital assets to be held in offshore trusts. Such agreements may provide to hold such assets in jurisdictions that clearly uphold separate non-marital asset rights, and to resolve any dispute under the law of a jurisdiction that protects such premarital assets. Other examples are longer or eliminated perpetuity statutes, and the ability to use in *terrorem* clauses.

³⁶ 11 U.S.C. § 522(b)(3)(A)(2007).

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ Fla. Const. Art. X § 4 providing, in general, that Florida homestead shall be exempt from forced sale; see Fla. Stat. § 222.20 excluding the availability of federal exemptions to Florida residents.

Also, it is common for non-U.S. clients to want their assets held in a jurisdiction that allows free movement between the country where many of their relatives reside, and the jurisdiction where some portion of their wealth is held. An example would be clients who have relatives that they support or may need to support in the future.

One author has also recently found that many spouses holding significant tenancy by the entireties assets want “contractual assurances” from a surviving spouse that the assets will not be mishandled or lost to a creditor of the surviving spouse. Married couples may choose to execute agreements whereby the surviving spouse agrees to immediately fund and become co-trustee of a trust established in a “creditor protection trust” jurisdiction.

Clients who have offshore asset protection trust motivation factors, and particularly those who live in states that provide protection for the “cash value” of life insurance policies, also should consider offshore life insurance arrangements that can facilitate holding the underlying policy investments in favorable jurisdictions while offering income tax avoidance under the life insurance provisions of the Internal Revenue Code. Annuity contracts with offshore life insurance companies are also a popular way of attempting to defer income tax on investments that cannot be held under U.S.-sponsored annuities because of insurance commissioner limitations that do not apply in offshore jurisdictions.

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

PAPER TRAIL

In defending any estate or asset protection plan, it is important to have a paper trail that justifies the estate-planning purposes behind the transfers. Again, assuming that the timing is in favor of the debtor, documentation that proves adequate and reasonable non-creditor planning purposes for the transfers may provide a bankruptcy judge with sufficient ammunition to defeat efforts by a bankruptcy trustee to enforce a claim against the protected assets. For instance, if a debtor’s medical condition is one factor that supports an estate or asset protection plan, it is wise to document the debtor’s health and include letters from treating physicians.

LLCS AND FLPS

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

There are some state statutes that limit creditors of a debtor-limited partner. For example, Florida Statutes Section 608.433(4) safeguards the membership interest of an LLC owner or member by limiting creditors of a debtor-limited partner to a “charging order.” A charging order provides the creditor with the

right to receive any distributions that may be paid to the debtor-limited partner, but does not allow the creditor to exercise any rights otherwise held by the limited partner.

A charging order may turn the creditor into a partner for federal tax purposes, although the tax law is not clear on this. The one Revenue Ruling reaching this result involved a situation where the debtor-limited partner voluntarily gave the creditor an assignment of the limited partnership interest. Many authorities believe that a creditor will not be subject to federal income tax by reason of merely holding a charging order.⁴⁰ If income is allocated but not distributed, then the creditor has the risk of being taxed on income that is never received.

One suggestion is to make an LLC or limited partnership agreement impose affirmative obligations on members and partners to make future capital calls and to be involved in partnership management.⁴¹ This conclusion is based upon the Bankruptcy Court decision in *Ehmann*,⁴² where a bankruptcy judge concluded that charging order protection does not apply once a limited partnership interest is subjected to the Bankruptcy Court's jurisdiction when the debtor-limited partner has filed or has been forced into bankruptcy if the partnership arrangement is non-executory.⁴³ If executory, a trustee is bound by the operating agreement. LLC and FLP agreements should state that they are intended to be executory contracts, that is to say, a contract in which obligations exist on both sides that are unperformed.

There is limited case law addressing the question of whether a limited liability company's operating agreements are an executory contract, as they are determined on a case by case basis. Although the Bankruptcy Code does not define the term "executory contract," legislative history and case law cite with approval Professor Vern Countryman's⁴⁴ definition: "a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."⁴⁵

The Bankruptcy Court in *In re Strata Title* concluded that a manager-managed LLC's operating agreement was executory based on specific material actions that required approval by a super majority of the members and participation of all members was necessary for purposes of voting.⁴⁶ *In re Strata Title* was later distinguished by the Bankruptcy Court in *In re Alameda Investments*, which held that the mere fact that members have a right to vote on various matters would not, by itself, make an operating agreement executory.⁴⁷

⁴⁰ 812-2nd Tax Mgmt. Est., Gifts & Tr. J. IX.D.2 (2006).

⁴¹ See Thomas O. Wells & Jordi Guso, *Business Law: Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member*, 81 Fla. Bar J. 34 (2007).

⁴² This decision was subsequently vacated when the parties settled and the Court approved same. See *Movitz v. Fiesta Investments, LLC*, 337 B.R. 228 (Bank. D. Ariz. 2005).

⁴³ 319 B.R. 200, 203 (Bankr. D. Ariz. 2005).

⁴⁴ Also commonly referred to as the "Countryman Test."

⁴⁵ Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 Minn.L.Rev. 439, 460 (1973).

⁴⁶ WL 1773619 (Bankr. D. Ariz. 2013) (material actions included the processes for removing a manager and sale of the property owned by the company).

⁴⁷ 6:09-BK-10348-PC, 2013 WL 3216129 (Bankr. C.D. Cal. June 25, 2013), *aff'd*, 2014 WL 868605 (Bankr. App. 9th Cir. Mar. 5, 2014) (holding operating agreement as non-executory because debtor had no outstanding performance due before the

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

Moreover, LLC members and FLP partners should assume an active role in the management of the entity. Changes to the limited partnership statutes in many states permit participation of limited partners in the management of the entity with loss of limited liability.⁴⁸

Another suggestion made in the article is to include contractual provisions which are authorized by state statute to require the consent of the remaining members when one member seeks to transfer a membership interest.

Another example of bankruptcy court “interjection” in this area is the case of *In re Ashley Albright*,⁴⁹ where a Colorado bankruptcy court held that the trustee in bankruptcy, as the successor of the LLC that had been owned by a debtor, had the ability to provide consent to the transfer of member interest in a single-member LLC, and could therefore exercise management control over the LLC and liquidate the assets of the LLC to realize the value as the sole member. The bankruptcy judge concluded that the purpose of the Colorado charging order statute was to protect other members, even though the language of the statute itself had no mention of the charging order protection only applying in a multiple member situation.

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

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

FRAUDULENT TRANSFERS

A fraudulent transfer is defined under the Bankruptcy Code as a transfer that can be avoided by a trustee if the transfer was made with (1) the intent to actually defraud, hinder and delay creditors or (2) in exchange for less than reasonably equivalent value while the debtor was insolvent.⁵⁰

bankruptcy filing, no role in the management of the company, and no obligation to provide personal expertise or service to the company).

⁴⁸ See Thomas O. Wells & Jordi Gusó, *Business Law: Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member*, 81 Fla. Bar J. 34 (2007).

⁴⁹ 291 B.R. 538 (Bankr. D. Co. 2003).

⁵⁰ 11 U.S.C. Section 548(a)(1)(2007).

A fraudulent transfer also can be found to have occurred when a debtor has assumed a creditor's obligation instead of making a transfer. If a debtor makes a transfer to a creditor and does not receive equivalent value,⁵¹ a fraudulent transfer exists if

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

There is a popular misconception that a "fraudulent transfer" is a transfer that involved defrauding one or more creditors in the bankruptcy court. Under debtor-creditor law, the term "fraudulent transfer" means a transfer made for the purpose of avoiding creditors, or in a situation where the transferor is undercapitalized when business operations and potential risk relating thereto is taken into account. This is certainly different than "committing fraud," which occurs when one party actively misleads another party.

A "fraudulent transfer" in the debtor-creditor law context is generally not a crime, although some states have passed bar rules that prevent lawyers from being integrally involved in helping or advising clients to effectuate fraudulent transfers,⁵² even though it may be unconstitutional, and seems at least distasteful by many to prohibit lawyers from advising their clients to take actions that are in the client's best interests. At the least, a client has the right to know all potential actions and potential implications thereof.

A 2012 Florida case involved an attorney who became financially responsible for transfers made to avoid creditors that were processed through his trust account. This case, *Harwell*, establishes that a lawyer may be held liable in Bankruptcy Court for disbursing funds in the way a client wishes, if they are being disbursed with the intent to avoid creditors.⁵³ The bankruptcy trustee tried to recover the funds under 11

⁵¹ Value is defined in 11 U.S.C. Section 548(d)(2)(a) as property, or satisfaction or securing of a present or antecedent debt of the debtor. Thus, a promise to remain employed does not satisfy this definition and is not enough to prevent a fraudulent transfer.

⁵² See, for example, Connecticut Informal Opinion 91-23-: "A lawyer may not counsel or assist a client to engage in a fraudulent transfer that the lawyer knows is either intended to deceive creditors or that has no substantial purpose other than to delay or burden creditors." The opinion went on to say that the determining factor of impropriety was whether the lawyer knew that the transfer was intended to deceive, embarrass, delay or burden a creditor. But see South Carolina Bar Ethics Advisory Opinion 85-02, which specifically held that it was ethical for an attorney to transfer a client's assets to protect against the potential claims of future creditors. There, the Committee held that if there was no immediate reasonable prospect of judgment against the client, to transfers to avoid future creditors was not a violation of the ethics code. The Florida Supreme Court in the case of *Freeman v. First Union Nat'l Bank*, 329 F.3d 1231 (2003), held that Florida's fraudulent conveyance statute is only a creditor collection tool and is not a basis for damage claims against non-transferees such as third-party financial consultants or legal advisors.

⁵³ *Harwell Trans.* at 24:23-25:4 (M.D. Fla. Nov. 20, 2012). The attorney in question was representing his client in two separate matters, a shareholder dispute and a judgment entered in Colorado. The first matter resulted in the client receiving a substantial settlement from a shareholder dispute action that was to be deposited into an escrow account held by the attorney's firm. The second matter was a judgment entered against the client for over one million dollars. Neither the client nor the attorney revealed to the party which held the million dollar judgment, the client instructed the lawyer to disburse the funds to third

United States Code Section 550(a)(1) claiming the attorney was the initial transferee.⁵⁴ Eventually, the bankruptcy court held that the attorney was the initial transferee and was liable to the trustee for the funds.

Some transfers that are intended to defeat creditors may be illegal, such as transfers intended to evade collection of taxes by the Internal Revenue Service, under Internal Revenue Code Sections 7206(4) and 7201.⁵⁵

Any person who (1) conceals a debtor's assets, (2) receives the debtor's assets fraudulently, or (3) transfers or conceals assets on behalf of a corporation intending to defeat the Bankruptcy Code will find himself, and possibly his lawyer, in prison for up to five years.⁵⁶ Take for instance *U.S. v. Smithson*,⁵⁷ in which the debtor and his lawyer were both convicted and served jail time for a transfer made two days before filing bankruptcy.

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

- (1) an agreement between two people;
- (2) a scheme to defraud the United States; and
- (3) an overt act committed in furtherance of the agreement.⁵⁸

An attorney was convicted of conspiring to transfer the assets of one corporation to another in contemplation of bankruptcy under both 18 U.S.C. Section 371 and Section 152.⁵⁹ There, the attorney counseled the client to transfer some of the corporation's inventory to another company and then auction off the rest of the company's assets. The attorney, Switzer, set up the transactions and prepared confessions of judgment for some favored creditors. The transaction took place prior to the judicial sale for the trustee in

parties which included the client's wife, father, and various other people. The attorney followed the client's instructions with the knowledge that there was this substantial judgment in place.

⁵⁴ § 550(a)(1) states: (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate the property transferred, or, if the court so orders, the value of such property, from--

1. The initial transferee of such transfer or the entity for whose benefit such transfer was made; and

2. Any immediate or mediate transferee of such initial transferee.

⁵⁵ Fines in the amounts of not more than \$100,000 (\$500,000 for corporations) and not more than 3 years in prison or both. See *U.S. v. Hook*, 781 F.2d 1166 (6th Cir. 1986), in which the court affirmed appellant's conviction under IRC Section 7201 for concealing assets from the IRS, by forming a corporation to hold stock and automobiles with his wife and daughter as the sole shareholders. He also conducted other transactions not in compliance with the Tax Code. In dicta, the court also discussed the effect of Section 7206(4), providing that any attempt to conceal assets after a tax assessment, notice and demand of payment, and refusal to pay is a felony under that statute. This case effectively states that some transfers and transactions intended to conceal assets for tax purposes prior to a tax deficiency assessment will be illegal under IRS Section 7201, and that any transfer or concealment of assets after an assessment will be illegal.

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

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

⁵⁸ 18 U.S.C. § 371 (2007).

⁵⁹ *U.S. v. Switzer*, 252 F.2d 139 (2nd Cir. 1958).

bankruptcy's benefit. The Switzer's conviction was upheld on appeal because he was found to have attempted, through his advice and participation in the transactions, to defeat the bankruptcy statutes, and thereby defraud the United States of the client's assets in bankruptcy.

When "mental intention" to avoid creditors cannot be proven by the testimony or admission of the debtor who allegedly committed a "fraudulent transfer" under Florida Statutes Sections 726, the above factors will be evaluated to determine whether the court can conclude that "fraudulent intent" existed.

PREFERENTIAL TRANSFERS

While most attorneys understand state law and Bankruptcy Code fraudulent transfer rules, many attorneys are not conversant with the code's preferential transfer provisions. Transfers made by a debtor to an "insider" within one year of filing a bankruptcy may be set aside, notwithstanding whether the transfer would be considered a "fraudulent transfer" under fraudulent transfer rules.⁶⁰ Also, preferential transfers made to any party within one year (if an insider) or 90 days (if not an insider) of the filing of a bankruptcy petition can be set aside as well.⁶¹ Reasonable compensation paid for services actually rendered will not be considered to be a preferential transfer,⁶² but dividends paid by a professional practice corporation to its owner or member can be considered a preferential transfer. In addition, repayment of shareholder loans may be set aside as a preference.

This is discussed in more detail in Section H of this chapter.

A case that deals with this insider creditor issue in circumstances where a debtor is making payment to a creditor that is guaranteed by an insider is *In re Halling*, 449 B.R. 911 (2011). Here, the debtor's son was a guarantor on a loan that was owed by his mother. The mother made regular payments to the bank for this loan, and eventually filed for bankruptcy. The trustee sought to avoid the transfers as preferential, stating that the son was an insider creditor and that transfers made up to one year before bankruptcy were avoidable. The Court stated that guarantors are creditors within the bankruptcy code. The payments to the bank benefitted the son because each payment reduced his liability to the bank. Thus, the Court allowed the trustee to recover the amounts transferred as legitimate loan payments **from the son** because the preference claims against non-insiders (the bank in this case) are limited to transfers made within 90 days. Transfers made more than 90 days before the filing of bankruptcy cannot be recouped from creditors who are not insiders in this situation. Thus, for transfers between 90 days and one year, the trustee can only get transfers to inside creditors (in this case the son).

DISTRIBUTIONS FROM "INSOLVENT" ENTITIES

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

⁶⁰ 11 U.S.C. § 547(b)(4)(B)(2007).

⁶¹ 11 U.S.C. § 547(b)(4)(A)(2007).

⁶² *In re Double Eagle Const. Co.*, 188 B.R. 406 (Bankr. D.W. Mo. 1995).

Attorneys need to consider state laws concerning distributions made from a company under circumstances in which sufficient reserves have not been set aside to pay known or expected creditors. The board of directors of a company allowing such distributions can become liable to a creditor. The liability of the directors would be based upon the amount of monies or other assets that should have been left in the company as opposed to being paid out. For example, Florida Statutes Section 607.0640(3), no distributions to shareholders may be made, if after such distribution

- (a) the corporation would not be able to pay its debts as they become due in the usual course of business; or
- (b) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

If the distribution falls within the bounds of either of the above definitions, then the distribution is characterized as a wrongful distribution. The director's personal liability is addressed by Florida Statutes Section 607.0834, which places personal liability on any director who votes affirmatively for such a distribution.

The director is personally liable for the amount of the distribution that exceeds what could have been distributed without violating Section 607.06401 or the articles of incorporation if it is established that the director did not perform his or her duties as required by Section 607.0830 (good faith; reasonable, prudent person standard; in the best interest of the corporation).

Additionally, subsection (2) states that a director held liable under subsection (1) is entitled to contribution from each shareholder for the amount that such shareholder accepted knowing the distribution was made in violation of Section 670.06401.

Further, the director is entitled to contribution from every other director who could be liable under subsection (1) for the unlawful distribution. For example, if there were two director shareholders who split the initial \$150,000 distribution, then they could each be held to be jointly and severally responsible for the entire \$150,000.

WAGE STATUTE INTERACTION

Some states allow for exemption of wages and even deferred compensation from creditor claims. The 2005 revisions to the Bankruptcy Code provide that a Trustee may void a transfer of property or an obligation (including any "transfer to or for the benefit of an insider under an Employment Agreement") if made within two years before filing, as a fraudulent conveyance or a preferential transfer for less than adequate consideration.

It is therefore important to be able to document that any compensation was actually owed when wages are paid to related parties or "insiders" if a company may become insolvent.

10-YEAR RULE FOR ASSET PROTECTION TRUSTS AND SIMILAR ARRANGEMENTS

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

The 2005 revisions to the Bankruptcy Code make transfers to self-settled trusts or similar devices subject to being set aside in bankruptcy when made within 10 years of filing. A self-settled trust is a trust established by an individual that allows for the trust assets to be held for the possible benefit of that individual. This 10-year set aside statute applies if the transfer was made with the “actual intent” to hinder, delay or defraud present or future creditors.⁶³

The 10-year rule should not apply if the debtor forms an offshore trust for the benefit of the debtor’s family, and not for the debtor himself. “Substantial de facto control,” however, has been found to be sufficient for a court to find that the trust should be disregarded for creditor protection purposes.⁶⁴

New Bankruptcy Code Section 548(e)(1) applies to both domestic and offshore asset protection trusts. Time will tell whether asset protection trusts that have been funded for more than 10 years before the filing of bankruptcy will be better respected than they have been in the past by bankruptcy courts.

As discussed above, several bankruptcy court decisions have concluded that offshore asset protection trusts are either invalid, or that the debtors involved with offshore asset protection trusts can be jailed on contempt.

Nevertheless, informal reports of favorable settlements reached by debtors whose creditors would apparently prefer not to “go the distance” to obtain offshore trust assets have been reported. Further, there is no case known to the authors where the assets of an offshore asset protection trust have been involuntarily obtained by a creditor.

ANNUITIES AND LIFE INSURANCE

Some states offer unlimited protection of life insurance and the cash values of annuity contracts. Some states only protect certain financial products if and to the extent that they are reasonably necessary for the support and/or retirement of a debtor. The life insurance, annuity, and offshore financial service industries have come to market with mutual fund wrapped products that provide income tax deferral and creditor protection for policyholders and their families.

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

⁶³ 11 U.S.C. § 548(a)(1)(2007).

⁶⁴ See Steve Leimberg’s Asset Protection Planning Newsletter #70 (September 12, 2005) at www.leimbergservices.com, which discusses *Federal Trade Commission v. Ameridebt*, 373 F. Supp.2d 558(D. MD. 2005) in which the debtor, under FTC investigation, transferred nearly \$24 million to offshore trusts and used other money to pay for lavish expenses.

The only case that has considered this question is *In re Porco, Inc.* which is a March 30, 2011 Bankruptcy Court decision that held that Congress only intended to capture “a similar device [to an asset protection trust] that had the same effects as a self-settled trust, and that only an express trust was within that definition.” The court stated that the purpose of the Bankruptcy Code Section 458(c) was to thwart the protection of “domestic asset protection trust jurisdiction.” In this case a debtor company was entitled to receive real estate from a third party by contract, and instead allowed the real estate to go to a separate company owned by the same shareholder.

At one point in the legislative process this asset protection trust 10-year set aside provision was proposed to specifically exclude qualified retirement plans. Does this mean that the legislative intent was to specifically include many financial products that would be similar to qualified retirement plans, such as cash value life insurance and annuities? Is the language “self-settled trust or similar device” broad enough to include annuity and life insurance arrangements where money is given to a life insurance company that invests it and makes cash available at a later time, subject to state or foreign jurisdiction creditor protection laws and arrangements?⁶⁵

HOMESTEAD EXEMPTION

The “mansion loophole closing” provisions of the 2005 revisions to the Bankruptcy Code reduced the protected homestead equity value to as low as \$170,350 if one of three exception provisions applies:

- (1) The entire value of homestead property will not be protected where its value has been increased by a disposition of non-exempt property made by the debtor during the 10 years prior to filing bankruptcy with the intent of hindering, delaying, or defrauding creditors.⁶⁶

The reduction is based upon the value of the homestead resulting from such “fraudulent transfers.” The courts must determine how to apportion appreciation in the value of a homestead that occurs after the “fraudulent conversion” has occurred.

- (2) A debtor cannot exempt any amount of homestead property worth in excess of \$170,350 that is acquired during the 1,215 days (three years and four months) before the bankruptcy filing.⁶⁷

This was originally \$125,000, but under the legislation it was adjusted to \$170,350 in 2019, and will adjust with the Consumer Price Index each three years thereafter pursuant to U.S.C. § 104(b).

⁶⁵ See 11 U.S.C. § 548(e)(2007); *See also* Alan S. Gassman, Steven Holub, and Jeffrey M. Gad, Steve Leimberg’s Estate Planning Newsletter, No. 485.

⁶⁶ 11 U.S.C. § 522(o)(2007).

⁶⁷ 11 U.S.C. § 522(p)(2007); *but see* Steve Leimberg’s Employee Benefits and Retirement Planning Newsletter #75 (Dec. 9, 2005) at www.leimbergservices.com, which discussed *In re Blair*, No. 05-35922-HDH-7 (Bankr. Ct. N.D. Texas) in which an increase in the value of a debtor’s homestead (increase of value of over \$136,875 in 12-day period) was not subject to the \$136,875 cap; however, the article cautioned that *irregular* payments of a mortgage may not be disregarded.

This is not an intent-based provision, but applies automatically when a person does not have the requisite time period to qualify for protection.

As an exception to this \$170,350 cap, money derived from the sale of a prior residence can be applied to facilitate the purchase of a replacement property if certain requirements are met. Where the new homestead costs significantly more than the prior homestead, the amount of homestead protection is limited to \$170,350 plus the proceeds from the sale of the prior residence used to purchase the new residence.

Several issues will arise with respect to how to handle appreciation, depreciation, and amortization of mortgage indebtedness in the context of successor homes.

In a post-BAPCPA case decided in October of 2005, *In re Charles H. Wayrynen*, a debtor who had not lived in Florida 1,215 days filed bankruptcy with a homestead and was found not to be subject to the then applicable \$136,875 cap, which in 2019 is \$170,350.⁶⁸ The court found that the statute would only apply where the debtor elects to use state exemptions, and Floridians are *required* to use the state exemptions, and have no elective choice between the federal and state exemptions.

Whoever drafted the statute must have assumed that all debtors have the opportunity to elect to use the federal exemptions or the state exemptions, not realizing that in Florida the debtors are required to use the state exemptions. Congress' obvious intent was to limit the Homestead Exemption to \$170,350 for debtors who choose to flee to debtor-friendly Homestead Exemption states, the most notable being Florida and Texas, unless the debtor resides in the Homestead protection state for at least 1,215 days before filing.⁶⁹

At least three courts have found that the clear intent of the statute overrides the literal reading, and have enforced the 1,215-day rule in states, such as Florida and Nevada, that allow debtor's to "opt out" of the federal exemptions in favor of using the state exemptions.⁷⁰

- (3) The homestead exemption can be limited to an absolute cap of \$170,350, where the debtor is convicted of a felony, which evidences that the filing of the bankruptcy was abusive (perhaps the rationale here is that the debtor will not need a house if he is going to jail).⁷¹

⁶⁸ *In re Charles H. Wayrynen*, 2005 WL 2756059 (Bankr. S.D. Fla. 2005).

⁶⁹ Some states may offer unlimited protection like Florida, Texas, Kansas and Iowa while other states provide protection well below the federal limit like Arkansas, which only offers \$2,500 as a state homestead exemption protection.

⁷⁰ See Steve Leimberg's Asset Protection Planning Newsletter #74 (Nov. 17, 2005) at www.leimbergservices.com, which discussed *In re Virissimo* and *In re Heisel*, Chapter 7, Case Nos. BK-s 13605-LBR and BK-S-05-15667-LBR, a decision by U.S. Bankruptcy Judge Linda B. Riegle which resolved both *In re Robert* and *Virissimo* and *In re Cheryl Heisel*. The court applied the federal \$136,875 cap to debtors in Nevada which provides a \$200,000 cap on homestead and \$350,000 effective July 1, 2005; see also *In re Kaplan*, 331 B.R. 483 (S.D. Fla. 2005) which applied the federal \$136,875 to a Florida (a state that requires state exemptions and does not allow debtors to choose between state or federal exemptions) debtor and stated, "[d]etermining whether the homestead caps apply in Florida should not be in dispute and should not distract us further. This Court sincerely hopes that there will be uniformity amongst the Florida judges in finding, as this Court does with certainty, that the limitations in Bankruptcy Code Section 522(p) and (q) apply to debtors claiming exemptions under Florida law."

⁷¹ 11 U.S.C. § 522(q) (2010).

The homestead protection is limited to \$170,350 where the debt involved arises from the violation of federal or state securities laws, fiduciary fraud violations of RICO, intentional torts or willful or reckless conduct resulting in serious physical injury or death in the preceding five years.⁷² Doubtlessly, there will be more suits filed against doctors alleging willful and reckless conduct in malpractice actions. However, since negligence is not tantamount to an intentional tort, the doctor's liability should be dischargeable in bankruptcy.

The Section 522(q)(1) reduction to \$170,350 will not apply to the extent that the homestead property is reasonably necessary for the support of the debtor and any dependent of the debtor.⁷³ How much of a home will debtors be found to need?

- a. In *In re Rasmussen*,⁷⁴ the Bankruptcy Court in the Middle District of Florida ruled that two spouses could stack their state law homestead exemptions together, creating \$250,000 of coverage for their home. The court cited Section 522(m), which applies Section 522 separately to individuals filing joint bankruptcy cases. The court went on to analogize the homestead exemption to other exemptions married bankrupts may file together, such as \$2,000 total for automobile exemptions and \$2,000 total for personal property exemptions.
- b. The homestead of a married debtor residing in a tenants by the entirety state may be protected, if the homestead is owned as tenants by the entirety, thus, circumventing the exceptions to homestead protection described above.
- c. The home to be protected does not appear to be required to be actually occupied as a *principal* residence for the 1,215 days.⁷⁵ Many individuals will therefore be advised to acquire a second home in a homestead protective state such as Florida or Texas to start the 1,215-day period, and then to move to such state 730 days before filing a bankruptcy.
- d. A debtor can lose his or her house if he or she loses the discharge. Paying one's mortgage down with non-exempt monies can be detrimental where the payment causes the debtor to lose his bankruptcy discharge. In the case of *In re Chauncey*, a pre-BAPCPA case, the United States District Court affirmed the Bankruptcy Court's opinion where the debtor filed bankruptcy within one year from having a personal injury settlement applied to pay down her mortgage.⁷⁶

Because the personal injury settlement was non-exempt money, the Bankruptcy Court denied the discharge. Moreover, the Bankruptcy Court imposed an equitable lien upon Mrs. Chauncey's home in order to allow the creditor to recover the monies that were secreted into the home from the personal injury settlement.

⁷² 11 U.S.C. § 522(q)(1)(2010).

⁷³ 11 U.S.C. § 522(q)(2)(2010).

⁷⁴ 349 B.R. 747 (M.D. Fla. 2006).

⁷⁵ 11 U.S.C. § 522(p)(2007).

⁷⁶ *In re Chauncey*, 2005 WL 2456223 (S.D. Fla. 2005).

- e. Fear and loathing in Florida – A married physician owning a joint mortgaged house and individual exposed assets meets a potential judgment creditor. Assume that a married physician has cash or similar liquid assets exposed to creditor claims *and* a serious malpractice action against her.

The Florida Supreme Court has held that a fraudulent transfer into a homestead owned by her would not be susceptible to the Florida Fraudulent Transfer Statute.⁷⁷ This means that a creditor would not be able to force her to sell the home if it is her legitimate homestead when the creditor attempts to collect upon a judgment.

A “transfer into homestead” can include buying a new home, paying to improve a home, or paying down a mortgage on a home.⁷⁸

The creditor might attempt to force the doctor into bankruptcy. If the doctor has 12 legitimate creditors, which could include “material” credit card debts and/or other individual (including joint) indebtedness, then it would take three creditors to force her into bankruptcy. One issue is if the doctor is not eligible to file, then can the involuntary petition stick?⁷⁹ For instance, a possible argument is that in order to qualify as a debtor, the debtor must pass a “means test.” If the debtor is not eligible, then the involuntary petition should be dismissed.

If the doctor is forced into bankruptcy with her “fraudulently acquired” home then under the Bankruptcy Code she loses the homestead protection (exemption) to the extent of the value of the homestead attributable to such fraudulent transfers⁸⁰ (but there will be at least \$170,350 of protection notwithstanding).⁸¹

The transfer into the homestead may not actually be a fraudulent transfer under the Bankruptcy Code. For example, if the doctor buys the home because she wants to have a larger home for her family, and at the time she buys the house it is the opinion of reputable legal counsel that the lawsuit is nothing to worry about because she has enough malpractice insurance and other assets set aside to cover any likely potential verdict, then the creditor may not be able to satisfy its burden of showing that the homestead transfer was subject to the fraudulent transfer rules.

How about if the doctor transfers her cash into a jointly owned homestead, either by simply purchasing a joint homestead, or improving or paying down the mortgage on a jointly owned homestead.

⁷⁷ *Havoco of America, LTD. v. Hill*, 790 So.2d 1018 (Fla. 2001).

⁷⁸ Fla. Stat. § 193.155(4)(2007).

⁷⁹ See 11 U.S.C. § 303(b)(2)(2007) indicating that a debtor must have at least 12 legitimate creditors before filing a voluntary petition.

⁸⁰ Fla. Stat. § 222.29 (2007).

⁸¹ 11 U.S.C. § 522(p)(2007).

Using this approach, the doctor could later file bankruptcy and would not have to “take the homestead exemption” in bankruptcy because her Florida jointly owned property can qualify under the “tenancy by the entireties” exception. Therefore, the Bankruptcy Code 10-year look back for fraudulent transfers into a homestead would not apply, because the exemption in bankruptcy would be based upon tenancy by the entireties, and not homestead.

A possible problem here is that the transfer of monies by the debtor into a *joint homestead* could be considered a fraudulent transfer of one half of those monies to the husband under the BAPCPA. While the Florida Fraudulent Transfer Rules are trumped by the state law homestead exemption, if the doctor is forced into bankruptcy, it is possible that the Bankruptcy Court’s ability to pursue the “transferee of a fraudulent transfer” could result in the husband being pursued for one-half (1/2) of the amounts transferred.

If the husband has no other significant assets, then this may not be a problem. Even if there is a judgment against the husband for having received a fraudulent transfer, the creditor will not be able to attach the husband’s homestead under Florida law, unless the husband could then be forced into bankruptcy and then be subject to the 10-year look back rule. If the husband has other assets that would be subject to creditor claims in bankruptcy, then this alternative of transferring assets into a joint homestead, as opposed to moving such assets into a solely held homestead, may not be advantageous.

What about if the doctor uses her money to buy out her husband’s half of the homestead? If the wife has \$500,000 in cash and the jointly owned home has \$1,000,000 in equity, she can transfer the \$500,000 in cash to her husband in exchange for 100% ownership of the home. In effect she has purchased the husband’s ownership in the home.

The question becomes whether the husband has then received \$500,000 as a fraudulent transfer that could be set aside under the fraudulent transfer rules?

When the debtor (doctor) has transferred assets as “good and valuable consideration” in exchange for 100% ownership in a homestead, then the creditor is going to have a more difficult burden to satisfy, because under the fraudulent transfer rules a “fraudulent transfer” made for “adequate consideration” can only be set aside if it can be proven that the transfer was made with actual intent to “hinder, delay, or defraud” a creditor.⁸²

⁸² Fla. Stat. § 726.105(1) (2007). *See also* Fla. Stat. § 726.105(2) and the Bankruptcy Code for factors used in determining whether there exists actual intent to hinder, delay, or defraud with respect to fraudulent transfers, which include the following: (a) whether the transfer was to an insider, (b) whether the debtor retained control over the transferred property, (c) whether the transfer was concealed, (d) whether the debtor was involved or threatened by a suit prior to, or at the time of, the transfer, (e) how much of the debtor’s assets were transferred, (f) whether the debtor absconded, (g) whether the debtor concealed assets, (h) the value of the property received in exchange for the property transferred, (i) whether the debtor was insolvent at the time of, or shortly after, the transfer, (j) the timing of the transfer in relation to the incurrence of a substantial debt by the debtor, and (k) whether the debtor transferred essential business assets to a lienor, who then transferred the assets to an insider.

If a transfer is not made for valuable consideration, then the creditors have a lower burden in establishing that the “fraudulent transfer statute” applies. Under such circumstances (where there is not adequate consideration for the transfer) the fraudulent transfer statutes allow for the transfer to be set aside under circumstances defined in the statute.⁸³

Thus, if a physician senses impending insolvency she may be wise to buy her spouse’s half of the homestead property and have him hold the cash in a separate account, portfolio, or other liquid form. If the transfer is deemed “fraudulent” the spouse can return the money to the doctor’s creditor without penalty, none-the-worse for having tried. If the transfer is not deemed “fraudulent” the physician has in effect saved a substantial asset by keeping it in the family.

Another situation to consider is where the creditor, knowing that he or she may be going into bankruptcy, gives the monies to a close friend who puts them into a homestead and then intends to hunker down and remain judgment proof, and outside of bankruptcy, so that the creditor is not able to recover the funds, and the debtor is able to live with the close friend and enjoy the benefit of the home. Will this boat float? This exact fact pattern occurred in *In re Bifani*,⁸⁴ where the debtor transferred property to his significant other before filing bankruptcy. The significant other sold the property and used the proceeds to purchase a homestead for herself in Florida. The court held that a fraudulent transfer, directly or indirectly, to the debtor’s cohabiting and apparent significant other (Arlene LaMarca) before filing bankruptcy rose to the level of being considered a secretion of “ill-gotten gains” under Florida law, which would have otherwise not permitted any creditor to pursue the property, stating specifically that:

Here, LaMarca’s Sarasota house was acquired with ill-gotten proceeds. LaMarca used the nearly \$670,000 from the sale of the Golden Eagle Road property to purchase her Sarasota house. It would be inequitable and unjust to allow the Debtor (Bifani) to fraudulently transfer property to LaMarca to keep it from his creditors.⁸⁵

This decision was overturned by the Federal Court in Tampa, but then upheld by the Eleventh Circuit Court of Appeals, which indicated as follows:

Under Florida law, homestead property purchased with funds obtained by fraud is not exempted from equitable liens.⁸⁶ The facts of this case do not fall within *Havoco*’s exception because the funds used to purchase the Sarasota property were obtained through Bifani’s fraudulent transfers....That the fraud occurred in a bankruptcy proceeding rather than a criminal offense is irrelevant.⁸⁷

STAYING OUT OF BANKRUPTCY

⁸³ See 11 U.S.C. § 548(a)(1) (2007).

⁸⁴ *In re Bifani*, 493 B.R. 866, 871 (Bankr. M.D. Fla. 2013).

⁸⁵ *Id.*

⁸⁶ See *Havoco*, 790 So.2d at 1028.

⁸⁷ *In re Bifani*, 580 F. Appx. 740, 747 (11th Cir. 2014).

Sometimes creditors will force a debtor into bankruptcy in order to have the advantage and oversight of federal bankruptcy law. This may occur in particular where Florida homestead law would otherwise protect a recently acquired homestead, or a creditor wishes to have applicable bankruptcy law and Bankruptcy Court oversight apply. Many debtors will want to stay out of bankruptcy for the same reasons, and oftentimes this occurs when a debtor has purchased a homestead in Florida, where state law will not apply the fraudulent transfer statute to divest the debtor of homestead, although bankruptcy law would. This is also further discussed within the following article that will be of interest to those who advise debtors who need to stay out of bankruptcy.

Filing an involuntary petition is an aggressive creditor strategy and there are serious and costly consequences if the petition is dismissed. A creditor who files for an involuntary bankruptcy “in bad faith” can be forced to pay the debtor’s fees, costs and actual and punitive damages.⁸⁸ In *In re Cannon Express Corporation*,⁸⁹ the U.S. Bankruptcy Court for the Western District of Arkansas awarded compensatory and punitive damages where three creditors filed involuntary bankruptcy proceedings against the debtor and the court found the creditors to be acting in bad faith.

The decision was based on a combination of five tests identified in *In re Landmark Distributors, Inc.*⁹⁰ The *Cannon* court combined⁹¹ and restated the tests, finding that:

- J. The claims were not well grounded in fact because the creditors did not speak with an attorney, talk to other creditors or attempt to collect the money from the debtor directly;
- K. The creditors could have advanced their own interests in a different forum by using a collections agency or setting up a payment system with the debtor or other forum, instead holding that using bankruptcy courts is a proper use of judicial resources;
- L. The creditors used the bankruptcy proceedings to gain a disproportionate advantage over other creditors because the creditors testified that they thought filing involuntary bankruptcy proceedings would put them ahead of the other creditors, thus gaining priority; and
- M. The creditors were motivated, the court held, by an improper use because the creditor “knew that he was not going to be paid” but thought filing would force the debtor to make payment. Finally, the court held that no other reasonable person would have filed the same or similar claim without first investigating whether or not the debtor was paying its debts on time, or first attempting to collect the debts in some other fashion.

⁸⁸ 11 U.S.C. § 303(l) (2017).

⁸⁹ 280 B.R. 450 (Bankr. D.W. Ark. 2002).

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

⁹¹ Those five tests are: (1) the improper use test which finds bad faith if a creditor files involuntary bankruptcy to gain a disproportionate advantage for himself over other creditors; (2) the improper purpose test which finds bad faith if a creditor’s motivation for filing is ill will, malice or harassment; (3) the objective test which asks if a reasonable person would have also filed an involuntary bankruptcy; (4) the subjective test which looks at the subjective motivation of the creditor (almost identical to the improper purpose test); and (5) the two part test which combines the subjective and objective tests. *Cannon* at 453.

The court awarded \$14,000 in compensatory damages and \$35,000 in total punitive damages. Had the debtor proven losses in sales by a preponderance of the evidence, the court would have awarded these damages as well, which were to be \$2,768,288 according to the debtor.

In re Adell, 321 B.R. 561 (Bankr. D. Fla. 2005) is another good example of an involuntary bankruptcy filing that backfired on the petitioning creditor and resulted in the petitioning creditor becoming a debtor in bankruptcy! In *Adell*, a bankruptcy court in Michigan dismissed an involuntary petition which was filed by Mr. Adell against his former builder. The Court awarded sanctions in the amount of \$6,413,230.68 against Adell. Adell then quickly moved to Naples, Florida and filed a Chapter 11 bankruptcy petition. Substantial litigation ensued resulting in the conversion of the Chapter 11 case to a Chapter 7, and ultimately the dismissal of the Chapter 7 case for substantial abuse. The court discussed that the damages awarded in the Michigan case constituted sanctions for a bad faith filing, and were therefore warranted pursuant to 11 U.S.C. § 303(i) of the Bankruptcy Code.

An article published by Alan Gassman and Lydia Greiner on the question of what creditors can count towards the 12 needed to avoid an involuntary bankruptcy is as follows:

BAKER'S DOZEN: NO CUPCAKES FOR THE UNIFORMED DEBTOR

by Alan Gassman and Lydia Greiner

**I had 12 cupcakes and 3 ex-friends
When we get together, the fun never ends.**

Many debtors prefer to stay out of bankruptcy for a number of good reasons;⁹² however, under Section 303 of the Bankruptcy Code, a debtor can be forced into bankruptcy through an involuntary proceeding. It is well established under Bankruptcy Code Section 303 that it takes three qualified creditors to force a debtor into bankruptcy if the debtor has twelve or more creditors with undisputed claims that together exceed a statutorily established amount.

In determining which creditor (or three, if there are twelve or more) can force a debtor into involuntary bankruptcy, the court will evaluate the creditor's claims and whether they are non-contingent as to liability and amount **and** whether the claims are undisputed.⁹³ Additionally, for a proceeding under 11 U.S.C. § 303(b)(1), the court will need to determine whether the undisputed, non-contingent claims have an aggregate value of \$15,775⁹⁴ "*more than the value of any lien on property of the debtor securing such claims held by the holders of such claims.*"⁹⁵

⁹² Often, the primary reason is to avoid losing a homestead protected under state law but not under the 2015 Bankruptcy Act 10-Year Look-Back for Fraudulent Transfers or the 1,215 day ownership requirement, or the 730-day residency requirement. Also, a bankruptcy discharge right will be lost forever if a bankruptcy action is filed within one year of making a fraudulent transfer.

⁹³ 11 U.S.C. § 303(b)(1-2).

⁹⁴ The aggregate amount required for claims is statutorily provided and is periodically adjusted to compensate for inflation: \$15,775 is the amount required for filings as of 2020.

⁹⁵ 11 U.S.C. § 303(b)(1).

If there are **fewer** than 12 creditors, 11 U.S.C. § 303(b)(2) will apply. However, creditors proceeding under Section 303(b)(2) are still subject to some statutory requirements. The aggregate amount of the creditors' claims, for example, must be \$15,325 or more.⁹⁶ Additionally, certain types of creditors, **insiders**, are not eligible to initiate the proceeding.⁹⁷ Unlike Section 303(b)(1), there is no additional requirement under Section 303(b)(2) that the creditor's aggregate claims exceed the value of any lien on the debtor's property securing the claims by the statutorily prescribed \$16,750.⁹⁸

Confusion arises when trying to determine what is an eligible creditor that may be counted as one of the twelve required in a Section 303(b)(1) proceeding. Whether a creditor is eligible to file for involuntary bankruptcy depends on their claim(s) against the debtor.

Although "creditor" only has one definition in these types of proceedings,⁹⁹ the type of creditor qualified to file for involuntary bankruptcy *may* differ from those counted in determining whether the debtor has a sufficient number of holders to initiate a Section 303(b)(1). Unfortunately for debtors, the definition of "creditor" under Section 303 is not as broad as the common law definition, and there have been a significant number of inconsistent court cases.

Courts have reached different conclusions in deciding who is eligible¹⁰⁰ to count toward the required 12 or more creditors. While some illegitimate creditors may easily be identified and discounted, others require the court to examine factors related to the creditor's claim and the relationship between the debtor and creditor. These inconsistencies result in difficulty and confusion when trying to identify eligible creditors.

The primary categories of creditors that will be eliminated in determining if the 12 creditor requirement is met under a Section 303(b)(1) proceeding are as follows:

1. Creditors whose claims are contingent or not finally determined.
2. Creditors whose claims are adequately secured by collateral worth as much or more than is owed.
3. Creditors who are "insiders."
4. Creditors who owe the debtor more than the debtor owes the creditors.
5. Creditors who owe so little that the debt will not be considered to be "real."
6. Creditors who are considered to be an alter ego of the debtor.

**Don't share cupcakes with insiders.
They aren't known to be providers.
You'll end up with just a wrapper,
And not feeling so dapper.**

⁹⁶ 11 U.S.C. § 303(b)(2).

⁹⁷ 11 U.S.C. § 303(b)(2).

⁹⁸ 11 U.S.C. § 303(b)(2).

⁹⁹ 11 U.S.C. § 101(10)(A-C). Creditor is defined under the Federal Bankruptcy Statute as the "entity that has a claim against the debtor that arose at the time of or before the order of relief concerning the debtor," or an "entity that has a community claim."

¹⁰⁰ In addition to the statutory requirements that their claims be qualified (undisputed and non-contingent.)

In determining the number of legitimate creditors who may trigger involuntary bankruptcy, insiders are a large group of creditors that include different individuals or entities depending on who the debtor is – a natural person, a fictitious entity, or a municipality.¹⁰¹ Although an insider is not among the creditors who are counted when determining whether the debtor has a sufficient number of creditors to trigger involuntary bankruptcy under 11 U.S.C. § 303(b)(1), they are not barred from pursuing claims against the debtor if a proceeding is initiated.¹⁰² Insiders in an involuntary bankruptcy context include:

- (A) If the debtor is an individual --
 - i. Relative of the debtor or of a general partner of the debtor;
 - ii. Partnership in which the debtor is a general partner;
 - ii. General partner of the debtor; or
 - iv. Corporation of which the debtor is a director, officer, or person in control.
- (B) If the debtor is a corporation –
 - i. Director of the debtor;
 - ii. Officer of the debtor;
 - iii. Person in control of the debtor;
 - iv. Partnership in which the debtor is a general partner;
 - v. General partner of the debtor; or
 - vi. Relative of a general partner, director, officer, or person in control of the debtor.
- (C) If the debtor is a partnership –
 - i. General partner in the debtor;
 - ii. Relative of a general partner in, general partner of, or person in control of the debtor;
 - iii. Partnership in which the debtor is a general partner;
 - iv. General partner of the debtor; or
 - v. Person in control of the debtor.
- (D) If the debtor is a municipality, elected official of the debtor, or relative of an elective official of the debtor.
- (E) Affiliate or inside of an affiliate as if such affiliate were the debtor.
- (F) Managing agent of the debtor.¹⁰³

Additionally, the requirement of “generally not paying such debtor’s debts” may resonate differently with different courts depending on where the creditors filed for the involuntary bankruptcy action. Courts will use a totality of the circumstances test and balance the interests of the parties in determining whether a creditor pursuing an involuntary bankruptcy action should be dismissed. A few factors that most courts examine include: the number of unpaid claims; the amount of the claims; the materiality of the non-payments; and the debtor’s conduct in financial affairs.

¹⁰¹ 11 U.S.C. § 101(31).

¹⁰² 11 U.S.C. § 303(b)(2); see also *In re Little Bldgs, Inc.*, 49 B.R., 889 (Bankr. N.D. Ohio, 1985).

¹⁰³ 11 U.S.C. § 101(31)(A-F).

Further, the court in *In re The District of McAllen* found that ad valorem tax authorities, insiders, persons that owe more money than they are owed, and lease deposits that are contingent do not count to make creditors eligible to join an involuntary bankruptcy action, while de minimis claims do count.¹⁰⁴

There have been many notable decisions, including one by the U.S. Court of Appeals for the Fifth Circuit in *Denham v. Shellman Grain Elevator*,¹⁰⁵ where the bankruptcy court refused to count small and recurring claims as “countable” under the 12 creditors’ requirement. One Florida bankruptcy case, *In re Smith*, cited *Denham* and excluded creditors holding de minimis claims of up to \$275.¹⁰⁶ Other cases have permitted claims of \$65 and \$10 to be countable under the Section 303 requirement that the aggregate claims must equal or exceed \$12,300.

Courts that have chosen not to follow *Denham*, and to instead allow small and recurring claims to count, have dismissed the de minimis exception based upon the premise that Congress has not explicitly ruled out small and/or recurring debt, so the statute¹⁰⁷ should be applied literally.¹⁰⁸ Some courts, however, such as the court in *Matter of Runyan* have indicated that a \$25 debt would not be sufficient, and will evaluate the claims on a case-by-case basis.¹⁰⁹

While there is no bright line rule to determine which creditors are “legitimate creditors,” in every situation involving an involuntary bankruptcy proceeding, the table below may help to provide some general guidelines.

**I like cupcakes,
And I eat quite a few,
But every so often,
Instead I get a screw.**

¹⁰⁴ *In re District of McAllen LP*, 14-70661, 2015 WL 4116862 (Bankr. S.D. Tex. July 7, 2015).

¹⁰⁵ *Denham v. Shellman Grain Elevator*, 444 F.2d 1376 (5th Cir. 1971), the debtor listed 18 creditors with an aggregate indebtedness of only \$467.13, all but one of whom were owed less than \$100, to defeat an involuntary petition for bankruptcy filed by one of *Denham*’s very large creditors. The court found that all of the debts were open and unliquidated as opposed to claims reduced to judgments, and that small recurring debts cannot qualify creditors to be counted toward the necessary amount required to initiate a petition.

¹⁰⁶ See *In re Smith*, 123 B.R. 423 (M.D. Fla. 1990).

¹⁰⁷ 11 U.S.C. § 303(b)(2) (2017).

¹⁰⁸ See *In re Okamoto*, 491 F.2d 496 (7th Cir. 1974) which allowed eight debts, all of which were below \$65 each, to count toward the 12 creditor threshold and stated that most courts abandon *Denham* because *Denham* refused to acknowledge Congressional intent by specifically differentiating between large and small debts and removing a prior provision excluding debts below \$50; See *Matter of Rassi*, 701 F.2d 627 (7th Cir. 1983) which prevented the petitioner from forcing the debtor into an involuntary bankruptcy by allowing two claims, both \$10 or less; See also 11 U.S.C. § 548(e); See also Steve Leimberg’s Estate Planning Newsletter Number 485 by Alan S. Gassman.

¹⁰⁹ *Matter of Runyan*, 832 F.2d 58 (Tex. Court App. 1987).

Who is a Legitimate Creditor in an Involuntary Bankruptcy Proceeding under 11 U.S.C. § 303			
Factor or Type of Claim	Legitimate Claim?	Law	Cupcake?
Contingent claims	No	Statute: 11 U.S.C. § 303	
Subject to a bonafide dispute as to liability	No	Statute: 11 U.S.C. § 303	
Subject to a bonafide dispute as to amount	No	Statute: 11 U.S.C. § 303	
Held by insiders of the debtor* (See definition from statute above)	No	11 U.S.C. § 303	
Debtor's debt has an aggregate value less than \$15,325	No	11 U.S.C. § 303	
Employee	No	11 U.S.C. § 303(b)(2)	
Former Employee	Yes	<i>In re Demirco Group</i> , 343 B.R. 898 (B.C. C.D. Ill., 2006).	
Transferee of a voidable transfer	No	11 U.S.C. § 303(b)(2)	

Who is a Legitimate Creditor in an Involuntary Bankruptcy Proceeding under 11 U.S.C. § 303			
An indentured trustee representing a holder	No	11 U.S.C. § 303	
Creditor to whom debtor's debt is not yet due**	No	<i>Atlas Machine & Iron Works, Inc. v. Bethlehem Steel Corp.</i> , 986 F.2d 709 (VA Ct. App. 4, 1993).	
Lenders who make loans to debtor without formal loan documentation paperwork	No	<i>In re Smith</i> , 415 B.R. 222 (BC ND Tex, 2009).	
Debtor's Accountant	Yes	<i>In re Blaine Richards & Co.</i> , 10 B.R. 424 (B.C. E.D. NY, 1981).	
Debt for gasoline when purchased using a credit card	No	<i>In re Blaine Richards & Co.</i> , 10 B.R. 424 (B.C. E.D. NY, 1981).	
Small recurring or de minimis claims	Yes	11 U.S.C. § 303; <i>In re Elsa Designs, Ltd.</i> , 155 B.R. 859 (B.C. S.D. NY, 1993).	

***Insiders are not prohibited from filing a claim against the debtor; they are only excluded from consideration in determining debtor's legitimate creditors.¹¹⁰**

**** A creditor who is paid on time is unable to bring a claim against the debtor, and, thus, the claim would be subject to dispute.¹¹¹**

¹¹⁰ See *In re Little Bldgs, Inc.*, 49 B.R. 889 (Bankr. N.D. Ohio. 1985).

¹¹¹ See *Atlas Machine & Iron Works, Inc. v. Bethlehem Steel Corp.*, 986 F. 2d 709 (VA Ct. App. 4th Cir. 1993).

BANKRUPTCY PREVENTION PROVISION FOR STATUTORY ENTITIES.

Sometimes lenders will put language into articles of incorporation, organization, or other documents to prevent the entity from filing bankruptcy and having the advantages of bankruptcy law apply with respect to the particular creditor. These types of provisions will normally be unenforceable and considered to be against public policy, unless a special officer or other fiduciary is named and appointed to have the right to approve or initiate the filing of a bankruptcy. When this right is given in the document, it may be possible to prevent a non-person entity from filing bankruptcy.

Usually the special officer or fiduciary that is appointed to facilitate this is referred to as an “Independent Manager,” and the language that is inserted into the limited liability company Operating Agreement is as follows:

“Independent Manager” shall mean an individual who has prior experience as an independent director, independent manager or independent member with at least five years of employment experience and who is provided by Stewart Management Company, Wilmington Trust Company, CT Corporation, National Registered Agents, Inc., Lord Securities Corporation, Corporation Service Company, or, if none of those companies is then providing professional independent managers, another nationally-recognized company reasonably approved by Lender, in each case that is not an affiliate of the Company and that provides, in the ordinary course of its business, professional independent managers and other corporate services, and which individual is duly appointed as an Independent Manager and is not, and has never been, and will not while serving as Independent Manager be, any of the following:

- (i) a member, partner, equity holder, manager, director, officer or employee of the Company, the Member, or any of their respective equity holders or affiliates (other than as an Independent Manager of the Company or an affiliate of the Company that is not in the direct chain of ownership of the Company and that is required by a creditor to be a single purpose bankruptcy remote entity, provided that such Independent Manager is employed by a company that routinely provides professional independent directors in the ordinary course of its business);
- (ii) a supplier, service provider or a creditor (including provider of professional services) to the Company, or any of its equity holders or affiliates (other than a nationally-recognized company that routinely provides professional independent managers and other corporate services to the Company or any of its equity holders or affiliates in the ordinary course of its business);

(iii) a family member of any such partner, member, equity holder, officer, director, manager, employee, creditor, service provider or supplier; or

(iv) a Person that controls (whether directly, indirectly or otherwise) any of (i), (ii) or (iii) above.

A natural person who otherwise satisfies the foregoing definition and satisfies subparagraph (i) by reason of being the Independent Manager of a “special purpose entity” affiliated with the Company shall be qualified to serve as an Independent Manager of the Company, provided that the fees that such individual earns from serving as Independent Manager of affiliates of the Company in any given year constitute in the aggregate less than five percent (5%) of such individual’s annual income for that year. The same persons may not serve as Independent Managers of the Company and the Member.

When the above right is given without any ownership interest in the entity itself, this should not violate the S corporation second class of stock rules, which are provided under Internal Revenue Code Section 1361.

These provisions are sometimes used by institutional lenders in order to provide the lender with added security and confidence that the borrower will not enter into bankruptcy. These provisions could entice a lender to provide the borrower with a lower interest rate, or possibly to extend more funds to the borrower.

HOW THE FRAUDULENT TRANSFER RULES WORK.

Under fraudulent transfer rules, conveyances made for the purpose of avoiding creditor claims may be set aside. Florida’s Fraudulent Transfer Act (“FUFTA”) in Chapter 726 of the statutes, defines “fraudulent transfer” and provides the remedies available to a creditor who is able to establish that a debtor has engaged in a fraudulent transfer.¹¹² Under FUFTA, a fraudulent transfer is generally defined as “a transfer made or obligation incurred by a debtor if made with actual intent to hinder, delay or defraud any creditor of the debtor” or a transfer made “without receiving a reasonably equivalent value in exchange for the transfer or obligation.”

Just because a transfer or obligation is deemed to be a “fraudulent transfer” under the statute, however, does not mean that the individual has committed or has engaged in a crime or tort.¹¹³ This is further discussed below.

Florida Statutes Section 726.105 states that a transfer is “fraudulent” if:

(1) it was made with the actual intent to hinder, delay, or defraud any creditor of the debtor;
or

¹¹² Fla. Stat. § 726.105 (2017).

¹¹³ See *Freeman v. First Union*, 865 So. 2d 1272 (Fla. 2004) (noting that there is a difference between a fraudulent transfer and the common law tort of fraud and deceit).

(2) the transfer was made without receiving a reasonably equivalent value and the debtor was engaged or about to engage in a business, or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or the debtor intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond the ability to pay as they became due.¹¹⁴

Thus, FUFTA addresses two types of fraudulent transfers: “actual” and “constructive.”

The first type is an “actual” fraudulent transfer, which focuses on the transferor’s intent to delay, defraud or hinder creditors. Proving intent here tends to be difficult. FUFTA provides a list of considerations from which a court may infer the debtor’s intent. These include, among other factors, whether:

1. The transfer or obligation was to an insider;
2. The debtor retained possession or control of the property transferred after the transfer;
3. The transfer or obligation was disclosed or concealed;
4. Before the transfer was made or obligation was incurred; the debtor had been sued or threatened with suit;
5. The transfer was of substantially all the debtor’s assets;
6. The debtor absconded;
7. The debtor removed or concealed assets;
8. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
10. The transfer occurred shortly before or after a substantial debt was incurred; and/or
11. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Under this type of fraud, a cause of action is extinguished unless the action is brought “within 4 years after the transfer was made or the obligation was incurred or, if later, within 1 year after the transfer

¹¹⁴ Fla. Stat. § 726.105 (2017).

or obligation was or could reasonably have been discovered by the claimant.”¹¹⁵ The one-year discovery extension to the limitations period is referred to as the “one-year savings clause.”

The second type is a “constructive” fraudulent transfer, which focuses—not on the transferor’s intent—but rather, the economic effects of the transaction.¹¹⁶ Proving a constructive fraudulent transfer requires proof that the debtor, regardless of their intent, (a) did not receive reasonably equivalent value for the asset; and (b) that the debtor was insolvent at the time of, or as a result of, the transfer.

FUFTA does not define “reasonably equivalent value.” Accordingly, whether value is reasonably equivalent must be determined on a case-by-case basis. To determine equivalent value, courts consider many factors, including the good faith of the parties, the disparity between the FMV and what the debtor actually received, and whether the transaction was at arm’s-length.

A debtor ordinarily may transfer its assets for consideration that it deems appropriate. Once a debtor becomes insolvent, however, the rules change. An insolvent debtor that transfers its assets or incurs obligations for insufficient value effectively commits a fraud on its creditors.

Under FUFTA, a debtor is considered “insolvent” when the “sum of the debtor’s debts is greater than all of the debtor’s assets at fair valuation.”¹¹⁷ The statute also provides that there is a presumption of insolvency when a debtor is “generally not paying his or her debts as they become due.”¹¹⁸

Under this type of fraud, a cause of action is extinguished unless the action is brought “within 4 years after the transfer was made or the obligation was incurred,” regardless of when the fraud was or could have been discovered.¹¹⁹

More generally, in order to pursue an action for a fraudulent transfer against a debtor or transferee, the creditor generally must bring the action within four years after the transfer was made or obligations incurred, or, if later, within one year after the transfer or obligation was or could reasonably have been discovered by the claimant. The one year after discovery of transfer rule, however, will not apply if the transfer was from a non-exempt asset to an exempt asset held by the same debtor.¹²⁰ If the one year rule applies, then the key question is often whether the creditor knew or should have known of the transfer within a year. Two Florida courts have held that the mere recording of a deed is not a sufficient notice to trigger the Section 726.110 one year statute to begin running.^{121 122}

¹¹⁵ Fla. Stat. § 726.110 (2017).

¹¹⁶ Fla. Stat. § 726.105(1)(b); 726.106(1) and 726.106(2).

¹¹⁷ Fla. Stat. § 726.103(1) (2017).

¹¹⁸ Fla. Stat. § 726.103(2) (2017).

¹¹⁹ Fla. Stat. § 726.110(2) (2017).

¹²⁰ Fla. Stat. § 726.110 (2017).

¹²¹ See generally, *Winn-Dixie Stores, Inc. v. Dolgencorp, Inc.*, 964 So.2d 261, 267 (Fla. 4th DCA 2007); *Freligh v. Maurer*, 111 So.2d 712, 714 (Fla. 2d DCA 1959).

¹²² 98 So.3d 710, 713 (Fla. 1st Dist. App. 2012).

Please note that actions for “preferential” transfers where a debt owed to an insider has been paid when other creditors were not paid must normally be brought within one year of the transfer, but the preferential transfer set aside period under the Bankruptcy Code for a non-insider is 90 days.¹²³ Generally, creditors who bring these actions seek to avoid the transfer to the extent necessary to satisfy their claim.

THE 2019 *RENSIN* OPINION - A DEBTOR IS NOT RESPONSIBLE FOR A “FRAUDULENT TRANSFER” MADE BY THE TRUSTEE OF AN ASSET PROTECTION TRUST?

The 2019 Bankruptcy Court case of *In re Rensin* startled many planners when the judge concluded that a transfer made from an offshore asset protection trust that was otherwise being “pierced” by having Florida law apply was not a “fraudulent transfer” under Section 726, because it was not Mr. Rensin who made the transfer. The judge based this upon Florida Statutes Section 222.30, which is substantially similar to Section 726, and specifically applies when there is a conversion of non-exempt assets to exempt assets by a debtor. The judge’s discussion on this was as follows:

The annuity contracts are not subject to Florida Statutes Section 222.30.

Florida Statutes Section 222.30 is aimed at preventing a person who is liable to a creditor from taking an asset owned by that person and converting it into a form that is immune from collection specifically to stymie the creditor. Section 222.30(2) provides: “Any conversion by a debtor of an asset that results in the proceeds of the asset becoming exempt by law from the claims of a creditor of the debtor is a fraudulent asset conversion as to the creditor, whether the creditor’s claim to the asset arose before or after the conversion of the asset, if the debtor made the conversion with the intent to hinder, delay, or defraud the creditor.” A creditor harmed by a fraudulent asset conversion may seek avoidance of the conversion, attachment of the asset converted, and other equitable relief. Florida Statutes Section 222.30(3).

Mr. Rensin provided \$350,000 of non-exempt funds to his counsel for deposit in the Joren Trust. The Joren Trustee then used the funds to purchase a variable annuity. The plaintiff argues that Mr. Rensin, acting through his counsel as agent, placed his non-exempt assets in the Joren Trust to facilitate the purchase of the variable annuity in an attempt to remove the assets from the reach of his creditors. Likewise, the plaintiff argues that Mr. Rensin caused the Joren Trustee to use funds long held in the Joren Trust to purchase the fixed annuity, also in an attempt to remove the assets from the reach of his creditors. The plaintiff claims that these conversions of assets to the fixed and variable annuities are subject to remedies under Section 222.30. While the plaintiff presents a seemingly compelling review

¹²³ *Id.*

of the facts under the traditional badges of fraud, there are fatal errors in the plaintiff's analysis.

Section 222.30 requires a “conversion by a debtor.” A “conversion” under this statute involves an intentional act with the power to follow through. The plaintiff argues that the badges of fraud indicate Mr. Rensin intended to stymie his creditors by causing the Joren Trustee to purchase the annuities. The “conversion by a debtor” is, in the plaintiff’s view, the Joren Trustee following through on Mr. Rensin’s desires. But there is no evidence that Mr. Rensin asked the Joren Trustee to purchase either of the annuities. To the contrary, the only relevant evidence is that Mr. Rensin objected to the purchase of the annuity contracts. Even if Mr. Rensin had asked the Joren Trustee to purchase the annuities, this would not be sufficient for relief under Section 222.30. Mr. Rensin does not have the legal ability to require the Joren Trustee to use trust assets in any regard. In other contexts, Florida courts have held that, even where the evidence shows that a trustee has historically acted as requested by a beneficiary, if the trust document provides the trustee with complete discretion the courts need give no weight to past practice. *Miller v. Kresser*, 34 So.3d 172, 175-76 (Fla. 4th DCA 2010). In other words, because Mr. Rensin had no legal power to require the Joren Trustee to buy the annuities, he could not have converted non-exempt assets under Section 222.30. This is a moot point as, here, the only relevant evidence shows that Mr. Rensin did not cause the Joren Trustee to purchase the annuities.

Nor does Mr. Rensin’s deposit of the \$350,000 into the Joren Trust fit within the requirements of Section 222.30. When Mr. Rensin took his non-exempt personal funds and deposited them into the Joren Trust, this did not result in the funds becoming “exempt by law from the claims of a creditor” as required under the statute. Section 222.30 provides an exception from the exemptions otherwise granted under Chapter 222. There is no provision of Chapter 222 that would protect assets in the Joren Trust. Since a deposit into the Joren Trust would not result in the funds becoming protected under any provision of Chapter 222, Section 222.30 does not apply. Even if Section 222.30 is read more broadly to cover any conversion resulting in an asset becoming no longer subject to execution by creditors, all of the Joren Trust assets are subject to claims of Mr. Rensin’s creditors, and so Mr. Rensin’s transfer of \$350,000 into the Joren Trust did not place those funds beyond the reach of creditors. In any case, in the complaint the plaintiff did not seek any relief relating to the transfer of \$350,000 into the Joren Trust, but rather focused on the use of those funds to acquire the variable annuity.

Because the Joren Trustee purchased the fixed annuity, and not Mr. Rensin, the plaintiff argues that the Joren Trust itself is covered by Section 222.30. The plaintiff contends that the defined terms in Section 222.30 apply to the Joren Trustee and its creditors, including the FTC and the bankruptcy estate. Even assuming that this is correct, for Section 222.30 to apply, the conversion of assets must result in the assets becoming exempt from creditors of the converting party. But the Joren Trust

is not a Florida citizen or resident and so obtains no protection under Section 222.14. Nor does any other provision of Chapter 222 protect the Joren Trustee. In other words, the Joren Trust's purchase of the fixed annuity did not result in the asset becoming protected from creditors of the Joren Trust. Section 222.30 does not apply.

The annuities are not subject to avoidance, attachment, or equitable remedies under Florida Statutes Section 222.30. Mr. Rensin's payment rights under the annuities, and the Regions Bank account containing only proceeds from the fixed annuity, remain exempt from administration in this bankruptcy case.

The Florida fraudulent transfer and preferential transfer statutes are summarized by the charts on the following pages, which are followed by the applicable statutes.

FRAUDULENT TRANSFER ACTION EXTINGUISHMENT CHART

	TERM	ITEMS	STATUTE LANGUAGE
1	The later of four years after the transfer is made or the obligation is incurred, or one year after the transfer or obligation was or could reasonably have been discovered by the claimant.	FS 726.105(1)(a)	Transfers fraudulent as to present and future creditors (1) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation. (a) With <u>actual intent</u> to hinder, delay, or defraud any creditor of the debtor; or... See: <i>Biel Reo v. Barefoot Cottages Development Company</i>, No. 1D14-46 (1st DCA 2014); <i>In re C.D. Jones & Company</i>, No. 09-31595-KKS.
2	Four years after the transfer was made or the obligation was incurred.	FS 726.105(1)(b)	Transfers fraudulent as to present and future creditors – “The transfer was made or the obligation was incurred...” (1)(b) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor: 1. Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or 2. Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.
3	One year after the transfer was made or the obligation was incurred.	FS 726.106(2)	(2) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the <u>transfer was made to an insider for an antecedent debt</u>, the debtor was insolvent

			at that time, <u>and the insider had reasonable cause to believe that the debtor was insolvent.</u>
4	Four years after a transfer from a nonexempt to an exempt asset was made or the obligation was incurred.	FS 222.30(5)	(5) A cause of action with respect to a fraudulent asset conversion is extinguished unless an action is brought within 4 years after the fraudulent asset conversion was made.
5	The later of four years after the transfer is made or the obligation is incurred, or one year after the transfer or obligation was or could reasonably have been discovered by the claimant.	FS 222.30(6)	(6) If an asset is <u>converted</u> to exempt and the converted asset is subsequently transferred to a third party, the provisions of chapter 726 apply to the transfer to the third party.
6	Preferential transfer statute – Within one year after transfer is made or obligation is incurred.	FS 726.106(2) and 726.110(3)	(2) Transfers made to an insider for an antecedent debt while the debtor was insolvent, and insider had reasonable cause to believe that the debtor was insolvent.

NOTE: The filing of bankruptcy extends the ability of the trustee in bankruptcy to pursue fraudulent transfers until the later of two years from the filing of the bankruptcy or four years from when the transfer occurred.

NOTE: Conversion is defined at FS 222.30 as “every mode, direct or indirect, absolute or conditional, of changing or disposing of an asset, such that the products or proceeds of the asset become immune or exempt by law from claims of creditors of the debtor and the products or proceeds of the asset remain property of the debtor.”

NOTE - 726.105 (2) provides as follows:

(2) In determining actual intent under paragraph (1)(a), consideration may be given among other factors, to whether:

- (a) The transfer or obligation was to an insider.
- (b) The debtor retained possession or control of the property transferred after the transfer.
- (c) The transfer or obligation was disclosed or concealed.
- (d) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit.
- (e) The transfer was of substantially all the debtor's assets.
- (f) The debtor absconded.
- (g) The debtor removed or concealed assets.
- (h) The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.
- (i) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
- (j) The transfer occurred shortly before or shortly after a substantial debt was incurred.
- (k) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

FS 726.105 Transfers fraudulent as to present and future creditors.—

(1) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

- (a) With actual intent to hinder, delay, or defraud any creditor of the debtor; or
- (b) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

- 1. Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
- 2. Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

(2) In determining actual intent under paragraph (1)(a), consideration may be given, among other factors, to whether:

- (a) The transfer or obligation was to an insider.
- (b) The debtor retained possession or control of the property transferred after the transfer.
- (c) The transfer or obligation was disclosed or concealed.
- (d) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit.
- (e) The transfer was of substantially all the debtor's assets.
- (f) The debtor absconded.
- (g) The debtor removed or concealed assets.
- (h) The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.
- (i) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
- (j) The transfer occurred shortly before or shortly after a substantial debt was incurred.
- (k) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

FS 726.106 Transfers fraudulent as to present creditors.—

(1) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

(2) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

FS 222.30 Fraudulent asset conversions.—

(1) As used in this section, “conversion” means every mode, direct or indirect, absolute or conditional, of changing or disposing of an asset, such that the products or proceeds of the asset become immune or exempt by law from claims of creditors of the debtor and the products or proceeds of the asset remain property of the debtor. The definitions of chapter 726 apply to this section unless the application of a definition would be unreasonable.

(2) Any conversion by a debtor of an asset that results in the proceeds of the asset becoming exempt by law from the claims of a creditor of the debtor is a fraudulent asset conversion as to the creditor, whether the creditor’s claim to the asset arose before or after the conversion of the asset, if the debtor made the conversion with the intent to hinder, delay, or defraud the creditor.

(3) In an action for relief against a fraudulent asset conversion, a creditor may obtain:

(a) Avoidance of the fraudulent asset conversion to the extent necessary to satisfy the creditor’s claim.

(b) An attachment or other provisional remedy against the asset converted in accordance with applicable law.

(c) Subject to applicable principles of equity and in accordance with applicable rules of civil procedure:

1. An injunction against further conversion by the debtor of the asset or of other property.

2. Any other relief the circumstances may require.

(4) If a creditor has obtained a judgment on a claim against the debtor, the creditor, if the court so orders, may levy execution on the asset converted or its proceeds.

(5) A cause of action with respect to a fraudulent asset conversion is extinguished unless an action is brought within 4 years after the fraudulent asset conversion was made.

(6) If an asset is converted and the converted asset is subsequently transferred to a third party, the provisions of chapter 726 apply to the transfer to the third party.

The fraudulent transfer rules under the Bankruptcy Code are very similar to Florida’s four-year fraudulent transfer rules, and bankruptcy courts will apply the latter in situations where more than two years has transpired since the transfer as long as the four year statute has not run when the bankruptcy is filed and the Trustee in Bankruptcy files a timely motion to set aside the transfer.

Under the Bankruptcy Code, 11 U.S.C. Section 548, the trustee is given a two-year look-back period and is able to avoid any fraudulent transfer made within that time, or whatever longer period may apply under state law. Also, under 11 U.S.C. Section 727(a)(2) of the Bankruptcy Code, a debtor can be denied a bankruptcy discharge if property of the debtor was concealed or transferred within one year before the date of filing the petition or property of the estate is improperly transferred after the date of filing the petition.

However, there is one notable exception to the fraudulent transfer rules. In *Havoco v. Hill*, the Florida Supreme Court ruled that transfers made into a homestead are protected from Florida’s Fraudulent

Transfer Act, except where the funds were obtained through fraud or egregious conduct.¹²⁴ This resulted in changes to the Bankruptcy Code to prevent last minute transfers to a homestead from holding up under the bankruptcy period, which is further discussed in Chapter 5.

ADVISOR LIABILITY FOR FRAUDULENT TRANSFERS.

The following is an outline that was prepared by the authors specifically for the 2017 41st Annual Alexander L. Paskay Memorial Bankruptcy Seminar with the American Bankruptcy Institute (ABI):

**ETHICAL AND LIABILITY EXPOSURE OF LAWYERS
WHO ADVISE DEBTORS OF THEIR LEGAL RIGHTS
WHEN A JUDGMENT EXISTS OR MAY BE IMMINENT
Prepared by: Alan S. Gassman and Michael C. Markham
American Bankruptcy Institute (ABI) – February 2, 2017**

In some states, such as California and Connecticut, it is a breach of the rules of professional conduct, and in some cases a tort, for a lawyer to advise a client to engage in a “fraudulent transfer,” or to assist a client in effectuating such a transfer, notwithstanding the significant difference that exists between committing “fraud” and making a transfer that may be for the purpose of avoiding a creditor. This can also violate federal law, such as when there is an attempt to evade paying the Internal Revenue Service or certain other federal agencies. See 18 U.S.C. §1032 (criminal penalties for concealing assets from the FDIC, any conservator appointed by the Comptroller of the Currency, or the National Credit Union Administration Board); IRC §7206(4) (criminal penalties for evading or defeating the collection of a tax; and IRC §7212(a) (criminal penalties for corruptly interfering with the due administration of the Internal Revenue Code.)

The authors have found that many good Florida lawyers believe that a lawyer is not permitted to assist a client in engaging in a fraudulent transfer, as if a fraudulent transfer were the equivalent of committing fraud, which is not the case.

The below discussion should be of assistance to those Florida lawyers who represent debtors or potential debtors in situations where allegations of the making of a “fraudulent transfer” might be possible based upon future conduct. The authors thank Denis Kleinfeld and Jonathan Alper for writing the June 2004 Florida Bar Journal Article entitled “The Florida Supreme Court Finds No Liability for Aiding or Abetting a Fraudulent Transfer,” which is quoted in several places below where indicated, and encourage that advisors who work in this area actually read the cases herein discussed, which provide not only law but also the flavor that we have attempted to describe in this article.¹²⁵

Common law and statutory fraud consists of conduct which constitutes the misleading of a third party. For example, the most prevalent definition provided by Black’s Law Dictionary is as follows:

¹²⁴ 790 So. 2d 1018, 1028 (Fla. 2001), opinion after certified question answered, 255 F.3d 1321 (11th Cir. 2001).

¹²⁵ Nevertheless, in the words of Jimmy Buffett, “You had to be there.” Don’t miss his double album performance recordings from 1978 if you have not heard them. Pirates were early role models for aggressive debtors.

“A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.”¹²⁶

In *Sheridan v. Rennhack*, 200 So. 3d 255, 258 (Fla. 1st DCA 2016), the Florida Supreme Court confirmed that a finding of fraud requires all four of the following elements exist: (1) A false statement concerning a specific material fact; (2) the makers’ knowledge that the representation is false; (3) an intention that the representation induces another’s reliance; and (4) consequent injury by the other party acting in reliance on the representation.

Under Florida Statutes Section 726.105, a fraudulent transfer occurs when a debtor:

- (a) With actual intent to hinder, delay, or defraud any creditor of the debtor; or
- (b) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor
 - (1) was engaged or about to engage in a business or a transaction which the remaining assets of the debtor were unreasonably small in relation to the business or transacting; or
 - (2) intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

Committing a fraudulent transfer is therefore much different than committing “fraud,” although it is possible that both could occur simultaneously in certain situations. Hence the difference in the terms “hinder, delay or defraud” as used in the statute. Obviously, an act to hinder or delay is not an act to defraud. See *In re Ellison*, 2016 WL 5349715 (Bankr. C.D. Cal. 2016) (The dictionary definitions of these words reinforce these observations. The word “hinder” has been defined as a transitive verb: “1. To be or get in the way of. 2. To obstruct or delay the progress of.” The American Heritage Dictionary of the English Language at 830 (4th ed. 2006). The word “delay” has been defined as a transitive verb: “1. To postpone until a later time; defer. 2. To cause to be later or slower than expected or desired.” The word “defraud” has been defined as a transitive verb: “To take something by fraud; swindle.”

This is further evidenced by the passage by many states of the Uniform Voidable Transfer Act, which is replacing the Uniform Fraudulent Transfer Act, and is for the most part identical to the Uniform Fraudulent Transfer Act, with the notable change of the words “fraudulent transfer” to “voidable transfer,” although commentators have voiced concern that the new official comments to the Act may impact its effect in situations where (1) transactions or transitions convert easily accessible assets that are illiquid and more difficult to seize and sell for cash, (2) entities or assets may be converted into limited partnerships or LLCs that are more difficult for a creditor to pierce, (3) with respect to the choice of law to apply when an asset

¹²⁶ Misrepresentation is an affirmative declaration contrary to fact. Concealment of a material fact is a failure to disclose or an omission of relevant information that can be critical to the decision making process. Moreover, “knowing” means that the misrepresentation or concealment must be intentional. In a decision regarding one’s finances, misrepresentation of the truth or concealment of material fact must be done with knowledge of substantial certainty or purpose that the misrepresentation or concealment is to the other party’s financial detriment.

protection trust is formed by a debtor residing in a non-asset protection trust jurisdiction, and (4) in other instances.

Florida Bar Disciplinary Rule 4-8.4(c) provides that a lawyer is not to “engage in conduct involving dishonesty, fraud, deceit, or misrepresentation” and Rule 4-8.4(d) prohibits “conduct in connection with the practice of law which is prejudicial to the administration of justice.” The commentary to Rule 4-8.4 provides a good-faith exception when a “lawyer may refuse to comply with an obligation imposed by law upon a good faith belief that no valid obligation exists.” There is also a well-known saying that “Justice depends on whose ox is being gored.”¹²⁷ Further discussion of Rule 4-8.4 and a 2015 Florida Supreme Court Referee’s decision with respect thereto is discussed below.

In the 2003 Fifth District Court of Appeals case of *Bankfirst v. UBS Paine Webber, Inc.*, 842 So. 2d 155 (Fla. 5th DCA 2003), which is further described below, the dissenting judge, C. Harris, concluded that where lawyers and financial consultants actively advise and assist a debtor to transfer assets with the intent to defeat legitimate creditor rights, a valid cause of action for civil conspiracy, and assessment of damages against the advisors would apply, while the other two judges concluded in the majority decision that no such cause of action would exist absent the elements further described below. Judge Harris’s dissenting opinion indicated that the fraudulent transfer law is applied by a Court of Equity and that Section 726.108(1)(c)3 enables the court to apply “any other relief the circumstances may require...subject to applicable principles of equity” and noted that the Fourth District Court of Appeals in the 2001 opinion of *Hansard Construction Corporation v. Rite Aid of Florida, Inc.*, 783 So.2d 307 (Fla. 4th DCA 2004), held that a plaintiff may recover money damages against the transferor under the “any other relief” provision.¹²⁸

The following excerpt is from the Kleinfeld Alper article which notes and cites a number of cases that we discuss after the below quotation:

Ethical Issues

Prior to the Florida Supreme Court’s decision in *Freeman v. First Union National Bank*, 329 So. 2d 1272 (Fla. 2004), some commentators argued that it was unethical in some circumstances for an attorney to assist a client’s property transfer which was subsequently found to be a fraudulent conveyance. The most prevalent arguments were, one, that attorneys had a duty as an “officer of the court” not to impair the collection of a court’s money judgment, or two, that assisting a client’s fraudulent conveyance constituted the assistance of “fraud.” Both ethical positions are inconsistent with the Florida Supreme Court’s interpretation of the FUFTA.

To begin with, the Florida Bar Model Rules of Conduct (the “Rules”) provides in the preamble that, “A lawyer is a representative of clients, an officer of the legal system and a public citizen having special responsibility of the quality of justice.” The concept of lawyer as “an officer of the court” suggests the close working relationship between judges and traditional courtroom practitioners. The phrase “an officer of the court” is relevant primarily to representation involving work in a courtroom. The Florida

¹²⁷ Derived from the Book of Exodus and interpreted by Martin Luther at Diet of Worms in 1521.

¹²⁸ See also *Profeta v Lombardo*, 75 Ohio App. 3d 621 (1991).

Supreme Court has explained that an attorney's role as "officer of the court" is to work with the court system, for example, by improving the Bar admissions process, serving on disciplinary committees, and representing indigents.¹²⁹ This Court has never used the term "officer of the court" to impose on attorneys additional duties that could create conflict with or diminish the attorney's ethical responsibilities to diligently advocate on his client's behalf.¹³⁰ Any other meaning would place the attorney in the role of being an ombudsman rather than a zealous advocate.¹³¹

It is well settled that because of the adversarial nature of litigation and the duty for attorneys to zealously represent their clients with total loyalty and confidentiality, a lawyer lawfully providing services to a client has no legal liability to any third party in contract, tort or for a fiduciary duty because of a client's conduct.¹³² More specifically, the general principle is that an attorney has no legal duty to a third party adversary of his client's interest, including a client's potential creditors.

Secondly, there is an important ethical distinction between assisting actual common law fraud and assisting a fraudulent conveyance. Under Rule 4-1.2(d), Scope of Representation, "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent". (Rule 4-8.4(c) defines professional misconduct to include "engage[ing] in conduct involving dishonesty, fraud, deceit or misrepresentation"). Rules 4-1.2(d) and 4-8.4(c) are the only references in the Model Rules to conduct of the attorney or client which involve fraud. The term "fraud" or "fraudulent" is specifically defined by the Rules¹³³ as denoting "conduct having a purpose to deceive and not merely negligent misrepresentation or failure to apprise another of relevant information." This definition makes no reference to a fraudulent conveyance or fraudulent transfer as under the Uniform Fraudulent Transfer Act, Uniform Fraudulent Conveyance Act or similar statute. "Fraud" does not include conduct which, although characterized as "fraudulent" by statute or administrative rule, lacks an element of scienter,¹³⁴ deceit, intent to mislead, or knowing failure to correct misrepresentations which can be reasonably expected to induce detrimental reliance by another.

Florida's Supreme Court and appellate courts have clearly elucidated this distinction between the intentional tort of common law fraud and deceit, on one hand, and remedies under the FUFTA, on the other. By specifically rejecting the notion that the FUFTA creates an independent tort for damages, the Supreme Court in *Freeman* distinguished fraudulent transfers from the common law tort of fraud and deceit of

¹²⁹ *In re: Petition for Advisory Opinion Concerning Applicability of Chapter*, 316 So. 2d 45 (Fla. 1975).

¹³⁰ The Rules, 4-1.3.

¹³¹ Standard of care for an attorney-client relationship is a duty to exercise the degree of reasonable knowledge and skill that lawyers of ordinary ability and skill possess and exercise. *See Rowell v. Holt*, 850 So. 2d 474, 484 (Fla. 2003).

¹³² Limited exceptions have been carved out in probate on the theory of a fiduciary duty involving wills and trusts cases in relation to deemed or intended third party beneficiaries. *See also* footnote 14.

¹³³ Terminology (4-8.4(c)).

¹³⁴ Requires that intent, a state of mind requiring knowledge, or *mens rea*, simultaneously occur with a bad act, or *actus reus*.

which damage is an essential ingredient. The Court recognized that despite the FUFTA's archaic language including the word "fraud," the statute does nothing more than create a creditor remedy similar to replevin or other equitable remedies. Such equitable remedies are different than damages awarded to remedy the intentional tort of common law fraud and deceit which requires all of the elements of misrepresentation, reasonable detrimental reliance, and proximate cause as well as damages.

The Florida Supreme Court also differentiated fraudulent transfers from common law fraud in *Havoco of America, Ltd. v. Hill*.¹³⁵ In *Havoco*, the Court focused on exemption of a Florida homestead from remedies under the fraudulent asset conversion provisions of the Florida Statutes and the Uniform Fraudulent Transfer Act. The Court concluded that homestead property is protected from the FUFTA's equitable remedies except where funds were obtained through fraud or egregious conduct. In sum, the Court held that a fraudulent conveyance is not fraud and not egregious conduct.

As previously discussed, several recent Florida appellate court decisions contrasted tortious fraud and fraudulent conveyance. The Third District Court of Appeals has twice stated that a fraudulent transfer is not a tort, and therefore unrelated to the intentional tort of common law fraud. Though not addressing the issue directly, the Fifth District Court of Appeals, in its *Bankfirst* decision, cited several federal appellate cases to support its holding, including the Ninth Circuit decision of *Elliott v. Glushon*,¹³⁶ which held that fraudulent transfers in the context of bankruptcy include a great variety of actions which are not common law fraud. Thus, the Florida Supreme Court and Florida appellate courts have made clear that a fraudulent transfer falls outside the definition of fraud, under the law of deceit, proscribed by Florida's ethical rules, and is not otherwise considered egregious conduct. *See also Burris v. Green*, 2016 WL 5844165 (M.D. Fla. 2016)(fraudulent transfer claim is not a "tort" for purposes of personal jurisdiction or a "tortious act" under Florida's long-arm statute); *In re Wiand Receivership Cases*, 2007 WL 963165 (M.D. Fla. 2007)(fraudulent transfer is not a tort for purposes of *in pari delicto*).

The American debtor/creditor justice system clearly provides, with few exceptions, that a debtor has complete and uninterrupted ownership, possession, and control of his or her assets until there has been a judgment and legally permitted action to attach the assets once a judgment has been received. The colonial states were settled in large part by those escaping debtor prisons in Europe in the 1600's and 1700's. For example, the State of Georgia was initially populated by penal prisoners from debtor's prisons under the auspices of James Oglethorpe to create a "debtors colony."¹³⁷

¹³⁵ 790 So. 2d 1018, 1028 (Fla. 2001).

¹³⁶ 390 F.2d 514 (9th Cir. 1967).

¹³⁷ Ekirch, A. Roger (1987), *Bound For America: The Transportation of British Convicts to the Colonies, 1718–1775*, Oxford University Press.

While there are limited mechanisms under the law for prejudgment injunctions that enable creditors to “lock down” on a debtor’s assets before a judgment has been levied upon, the statutes permitting this will rarely be used because of the requirements that exist for the exercise thereof.

Florida Statute, Chapter 76 provides creditors with attachment rights. Specifically, Section 76.01, Right to attachment, reads as follows:

Right to attachment.—Any creditor may have an attachment at law against the goods and chattels, lands, and tenements of his or her debtor under the circumstances and in the manner hereinafter provided.

Section 76.03, Courts from which attachments shall issue, reads as follows:

Courts from which attachments shall issue.—Attachments shall be issued by a judge of the court which has jurisdiction of the amount claimed by the creditor, but if the property to be attached is being actually removed from the state and the creditor is unable to obtain process from the proper court in time to prevent such removal, any judge may issue the writ, making it returnable to the proper court and immediately sending all papers in the action to the clerk of the court to which the writ is returnable.

The Third DCA case of *Cerna v. Swiss Bank Corp. (Overseas), S.A.*, 503 So.2d 1297 (Fla. 3rd DCA 1987), concluded that a creditor could not obtain a prejudgment order to seize assets on the basis that the debtor was “fraudulently disposing of ... property” which was titled under the name of a shell.¹³⁸

It is noteworthy that the United States Justice Department can use 18 U.S.C. § 1963¹³⁹ to enforce prejudgment injunctions against those who have committed fraudulent¹⁴⁰ criminal acts.¹⁴¹ Pursuant to subsection (d) paragraph (2) of 18 U.S.C. § 1963, the United States can apply for a temporary order when an information or indictment has not been filed yet, “if the United States demonstrates that there is probable cause to believe that the property with respect to which the order is sought would, in the event of conviction, be subject to forfeiture under this section.” The United States may also apply 28 U.S.C. § 3001 to garnish wages or obtain assets prior to a judgment for any outstanding debts owed to the United States.

¹³⁸ 503 So.2d at 1299 (explaining that the debtor was not fraudulently disposing of property that remained in her name, and stated that “In sum, while we hold that property purportedly owned by Cerna may not be properly attached prejudgment, we do not agree that debts allegedly owed to Cerna by someone else, such as the sums in her bank and stockbroker accounts, may be garnished until her own liability to the plaintiff has been established by judgment.”)

¹³⁹ Criminal Penalties for a violation of the Racketeering Influenced and Corrupt Organizations statute, prohibited activities. See 18 U.S.C. § 1962.

¹⁴⁰ “Common-law meaning of ‘fraud’ required a misrepresentation or concealment of material fact. Thus, this Court cannot infer from the absence of a specific reference to materiality that Congress intended to drop that element from the fraud statutes and must presume that Congress intended to incorporate materiality unless the statutes otherwise dictate.” *Neder v. United States*, 527 U.S. 1, 3 (stating that materiality is an element of a scheme or artifice to defraud under the Federal mail fraud, wire fraud and bank fraud statutes.); Specific-intent requires willfulness in committing a particular proscribed act.

¹⁴¹ RICO’s prohibited activities of a “pattern or practice” are a criminal act usually based on predicate mail fraud or wire fraud violations. A fraudulent criminal act against the United States is utilizing the United States Postal Service or any electronic or wire broadcasting communication service with an intent to devise a scheme or artifice to defraud. See 18 U.S.C. §§ 1341, 1343.

Many authors refer to the 1999 U.S. Supreme Court case of *Grupo Mexicano de Desarrollo S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999), where Justice Scalia, on behalf of himself and four other members of the Supreme Court, decided that a federal Court of Equity does not have the power to authorize a creditor to attach the assets of a debtor before receiving a judgment, unless a federal or state statute applies which would explicitly allow a pre-judgment attachment order. Judge Scalia noted that Federal courts of equity are limited to those powers provided to the English Court of Chancery at the time that the United States became independent, meaning that because courts of equity in England in 1776 did not have the power to grant pre-judgment attachment orders, these will not be permitted now in the absence of statutory authority.

Justice Ginsberg, joined by Justices Stevens, Souter and Breyer, noted that the Court of Equity under The Judiciary Act of 1789 probably did not need to issue pre-judgment injunctions because things moved slower and it was probably more likely that a judgment creditor would be able to find and attach assets post-judgment in the 1700s than is now the case, noting that “increasingly sophisticated foreign-haven judgment proofing strategies, coupled with technology that permits the nearly instantaneous transfer of assets abroad, suggests that defendants may succeed in avoiding meritorious claims in ways unimaginable before the merger of law and equity.”

This case has been cited in a number of other decisions and articles for the proposition that debtors have the right to remain in control of, and to decide what to do with their assets until a judgment is being enforced. As Judge Scalia wrote in the opinion, “The requirement that the creditor obtain a prior judgment is a fundamental protection in a debtor-creditor law.”¹⁴² Justice Scalia further stated that by allowing federal courts to issue such injunctions for creditors “could radically alter the balance between debtors’ and creditors’ rights and might induce creditors to engage in a race to the courthouse...which might prove financially fatal to the struggling debtor.”

Kleinfeld and Alper say the following about this case in the article cited:

The U.S. Supreme Court in *Grupo*, solidified a property owner’s right to freely transfer his property prior to judgment subject to subsequent equitable remedies under fraudulent conveyance statutes. This case involved an action for money damages where the creditor sought a preliminary injunction in federal court to prevent a defendant from transferring its assets prior to judgment being entered. The majority opinion pointed out prerequisites for equitable remedies as well as the general availability of injunctive relief against asset transfers depend on common law principles of equity. The Supreme Court stated, “It was well established, however, that, as a general rule, a creditor’s bill could be brought only by a creditor who had already obtained a judgment establishing the debt.” The Court reiterated its understanding of the well-established general rule, “that a judgment establishing the debt was necessary before a Court of Equity would interfere with the debtor’s use of his property.”¹⁴³ In other words, under common law a creditor has no property interest

¹⁴² *Id* at 330.

¹⁴³ *Grupo*, 527 U.S. 308 at 1969 (1999).

in the assets of a debtor prior to the creditor obtaining a judgment, and before judgment, a debtor's property is freely alienable.

The point is that all people, even potential debtors, have fundamental rights to protect and control their property. The transfer of freely alienable property is not unlawful and cannot be restrained by a creditor, absent obtaining remedies allowed under other statutory law such as bankruptcy, even if the transfer could subsequently be challenged under fraudulent transfer statutes.

In many instances, estate planning or asset protection involves converting non-exempt assets into exempt assets so as to take full advantage of available exemptions, i.e. homestead, retirement assets, annuities, life insurance, and entireties property. Many bankruptcy decisions in Florida, particularly authored by Judge Paskay, expressly hold that "Congress intended to permit Debtors to take full advantage of the exemptions available under applicable law."¹⁴⁴

For at least ten years, Judge Paskay repeatedly cited to the legislative history of Section 522 of the Bankruptcy Code and expressly indicated that it was not fraudulent to take full advantage of exemptions on the eve of bankruptcy. *Matter of Rowe*, 46 B.R. 34 (Bankr. M.D. Fla. 1984); *In re Decker*, 105 B.R. 79 (Bankr. M.D. Fla. 1989); *In re Horath*, 116 B.R. 835 (Bankr. M.D. Fla. 1990); *In re Levine*, 139 B.R. 551 (Bankr. M.D. Fla. 1992). The oft-cited legislative history quote reads as follows:

As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition...the practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled. H.R. No. 595, 95th Cong., 1st Sess., 361 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5787, 6317.

In *Decker*, Judge Paskay cited to the Fifth Circuit's decision in *Matter of Reed*, 700 F. 2d 986 (5th Cir. 1983) and stated:

"The fact that the net effect of these transactions did, in fact, put under the exemption substantial assets is of no consequence. The Debtor merely attempted to do that which the function of exemptions was meant to do, and that is to put the property beyond the reach of creditors."

In *Horath*, Judge Paskay cited to numerous cases, including the Eighth Circuit's decision in *Norwest Bank Nebraska, N.A., v. Tveten*, 848 F. 2d 871 (8th Cir. 1988), and drew a distinction between an objection to exemptions and an objection to discharge. Judge Paskay further stated that:

"This Court is unaware of any provision in the Bankruptcy Code which condemns the conversion of non-exempt property into exempt property and which would operate as a forfeiture of right to claim an exemption otherwise available to Debtors."

¹⁴⁴ *In re Russell*, 1982 WL 19332 (Bankr. M.D. Fla. 1982).

In *Levine*, Judge Paskay expressly held that the legislative history “leaves no doubt” that the conversion of non-exempt property into exempt property is “not per se fraudulent, and it permits a debtor to make full use of the exemptions to which the debtor is entitled.” Judge Paskay further stated:

“This Court’s opinion should not be construed to be an approval of such ‘pre-bankruptcy planning’ or conversion of nonexempt assets into exempt assets, which might in some cases, be grounds to bar a debtor’s discharge.”

Then, Judge Paskay shifted his thinking in *In re Schwarb*, 150 B.R. 470 (Bankr. M.D. Fla. 1992), wherein he receded in part from *Levine* without mentioning his other published decisions on the issue. “After further research and consideration” of the oft-cited legislative history, Judge Paskay discounted the above quote and held that an exemption could be disallowed if property was converted “for the specific purpose of placing the asset out of the reach of creditors.”

Perhaps Judge Paskay was clairvoyant as the Florida Legislature enacted Florida Statutes Sections 222.29 and 222.30 a year later, specifically, making a conversion of a non-exempt asset into an exempt asset with the specific intent to hinder, delay or defraud a creditor a “fraudulent asset conversion” that can be set aside under the statute. See *Havoco of America, Ltd. v. Hill*, 197 F.3d 1135 (11th Cir. 1999).

Notwithstanding his decision in *Schwarb* and the change in chapter 222, Judge Paskay continued to cite to the legislative history and held yet again that conversion of non-exempt property into exempt is permitted. In *In re Snape*, 166 B.R. 184 (Bankr. M.D. Fla. 1994), Judge Paskay concluded that the evidence did not support a disallowance of the claim exemption where the debtors had embarked on “an elaborate strategy” to avoid a creditor because the debtors “believed” that the claim had been satisfactorily resolved.

The debtor-friendly rule pronounced by Judge Paskay many times and set forth by the Eighth Circuit in *Tveten* has continued to be cited in more recent cases. Twenty years later, the Tenth Circuit in *In re Warren*, 512 F. 3d 1241 (10th Cir. 2008), noted that the “very purpose of having exemptions is to permit a debtor to retain certain [assets]...without fear of creditors taking them.” The Tenth Circuit further noted that bankruptcy lawyers can face a dilemma in advising clients whether to acquire exempt assets stating:

As one commentator observed, “[T]he same conduct can be malpractice not to advise in one jurisdiction, but voidable and grounds for denial of discharge and possibly for disbarment in another...”¹⁴⁵

At the end of the day, “[T]he cases...are peculiarly fact specific, and the activity in each situation must be viewed individually.”¹⁴⁶

As recently as 2016, at least one bankruptcy court expressly held that “as courts have held in connection with exemption planning, simply doing what the law allows you to do is not, in and of itself, bad faith.” *In re Portell*, 557 B.R. 161, 170 (Bankr. W.D. Mo. 2016).

In *In re Arends*, 506 B.R. 516, 523 (Bankr. N.D. Iowa 2014), the court held:

¹⁴⁵ John D. Ayer, *How to Think About Bankruptcy Ethics*, 60 Am. Bankr. L.J. 355, 374 (1986).

¹⁴⁶ *Warren*, 512 F. 3d at 1250.

“It is well settled that the mere conversion of non-exempt assets to exempt assets is not in itself fraudulent.”

The Iowa Bankruptcy Court went on to state the colloquial phrase “pigs get fat; hogs get slaughtered.”

Against this backdrop of legislative history and case law, query whether a lawyer could or should be attacked for assisting a client with asset protection through a conversion of non-exempt assets to exempt assets.

ADVISOR LIABILITY FOR FRAUDULENT TRANSFERS

Freeman v. First Union Nat’l Bank

In 2004, The Florida Supreme Court held that the Florida Uniform Fraudulent Transfers Act (FUFTA) does not give a cause of action against third parties who actively aid and abet a fraudulent transfer, notwithstanding the “catch all” phrase in the statute which permits a court to award “any other relief the circumstances may require.”¹⁴⁷ In *Freeman*, victims of a \$90,000,000 international Ponzi scheme sued First Union National Bank for “aiding and abetting” Unique Gems International Corp., which allegedly defrauded approximately 16,000 people who were led to pay money as a “deposit” in connection with the assembly of necklaces. The Court concluded that “FUFTA” was not intended to serve as a vehicle by which a creditor may bring a suit against a non-transferee party (like First Union in this case) for monetary damages arising from the non-transferee party’s alleged aiding-abetting of a fraudulent money transfer.¹⁴⁸

Bankfirst v. UBS Paine Webber, Inc.

The Florida Supreme Court in the *Freeman* case described above made mention of the Florida 5th District Court of Appeals case of *Bankfirst v. UBS Paine Webber, Inc.*, 842 So. 2d 155, 156 (Fla. 5th DCA 2003), where two of the three judges on the panel held that there is no cause of action for civil conspiracy where a professional actively assists a client in making a “fraudulent transfer.” In that case, attorney Jonathan Alper, who co-authored the Kleinfeld Alper article that is extensively quoted herein, actively assisted a client who had a judgment against him in funding a Bahamian Asset Protection Trust after being introduced to this lawyer by PaineWebber. (Check out Mr. Alper’s excellent website at alperlaw.com.) Mr. Alper and PaineWebber were sued by Bankfirst, and reportedly the bank had to pay their attorney’s fees after losing the appeal. The majority stated that “neither Section 222.30 nor Chapter 726 of the Florida Statutes creates a cause of action against a party who allegedly assists a debtor in a fraudulent conversion or transfer of property, where the person does not come into possession of the property.” In the dissent, however, Judge Harris stated that “[w]hile I agree that extreme caution should be taken before holding an attorney liable in civil conspiracy for a wrong committed by a client, still if a conspiracy is properly proved and the lawyer is shown to have willingly and knowingly participated in it, there is no immunity.”¹⁴⁹

¹⁴⁷ *Freeman v. First Union Nat’l Bank*, 865 So. 2d 1727, 1277 (Fla. 2004).

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

Does Judge Harris' dissent and potential future "bad facts cases" leave the door open for activist courts to eventually find a way to punish lawyers who actively assist debtors in the avoidance of creditors? The *Harwell* bankruptcy case in Tampa should certainly give practitioners some pause.

In *In re Harwell*, 8:08-mp-0002-MGW (Doc. 73), aff'd 414 B.R. 770 (M.D. Fla. 2009), rev'd 628 F.2d 1312 (11th Cir. 2010), a well-respected Sarasota litigation lawyer permitted a debtor to have proceeds from the sale of a business pass through the lawyer's trust account, and from there to several different individuals in an apparent attempt to avoid a judgment creditor's active attempts to collect on the judgment. On summary judgment, Bankruptcy Judge Michael Williamson found that there was no cause of action for aiding and abetting a fraudulent transfer under the above-referenced *Freeman* case, assuming that the lawyer was not considered to be an "initial transferee" under Bankruptcy Code Section 550(a)(1), which empowers a trustee in bankruptcy to recover property from "the initial transferee" of a fraudulent transfer under certain circumstances. District Judge James Moody affirmed on appeal. *In re Harwell*, 414 B.R. 770 (M.D. Fla. 2009). Hutton was later determined to be liable as an initial transferee by the bankruptcy court in a subsequent opinion, after remand on appeal based upon an updated definition of "initial transferee" that was provided by the Eleventh Circuit. *In re Harwell*, 2011 WL 4566443 (Bankr. M.D. Fla. 2011). There was no further discussion of whether the *Freeman* case would apply, which was presumably because Hutton was found to owe the money to the trustee under the above-referenced Bankruptcy Code provision, so Florida law was no longer relevant. Judge Moody's August 31, 2009 opinion also discussed whether Florida law recognizes a cause of action for civil conspiracy to commit a fraudulent transfer, and noted that one element of a civil conspiracy is "an unlawful act is that the conspirator must do an unlawful act...or do a lawful act by unlawful means," in addition to (1) the act being overt, (2) the act being in the pursuance of the conspiracy, and (3) the act causing damage to the plaintiff.¹⁵⁰

Judge Moody noted that Judge Harris' dissent in the *Bankfirst* case indicated that "there should be no policy reason to immunize someone who knowingly and willingly makes it possible for the transferor to commit a fraud."¹⁵¹

Despite affirming the summary judgment in the attorney's favor, Judge Moody's "shot over the bow" to "asset preservation" lawyers¹⁵² reads as follows:

"Like the Florida Supreme Court, this Court is reluctant to say there is no set of facts under which a party who assists a fraud might be liable under a civil conspiracy theory. For example, had Hutton, the lawyer in this case, assisted Debtor in falsely answering the collection interrogatories, or had he violated the Colorado state turnover order requiring the debtor to turn over settlement proceeds to the creditor, such an act might well be considered in furtherance of a conspiracy to commit fraud."¹⁵³

¹⁵⁰ *Harwell*, 414 B.R. at 786.

¹⁵¹ *Bankfirst*, 842 So. 2d at 157.

¹⁵² Jimmy Buffet song *A Pirate Looks at 40* lyrics, "Mother, mother ocean, after all the years I've found, my occupational hazard being my occupation's just not around, I feel like I've drowned, gonna head uptown, I feel like I've drowned, gonna head uptown."; See also footnote 2.

¹⁵³ *Harwell*, 414 B.R. at 787.

In saying that, this Court does not hold that such an action for civil conspiracy exists for aiding a fraudulent transfer. It is not required to reach that issue since there were no “wrongs” committed by the lawyer in this case. This issue is best left for another day, but, at least, a warning bell has sounded for parties involved in “asset preservation.”

If and when a lawyer actively assists a client in making a “fraudulent” transfer, and also assists that client in misleading a creditor in a way that causes violation of law, such as under the Federal Wire Fraud Act where untruthful information is communicated by mail or internet,¹⁵⁴ then the Civil Conspiracy Law may be found to apply, and the advisor or advisors may find themselves to be jointly and severally liable for the value of assets transferred, and damages, including attorneys’ fees and costs.

***Harwell* – Lawyers as Targets If They Have Received Actual or Constructive Receipt of a Bankruptcy Debtor’s Assets by Cooperating in a Fraudulent Transfer or Similar Conduct**

The Eleventh Circuit Court of Appeals decision issued in *Harwell* reversed the lower court’s finding that the attorney was an “initial transferee.” The court noted that the lawyer in this case may have gone beyond being an agent or conduit for the client under Bankruptcy Code Section 550(a)(1), and concluded that the “party must have acted in ‘good faith’ with respect to the relevant transaction in order to be spared the effects of Section 550(a)(1) by establishing that (1) they did not have control over the assets received, i.e., that they merely served as a conduit for the assets that were under the actual control of the debtor-transferor and (2) that they acted in good faith and as an innocent participant in the fraudulent transfer.”¹⁵⁵

Footnote 10 of the opinion indicates that “We now explicitly hold that good faith is a requirement under this Circuit’s mere conduit or control test.”

The Court further stated that “in the vast majority of cases, a client’s settlement funds transferred in and out of a lawyer’s trust account will be treated just like bank transfers, and lawyers as intermediaries will be entitled to mere conduit status because they lack control over the funds.” Mere conduits, such as lawyers and banks, do not have an affirmative duty to investigate the underlying actions or intentions of the transferor. However, under the particular circumstances of this case, and given the Bankruptcy Court’s assumptions about Hutton’s major role in the fraudulent transfer of these funds at issue, Hutton was not entitled to summary judgment in his favor based on the mere conduit or control test.¹⁵⁶

After this Eleventh Circuit opinion, Bankruptcy Judge Michael Williamson found that the lawyer was subject to liability under Section 550(a)(1), and there was no further mention of aiding and abetting or civil conspiracy, given that the Bankruptcy Code liability was apparently sufficient for the trustee’s purposes. The attorney’s liability in *Harwell* was linked to his actual possession of the funds. Therefore, counsel should think long and hard before taking clients’ funds into their own trust account.

¹⁵⁴ See 18 U.S.C. §§ 1341, 1343.

¹⁵⁵ See also *Harwell*, 628 F.3d at 1323.

¹⁵⁶ *Id.*

Section 550(a) provides that:¹⁵⁷

Except as otherwise provided in this section, to the extent that a transfer in avoided under Section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from –

- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
- (2) any immediate or mediate transferee of such initial transferee

It is noteworthy that the Eleventh Circuit’s opinion made mention of the following:

The bankruptcy court also addressed whether Trustee Martinez had cognizable claims against Hutton, under Florida law, for (1) aiding and abetting a fraudulent transfer, or (2) civil conspiracy to effect a fraudulent transfer. Citing *Freeman v. First Union Nat’l Bank*, 865 So.2d 1272, 1277 (Fla. 2004), the bankruptcy court determined that the Florida Uniform Fraudulent Transfer Act did not allow Trustee Martinez to assert a cause of action against Hutton for either aiding and abetting or civil conspiracy if Hutton was not an “initial transferee” of the money within the meaning of the Bankruptcy Code. The district court affirmed. *Martinez v. Hutton (In re Harwell)*, 414 B.R. 770, (M.D. Fla. 2009).

This language seems to imply that being an “initial transferee” under the Bankruptcy Code could cause liability for aiding and abetting or civil conspiracy. Would this be the case needed outside of bankruptcy?

Kleinfeld and Alper describe the above two cases and other Florida cases as follows:

Freeman v. First Union Nat’l Bank

In *Freeman*, the State of Florida filed a lawsuit in the U.S. District Court for the Southern District of Florida, alleging that a company called Unique Gems ran a “Ponzi scheme.” Unique Gems maintained bank accounts at First Union National Bank. In the course of litigation, Lewis B. Freeman was appointed receiver over the company. Plaintiff receiver’s second amended complaint claimed that First Union National Bank was liable to the receiver for money damages on the grounds that it aided and abetted a fraudulent transfer by allowing Unique Gems to wire transfer money to Liechtenstein even after the state filed the lawsuit. The complaint alleged that although First Union informed Unique Gems in a letter dated February 21, 1997, that it would close its accounts in ten days, the bank did not close the account. Subsequently, a court-order injunction was entered on March 5, 1997, freezing the Unique Gems account. Presumably, while the motion to freeze its assets was pending, Unique Gems transferred a total of \$6.6 million from its First Union account to Liechtenstein. Even after the injunction was entered, and after First Union told Unique Gems that its

¹⁵⁷ 11 U.S.C. § 550.

account would be closed 30 days thereafter, First Union still allowed Unique Gems to wire transfer an additional \$2 million to Liechtenstein. Finally, First Union closed the Unique Gems account on July 24, 1997. These facts represent an exceptional and excellent context to analyze the interrelationship between Florida's fraudulent transfer statutes and the common law tort of aiding and abetting by a third party non-transferee.

The district court dismissed the receiver's aiding and abetting claim against First Union with prejudice because it did not state a cause of action under Florida law. The district court held that the FUFTA allows creditors only to set aside fraudulent transfers. The court considered the FUFTA to be similar to the fraudulent transfer provisions of the Bankruptcy Code,¹⁵⁸ and held that neither provides for aider and abettor liability. The district court noted that while the receiver cited cases recognizing aiding and abetting as common law fraud, or another cause of action, none of these cases related to the Uniform Fraudulent Transfer Act.

On appeal, the Eleventh Circuit Court of Appeals noted that the FUFTA remedies for fraudulent conveyance are different and possibly broader than those of the Bankruptcy Code. The appeals court said that, "While the Bankruptcy Code limits remedies to the recovery of transferred property or its value . . . the FUFTA clearly provides additionally for 'any other relief the circumstances may require.'" Thus, the issue before the Eleventh Circuit was whether the FUFTA remedies, like bankruptcy remedies, include only equitable powers to cancel a fraudulent transfer, or whether the FUFTA's "catch-all" phrase of "any other relief the circumstances may require" gives rise to common law theories for damages against third party non-transferees. The Eleventh Circuit felt it could not predict how the Florida Supreme Court would rule on the issue.¹⁵⁹ Specifically, the Eleventh Circuit asked the Florida Supreme Court, "Under Florida law, is there a cause of action for aiding and abetting a fraudulent transfer when the alleged aider-abettor is not a transferee?"¹⁶⁰

The Florida Supreme Court began its own analysis by reviewing the meaning of the wording "any other relief the circumstances may require" in F.S. §726.108(1)(c)(3). The court concluded that, "We believe that the Legislature intended it to facilitate the use of other remedies provided in the statute, rather than creating new and independent causes of action such as aider-abettor liability"¹⁶¹ After further considering legislative intent, the Supreme Court stated, "There is simply no language in the FUFTA that suggests the creation of a distinct cause of action for aiding-abetting claims against non-transferees. Rather, it appears that the FUFTA was intended to codify an existing but imprecise system whereby transfers that were intended to defraud creditors were to be set aside."¹⁶² The court stated, "We simply can see no language in FUFTA that suggests intent to create an independent tort for damages."¹⁶³ The Supreme Court

¹⁵⁸ 11 U.S.C. § 548.

¹⁵⁹ The Appeals Court believed there was conflicting guidance from Florida's intermediate appellate courts on the nature of Florida's Uniform Fraudulent Transfer Act, its remedies, and its relationship to the Bankruptcy Code and therefore it certified this question to the Florida Supreme Court.

¹⁶⁰ *Freeman*, 329 F. 3d at 1234.

¹⁶¹ *Id.* at 1276.

¹⁶² The Court cited its recent decision in *Friedman v. Heart Institute of Port St. Lucie, Inc.*, 863 So. 2d 189 (Fla. 2003) to illustrate the FUFTA's narrow focus. *Id.* at 1277.

¹⁶³ *Id.* at 1277.

explained that “[t]o adopt the appellants’ position in this case would be to expand the FUFTA beyond its facial application and in a manner that is outside the purpose and plain language of the statute. Consistent with this analysis we conclude that the FUFTA was not intended to serve as a vehicle by which a creditor may bring a suit against a non-transferee party’s alleged aiding and abetting of a fraudulent money transfer.”¹⁶⁴ In *Freeman*, the Florida Supreme Court strictly interpreted the Florida Uniform Fraudulent Transfer Act and circumscribed the statute’s remedies. The Supreme Court’s unanimous decision is a remarkably clear and unequivocal rejection of the plaintiff/receiver/appellant’s position.

The court’s decision in *Freeman* is in keeping with a series of recent Florida appellate decisions concerning fraudulent conveyance law. In *Yusem v. South Fla. Water Mgmt. Dist.*, 770 So. 2d 746 (Fla. 3d DCA 2000), the Fourth District Court of Appeals reviewed an alleged fraudulent transfer of funds to an offshore account. The holding provides a clear definition of a fraudulent conveyance action. The court stated, “A fraudulent conveyance action is simply another creditor’s remedy.”¹⁶⁵ The court proceeded to define the nature of this remedy as “either an action by a creditor against a transferee directed against a particular transaction, which, if declared fraudulent, is set aside thus leaving the creditor free to pursue the asset, or it is an action against a transferee who has received an asset by means of a fraudulent conveyance and should be required to either return the asset or pay for the asset (by way of a judgment and execution).”¹⁶⁶ The Fourth District Court of Appeals emphasized that a fraudulent conveyance action is not an action against the debtor for failure to pay an amount owing from a prior judgment and does not warrant an additional judgment against the same debtor because of the fraudulent transfer. A fraudulent conveyance action is not a lawsuit against a transferor/debtor, but it is an action against the property or the transferee holding the property.

In *Beta Real Corporation, etc. v. Lawrence Graham*, 839 So. 2d 890 (Fla. 3d DCA 2003), the Third District Court of Appeals reviewed a situation where a partner in a British law firm allegedly stole \$9 million, of which \$1.4 million wound up in a Florida bank in the name of a BVI corporation and \$675,000 was spent acquiring a Florida condominium. The plaintiff’s only argument for in personam jurisdiction in Florida was that the defendant had committed a tortious act, specifically a fraudulent transfer, within this state. The appellate court held that a fraudulent conveyance is not a tortious act, and therefore not a basis for jurisdiction. However, the court did leave open further proceedings, including assertions of in rem or quasi in rem jurisdiction, by imposing a constructive trust, equitable lien, or similar remedy even though the damages could not exceed the amounts which have been traced to the theft and thus recoverable in rem or quasi in rem.

In *Bankfirst v. UBS Paine Webber, Inc.*, 842 So. 2d 155 (Fla. 5th DCA 2003), the Fifth District Court of Appeals reviewed an asset protection plan where Bankfirst sued a debtor’s lawyers and financial advisors for damages on the theory of common law civil conspiracy to make a fraudulent conveyance. The Fifth District, in what is probably one of its most concise decisions, upheld the trial court’s dismissal of Bankfirst’s civil conspiracy action based on the “conclusion that neither §222.30 nor Chapter 726, Florida Statutes, creates a cause of action against the party who allegedly assists a debtor in a fraudulent conversion or transfer of property, where the person does not come into possession of the property.”¹⁶⁷ Interestingly,

¹⁶⁴ *Id.*

¹⁶⁵ *Yusem*, 770 So. 2d at 749.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

the legal basis for the relatively lengthy dissenting opinion in that case is now completely refuted by *Freeman*.

The Third District Court of Appeals, in *Danzas Taiwan, Ltd. v. Freeman*, 868 So.2d 537 (Fla. 3rd DCA 2004), again reviewed the argument that a fraudulent transfer was a tortious act that gave rise to personal jurisdiction within the State of Florida and reviewed an allegation of conspiracy. There was no allegation that the alleged tortfeasor, Danzas Taiwan, received fraudulently conveyed assets, only that it was paid fees for services rendered to facilitate the physical transfer of assets. The appellate court, citing the decisions of both *Bankfirst* and *Beta Real*, held that there could be no jurisdiction over Danzas Taiwan for commission of a tortious act in Florida “because there is no cause of action against Danzas Taiwan for conspiracy to engage in fraudulent transfers.”¹⁶⁸ Thus, *Freeman* and its predecessors in Florida’s appellate courts unequivocally and unanimously define an action under Florida’s Uniform Fraudulent Transfer Act as a creditor’s equitable remedy, and they further agree this statute gives creditors no cause of action in tort against non-transferees for aiding and abetting or civil conspiracy.

The Client’s Right to Convey Assets

The Florida courts’ characterization of fraudulent transfers as reversible acts, but not tortious acts, is important for the protection of a person’s assets from creditor attack. Otherwise, it would be difficult and risky for people to design their business ownership and to arrange personal assets defensively if any asset transfer later cancelled as a violation of the FUFTA exposed the transferor and their professional advisors to additional civil damages based on theories of tort liability. Moreover, according to both the Florida Constitution and the U.S. Supreme Court, people have a basic right to both protect and freely transfer their property. The Florida Constitution refers specifically to the protection of citizens’ property. Art. I, §2, Basic Rights, provides that “[a]ll natural persons, female and male alike, are equal before the law and have inalienable rights, among which are . . . to acquire, possess and protect property.” It is clear that constitutional rights are accorded broad interpretation. While there are yet no cases which have asserted the constitutional right to protect property against creditor legal attack, this issue, no doubt, will arise and be examined by the courts.

The case of *In re Harwell*¹⁶⁹ mentioned above makes clear that lawyers who possess funds and actively assist debtors in making fraudulent transfers to avoid creditors will have liability exposure if the debtor ends up in bankruptcy.

Gosman and Rosen – Exposure of lawyers for allegedly participating in fraud upon creditors, malpractice in failing to properly advise a debtor, or unjust enrichment.

In the below discussed cases of *Gosman* and *Rosen*, bankruptcy trustees pursued lawyers for acts that included allegedly conspiring with clients to mislead creditors, overcharging for services not needed or called for (like \$41,000 for an offshore trust when the court indicated that the client would have been better served by buying a larger homestead than placing assets offshore), or when the debtor lost assets to the creditor that might have been saved if the lawyer had done a better job at asset protection. It is ironic that a creditor who is able to seize assets that would have otherwise been unavailable may be able to “double dip”

¹⁶⁸ *Id.*

¹⁶⁹ *In re Harwell*, 2011 WL 456643, *8 (Bankr. M.D. Fla. Sept. 30. 2011).

by stepping into the debtor's shoes, via a bankruptcy trustee, and pursuing a malpractice claim against the lawyer, with the active assistance of the ex-client, who may have turned against the lawyer and assigned all rights to malpractice suit recovery as part of the settlement with the creditor. More discussion of these two cases now follows:

Abraham D. Gosman v. Peabody & Arnold, LLP and Joel Reinstein, P.A.

In the 1999 Bankruptcy Court case of *Abraham D. Gosman v. Peabody & Arnold, LLP and Joel Reinstein, P.A.*, 382 B.R. 826 (Bankr. S.D. Fla. Dec. 13, 2007), the Bankruptcy Trustee brought claims against the law firm that had represented Mr. Gosman to recover damages on behalf of the bankruptcy estate for having cooperated and provided guidance for what the Bankruptcy Court had found to be fraudulent transfers. The trustee claimed that such transfers were made under the guise of compensating Mrs. Gosman for alleged breaches of a pre-existing Prenuptial Agreement that was amended in conjunction with her receipt of assets in what the Court found to be a ruse for the purpose of avoiding creditors. The Court found that the doctrine of *in pari delicto* applied to prevent the trustee from having stated that Mr. Gosman's actions were intentional, and that the law firm was merely negligent in its representation.

The opinion included the following:

Furthermore, "[e]ven if the parties did not participate in the *same* wrongdoing, Florida also follows a general principle that no one shall be permitted to profit by his own fraud, or take advantage of his own wrong, or found any claim upon his own iniquity, or profit by his own crime." *May*, 2007 WL 2120269, at *4 (emphasis in original). In determining whether *in pari delicto* applies, "a court first determines whether the plaintiff's *13 guilt is far less in degree than defendant's, so as to make the doctrine inapplicable. If plaintiff's guilt is not far less, the court inquires if applying the doctrine would be contrary to public policy." *Id.* (Quoting *Turner*, 704 So. 2d at 750).

Here, the Trustee alleges in its Second Amended Complaint that the Debtor, Mr. Gosman, was found to have acted with actual intent to defraud his creditors when he transferred assets to Mrs. Gosman. Therefore, Mr. Gosman's fraud appears on the face of the complaint. Because the Trustee stands in the shoes of the Debtor, I must determine whether this fraud would bar a claim by the Debtor against Peabody for negligence.

In determining whether the doctrine of *in pari delicto* applies under Florida law, I first determine whether the Debtor's guilt is far less in degree than Peabody's, based on the allegations in the Second Amended Complaint. According to the allegations, the Debtor acted with actual intent to defraud while Peabody was only negligent, and therefore I find that the Debtor's guilt is not far less than Peabody's. Second, I find no reason why applying the doctrine of *in pari delicto* in this case would be contrary to public policy. Based on the allegations in the Second Amended Complaint, the Debtor's guilt is clearly at least as great as Peabody's, and therefore this can be resolved on a motion to dismiss.

The Court noted that the Trustee stands in the shoes of the debtor, and that any affirmative defenses that could be asserted against the debtor may also be asserted against the Trustee.

In the 2012 Bankruptcy Court cases captioned *In re Akram Niroomand, Debtor, Alan L. Goldberg, Plaintiff v. Howard D. Rosen, Donlevy-Rosen & Rosen, P.A.*,¹⁷⁰ the trustee in bankruptcy filed an action against the law firm that represented a debtor and had established an offshore asset protection trust that was apparently funded during a time that the creditor's claim was well developed and expected to cause possible insolvency.

The trustee sued for malpractice, and unjust enrichment, claiming that the law firm should not have charged \$47,000 to establish an offshore trust and to provide other advice and services when the debtor was insolvent. While the debtor testified that she was insolvent at the time of the transfer of assets to the offshore trust, she had executed an Affidavit of Solvency, and had apparently assured the law firm that she was solvent.

The case against the lawyer was dismissed, based upon the Bankruptcy Court's conclusion that there was no evidence of legal malpractice or unjust enrichment, and that there was credible evidence to support a finding that the debtor was solvent at the time she made the transfer. The decision of the Bankruptcy Court was appealed and affirmed by both the District Court and the Eleventh Circuit Court of Appeals (493 Fed. Appx. 11).

Much has been written about this case, with commentators noting the importance of making sure that clients are solvent when they enter into offshore trust or associated planning.

One author of this paper discussed this case with Mr. Rosen, who confirmed that it should not have made a difference as to result if the court had found that the debtor was insolvent at the time that she had funded the offshore trust. If the court had determined that she was insolvent, then the authors believe that it would have had to find that the Florida case law described above would not make the lawyer responsible to creditors as the result of actively assisting and advising with respect to what is defined as a "fraudulent transfer" under Florida Statutes Section 726, absent other facts that were apparently not existent in this case. No law was apparently broken, and no creditor was apparently misled by the conduct of the debtor and her legal counsel. The offshore trust protected the assets conveyed to it until eventually used to purchase a homestead. Mr. Rosen also pointed out that the trust had been dissolved long before the bankruptcy proceeding was commenced.

Naples attorney and an offshore trust expert, Jonathan Gopman, has written the following with respect to this case:

Niroomand illustrates several important points that should be considered as part of the asset protection planning process. The following are also tips to live by when counseling clients on asset protection strategies.

¹⁷⁰ 2013 Bankr. LEXIS 383, *6-10 (Bankr. S.D. Fla. Jan. 30, 2013).

First, timing is a critical aspect of effective asset protection planning. Given the existence of a claim, the creation and funding of an offshore trust was not appropriate. Clients should plan only at appropriate times and under appropriate circumstances and attorneys should only assist clients under such conditions. Many people seek advice about wealth protection strategies because they are involved or concerned that they are about to become involved in serious litigation. This may be the wrong time to plan or valuable opportunities may be foreclosed without raising serious fraudulent transfer issues.

As a general rule, if assisting a client with a particular strategy raises an issue as to a fraudulent transfer do not proceed or proceed with a great caution. Bad things can happen to good people if planning is done under inappropriate circumstances. This does not mean that we cannot ethically assist clients who are involved in litigation (or concerned that litigation is imminent). However, it does mean exercise discretion. Contrary to Rosen's stated practice, *Grupo Mexicano* should not be interpreted as providing an attorney and his or her client the ability to engage in aggressive planning so long as it is completed before judgment.

Second, as a result of the jurisdiction where a client resides or may want to reside, the manner in which a client owns certain property interests (for example, homestead or tenancy by the entirety), it may be possible to achieve significant wealth protection for a client involved in litigation or concerned that litigation is imminent. In *Niroomand*, it was only after tens of thousands of dollars were wasted on an offshore trust structure that D eventually followed advice to pay down her mortgage – which ultimately may have been a much safer strategy for D and far less expansive. Nonetheless, D would have also most likely found it necessary to avoid finding herself in a bankruptcy proceeding for many years following the payment of the mortgages on her primary residence.

Third, carefully consider the consequences of using a "Jones Clause" in an asset protection trust. If the clause is substantially similar to the one used in the Trust, that is, it creates substantial hurdles for a creditor, it probably will not work to protect the client (or the attorney).

Fourth, following the creation and funding of a foreign trust or any other wealth protection strategy, filing bankruptcy should be viewed as an option of last resort, notwithstanding that the planning may have been completed under appropriate circumstances. This is not to say that a properly implemented foreign trust structure or other wealth protection strategy cannot survive a challenge in a bankruptcy proceeding. Nonetheless, it is clear from a few bad fact cases that the present environment in the Bankruptcy Court system is hostile toward certain wealth protection strategies. Unfortunately,

bankruptcy judges typically have the pleasure of reviewing bad fact cases involving foreign trusts. Experience demonstrates that judges in bad fact cases usually reach the proper result; however, the legal analysis is faulty. This faulty analysis has significantly damaged public perception regarding legitimate wealth protection planning. It is clear, however, that §548(e)(1) of the Bankruptcy Code (that is, the ten (10) year fraudulent transfer rule that applies to self-settled or classic asset protection trusts) mandates that bankruptcy courts respect the validity of such trust structures. Gone are the days when bankruptcy judges could wrongfully dismiss such trust structures as shams. Instead, the court must now engage in an analysis of whether a debtor's transfer of assets to such a trust constituted a fraudulent transfer. *See e.g., Battley v. Mortensen, et. al., (In re Mortensen)*, 2011 WL 5025249 (Bankr. D. Alaska). For an excellent discussion of *Mortensen* see Shaftel, "Court Finds Fraudulent Transfer to Alaska Asset Protection Trust," 39 EP 15 (April 2012); Sullivan, Merrick, Gillen, Bove & Nenno, "Fraudulent Transfer Claims," 150 Trusts & Estates 43 (Dec. 2011); and **"Gopman & Rubin: Further Analysis on *In re Mortensen*,"** LISI Asset Protection Planning Newsletter #187 (November 7, 2011) at <http://www.leimbergservices.com>. See also, **"Oshins & Keebler on Mortensen: No, the Sky Isn't Falling for DAPTs!,"** LISI Asset Protection Planning Newsletter #186 (October 31, 2011) at <http://www.leimbergservices.com> and **"Adkisson & Riser on Mortensen: Alaska Asset Protection Trust Fails to Protect Future Assets in Bankruptcy under New Section 548(e) Against Future Creditor,"** LISI Asset Protection Planning Newsletter #185 (October 20, 2011) at <http://www.leimbergservices.com>.

The importance of obtaining an affidavit of solvency should not be ignored in this context. If a debtor's financial situation and affidavit is such that a transfer would not render the debtor insolvent, it would seem difficult for a creditor to argue that a debtor possesses the *actual* intent to hinder, delay or defraud such creditor from collecting on its judgment.

Fifth, reliance on *Grupo Mexicano*, for the proposition that a creditor has no pre-judgment remedies seems misplaced. Clearly, a creditor does have pre-judgment rights and can exercise such rights to a client's detriment. These rights should be disclosed to a client prior to assisting a client with making any transfers. Additionally, the issue of civil contempt should be discussed in these situations emphasizing that a judge may order incarceration in certain circumstances. It is important to advise a client in the context of using a foreign trust that it is likely that the client will remain in the United States within the jurisdiction of a court here.

It is just as important, however, to recognize that honest people seek legitimate wealth protection by using foreign trusts that are created and funded under appropriate circumstances. When properly structured and established

under appropriate circumstances, foreign trusts are one of the most (if not the most) effective wealth protection strategies available. It is also important to recognize that the law permits individuals, businesses and other organizations to plan to protect assets and income from the claims of future unforeseen creditors. It is equally important to recognize that lawyers have a duty to zealously represent their clients, including lawyers who practice in the estate planning area. Zealous representation mandates that practitioners discuss all available planning wealth protection strategies and convey sufficient accurate information regarding such strategies so clients can make informed decisions.

Finally, collection of due diligence should never be viewed primarily as a method of impeaching a client's testimony as addressed by the court. Properly collecting due diligence to ensure that an attorney is not assisting a client with a fraudulent transfer should not only protect the attorney by proving the planning was done under appropriate circumstances, it should also protect the client by enabling the attorney, as the client's advocate, to prove to the court that such planning should be respected and accepted by the court.

FLORIDA BAR ACTION AGAINST LAWYER FOR ALLEGED FRAUDULENT TRANSFER ACTIVITY TO AVOID PAYING MONIES TO HIS EX-CLIENT

In December of 2015, a Florida Supreme Court-appointed referee determined that a lawyer who formed a new professional association in an attempt to avoid paying a judgment owed by his older professional association, did not violate Florida's Rules of Professional Conduct.¹⁷¹ Initially, the Florida Bar sued the lawyer,¹⁷² claiming two separate violations. First, that the new professional association he created was a mere continuation of the prior one, and had been formed with the intent to hinder, delay, or defraud collection action, which the Bar alleged to be in violation of Rule 4-8.4, and, second, that the lawyer diverted monies belonging to the first professional association to a bank account owned by the second professional association with the intent to hinder, delay, or defraud the creditor.

As indicated above, Rule 4-8.4(c)-(d), titled "Misconduct," states that "a lawyer shall not engage in conduct involving dishonesty, fraud, deceit, or misrepresentation, (d) a lawyer shall not engage in conduct in connection with the practice of law that is prejudicial to the administration of justice."

The referee found that the lawyer did not transfer tangible assets or accounts receivable from the first professional association to the second, and that there was no transfer of goodwill to the second professional association. The referee also found that the lawyer's long standing practice of paying personal expenses from the business operating account of the professional association "is more the norm for small business than the exception," and that every year his CPA sorted out personal and business expenses so that "nothing was hidden," and "nothing was 'laundered.'" The referee further noted that the respondent did not commit fraud, deceit, or misrepresentation.

¹⁷¹ When violations of the Florida Rules of Professional Conduct occur, the complaint is first brought before the Florida Bar Committee on Professional Ethics, and once a decision is rendered at that level, an appeal to the Florida Supreme Court may be filed. Upon the Florida Supreme Court receiving the case a "Referee" is assigned to the case to determine the final holding.

¹⁷² *The Florida Bar v. Jefferson Riddell*, SC 15-1288, 2016 WL 1597199 (Fla. 2016).

The referee indicated that the evidence was not clear and convincing such that it could be proven that the lawyer acted in an unlawful or contrary manner to honesty and justice.

It would have been nice if the referee had further pointed out that even if this lawyer had committed a “fraudulent transfer” to avoid a creditor, that it would not be considered as conduct involving dishonesty, fraud, deceit, or misrepresentation.

Notwithstanding the above decisions, creditors, and sometimes debtors who have become cooperative with creditors after the fact, will continue to attempt to pursue causes of action against lawyers who assist in fraudulent transfers. In particular, this will occur when the conduct has been extremely aggressive, or on the edge of fraud.

Florida lawyers must therefore be careful to assure that their conduct is above reproach from an ethical and professional standpoint when advising debtors, given the high degree of past and expected future criticism that can apply in this arena.

Further, lawyers advising debtors in situations where the creditors consist of certain U.S. government agencies or where the debtors or contemplated actions are controlled by the laws of States that have “outlawed” transfers to avoid creditors must be especially careful.

The remainder of the above article written by Jonathan E. Gopman, Esq. of Akerman, LLP, David Slenn, Esq. of Shumaker, Loop & Kendrick, LLP, and Ryan Beadle of Huntington National Bank is provided below:

**GOPMAN, SLENN & BEADLE ON *GOLDBERG V. ROSEN*:
IMPORTANT LESSONS FOR ADVISORS WHEN COUNSELING
CLIENTS ON ASSET PROTECTION STRATEGIES**

By: Jonathan E. Gopman, Esq., David Slenn and Ryan Beadle

EXECUTIVE SUMMARY:

An overly aggressive, imprudent and perhaps poorly advised bankruptcy trustee pursued the legal fee charged by an attorney who specialized in asset protection. The trustee pursued the legal fee on a fraudulent transfer theory and argued that the attorney committed malpractice. As the facts of the case demonstrated, however, the attorney did his job in collecting sufficient due diligence prior to assisting the client with the planning. Collection of due diligence by the attorney included requiring his client to execute an affidavit of solvency. On the other hand and a bit refreshing from an asset protection planner’s standpoint, the bankruptcy trustee found himself in hot water along with his attorney who are each now defending a malicious prosecution action and the trustee’s attorney had to respond to a bar complaint. This time the good guy won!!!! Although the bar

complaint was dismissed, the bankruptcy trustee and his attorney have been unable to bring the litigation to a close. “[Rosen’s attorney] and [Rosen], on the other hand, as can be gleaned from their desire to take pointless depositions, their filing of numerous, groundless motions, want to continue the litigation even after obtaining a final, appellate victory. It is therefore abundantly clear that their intent is to exacerbate the litigation and harass and malign Plaintiffs.” See *In re Niroomand*, Case No. 09-12141-AJC, Bankr. S.D. Fla., Pls.’ Opp’n to Defs.’ Emerg. Mot. to Compel (Dec. 4, 2012).

In *Goldberg v. Rosen (In re Niroomand)*, 11th Cir., No. 12-11231, Oct. 17, 2012, Alan Goldberg (“**T**”) was the bankruptcy trustee in the Chapter 7 bankruptcy of the debtor, Akram Niroomand (“**D**”). D was being pursued by Great American Insurance Company (“**C**”), which commenced a bond indemnity action on June 8, 2007 in the Southern District of Florida. Nearly a year later in May of 2008, C obtained a judgment against D in the amount of \$2,930,899.97 (the “**Judgment**”).

Approximately one (1) year prior to the Judgment and eighteen (18) months prior to filing for bankruptcy protection, D engaged the law firm Donlevy-Rosen & Rosen, P.A. (“**Rosen**”) to create and fund an offshore asset protection trust structure. (Interestingly, Alan Goldberg was also the bankruptcy trustee in *In re Lawrence*, 279 F.3d 1294 (11th Cir. 2002), another famous “bad” fact case involving a foreign asset protection trust.) According to D, Rosen advised her to establish the Niroomand Family Trust, dated July 6, 2007 (the “**Trust**”) in the Cook Islands to protect her assets. The pending claim was disclosed to Rosen.

After establishing the Trust, D transferred \$500,000 to it, however, following this initial transfer D requested the trustee to return approximately \$325,000. D used the funds that were distributed to her to pay down mortgages on her home in Florida. (Applying funds to pay down a mortgage on a primary residence is a common asset protection technique used in Florida when a debtor has an existing outstanding claim. Under Section 4 of Article X of the Florida Constitution a debtor can shelter such wealth even though such act represents a fraudulent conversion or transfer as to an existing creditor. See e.g., *Havoco of America, Ltd. v. Hill*, 790 So.2d 1018 (Fla. 2001), *Republic Credit Corporation, Inc. v. Upshaw*, 4th Dist. Case No. 4D08-1591 (March 25, 2009); *Palm Beach Savings & Loan Ass’n. v. Fishbein*, 619 So.2d 267 (Fla. 1993); *Jones v. Carpenter*, 106 So. 127 (Fla. 1925); *Craven v. Hartley*, 135 So. 899 (Fla. 1931); *LeMar v. Lechliden*, 185 So. 833 (Fla. 1939); *Sonneman v. Tuszyński*, 191 So. 18 (Fla. 1939); *In re: Gosman*, 382 B.R. 826 (S.D.Fla. 2007). Of course, following the enactment of the Bankruptcy Reform Act of 2005 the ability to shelter such wealth using this strategy was greatly reduced by the addition of several new statutes specifically designed to prevent the use of an unlimited homestead exemption to shelter such wealth immediately prior to filing for bankruptcy. See §

522(b)(3)(A) (730 day residency rule), § 522(p) (the value of the homestead of a debtor (other than farmers) in excess of \$146,450 (as adjusted for inflation pursuant to § 104(b)(1) and (2) of the Bankruptcy Code) is no longer exempt until 1,215 days (that is, three (3) years and four (4) months) after the debtor *acquired an interest* in the home) and § 522(o) (if within the ten (10) years prior to filing a petition a debtor converts non-exempt property to homestead with the actual intent to hinder, delay, or defraud a creditor, the value of the homestead is reduced by the value of such converted property).) Following receipt of the first distribution D then requested the trustee in the Cook Islands to terminate the Trust and repatriate the funds to the United States and the trustee complied with D's request. D made this request because presumably she was concerned that a court would eventually order her to repatriate such funds and then hold her in contempt if she failed to comply with such order. (In some cases involving egregious fact patterns where such orders have been issued to debtors courts have order such debtors incarcerated for failing to comply with such orders. See *e.g.*, *In re Lawrence*, 279 F.3d 1294 (11th Cir. 2002) and *Federal Trade Commission v. Affordable Media*, 179 F. 2nd 1228 (9th Cir. 1999). The authors strongly urge readers to review such cases carefully to understand the reasons such debtors were incarcerated. In each such case no debtor *was ever* incarcerated for creating and funding such a trust. Incarceration was ordered to remedy what the court deemed to be serious problems in the design or timing of the funding of such trusts.)

Based on the foregoing, T, in furtherance of his statutory duties as bankruptcy trustee, alleged D's payment of legal fees constituted a fraudulent transfer to Rosen (such transfers alleged to be both actually and constructively fraudulent). (According to T, the payment of legal fees for Rosen's advice, which T claimed was negligent, was not justified and did not constitute reasonably equivalent value.) Under Section 548 of the Bankruptcy Code, such transfers would be avoidable by T. T also alleged Rosen committed malpractice in assisting D in establishing the Trust and was unjustly enriched from the payment of legal fees. According to T, D was insolvent when she paid for such legal services.

The only evidence T presented to the bankruptcy court to prove his case was D's testimony. (However, according to T's Initial Brief, "extensive documentary evidence was introduced, for the most part, by stipulation." T further stated, "the Bankruptcy Court made manifest error by not considering the documentary evidence that establishes that the Debtor made the transfers to the Appellees in exchange for less than reasonably equivalent value..." Notwithstanding T's objections, the 11th Circuit did not find any support in the record for T's claim that the bankruptcy court did not consider the documentary evidence in reaching its conclusions.) D testified she was insolvent when she transferred assets to the trust. T did not present any expert testimony regarding the alleged malpractice claim. Rosen, however, presented "voluminous documentary and testimonial evidence" that D was solvent when

she transferred assets to the Trust. This evidence included D's affidavit of solvency in which D testified she was solvent and could pay her anticipated debts, including any judgment that might be incurred in a lawsuit. The affidavit of solvency was used to impeach D's testimony and the court found her testimony lacked credibility. As a result of D's lack of credibility, the court found T's case "woefully lacking" any evidence to support its allegations. The credible evidence supported finding D was solvent when she transferred assets to the Trust. The court found no fraudulent transfer and no evidence of malpractice or unjust enrichment.

According to the Bankruptcy Court:

The plaintiff's case consisted of one witness, which in the first place the Court did not find credible, but, in addition, the evidence presented is rather clear.

While, I never found any evidence about legal malpractice, I'm looking for what could possibly be argued as unjust enrichment. As to the constructive fraud, fraudulent transfer, the Court thinks it's abundantly clear that there's been no establishment of insolvency.

In fact, the record is abundant with records of solvency. The witness signed a solvency affidavit, which she said she did not read, *but the Court notes-noted that the witness could remember some things in the way of financial numbers of a rather complicated structure down to the penny, and other things, she couldn't remember at all.* (Emphasis added.)

On appeal, the district court upheld the bankruptcy court's findings. The 11th Circuit affirmed these decisions on Oct. 17, 2012. The court found no error in the bankruptcy court's findings. The bankruptcy court heard D's testimony and discredited it, which left T without any credible evidence to support his case. The bankruptcy court was entitled to find D was solvent at the time of the transfers because the credible evidence supported that finding. There was no indication that the Bankruptcy Court looked beyond the solvency badge to other indicia that established fraudulent intent. T's unwillingness to stop litigating after the Bankruptcy Court's dismissal apparently fueled a significant amount of animosity between Rosen and T. (Rosen and his attorney filed suit against T and T's attorney for malicious prosecution. See Case No. 12-10693CA23 filed in the Circuit Court of the Eleventh Judicial Circuit, Miami-Dade County. See paragraph 7 of T's Motion to Dismiss and for Sanctions, which amounts to three words, that is, "Shame on them" (referring to Rosen and his attorney). T accused Rosen and his attorney of engaging in a "vexatious, frivolous attempt to intimidate" T and his attorney in T's Motion to Dismiss.) Rosen moved for sanctions against T and in doing so, noted T's "evident personal disdain (and/or that of his counsel) for [Rosen's] area of practice --- "asset protection" --- cannot form a principled basis for an otherwise meritless appeal." (See Appellees'

Reply in Support of Their Motion for Sanctions under Rule 38, and Appellees' Response to Appellant's "Cross-Motion" for Sanctions, filed June 8, 2012.) T's rationale for his appeals is set forth below by cause of action.

Negligence & Unjust Enrichment. Rosen cited *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999) to justify its willingness to assist D with this planning. (A discussion of *Grupo Mexicano* is beyond the scope of this outline.) T disagreed with Rosen's reliance on this case. T's Civil Appeal Statement indicated that the determination of the appeal would turn on the interpretation of *Grupo*. Indeed, Rosen engaged in planning based on his interpretation of *Grupo*, which was articulated in the pleadings that stated:

I have sort of a general feeling about it, that once there's a judgment, there probably are restrictions on how you can transfer property, okay, that don't exist pre-judgment, at least according to the U.S. Supreme Court in *Groupo* [sic] *Mexicano*, so that's sort of been like the guideline for us...

However, T correctly countered that *Grupo*'s holding did *not* evaporate remedies available to creditors prior to obtaining a judgment providing:

Although *Grupo* held there was no common law authority entitling a plaintiff the right to a pre-judgment injunction preventing a debtor from transferring their property as they see fit, it specifically noted there may be one or more statutory basis that may nevertheless preclude a debtor from doing so, but that was not before the Court.

Indeed, the Supreme Court acknowledged pre-judgment remedies available to creditors under UFCA and UFTA. "Several States have adopted the Uniform Fraudulent Conveyance Act (or its successor the Uniform Fraudulent Transfers Act), which has been interpreted as conferring on a nonjudgment creditor the right to bring a fraudulent conveyance claim. See generally P. Alces, *Law of Fraudulent Transactions* & ¶ 5.04[3], p. 5-116 (1989). Insofar as Rule 18(b) applies to such an action, the state statute eliminating the need for a judgment may have altered the common-law rule that a general contract creditor has no interest in his debtor's property. Because this case does not involve a claim of fraudulent conveyance, we express no opinion on the point." See also, *American Surety Co. v. Conner*, 251 N.Y. 1, 166 N.E. 783, 65 A.L.R. 244 (1929), "We think the effect of these provisions is to abrogate the ancient rule whereby a judgment and a lien were essential preliminaries to equitable relief against a fraudulent conveyance. The Uniform Act has been so read in other states."

T argued that Rosen's advice, which grossly misinterpreted *Grupo*, was negligent, resulted in a fraudulent transfer of fees paid to Rosen, and

allowed Rosen to be unjustly enriched. D's planning amounted to legal fees of \$41,000 that accomplished nothing (and according to T, could have subjected D to civil contempt) and such fees should have been part of the bankruptcy estate. T felt Rosen should have known a creditor has remedies that involve reversing transfers pre-judgment and refusal to comply with a court order could result in D being held in civil contempt.

Rosen also argued that their inclusion of a "loophole" (commonly referred to as a "Jones Clause") negated liability on his part for alleged negligence in providing advice to create the Trust. (For a discussion of Jones Clauses see LISI Asset Protection Planning Newsletter #212 (October 30, 2012) at <http://www.leimbergservices.com>.) It should be noted, however, that the Jones Clause included in the Trust would have required T to file a law suit in a court in the Cook Islands and obtain a determination that T was entitled to a remedy. Nonetheless, the Cook Islands does not give full faith and credit to judgments entered by a court in the United States. Thus, any ruling issued by a court in the United States would not be respected under the law of the Cook Islands. As a result, it would seem strained to argue that the Jones Clause in the Trust assuaged a fraudulent transfer concern. To the contrary, it seems clear that it had the effect of hindering or delaying T from collecting on its debt.

T also disagreed with Rosen's view on the application the "impossibility defense" if D became subject to a court order involving the Rosen's planning. T cited Rosen's memorandum to file which included the note, "I told her that the law in the US is such that one cannot be incarcerated for failing to do that which is [im]possible to do, even if one has created the impossibility, no matter how reprehensible the conduct..." (See page 27 of T's Notice of Appeal to the United States Court of Appeals for the Eleventh Circuit, citing Defendants' Exhibit Register, Bankruptcy Court, ECF 99, Exhibit "L.")

Fraudulent Transfer. The court's ruling on the fraudulent transfer issue rendered the negligence argument asserted by T nugatory. As previously mentioned, T argued that the Supreme Court did not intend to eviscerate creditor remedies under the Uniform Fraudulent Transfer Act ("UFTA") in its holding in *Grupo Mexicano*. While the authors firmly believe this position is correct, the 11th Circuit accepted the Bankruptcy Court's findings that a fraudulent transfer simply *did not* exist in this case. Thus, the issue of whether *Grupo Mexicano* applied to UFTA became immaterial.

T also cited *Martinez v. Hutton (In re Harwell)*, 628 F.3d 1312, (11th Cir. 2010) in his Initial Brief for his 11th Circuit appeal and asserted a similar course of conduct between Rosen and the attorney in *Harwell*. (For a discussion of *Harwell*, see LISI Asset Protection Planning Newsletter #168

(January 13, 2011) at <http://www.leimbergservices.com>. See also, Gassman, “In re Harwell: Years of Bankruptcy Court Litigation End Badly for Lawyer Who Allowed His Trust Account to be Used for Transfers to Avoid Creditors,” LSI Asset Protection Planning Newsletter #243 (April 24, 2014 at <http://www.leimbergservices.com>.) However, in *Harwell*, the issue before the 11th Circuit was whether the attorney (who the court determined was an initial transferee) was entitled to use the conduit defense while failing to meet a good faith standard. (The attorney in *Harwell* faces strict liability for various fraudulent transfers amounting to nearly \$400,000.) In *Niroomand*, Rosen avoided transferee status due to D’s solvency. Furthermore, D did not use the Rosen’s trust account as a vehicle to orchestrate fraudulent transfers. Instead, D paid Rosen for services rendered which normally would constitute “reasonably equivalent value” in a fraudulent transfer analysis. T’s argument was essentially that the fees could not be reasonably equivalent value because the advice was negligent. According to T in his pleadings, “It is inconceivable that the Debtor received any value from Appellees when the facts are that Debtor could have been held in contempt for hiding behind the Trust in an attempt to avoid payment of her debts. Obviously, the Debtor realized such and repatriated the balance of the funds, after incurring substantial losses related to the creation and termination of the Trust.” (See page 22 of T’s Notice of Appeal to the United States Court of Appeals for the Eleventh Circuit, filed March 7, 2012.) As noted, however, the Bankruptcy Court dismissed the fraudulent transfer argument based on D’s solvency.

In assisting a client with the implementation of an effective wealth protection plan a firm should have due diligence-client intake procedures (know your client (“KYC”) procedures) in force that are used as a matter of common business practice in all cases.

An individual should be prepared to answer questions candidly and produce any documentation related to a wealth protection plan that may be required in a court proceeding. This does not mean that it is necessary to disclose such information if it is not required in a legal proceeding, however, a quality wealth protection plan will withstand scrutiny and should not require or be based upon any concealment.

Know your client and document the reasons your client is establishing an offshore structure. Reputable banks, trust companies and other financial institutions in quality foreign jurisdictions are required to conduct extensive due diligence before accepting a new client relationship. This process is generally far more extensive and impressive than the due diligence required by domestic institutions. A client may be required to prove source of wealth and substantiate that funding the structure will not result in a fraudulent transfer issue. Collect extensive financial information on a client who is

engaging you to provide wealth protection advice, including a financial statement prepared by a reputable accounting firm that has extensive knowledge of the client's financial condition, individual and corporate tax returns for at least the three past tax years and extensive information regarding the source of the client's wealth and employment or business history. Demand reference letters from professionals who have worked with the client such as attorneys, accountants, bankers and financial advisors. Finally, conduct an extensive background check on the client using Lexis-Nexis, WorldCheck, Google and any one or more of the deep web search engines available. Properly using these data bases should enable a planner to uncover civil and criminal cases involving the client as well as any tax liens, administrative proceedings and civil penalties that may have been imposed against the client.

From a moral and legal perspective it is acceptable to protect wealth using a properly implemented foreign wealth protection structure. When properly structured and implemented under appropriate circumstances, an offshore trust is one of the most effective and versatile wealth protection strategies available. In a mobile world where professional and business opportunities require clients to move from one jurisdiction to another, such trusts enable a client to protect wealth without relying on arbitrary local law exemptions that differ from one jurisdiction to the next. Additionally, for the sophisticated investor an offshore trust will be far more attractive as a wealth protection vehicle in comparison to most other strategies such as investment in annuities and insurance contracts (investment vehicles that are potentially exempt in one form or another from the claims of creditors under laws of many states). The cost and limitations of using such vehicles will not be palatable to many sophisticated clients.

Goldberg v. Rosen does represent an important victory for attorneys who assist clients with asset protection planning. It also teaches planners a valuable lesson, that is, engage in an appropriate level of due diligence in relation to your clients to help ensure that you are advising clients to engage in appropriate planning. Notwithstanding the foregoing, despite Mr. Rosen's testimony regarding the application of the holding in *Grupo Mexicano*, we believe it would be unwise to view this case (or *Grupo Mexicano* for that matter) as permitting free transferability of assets in disregard of existing or foreseeable claims that have not been reduced to judgment. Such reliance could place an attorney in a difficult position. This case also fires a warning shot at aggressive creditors counsel and bankruptcy trustees to proceed with caution and ensure that they have a strong basis for asserting claims against other professionals. In this case T and his attorney found themselves on the wrong end of a nasty malicious prosecution law suit and T's attorney on the wrong end of a complaint that was filed with The Florida Bar.

Good practitioners understand full well that we do not collect due diligence on the theory that it will later be used to impeach a client's

credibility. Quite the contrary, such due diligence is collected to protect a client's interest and prove why a structure and sound planning should be respected. What transpired in *Niroomand* regarding the use of the affidavit of solvency to discredit D is no different than a tax lawyer providing a letter that explained the risks of a transaction that is later being questioned by a client. Asset protection planning, when done properly, helps the client *and* the attorney. In this case, it only helped the attorney.

THE TRANSFEREE OF A “FRAUDULENT TRANSFER” MAY NOT BE ABLE TO BANKRUPT OUT TRANSFEREE LIABILITY OR USE THE CREDITOR EXEMPTION FOR TRANSFERS MADE TO HOMESTEAD TO AVOID CREDITORS IN CERTAIN CIRCUMSTANCES.

The 2013 Middle District Bankruptcy Court case of *In re Bifani*¹⁷³ held that an individual who received a transfer of real estate from her boyfriend on the eve of his bankruptcy, and sold the property and used the proceeds of the sale to buy a homestead that she and the debtor lived in, forfeited the homestead to creditors, because the property received was considered to be “ill-gotten gains” as further described in Chapter 5, Section E of this book. The Bankruptcy Court caused a forced sale of the home, over her objections, notwithstanding that she was not a debtor under the original bankruptcy. Her defenses are described in an Order dated January 23, 2014.¹⁷⁴

The 2008 Bankruptcy Court decision of *Elliott v. Kieseewetter*¹⁷⁵ contains an excellent analysis of why a recipient of a fraudulent transfer who knowingly engages in the act may not be able to discharge the obligation owed to the creditor:

The reach and extent of section 523(a)(2)(A) has been stated differently by different courts. The United States Supreme Court in *Field v. Mans*, 516 U.S. 59, 116 S. Ct. 437, 133 L. Ed. 2d 351 (1995), addressed whether justifiable or reasonable reliance was required for finding false misrepresentation under section §523(a)(2)(A). This Court's reading of *Field v. Mans* is that the Supreme Court in that case addressed solely misrepresentation as a form of fraud; and the Supreme Court did not address other forms of fraud. This distinction is important because litigants often presume, albeit incorrectly, that in order to find a debt nondischargeable under §523(a)(2)(A) there must have been an actual misrepresentation. See e.g., *McClellan v. Cantrell*, 217 F.3d 890, 892-893 (7th Cir. 2000)(opinion by Posner, J.) and the summary of cases cited therein.

Some courts have interpreted section 523(a)(2)(A) more broadly and do not require a specific misrepresentation to find a debt nondischargeable under that statute. Most notably, in *McClellan v. Cantrell*, *supra*, the United States Court of Appeals for the Seventh Circuit stated that by distinguishing between a “false representation” and “actual fraud”, the statute makes clear that the term “actual fraud” is broader than misrepresentation. The *McClellan*

¹⁷³ *In re Bifani*, 493 B.R. 866, 871 (Bankr. M.D. Fla. 2013).

¹⁷⁴ *Id.*

¹⁷⁵ 391 B.R. 740 (Bankr. W.D. Pa. 2008).

court noted that COLLIER ON BANKRUPTCY defines the term “actual fraud” as “any deceit, artifice, trick, or design involving direct and active operation of the mind, used to circumvent and cheat another”. Id. at 893 citing 4 COLLIER ON BANKRUPTCY P523.08[1][e] (15th ed., Lawrence P. King, ed., 2000). The *McClellan* court went on further regarding actual fraud:

Fraud is a generic term, which embraces all the multifarious means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false suggestions or by the suppression of truth. No definite and invariable rule can be laid down as a general proposition defining fraud, and it includes all surprise, trick, cunning, dissembling and any unfair way by which another is cheated. Id. (citing *Stapleton v. Holt*, 1952 OK 408, 207 Okla. 443, 250 P.2d 451, 453-54 (Okla. 1952)).

The *McClellan* court also recognized that the statute was applicable only to actual fraud but did not extend to constructive fraud. Id. at 894.

...

In reversing the lower court decision, the Court of Appeals for the Seventh Circuit in *McClellan* focused on the debtor’s intent and the distinction between constructive and actual fraud. The court noted that the debt would not have been obtained by actual fraud if the debtor sister did not intend to hinder the creditor from collecting the debt. But she was alleged to have been a full and equal participant in her brother’s fraud. As a result, the court found that the debt arose by operation of law from the fraud of the debtor. The debt owed by the debtor sister was created when she prevented the creditor from collecting the money owed by her brother. According to the court in *McClellan*, that debt was non-dischargeable. As Judge Posner wrote:

Pressed at argument, her lawyer was unable to suggest any reason why the type of fraud presented by the allegations of *McClellan*’s complaint should be treated differently from other types of fraud. The two- step routine that *McClellan* alleges and that we must take as true- in which Debtor A transfers valuable property to B for nothing in order to keep it out of the hands of A’s creditors and B then sells the property and declares bankruptcy in an effort to shield herself from liability for having colluded with A to defeat the rights of A’s creditors - is as blatant an abuse of the Bankruptcy Code as we can imagine. It turns bankruptcy into an engine for fraud. Though cases often say that exclusions from dischargeability should be narrowly construed, we have emphasized that they [i.e., the exclusions from discharge] serve vital functions. Congress concluded that preventing fraud is more important than letting defrauders start over with a clean slate, and we must respect that judgment. *McClellan*, 217 F.3d at 893 (quotations and case citations omitted).

A scenario similar to the one in *McClellan* is present in this case before the Court. An order was entered in the District Court Action granting partial summary judgment on the basis that

Mr. Kiesewetter had fraudulently transferred monies into joint accounts with Mrs. Kiesewetter and/or accounts in Mrs. Kiesewetter's name only. The jury determined that Mrs. Kiesewetter colluded with or otherwise actively participated with her husband in the fraudulent transfer of money to the detriment of the Plaintiffs. Doc. # 26, Statement of Undisputed Facts, Ex. E, p.4, Q.8.a. Collusion was specifically defined in the District Court Action as meaning "to connive with one another, to conspire, to plot, to work together, for a common goal." *Id.* The jury answered the question regarding Mrs. Kiesewetter's collusion affirmatively. In addition, the jury determined that Mrs. Kiesewetter's collusion with Mr. Kiesewetter regarding the transfers were done with fraudulent intent. *Id.*, Q.8.b. Fraudulent intent was defined as meaning "intent to defraud, to deceive, acting in bad faith". *Id.*

PREFERENTIAL TRANSFERS.

While most attorneys generally understand fraudulent transfer rules, many are not conversant with bankruptcy and state law preferential transfer rules. A preferential transfer is normally a payment made to a creditor prior to filing for bankruptcy. State law generally disfavors preferential treatment of creditors, thus strongly encouraging that insolvent debtors treat unsecured creditors equitably by paying them pro-rata to what is available.

Florida has a one year preferential transfer look-back provision in the fraudulent transfer statute at Section 726.106(2), as discussed in Chapter 1, Sections D and Q, and a procedure that can be pursued in state court, which is known as an Assignment for the Benefit of Creditors ("ABC") to allow a state circuit court to formally oversee and approve the sale of a debtor's assets to a court appointed "assignee," who can pursue any causes of action that the debtor might have, wind up the business or assets, and pay the creditors with whatever is left. The ABC process is further described in this chapter at Section Q.

Transfers made by a debtor to an "insider" within one year of filing a bankruptcy may be set aside, notwithstanding whether the transfer would be considered a "fraudulent transfer."¹⁷⁶ Also, preferential transfers made to any party within 90 days of the filing of a bankruptcy petition can be set aside as well.¹⁷⁷ Reasonable compensation paid for services actually rendered will not be considered to be a preferential transfer,¹⁷⁸ but dividends paid by a professional practice corporation to its owner or member can be considered a preferential transfer.

Oftentimes a debtor will want to settle or give a mortgage and/or lien on otherwise exposed assets to a "friendly creditor" to avoid having to lose those such assets to one or more other creditors. If the friendly creditor is considered an insider, then actions taken that benefit such creditor may be set aside by the other creditors within one year of when they occur.

On the other hand, an unrelated friendly creditor (i.e., a non-adversarial arm's-length creditor that is not an insider) may be able to hold whatever liens or assets it has been given as part of an arm's-length debt

¹⁷⁶ 11 U.S.C. § 547(b)(4)(B) (2017).

¹⁷⁷ 11 U.S.C. § 547(b)(4)(A) (2017).

¹⁷⁸ *In re Double Eagle Const. Co.*, 188 B.R. 406 (Bankr. D.W. Mo. 1995).

relief, or workout arrangement, as long as the debtor has not filed or been forced into bankruptcy within 90 days of the transfer.

For example, a debtor having \$750,000 of exposed assets who owes \$1,000,000 each to three different creditors may have a close friend purchase one creditor's position for \$400,000 and obtain a judgment against the debtor in the amount of \$1,000,000. The debtor may pledge all assets to that creditor, to the disadvantage of the other two creditors, who may be willing to settle for very little once they recognize the position that they are in.

The definition of "insider" under Florida Statutes Section 726.102(8) includes:

- (a) If the debtor is an individual:
 - 1. A relative of the debtor or of a general partner of the debtor;
 - 2. A partnership in which the debtor is a general partner;
 - 3. A general partner in a partnership described in subparagraph 2; or
 - 4. A corporation of which the debtor is a director, officer, or person in control.
- (b) If the debtor is a corporation:
 - 1. A director of the debtor;
 - 2. An officer of the debtor;
 - 3. A person in control of the debtor;
 - 4. A partnership in which the debtor is a general partner;
 - 5. A general partner in a partnership described in subparagraph 4; or
 - 6. A relative of a general partner, director, officer or person in control of the debtor.
- (c) If the debtor is a partnership:
 - 1. A general partner in the debtor;
 - 2. A relative of a general partner in, a general partner of, or a person in control of the debtor;
 - 3. Another partnership in which the debtor is a general partner;
 - 4. A general partner in a partnership described in subparagraph 3; or
 - 5. A person in control of the debtor.
- (d) An affiliate, or an insider of an affiliate as if the affiliate were the debtor.
- (e) A managing agent of the debtor.

Please note that the above definition is similar, but not identical, to the definition that applies under federal bankruptcy law, which is enumerated below.

The case law has expanded the Florida law definition of an "insider" to include people with close relationships with the debtor. The *Bifani* court described this as follows:

LaMarca contests the Bankruptcy Court's finding that she is a "functional insider" to Bifani. She argues that because she and Bifani are not married or related by blood, they cannot be "insiders" under § 726.102(8), Florida Statutes. While LaMarca is correct that section 726.102(8) only mentions family members, "[a] close relationship between a transferor debtor and a transferee is a factor equivalent to a badge of fraud which should be considered in determining fraudulent intent." *Gen. Trading Inc. v. Yale Materials Handling Corp.*, 119 F.3d 1485, 1489 (11th Cir.1997). See also *Orlando Light Bulb Serv., Inc. v. Laser Lighting & Elec. Supply, Inc.*, 523 So.2d 740, 744 (Fla. 5th DCA 1988) (close business relationship, although not listed in the statute, is badge of fraud). Accordingly, the Bankruptcy Court's conclusion that LaMarca was a "functional insider," which was indicative of fraud, was not clearly erroneous.¹⁷⁹

PREFERENTIAL TRANSFER TRAPS.

A GUARANTOR'S NIGHTMARE – THE PREFERENTIAL TRANSFER RULES MAY BE TRIGGERED.

The preferential transfer rules can be triggered in situations where a family member or other "insider" benefits indirectly by payments made. For example, the son of a bankruptcy debtor who had guaranteed loans that the debtor paid within one year of filing bankruptcy was required to pay the trustee in bankruptcy the amount of the loan payments, even though the son did not receive any of these monies or directly benefit. This was the result of *In re Halling*, 449 B.R. 911, 913 (Bankr. W.D. Wis. 2011) where the mother made regular payments to the bank on an installment loan.

The trustee sought to avoid the transfers as preferential, stating that the son was an insider creditor and that transfers made up to one year before bankruptcy were voidable. The Court found that guarantors are creditors within the Bankruptcy Code, and that the payments to the bank benefitted the son because each payment reduced his liability to the bank. Thus, the Court allowed the trustee to recover the amounts transferred as legitimate loan payments from the son because preference claims against non-insiders (the bank in this case) are limited to transfers within 90 days. Transfers made more than 90 days before the filing of bankruptcy cannot be recouped from creditors who are not insiders in this situation. Thus, for transfers between 90 days and one year, the trustee can only get transfers to inside creditors (in this case the son).

With reference to the above, the definition of an insider can be found at 11 U.S.C. § 101(31), which provides that the term "insider" includes the following:

- (A) if the debtor is an individual -

¹⁷⁹ *In re Bifani*, 493 B.R. 866, 871 (Bankr. M.D. Fla. 2013).

- (i) a relative of the debtor or of a general partner of the debtor;
 - (ii) a partnership in which the debtor is a general partner;
 - (iii) a general partner of the debtor; or
 - (iv) a corporation of which the debtor is a director, officer, or person in control;
- (B) if the debtor is a corporation –
- (i) a director of the debtor;
 - (ii) an officer of the debtor;
 - (iii) a person in control of the debtor;
 - (iv) a partnership in which the debtor is a general partner;
 - (v) a general partner of the debtor; or
 - (vi) a relative of a general partner, director, officer, or person in control of the debtor;
- (C) if the debtor is a partnership –
- (i) a general partner in the debtor;
 - (ii) a relative of a general partner in, general partner of, or person in control of the debtor;
 - (iii) a partnership in which the debtor is a general partner;
 - (iv) a general partner of the debtor; or
 - (v) a person in control of the debtor;
- (D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;
- (E) affiliate, or insider of an affiliate, as if such affiliate were the debtor; and
- (F) managing agent of the debtor.

Antecedent debt is a debt owed because of a past situation. Repayment of an antecedent debt will be considered to be a preferential transfer if the 90-day or one year rule applies. It is therefore important for an insolvent debtor to make payment contemporaneously for assets purchased or compensation paid to any creditor who is also owed money to help establish that the payment was for contemporaneous value, and not to repay antecedent debt.

PAYMENTS MADE BY FRIENDS OR RELATIVES ON BEHALF OF THE DEBTOR MAY HAVE TO BE RECOUPED IF THE PAYMENT WAS CONSIDERED TO BE A LOAN TO THE DEBTOR.

The June 4, 2019, 10th Circuit Court of Appeals decision of *In re Stevens, Littman, Biddison, Tharp and Weinberg, LLC*¹⁸⁰ held that a law firm that received payment for legal fees that were past due had to repay the fees because they were received within 90 days preceding the debtor's filing of bankruptcy and thus constituted as a preferential transfer. Even though the payment was made by the debtor's mother and the debtor was never in possession of the funds, the payment still constituted a preferential transfer because the debtor agreed to repay his mother for her payment.

The decision was based upon the 10th Circuit's decision in *Parks v. FIA Card Servs., N.A.*¹⁸¹ which held that the payment of a credit card balance through a loan from a new credit card lender constituted a preferential transfer to the old credit card lender and therefore must be repaid to the new one. The court in *Parks* applied two tests to determine the debtor's interest in the property; the dominion/control test and the diminution of the estate test. The court found that the actions of the debtor amounted to control over the funds because they essentially chose where the money would go. Although the value of the estate technically did not decrease, the court stated that the diminution of the estate test was also satisfied because a "transfer of loan proceeds (an asset) diminishes the bankrupt's estate."¹⁸²

It is important to note that the court in *Stevens* recognized that if the mother's payment to the law firm was a gift over which the debtor had no control, then the result might have been different.

Therefore, to avoid dilemmas such as these, recipients of legal, accounting, or other fees for past services paid by a friend or relative of the debtor will be well served to receive confirmation from the debtor and the payor that the debtor has no obligation to repay the payor.

CONVERTING CREDITOR EXEMPT ASSETS TO OTHER CREDITOR EXEMPT ASSETS WILL USUALLY NOT BE CONSIDERED A FRAUDULENT TRANSFER.

Generally, transferring an exempt asset into another exempt asset is not considered a fraudulent transfer.¹⁸³ For example, an individual may transfer wages protected under Florida Statutes Section 222.11 into another exempt asset, such as an annuity or life insurance contract. The specifics of wage accounts and other exempt assets are discussed in Chapter 3.

The proceeds from the sale of a homestead will be protected when they are reinvested in another homestead. However, in the 1962 decision of *Orange Brevard Plumbing & Heating Co. v. La Croix*,¹⁸⁴ the Florida Supreme Court somehow concluded that the proceeds from a homestead sale are not protected if

¹⁸⁰ *Stevens, Littman, Biddison, Tharp and Weinberg, LLC v. Walters (In re Wagenknecht)*, 2019 WL 2353534 (B.A.P. 10th Cir. June 4, 2019) (case no. 18-93).

¹⁸¹ *In re Marshall*, 550 F.3d 1251 (10th Cir. 2008).

¹⁸² *Id.* at *1258.

¹⁸³ See *In re Kimmel*, 131 B.R. 223 (Bankr. S.D. Fla. 1991) (holding that the transfer of funds from one form of exempt asset to another was not a fraudulent conveyance).

¹⁸⁴ 137 So. 2d. 201 (Fla. 1962).

they are invested in other exempt assets rather than being invested in a new homestead. Further discussion on this topic can be found in Chapter 5. For an in-depth discussion of the Supreme Court's decision in *La Croix*, and for more information on exchanging homesteads, see Chapter 5, Section J.

Case law has indicated that an individual may borrow on homestead property and directly invest the borrowed funds into other exempt assets without losing creditor protection. For example, in *In re Goldberg*, the court stated that “[m]ortgage and refinance proceeds are not the functional equivalent of sale proceeds.”¹⁸⁵ Thus, the fact that the Debtor did not reinvest the proceeds or have the requisite intent to reinvest the proceeds into another homestead within a reasonable period of time is irrelevant. According to *In re Goldberg*, it would appear safe to borrow funds secured by a homestead if the borrowed funds are not commingled with the debtor's other non-exempt assets. However, there have not yet been any cases specifically confirming that funds borrowed from the equity of a homestead may be directly invested into other exempt assets.

INABILITY TO WAIVE HOMESTEAD EXEMPTION STATUS; WILL THIS PROTECTION BE EXTENDED TO OTHER CREDITOR EXEMPT ASSETS?

In *Chames v. DeMayo*, the Florida Supreme Court held that an individual could not waive Florida's homestead protection via a general waiver in a loan agreement.¹⁸⁶ While the court noted that case law had not prohibited a waiver of the homestead protection, the Florida Constitution mandates that any waiver must be accomplished by mortgage, sale, or gift. The Court's analysis commenced with a statement that “the homestead exemption has been enshrined in our state constitution for over 100 years.”¹⁸⁷ The Court noted that many decisions by Florida courts have acknowledged that the public policy behind not upholding waivers of creditor rights is to promote both the stability and welfare of the state for a homeowner and his or her heirs. The Court stated that while it has permitted a surviving spouse to waive homestead inheritance rights, “we have repeatedly refused to find an exception to the protection from forced sale. . .”¹⁸⁸

However, some exemptions may be expressly waived. In 2011, the Second District Court of Appeals in Florida upheld a waiver of the statutory head of family exemption from garnishment that was included in a promissory note allowing the bank to garnish the borrower's wages and disposable income under Section 222.11 in satisfaction of a judgment against the borrower for default on the note.¹⁸⁹ The court reasoned that the explicit language in the note acted as a waiver of the head of household exemption and empowered the bank to enforce the writ of garnishment.

Notwithstanding the above, many debtors argued that they were not warned about the “small print” which was intended to deprive them of an important creditor exemption. Accordingly, the statute was changed to require a specific form of obvious waiver in future cases. However, the revised statute only applies to loan documents executed after the revision, which took effect on October 1, 2010.

¹⁸⁵ 229 B.R. 877, 883 (Bankr. S.D. Fla. 1998).

¹⁸⁶ 972 So.2d 850, 862 (Fla. 2007).

¹⁸⁷ *Id.* at 852.

¹⁸⁸ *Id.* at 854.

¹⁸⁹ *USAmeriBank v. Klepal, Jr.*, 100 So.3d 56 (Fla. 2d Dist. App. 2011).

Further, the bank loan document language will often waive the wages exemption only if and when the bank has a judgment against the debtor. It may be possible to keep wages from being garnished by considering them to be exempt and transferring them within six months to another exempt asset. Typical language that one bank has used in the loan documents is as follows:

Garnishment. You consent to the issuance of a continuing writ of garnishment or attachment against your disposable earnings, in accordance with Section 222.11, Florida Statutes, in order to satisfy, in whole or in part, any money judgment entered in favor of us.

The extensive intertwinement of the *Chames* opinion with constitutional rights and public policy analysis leaves open the question as to whether other creditor exemptions under Florida law may be waived. While the wage exemption statute specifically permits a waiver, most assuredly there will be litigation in future years where debtors sign waivers for life insurance policies, annuities, IRAs and other retirement accounts, tenancy by the entireties, and other exempt assets. Time will tell whether the public policy considerations found to be paramount in the *Chames* case will extend to protection of assets accorded under Florida Statutes.

WATCH OUT FOR “SUPER CREDITORS!”

Under the Supremacy Clause of the United States Constitution, state laws must yield to certain “super creditors” created by federal law. The IRS, Department of Justice (DOJ), SEC, FDIC¹⁹⁰ and FTC have been granted “super creditor” status.

Courts have consistently held that the IRS and other “super creditors” can seize otherwise creditor exempt assets to collect a debt owed to it.¹⁹¹ For example, in the U.S. Supreme Court decision of *United States v. Craft*, the Court found that the IRS can invade the debtor’s half of tenancy by the entireties property, regardless of whether a fraudulent transfer thereto has occurred.¹⁹² This holding was based on a federal statute that specifically allowed the IRS to place a lien on any property to satisfy unpaid taxes. United States Code, Title 26, Section 6321, specifically provides: “If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.”

One year later, in *United States v. Hatchett*,¹⁹³ the United States Court of Appeals for the Sixth Circuit expanded *Craft* by allowing the IRS to force the sale of such property in order to receive half of the value thereof.

¹⁹⁰ Applicable when the FDIC itself holds notes that are enforceable against debtors, which is rare as of the date of publication.

¹⁹¹ *U.S. v. Craft*, 535 U.S. 274, 288 (2002).

¹⁹² *Id.*

¹⁹³ *Id.*

The Department of Justice imposes forfeiture statutes for certain civil and criminal offenses, under which the Department of Justice can seize property or hold a person in contempt until assets are turned over.¹⁹⁴

The Securities and Exchange Commission (SEC) has a disgorgement statute that enables the SEC to recover profits from violators of the securities laws.¹⁹⁵ In *SEC v. Solow*,¹⁹⁶ the court determined that the SEC does not have to recognize the protections of tenancy by the entirety created under state law, and that the SEC will not be prevented from reaching tenancy by the entirety assets under a disgorgement judgment. This case ultimately placed Solow in civil contempt until he paid the amount owed under the disgorgement judgment or demonstrated good faith reasonable efforts to do so. After Solow, the question remains whether future case law will extend this ruling to allow creditors to actually force the sale of “protected” assets rather than simply holding the debtor in civil contempt for failing to surrender these assets.

Courts have also construed the FTC’s temporary restraining order and preliminary injunction provisions to allow the FTC to freeze assets and hold defendants in contempt for failing to surrender such assets.¹⁹⁷ In *FTC v. Ameridebt, Inc.*,¹⁹⁸ the United States District Court for the District of Maryland approved a preliminary injunction appointing a receiver, freezing the defendants’ assets, and directing that the defendants repatriate assets that they had transferred offshore. In this case, the FTC alleged that once the defendants became aware of the FTC investigation, they began transferring assets offshore in an effort to keep these assets out of the FTC’s reach. The FTC sought to stop this process and regain the transferred assets by filing the injunction. The court granted the injunction, which required the defendants to turn over the trust assets to the receiver. The court further noted that if the defendants failed to turn over these assets that the FTC could move to place the defendants in civil contempt.

Medicare will also be considered to be a super creditor when it is recovering penalties that have been imposed by a debtor who has failed to comply with appropriate billing or other procedures.

There is no evidence, however, that *Solow* and other similar decisions will extend “Super Creditor” power to other federal agencies; though experts believe other agencies, like the CMS, may try to apply the *Solow* case in the future to obtain “Super Creditor” status.

WHAT ABOUT DIVORCE?

Except as otherwise discussed below, divorce judges have exemplary powers that override most Florida or U.S. federal creditor protection rules when it comes to ordering people to use or pay assets that they would otherwise have control over to a spouse as alimony, child support, or in a property settlement arrangement.

For example, judges in divorce cases can override the protections given to retirement accounts, the wages of the head of the family, spendthrift trusts, Delaware asset protection trusts, offshore trusts, and there

¹⁹⁴ See 18 U.S.C. §§ 981, 982 (providing civil and criminal asset forfeiture statutes).

¹⁹⁵ 15 U.S.C. § 78u-2.

¹⁹⁶ 682 F.Supp.2d 1312, 1333 (S.D. Fla. 2010), aff’d, 396 Fed. Appx. 635 (Sept. 20, 2010).

¹⁹⁷ 15 U.S.C. § 53(b).

¹⁹⁸ 373 F.Supp.2d 558, 565 (D. Md. 2005).

are even cases where a court has forced a spouse to sell a homestead to enforce a support order. Since many of the statutes that allow for exempted assets were created with the intent to protect property in order to ensure that a family has a means of support and maintenance, courts do not want to allow exemption statutes to be construed in a way that enables fraud, impositions on creditors, or allows someone to escape honest debts. These exceptions are meant to prevent exempted assets from becoming a safe haven where a former spouse can hoard assets while simultaneously arguing that he or she does not have the ability to make alimony or child support payments.

However, it is well established that if a husband and wife own property as tenants by the entirety, this property should be exempt from the claim of a creditor against one spouse alone. Therefore, the rule of tenancy by the entirety protection should apply when an ex-spouse makes a claim for arrears in alimony, and the payor spouse has remarried and has assets held as tenants by the entirety that are not the result of a fraudulent transfer.¹⁹⁹ Due to the limited amount of case law that discusses the interplay between tenancy by the entirety protection and exceptions to asset protection laws regarding family law judgments, it remains unclear exactly how to reconcile these rules of law. But, as the case law stands now, tenancy by the entirety is still a valuable asset protection tool relating to divorce, while many other asset protection strategies remain susceptible to family law judgments.

In *Bendl v. Bendl*,²⁰⁰ the court refused to use property held by the former husband and his new wife as tenants by the entirety to satisfy the first wife's unpaid alimony judgment against her former husband. In this case, a husband and his first wife owned property as tenants by the entirety, and once they divorced, the ex-spouses became tenants in common. The husband remarried and designed the property as homestead, then later conveyed his one-half interest to both spouses as tenants by the entirety. The husband died, and his ex-spouse sought to obtain a judgment for alimony against the property. The question then became whether the property passed as homestead or by operation of law. The court found that the property passed to the new spouse by operation of law, specifically holding "that [new spouse's] undivided half interest in the property is held by her as the surviving spouse of an estate by the entirety and as such it is not available to satisfy, or answer for, the judgment of debts of [husband] individually after his death."²⁰¹

Important considerations relating to divorce are as follows:

1. Before the revisions to the Bankruptcy Code in 2005, it was possible to bankrupt out property settlement obligations. This is no longer the case, although many advisors mistakenly think that Section 523(a)(15) of the Code now makes all property settlement debts that are owed to a spouse, former spouse, or a child of the debtor non-dischargeable.
2. Further, the payment of the lawyer fees of the other spouse can become a non-dischargeable obligation if the debtor has been ordered to pay attorneys' fees by the divorce judge. High-earner clients with minimal net worth have been known to be placed in jail for failure to make court-ordered, divorce-related payments.

¹⁹⁹ See *Teardo v. Teardo*, 461 So.2d 276 (Fla. 5th Dist. App. 1985).

²⁰⁰ 246 So.2d 574, 576 (Fla. 3d Dist. App. 1971).

²⁰¹ *Id.* at 577.

3. Florida law even has exceptions to the Spendthrift Trust Rules, where someone subject to a court order to pay child support or alimony has not done so.²⁰² For this reason, the authors' trust documents commonly permit the "migration" of irrevocable trusts to jurisdictions that do not have this type of rule. Most clients leaving significant assets in a trust for a spouse or descendants do not intend that the trust is to automatically be invaded to pay child support to an ex-spouse or acquaintance who happens to be "parent in possession" of a descendant. It would not be as distasteful if the monies could be spent on the child himself or herself, as opposed to the monies going to someone who may not take good financial or personal care of the child. Often, these monies end up being diverted to the use of drugs, alcohol, or primarily to support other descendants that the "parent in possession" might have.

4. On the other hand, if the ex-spouse obligated to make payments is unable to access the assets to make payments, then the judge will not be able to reach these assets either.

5. Non-self-imposed impossibility is a defense to a contempt of court order to go to jail, but the question becomes whether the impossibility was self-induced to avoid the court order or not.

6. In the bankruptcy court cases of *Federal Trade Commission v. Affordable Media*²⁰³ and *In re Stephen J. Lawrence*,²⁰⁴ the Ninth Circuit Court of Appeals (which is the federal court of appeals for California, Nevada, Washington, Oregon, Idaho, Montana, Arizona, Alaska and Hawaii) and the Eleventh Circuit Court of Appeals (which is the federal court of appeals for Florida, Georgia and Alabama), both determined that debtors who had secreted assets into offshore trusts after there were lawsuits or judgments against them had "hidden control" over the trusts, and were required to serve jail time when they were "unable" to have the offshore trustees deliver money to satisfy the judgments.

Mr. Lawrence had an MBA from MIT, and spent approximately six years in a Miami federal facility before the courts exercised the rule that someone can be kept in jail on contempt only if the practical result is that the court gets what it requested. Mr. Lawrence lost six years of freedom to prove his point, but also had other issues, including whether turning over the funds to satisfy a judgment subsequent to testifying that he had no control would have opened him up to criminal prosecution.

7. Notwithstanding the above, in the case of *Reichers v. Reichers*,²⁰⁵ where a husband set up an offshore asset protection trust in the Cook Islands six years before a divorce and funded it with 99% of the assets of a Colorado limited partnership, the court concluded that the trust was funded with marital assets and was therefore subject to equitable distribution. The Court awarded half of the assets placed in the trust to the ex-wife.

8. Another example of a situation where creditor protection might assist in divorce negotiations occurs when the spouse owns a minority interest in a company or partnership, and therefore cannot exert any rights to receive distributions. A 33% owner of a company or a limited partner in a partnership typically

²⁰² See Fla. Stat. § 736.0503.

²⁰³ 179 F.3d 1228 (9th Cir. 1999) (also called the "Anderson Case").

²⁰⁴ 279 F.3d 1294 (11th Cir. 2002).

²⁰⁵ 679 N.Y.S.2d 233 (Sup. Ct. West. Co. N.Y. 1998).

would not have the right to require distributions or to sell an applicable interest in a closely-held business, although this can vary, based upon documentation and state law.

9. An email sent by one author to married couple clients who surprisingly informed him of a planned divorce is as follows:

MY THOUGHTS ON THIS:

1. Go to counseling first. Reconcile, if at all possible. If not, use a common counselor to make this easier on the kids, future grandkids, and on each other. Establish boundaries and procedures for whether you stay together or not.
2. Each of you can use a separate independent “collaborative divorce lawyer.” Collaborative divorce lawyers agree not to go to court, but to instead withdraw and let you get a new lawyer if they cannot settle without litigation. There is a published list of these lawyers, and most of them are very good.
3. Consider hiring a common expert at first to try to work out a deal without the “battle of the experts.” It is easier to reconcile if there is less fighting going on about money if you don’t settle.
4. See #1 above.
5. I cannot help or favor either of you. Anything you tell me is admissible as evidence in your divorce and must be disclosed to the other.

Best regards and good luck!

10. Our chapter on prenuptial agreements from *Creditor Protection for Florida Physicians* is provided below.

CHAPTER 7: PRENUPTIAL AND POSTNUPTIAL AGREEMENTS

If you have read Chapter 6 on divorce, you know why this chapter on prenuptial agreements is so important. Many successful physicians will consider a prenuptial agreement before a second marriage, or even before a first marriage, particularly if either spouse has children and there are significant assets or income to protect. Prenuptial agreements usually stand up in court, despite what many physicians and advisors often think. Where there is plenty of time, a clearly and appropriately written agreement, where each spouse has independent legal counsel with full disclosure of assets and liabilities, the great likelihood is that the terms of a prenuptial agreement will be upheld in a court. Incidentally, it is also possible for someone already married to enter into a postnuptial agreement. These are commonly used when married couples realize that there may be some issues that were never addressed before, or where the marriage has a rocky time and a spouse with more income and assets needs to decide whether to stay in the marriage while accumulating assets that

would have to be equally divided and being under more exposure to alimony and support claims, which are largely based upon the length of the marriage. The longer a couple is married, the higher the risk and degree of permanent alimony and the sharing of income accumulated during the marriage.

Each party to a prenuptial or postnuptial agreement should have a separate and independent lawyer to review or draft the agreement, although one spouse may pay both sets of legal fees where there is full disclosure and agreement by both parties with respect thereto. Important aspects of prenuptial and postnuptial agreements include the following.

- (a) The agreement should not be signed under duress. Prenuptial agreements should be signed before a wedding date is set and people are invited, if at all possible. It is good to document early in the relationship that both parties intend that a prenuptial agreement will be entered into. This is definitely something to discuss by the third date!
- (b) Fully and fairly disclose all financial and familial information to the other spouse.
- (c) Make sure each party has a separate and independent lawyer, if they are willing to do so.

Hopefully the lawyers will not be argumentative or try to “kill the deal.”

Oftentimes, tax and estate planning lawyers will draft or negotiate prenuptial agreements with the assistance of a family lawyer. Many family lawyers have a more aggressive or “war ready” approach to negotiating prenuptial agreements.

Both spouses do not have to have independent lawyers for a prenuptial agreement to be enforceable, but it is strongly recommended.

- (d) Essential language to guarantee it will stand up in court; some of this language may be unfamiliar to non-lawyers. Using a standard form that is not properly adapted to your individual situation or to Florida law can be a big mistake.
- (e) Many advisors favor prenuptial agreements that require any dispute to be resolved by private arbitration, as opposed to the more uncertain and public court system. Arbitrations are private, and a prenuptial agreement can require that the arbitrator be an individual with financial sophistication, or that there are multiple arbitrators. Arbitrators tend to have a no-nonsense approach to resolving matters, and are not overly busy or politically motivated, as may be the case with a divorce judge.

Arbitrators can also bifurcate proceedings into distinct phases so that they initially hear only as much evidence as is necessary to determine whether a prenuptial agreement is valid and enforceable. There should be no subsequent need to hear evidence regarding asset values or alimony if such factors are not at issue under a prenuptial agreement.

- (f) For obvious reasons, it is advisable to require both spouses to live near one another after the marriage if there are minor children. Often a non-physician spouse will have significant leverage, particularly if the spouse is the mother and she would be able to take the children to reside far away from where the working physician has his practice. There is a Florida Statute which would indicate that 50 miles is a safe and enforceable distance.
- (g) Sticky subjects, such as inheritance, possession of the home, and rights to life insurance and payment of debt in the event of death or divorce can be addressed and planned. It is much easier to agree on uncomfortable subjects when the couple is contemplating marriage and amicable.

Sometimes, the prenuptial agreement negotiations result in a break-up. It can be much better to lose a relationship in the negotiation of a prenuptial agreement than to get married to someone who is not on the same page from a financial and responsibility/entitlement standpoint.

Bankruptcy before divorce can be advantageous. Individuals contemplating divorce may wish to file bankruptcy before the divorce action in order to extinguish debts that could become the responsibility of one spouse or the other in the divorce action. The reason for this is that debts otherwise dischargeable in bankruptcy will become non-dischargeable as to the obligation to pay the debt for the benefit of the ex-spouse if a family law court decree or marital settlement agreement so require.

Divorces can also be simpler and less stressful if debt has been extinguished or is subject to a livable payment plan when a divorce proceeds or becomes finalized.

There can also be advantages to having both spouses file in bankruptcy before a divorce, as opposed to having one spouse file after divorce. These include the following:

1. It is normally less expensive for two people to file together as a married couple, as opposed to separately.
2. Commonly, one member of the couple is better organized and more adept at handling details, negotiations, and lawyers. This way both spouses have the advantage of the best executive and decision-making ability.
3. There may be less animosity and distrust if the spouses have common bankruptcy counsel and the process is simply “signed off on” by each divorce lawyer.
4. There will be more certainty as to what assets and liabilities to base the divorce upon, once a bankruptcy is final, and a skeptical divorce lawyer may be more certain of facts and circumstances, and less likely to “overuse” forensic accountants when findings of fact have occurred in the bankruptcy court shortly before a divorce is filed or finalized.
5. Exemptions can be higher in joint filings. For example, if there is a homestead involved that would otherwise be unprotected because of the homestead protection exceptions that apply

under the Bankruptcy Code, a married couple can nevertheless presently protect up to \$340,700 in homestead equity, while a sole individual will only be able to protect \$170,350 worth as of publication of this outline.

APPRECIATION OF MARITAL ASSETS.

One of the biggest problems in past years with respect to prenuptial agreements was the former Second District Court of Appeals decision in *Doig v. Doig*,²⁰⁶ which required that language in a prenuptial agreement should be construed to only address **passive appreciation**, unless **active appreciation** was specifically mentioned. The court noted that “both parties contributed to maintenance and improvement of the residence.”

This, and a line of cases that followed, was fortunately ameliorated by the Florida Supreme Court’s decision in *Hahamovitch*,²⁰⁷ which came only after a great many prenuptial and postnuptial-based divorces were completed based upon *Doig v. Doig* and associated jurisprudence that existed. Under the *Hahamovitch* case, the Florida Supreme Court held that the language in a spouse’s prenuptial agreement was valid, which subsequently waived the wife’s right to assert any property titled in the husband’s name that was acquired during the marriage or appreciated in value during the marriage. An article follows explaining the *Hahamovitch* case in detail.

ALAN GASSMAN & COURTNEY KOCH ON *HAHAMOVITCH*: BABY LOVE VS NONMARITAL ASSET APPRECIATION, THE FLORIDA SUPREMES WEIGH IN WITHOUT DIANA ROSS

By: Alan S. Gassman and Courtney Koch

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Steve Leimberg’s Estate Planning Newsletter – Archive Message #2383**

“Prior to the Florida Supreme Court decision in Hahamovitch, most practitioners would have reasonably assumed that general language such as ‘husband will retain any and all rights an any and all separate property acquired before or after the marriage’ would have been sufficient to safeguard appreciation attributable to marital efforts. However, decisions in the Second and Third District Court of Appeals held the opposite, that such waivers were insufficient because they lacked the necessary specificity. These holdings shocked many lawyers and left spouses in a vulnerable state.

In September 2015, the Florida Supreme Court addressed the circuit split among the Florida District Courts in Hahamovitch. The Court looked at whether it is possible for a spouse to waive his or her right to assets owned by the other spouse, including the appreciation and reinvestment of value and earnings thereof, if the proper language is used in a valid prenuptial agreement.

Oftentimes, assets earn income or appreciate in value because of marital efforts and some Florida courts have interpreted waivers of appreciation as not allowing the restriction of shared growth unless

²⁰⁶ 787 So. 2d 100 (Fla. 2d Dist. App. 2001).

²⁰⁷ 174 So. 3d 983 (Fla. 2015).

specific language is used. The Hahamovitch holding provides practitioners with specific language that can be used to protect a spouse's rights to these separate assets and earnings.

This holding demonstrates that prenuptial agreements need to have very specific language establishing the fact that one party is waiving his or her right to the assets acquired during the marriage and the appreciation of those assets due to marital contributions."

Alan Gassman and Courtney Koch provide members with their analysis of *Hahamovitch v. Hahamovitch*, a recent decision by the Florida Supreme Court.

EXECUTIVE SUMMARY:

Prior to the Florida Supreme Court decision in *Hahamovitch*, most practitioners would have reasonably assumed that general language such as "husband will retain any and all rights and any and all separate property acquired before or after the marriage" would have been sufficient to safeguard appreciation attributable to marital efforts. However, decisions in the Second and Third District Court of Appeals held the opposite, that such waivers were insufficient because they lacked the necessary specificity. These holdings shocked many lawyers and left spouses in a vulnerable state.

In September 2015, the Florida Supreme Court addressed the circuit split among the Florida District Courts in *Hahamovitch*. The Court looked at whether it is possible for a spouse to waive his or her right to assets owned by the other spouse, including the appreciation and reinvestment of value and earnings thereof, if the proper language is used in a valid prenuptial agreement. [2]

Oftentimes, assets earn income or appreciate in value because of marital efforts and some Florida courts have interpreted waivers of appreciation as not allowing the restriction of shared growth unless specific language is used. The *Hahamovitch* holding provides practitioners with specific language that can be used to protect a spouse's rights to these separate assets and earnings.

This holding demonstrates that prenuptial agreements need to have very specific language establishing the fact that one party is waiving his or her right to the assets acquired during the marriage and the appreciation of those assets due to marital contributions.

FACTS:

As is common in many divorces, the division of property raised some issues for the Hahamovitch couple. Mrs. Hahamovitch argued that because the Agreement was missing specific references to enhanced value and particular assets, she was entitled to more property during the process of equitable distribution. The trial court and the Fourth District Court of Appeals disagreed with Mrs. Hahamovitch, holding that the language in the Prenuptial Agreement was specific enough to waive spousal rights to nonmarital property. Specifically, the Fourth District relied on the trial court's order establishing that the parties had entered into the Prenuptial Agreement voluntarily, and that both parties had obtained legal counsel throughout the preparation and execution stages of the document. [3] Additionally, the Fourth District noted that the Agreement had been fair when it was entered into, and that the language of the Agreement was broad enough

to “waive the wife’s right to any asset titled in the husband’s name that was acquired during the marriage or that appreciated in value” during the marriage. [4]

COMMENT:

The Fourth District’s holding requires all prenuptial agreements to have language that specifically waives the right to the other spouse’s assets that are owned or acquired during the marriage, including a waiver of any enhancement in value for those assets from the marital contributions, or the parties will risk the enhancement value of the assets not being waived by the prenuptial agreement. The key language for the prenuptial agreement from *Hahamovitch* is reproduced and underlined below:

2. DIANNE’S RELEASE. Except as otherwise provided for herein, in the event either of the Parties hereto institutes legal proceedings for...dissolution of marriage..., DIANNE hereby waives and releases, and is hereby barred from any and all rights and claims of every kind, nature and description that she may acquire or to which she may be entitled under the laws of any jurisdiction as a result of the marriage between the Parties, in and to any of HARRY’s property including, but without intending thereby to limit the generality of the foregoing, any and all right to alimony, either lump sum, rehabilitative, permanent, or otherwise, support and maintenance, equitable distribution, division of property, special equities, attorney’s fees, or any other rights that DIANNE may have against HARRY relative to financial issues.

5. RETENTION OF SOLE PROPERTY. Except to the extent that the Parties may otherwise desire, HARRY and DIANNE shall, during their respective lifetimes, keep and retain sole ownership, control, enjoyment and power of disposition with respect to all property, real, personal or mixed, now owned or hereby acquired by each of them respectively, free and clear of any claim by the other...

9. MUTUAL RELEASE. In consideration of the marriage of the Parties to each other, and in consideration of the other provisions herein contained, each party agrees that neither will ever claim any interest in the other’s property and that the property of every kind, nature and description which either one has on the date of the[ir] marriage will remain the respective separate property of each after said marriage, and each agrees not to make any claim against the property of the other...

17. TITLE PRESUMPTIONS. It is additionally understood that if HARRY purchases, acquires, or otherwise obtains, property and title to said property is in HARRY’s name with DIANNE and no explanation is made as to the percentages of interest that either party has, then it shall be presumed that they shall be 50%-50% owners of said property. If HARRY purchases, [a]cquires, or otherwise obtains, property in his own name, then HARRY shall be the sole owner of same. If DIANNE purchases property in her name, then DIANNE shall be the sole owner of the same. [5]

To provide some context, the underlined language reproduced above is sufficient to create a waiver to the appreciated value of assets in a prenuptial agreement.

However, the Fourth District's *Hahamovitch* case deviated from other districts, which have held that similar language in prenuptial agreements was insufficient to waive a spouse's claim to the other spouse's earnings, any assets acquired with those earnings, and the appreciated value of nonmarital property resulting from marital labor or funds. [6]

For instance, the Second District Court of Appeals had a similar issue in *Irwin v. Irwin v. Irwin*. [7] It held that because the prenuptial agreement did not specifically reserve Mr. Irwin's marital earnings as his separate property, Mrs. Irwin was therefore able to claim a share in the value of assets purchased with those earnings. [8] Further, the prenuptial agreement did not waive Mrs. Irwin's claim to Mr. Irwin's separate assets that were enhanced by marital funds or labor. [9]

Similarly, in *Valdes*, the Third District Court of Appeals ruled on a case involving the equitable distribution of the enhancement value of nonmarital property. [10] In the *Valdes*' prenuptial agreement, the parties waived any entitlement to alimony and the prenuptial agreement specifically provided that each party would retain their own respective premarital property and any property or assets acquired during the marriage wherein title was held individually. [11] However, the prenuptial agreement was silent in regards to appreciation or enhancement of the parties' nonmarital property due to marital effort. The Third District affirmed the trial court's holding that Mrs. *Valdes* had not waived her right to seek equitable distribution of the enhanced value of nonmarital property, despite language suggesting the alternative in the prenuptial agreement. [12] Further, the District Court held that the enhancement value of the nonmarital property was a result of marital labor from both parties, and therefore both parties were entitled to it. [13]

Because the Fourth District Court of Appeals' decision conflicted with those decisions from the Second and Third Districts, the Florida Supreme Court decided to hear the issue of whether a spouse may waive rights to nonmarital assets acquired or enhanced during the marriage due to the parties' marital efforts. The Florida Supreme Court held that the plain language of the prenuptial agreement in *Hahamovitch* provided that any property the husband owned or acquired during the marriage, including any enhancement in value or appreciation of such assets, remained the husband's nonmarital assets. [14]

The key to the Court's decision was that the Husband and Wife both entered into the Prenuptial Agreement willingly and that the actual language of the Agreement clearly waived each spouse's rights and claims on the other spouse's property. Further, the Florida Supreme Court held that when a prenuptial agreement contains broad provisions, but does not specifically waive a spouse's claim to the other spouse's assets and earnings associated with those assets, the prenuptial agreement is insufficient to waive a spouse's right to seek equitable distribution of such assets. [15] However, when the prenuptial agreement's actual language encompasses all property solely owned by one spouse presently and in the future, and expressly waives all of the other spouse's rights and claims in such property, then there is a valid waiver.

CONCLUSION:

In sum, the Florida Supreme Court affirmed Fourth Circuit's decision in *Hahamovitch*, holding that a party can waive his or her right to assets titled in the other spouse's name that were acquired during the marriage or appreciated during the marriage, if there is specific language in the prenuptial agreement to that effect. It is unfortunate that the parties who lost these older decisions lost their assets, notwithstanding that

the decisions are now shown to have been wrong. The Supreme Court's decision saves a great many spouses and their lawyers from the wolves.

It is also noteworthy that a series of District Court of Appeals cases has also indicated that a waiver of alimony provision is not sufficient, unless the waiver specifically identifies each and every type and category of alimony and spousal support, notwithstanding that the language and intent of the parties is clear. [16] We are hopeful that the Supreme Court may review that as well.

ENDNOTES:

[2] *Hahamovitch v. Hahamovitch*, No. SC14-277 (Fla. Sept. 10, 2015).

[3] *Id.* at 1011.

[4] *Id.* at 1015.

[5] *Hahamovitch*, 133 So.3d at 1017.

[6] *Id.* at 1013-16.

[7] 857 So.2d 247 (Fla. 2d DCA 2003).

[8] *Id.*

[9] *Id.*

[10] 894 So.2d 264 (Fla. 3d DCA 2005).

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] 133 So.3d 1011.

[15] *Id.*

[16] Elaine M. Butcher, *Relationship Dissolution Planning, Part I: Nuptial Agreements*, The Fla. Bar J., 80 Fla. Bar 43 (Nov. 2006) (citing *Belcher v. Belcher*, 271 So. 2d 7 (Fla. 1972)).

PASSIVE APPRECIATION OF A NON-MARITAL ASSET.

Florida courts have long struggled with how to properly allocate passive (inflation or market-based) appreciation of non-marital property in divorce proceedings. Before the Florida Supreme Court's opinion in *Kaaa v. Kaaa*,²⁰⁸ at least three Florida appellate courts contemplated whether such appreciation should even be considered a marital asset, and if so, how to properly divide it between the divorcing spouses.

Resolving the circuit split, the Florida Supreme Court held that passive appreciation of non-marital property is an asset subject to equitable distribution when marital funds are used to service the property's mortgage.²⁰⁹ Additionally, the Court adopted a formula for calculating how the passive appreciation should be divided. This formula, illustrated below, is: the passive appreciation of the home multiplied by the percentage of the property's fair market value encumbered by a mortgage at the time of the marriage.

ILLUSTRATION: Going into a marriage, one spouse owned a home valued at \$100,000, but subject to a \$90,000 mortgage. During the course of the marriage, marital earnings were used to reduce the mortgage to \$80,000, and the value of the property

²⁰⁸ 58 So.3d 867 (Fla. 2010).

²⁰⁹ *Id.* at 872.

passively increased to \$200,000. Title of the home was never amended to include the other spouse.

The formula to calculate the division of the passive appreciation is as follows:

Division of passive appreciation = passive appreciation of home x % of the property's FMV²¹⁰

\$100,000 (passive appreciation of home during the marriage) x 90% (\$90,000/\$100,000 – amount of remaining mortgage obligation divided by home's value at beginning of marriage) = \$90,000 (amount of the passive appreciation subject to equitable distribution)

Therefore, \$110,000 (\$200,000 - \$90,000) of the property's equity is reserved for the owning spouse, while \$90,000 is subject to equitable distribution between the divorcing spouses.

The important omission in the formula is the amount of the mortgage actually paid during the marriage. In other words, it makes no difference whether marital funds are used to pay off all of a mortgage or a small portion of the mortgage. Thus, in the above example, the division of the passive appreciation would be unaffected had the couple paid down the mortgage by \$5,000 or \$50,000 during the marriage. So as long as marital funds were used to service the mortgage, the passive appreciation will be subject to equitable distribution using the formula adopted by the Florida Supreme Court in *Kaaa*.

The takeaway: the importance of paying down mortgages prior to marriage. Alternatively, soon-to-be spouses should consider entering into a prenuptial agreement that specifically exempts passive appreciation of non-marital property from marital assets subject to equitable distribution. Both methods will assist in insulating the owning spouse from sharing the passive appreciation of the property.

DEATH IS NOT THE END.

The rules can change when a debtor dies. The changes are the result of statutory, constitutional and common law that is not all firmly established in Florida.

Results can vary based upon whether assets are held individually or in trust, whether they pass by probate, trust or “pay-on-death” arrangements, whether a probate estate is opened, and whether homestead passes outright or into a trust for a beneficiary who may have creditor issues.

For these reasons, it is essential that debtors have good estate planning advice and that the impact upon death, both for the debtor's estate or trust and intended beneficiaries, be carefully considered.

This Section does not cover the issue of whether the homestead of a decedent will be protected from creditors of the decedent, which will often be the case. This is discussed in Section J of this Chapter, and should be closely reviewed by any planner who thinks that a homestead should always pass into a protective trust for beneficiaries.

²¹⁰ Encumbered by a mortgage at the time of marriage.

1. Creditor Exemption Expands Upon Death for Personal Items, Motor Vehicles, and Certain Other Assets.

Pursuant to the Florida Statutes Section 732.402, the statutory creditor exemptions extend after death to the debtor's probate estate. This statute alters the playing field for creditor exempt assets upon death, and reads as follows:

732.402 Exempt property.—

(1) If a decedent was domiciled in this state at the time of death, the surviving spouse, or, if there is no surviving spouse, the children of the decedent shall have the right to a share of the estate of the decedent as provided in this section, to be designated "exempt property."

(2) Exempt property shall consist of:

(a) Household furniture, furnishings, and appliances in the decedent's usual place of abode up to a net value of \$20,000 as of the date of death.

(b) Two motor vehicles as defined in s. 316.003, which do not, individually as to either such motor vehicle, have a gross vehicle weight in excess of 15,000 pounds, held in the decedent's name and regularly used by the decedent or members of the decedent's immediate family as their personal motor vehicles.

(c) All qualified tuition programs authorized by s. 529 of the Internal Revenue Code of 1986, as amended, including, but not limited to, the Florida Prepaid College Trust Fund advance payment contracts under s. 1009.98 and the Florida Prepaid College Trust Fund participation agreements under s. 1009.981.

(d) All benefits paid pursuant to s. 112.1915.

Section 112.1915 of the Florida Statutes outlines death benefits provided for teachers and school administrators. In the event that a teacher or school administrator is killed or injured and dies as a result of an unlawful intentional act while either engaged in the performance of work-related activities or when the motivation for the act was due to the fact that the individual was a teacher or school administrator, \$76,000 and possibly health insurance payments are to be paid to the decedent's beneficiary.

(3) Exempt property shall be exempt from all claims against the estate except perfected security interests thereon.

(4) Exempt property shall be in addition to protected homestead, statutory entitlements, and property passing under the decedent's will or by intestate succession.

(5) Property specifically or demonstratively devised by the decedent's will to any devisee shall not be included in exempt property. However, persons to whom property has been specifically or demonstratively devised and who would otherwise be entitled to it as exempt property under this section may have the court determine the property²¹¹ to be exempt from claims, except for perfected security interests thereon, after complying with the provisions of subsection (6)

²¹¹ Demonstrative designates the primary fund or property out of which a devise is to be satisfied.

(6) Persons entitled to exempt property shall be deemed to have waived their rights under this section unless a petition for determination of exempt property is filed by or on behalf of the persons entitled to the exempt property on or before the later of the date that is 4 months after the date of service of the notice of administration or the date that is 40 days after the date of termination of any proceeding involving the construction, admission to probate, or validity of the will or involving any other matter affecting any part of the estate subject to this section.

(7) Property determined as exempt under this section shall be excluded from the value of the estate before residuary, intestate, or pretermitted or elective shares are determined.

2. Creditor Claims Vanish Two Years After Death, Unless a Probate Has Been Filed and the Creditor Has Filed a Claim.

An individual debt or guarantee obligation will vanish two years after the death of the debtor if the creditor has not filed a claim against the probate estate. This applies even if the creditor receives no notice, and no probate estate is opened. This can be a good reason to not open a probate estate or to give notice to creditors in the manner that would normally apply when survivors would like to pursue estate administration that would necessitate sending notices to known or expected creditors.

What if the debtor made a fraudulent transfer (a transfer to avoid creditors) before dying, and the creditor loses their cause of action against the debtor?

Florida Statute Section 733.710 indicates that creditors must file a claim within two years of the death of a decedent in order to preserve their cause of action, notwithstanding whether the creditor is aware that the decedent has died. It is therefore an appropriate strategy to not file a probate proceeding during the first two years after a decedent's death, so as not to be required to give notice to known creditors. This is a good reason to use a revocable living trust for assets that would not otherwise be protected from creditors, so that there would not be the need to file a probate proceeding to allow a successor trustee and beneficiaries to facilitate administration of assets without giving notice to a creditor or creditors whose claims may be eliminated after two years.

The "two-year rule" does not apply to "super creditors," which are discussed in Chapter 1, Section L, or if the debtor made a fraudulent transfer during his or her lifetime (a transfer for the purpose of avoiding creditors), and the creditor loses their cause of action against the debtor under the two year rule. Can a super creditor pursue the transferee of a fraudulent transfer if the cause of action against the debtor was extinguished? The authors believe that this is the case, but are not aware of any cases that have addressed this.

The statute reads as follows:

733.710 Limitations on claims against estates.—

(1) Notwithstanding any other provision of the code, 2 years after the death of a person, neither the decedent's estate, the personal representative, if any, nor the beneficiaries shall be liable for any claim or cause of action against the decedent, whether or not letters of administration have been issued, except as provided in this section.

(2) This section shall not apply to a creditor who has filed a claim pursuant to s. 733.702 within 2 years after the person's death, and whose claim has not been paid or otherwise disposed of pursuant to s. 733.705.

(3) This section shall not affect the lien of any duly recorded mortgage or security interest or the lien of any person in possession of personal property or the right to foreclose and enforce the mortgage or lien.

In the 2000 Florida Supreme Court case *May v. Illinois National Insurance*,²¹² the Court held, "that section 733.710 is a jurisdictional statute of non-claim that is not subject to waiver or extension in the probate proceedings", and thus automatically bars untimely claims, even where a Personal Representative has agreed to extend the time for filing.

Even if the creditor filing a claim asserts fraud, estoppel or insufficiency of notice, the two-year statute under § 733.710 will apply.

Section 733.710 dates back to 1974, but case law dating back to 1937 applied to extinguish a cause of action for a lawsuit brought in Kentucky to recover property in Florida.²¹³ The Florida Supreme Court found that while Kentucky law governed whether the lawsuit could be brought, Florida law extinguished the liability of the administrator.

3. Revocable Trust Statute.

Florida Statute Section 733.707(3) enables the creditors of a deceased debtor to pursue the assets held in a revocable trust owned by that debtor.

The Statute reads as follows:

733.707 (3) Any portion of a trust with respect to which a decedent who is the grantor has at the decedent's death a right of revocation, as defined in paragraph (e), either alone or in conjunction with any other person, is liable for the expenses of the administration and obligations of the decedent's estate to the extent the decedent's estate is insufficient to pay them as provided in ss. 733.607(2) and 736.05053.

(a) For purposes of this subsection, any trusts established as part of, and all payments from, either an employee annuity described in s. 403 of the Internal Revenue Code of 1986, as amended, an Individual Retirement Account, as described in s. 408 of the Internal Revenue Code of 1986, as amended, a Keogh (HR-10) Plan, or a retirement or other plan established by a corporation which is qualified under s. 401 of the Internal Revenue Code of 1986, as amended, shall not be considered a trust over which the decedent has a right of revocation.

²¹² 771 So.2d 1143 (2000).

²¹³ *In re Paine's Estate*, 174 So. 430, 436 (1937).

(b) For purposes of this subsection, any trust described in s. 664 of the Internal Revenue Code of 1986, as amended, shall not be considered a trust over which the decedent has a right of revocation.

(c) This subsection shall not impair any rights an individual has under a qualified domestic relations order as that term is defined in s. 414(p) of the Internal Revenue Code of 1986, as amended.

(d) For purposes of this subsection, property held or received by a trust to the extent that the property would not have been subject to claims against the decedent's estate if it had been paid directly to a trust created under the decedent's will or other than to the decedent's estate, or assets received from any trust other than a trust described in this subsection, shall not be deemed assets of the trust available to the decedent's estate.

(e) For purposes of this subsection, a "right of revocation" is a power retained by the decedent, held in any capacity, to:

1. Amend or revoke the trust and revest the principal of the trust in the decedent; or

2. Withdraw or appoint the principal of the trust to or for the decedent's benefit.

4. No Claim Against Pay-On-Death Accounts or Similar Arrangements?

The authors are not aware of any statutory or common law method by which assets that pass by pay-on-death account or similar arrangements can be pursued by a creditor who was owed money by the debtor before the debtor died. These assets do not pass through a probate estate, and also do not pass through a revocable trust, so Florida Statutes Chapter 733, Part VII (Florida Statutes Sections 733.701-733.710) presumably does not apply to any such assets. Chapter 733, Part VII reads as follows:

733.701 Notifying creditors.—Unless creditors' claims are otherwise barred by s. 733.710, every personal representative shall cause notice to creditors to be published and served under s. 733.2121.

History.—s. 1, ch. 74-106; s. 83, ch. 75-220; s. 33, ch. 77-87; s. 4, ch. 89-340; s. 145, ch. 2001-226; s. 31, ch. 2003-154.

Note.—Created from former s. 733.15.

733.702 Limitations on presentation of claims.—

(1) If not barred by s. 733.710, no claim or demand against the decedent's estate that arose before the death of the decedent, including claims of the state and any of its political subdivisions, even if the claims are unmatured, contingent, or unliquidated; no claim for funeral or burial expenses; no claim for personal property in the possession of the personal representative; and no claim for damages, including, but not limited to, an action founded on fraud or another wrongful act or omission of the decedent, is binding on the estate, on the personal representative, or on any beneficiary unless filed in the probate proceeding on or before the later of the date that is 3 months after the time of the first publication of the notice to creditors or, as to any creditor required to be served with a copy of the notice to creditors, 30 days after the date of service on the creditor, even though the personal representative has recognized the claim or demand by paying a part of it or interest on it or otherwise. The personal representative may settle in full any claim without the necessity of the claim being filed when the settlement has been approved by the interested persons.

(2) No cause of action, including, but not limited to, an action founded upon fraud or other wrongful act or omission, shall survive the death of the person against whom the claim may be made, whether or not an action is pending at the death of the person, unless a claim is filed within the time periods set forth in this part.

(3) Any claim not timely filed as provided in this section is barred even though no objection to the claim is filed unless the court extends the time in which the claim may be filed. An extension may be granted only upon grounds of fraud, estoppel, or insufficient notice of the claims period. No independent action or declaratory action may be brought upon a claim which was not timely filed unless an extension has been granted by the court. If the personal representative or any other interested person serves on the creditor a notice to file a petition for an extension, the creditor shall be limited to a period of 30 days from the date of service of the notice in which to file a petition for extension.

(4) Nothing in this section affects or prevents:

(a) A proceeding to enforce any mortgage, security interest, or other lien on property of the decedent.

(b) To the limits of casualty insurance protection only, any proceeding to establish liability that is protected by the casualty insurance.

(c) The filing of a cross-claim or counterclaim against the estate in an action instituted by the estate; however, no recovery on a cross-claim or counterclaim shall exceed the estate's recovery in that action.

(5) Nothing in this section shall extend the limitations period set forth in s. 733.710.

History.—s. 1, ch. 74-106; s. 84, ch. 75-220; s. 2, ch. 80-127; s. 4, ch. 81-27; s. 160, ch. 83-216; s. 5, ch. 84-106; s. 4, ch. 85-79; s. 6, ch. 88-340; s. 5, ch. 89-340; s. 4, ch. 90-23; s. 1016, ch. 97-102; s. 146, ch. 2001-226; s. 6, ch. 2002-82; s. 26, ch. 2006-312; s. 21, ch. 2010-4.

Note.—Created from former s. 733.16.

733.703 Form and manner of presenting claim.—

(1) A creditor shall file a written statement of the claim. No additional charge may be imposed by a claimant who files a claim against the estate.

(2) Within the time allowed by s. 733.702, the personal representative may file a proof of claim of all claims he or she has paid or intends to pay. A claimant whose claim is listed in a personal representative's proof of claim shall be deemed to have filed a statement of the claim listed. Except as provided otherwise in this part, the claim shall be treated as if the claimant had filed it.

History.—s. 1, ch. 74-106; s. 84, ch. 75-220; s. 5, ch. 81-27; s. 5, ch. 85-79; s. 6, ch. 89-340; s. 147, ch. 2001-226.

Note.—Created from former s. 733.16.

733.704 Amendment of claims.—If a bona fide attempt to file a claim is made but the claim is defective as to form, the court may permit the amendment of the claim at any time.

History.—s. 1, ch. 74-106; s. 1, ch. 77-174; s. 148, ch. 2001-226.

Note.—Created from former s. 733.17.

733.705 Payment of and objection to claims.—

(1) The personal representative shall pay all claims within 1 year from the date of first publication of notice to creditors, provided that the time shall be extended with respect to claims in litigation, unmatured claims, and contingent claims for the period necessary to dispose of those claims pursuant to subsections (5), (6), (7), and (8). The court may extend the time for payment of any claim upon a showing of good cause. No personal representative shall be compelled to pay the debts of the decedent until after the expiration of 5 months from the first publication of notice to creditors. If any person brings an action against a personal representative within the 5 months on any claim to which the personal representative has not filed an objection, the plaintiff shall not receive any costs or attorneys' fees, nor shall the judgment change the class of the claim for payment under this code.

(2) On or before the expiration of 4 months from the first publication of notice to creditors or within 30 days from the timely filing or amendment of a claim, whichever occurs later, a personal representative or other interested person may file a written objection to a claim. If an objection is filed, the person filing it shall serve a copy of the objection as provided by the Florida Probate Rules. The failure to serve a copy of the objection constitutes an abandonment of the objection. For good cause, the court may extend the time

for filing or serving an objection to any claim. Objection to a claim constitutes an objection to an amendment of that claim unless the objection is withdrawn.

(3) If the objection is filed by a person other than the personal representative, the personal representative may apply to the court for an order relieving him or her from the obligation to defend the estate in an independent action or for the appointment of the objector as administrator ad litem to defend the action. Fees for the attorney for the administrator ad litem may be awarded as provided in s. 733.106(3). If costs or attorney's fees are awarded from or against the estate, the probate court may charge or apportion that award as provided in s. 733.106(4).

(4) An objection by an interested person to a personal representative's proof of claim shall state the particular item or items to which the interested person objects and shall be filed and served as provided in subsection (2). Issues of liability as between the estate and the personal representative individually for items listed in a personal representative's proof of claim shall be determined in the estate administration, in a proceeding for accounting or surcharge, or in another appropriate proceeding, whether or not an objection has been filed. If an objection to an item listed as to be paid in a personal representative's proof of claim is filed and served, and the personal representative has not paid the item, the other subsections of this section shall apply as if a claim for the item had been filed by the claimant; but if the personal representative has paid the claim after listing it as to be paid, issues of liability as between the estate and the personal representative individually shall be determined in the manner provided for an item listed as paid.

(5) The claimant is limited to a period of 30 days from the date of service of an objection within which to bring an independent action upon the claim, or a declaratory action to establish the validity and amount of an unmatured claim which is not yet due but which is certain to become due in the future, or a declaratory action to establish the validity of a contingent claim upon which no cause of action has accrued on the date of service of an objection and that may or may not become due in the future, unless an extension of this time is agreed to by the personal representative in writing before it expires. For good cause, the court may extend the time for filing an action or proceeding after objection is filed. No action or proceeding on the claim may be brought against the personal representative after the time limited above, and the claim is barred without court order. If an objection is filed to the claim of any creditor and the creditor brings an action to establish the claim, a judgment establishing the claim shall give it no priority over claims of the same class to which it belongs.

(6) A claimant may bring an independent action or declaratory action upon a claim which was not timely filed pursuant to s. 733.702(1) only if the claimant has been granted an extension of time to file the claim pursuant to s. 733.702(3).

(7) If an unmatured claim has not become due before the time for distribution of an estate, the personal representative may prepay the full amount of principal plus accrued interest due on the claim, without discount and without penalty, regardless of any prohibition against prepayment or provision for penalty in any instrument on which the claim is founded. If the claim is not prepaid, no order of discharge may be entered until the creditor and personal representative have filed an agreement disposing of the claim, or in the absence of an agreement until the court provides for payment by one of the following methods:

(a) Requiring the personal representative to reserve such assets as the court determines to be adequate to pay the claim when it becomes due; in fixing the amount to be reserved, the court may determine the value of any security or collateral to which the creditor may resort for payment of the claim and may direct the reservation, if necessary, of sufficient assets to pay the claim or to pay the difference between the value of any security or collateral and the amount necessary to pay the claim. If the estate is insolvent, the court may direct a proportionate amount to be reserved. The court shall direct that the amount reserved be retained by the personal representative until the time that the claim becomes due, and that so much of the reserved amount as is not used for payment be distributed according to law;

(b) Requiring that the claim be adequately secured by a mortgage, pledge, bond, trust, guaranty, or other security, as may be determined by the court, the security to remain in effect until the time the claim becomes due, and so much of the security or collateral as is not needed for payment be distributed according to law; or

(c) Making provisions for the disposition or satisfaction of the claim as are equitable, and in a manner so as not to delay unreasonably the closing of the estate.

(8) If no cause of action has accrued on a contingent claim before the time for distribution of an estate, no order of discharge may be entered until the creditor and the personal representative have filed an agreement disposing of the claim or, in the absence of an agreement, until:

(a) The court determines that the claim is adequately secured or that it has no value,

(b) Three months from the date on which a cause of action accrues upon the claim, provided that no action on the claim is then pending,

(c) Five years from the date of first publication of notice to creditors, or

(d) The court provides for payment of the claim upon the happening of the contingency by one of the methods described in paragraph (a), paragraph (b), or paragraph (c) of subsection (7), whichever occurs first. No action or proceeding on the claim may be brought against the personal representative after the time limited above, and the claim is barred without court order. If an objection is filed to the claim of any creditor and the creditor brings an action to establish the claim, a judgment establishing the claim shall give it no priority over claims of the same class to which it belongs.

(9) Interest shall be paid by the personal representative on written obligations of the decedent providing for the payment of interest. On all other claims, interest shall be allowed and paid beginning 5 months from the first publication of the notice to creditors.

(10) The court may determine all issues concerning claims or matters not requiring trial by jury.

(11) An order for extension of time authorized under this section may be entered only in the estate administration proceeding.

History.—s. 1, ch. 74-106; s. 86, ch. 75-220; s. 34, ch. 77-87; s. 1, ch. 77-174; s. 1, ch. 84-25; s. 1, ch. 86-249; s. 7, ch. 88-340; s. 7, ch. 89-340; s. 2, ch. 91-61; s. 1017, ch. 97-102; s. 149, ch. 2001-226.

Note.—Created from former s. 733.18.

733.706 Executions and levies.—Except upon approval by the court, no execution or other process shall issue on or be levied against property of the estate. An order approving execution or other process to be levied against property of the estate may be entered only in the estate administration proceeding. Claims on all judgments against a decedent shall be filed in the same manner as other claims against estates of decedents. This section shall not be construed to prevent the enforcement of mortgages, security interests, or liens encumbering specific property.

History.—s. 1, ch. 74-106; s. 86, ch. 75-220; s. 8, ch. 89-340.

Note.—Created from former s. 733.19.

733.707 Order of payment of expenses and obligations.—

(1) The personal representative shall pay the expenses of the administration and obligations of the decedent's estate in the following order:

- (a) Class 1.—Costs, expenses of administration, and compensation of personal representatives and their attorneys fees and attorneys fees awarded under s. 733.106(3).
- (b) Class 2.—Reasonable funeral, interment, and grave marker expenses, whether paid by a guardian, the personal representative, or any other person, not to exceed the aggregate of \$6,000.
- (c) Class 3.—Debts and taxes with preference under federal law, claims pursuant to ss. 409.9101 and 414.28, and claims in favor of the state for unpaid court costs, fees, or fines.
- (d) Class 4.—Reasonable and necessary medical and hospital expenses of the last 60 days of the last illness of the decedent, including compensation of persons attending the decedent.
- (e) Class 5.—Family allowance.
- (f) Class 6.—Arrearage from court-ordered child support.
- (g) Class 7.—Debts acquired after death by the continuation of the decedent's business, in accordance with s. 733.612(22), but only to the extent of the assets of that business.
- (h) Class 8.—All other claims, including those founded on judgments or decrees rendered against the decedent during the decedent's lifetime, and any excess over the sums allowed in paragraphs (b) and (d).

(2) After paying any preceding class, if the estate is insufficient to pay all of the next succeeding class, the creditors of the latter class shall be paid ratably in proportion to their respective claims.

(3) Any portion of a trust with respect to which a decedent who is the grantor has at the decedent's death a right of revocation, as defined in paragraph (e), either alone or in conjunction with any other person, is liable for the expenses of the administration and obligations of the decedent's estate to the extent the decedent's estate is insufficient to pay them as provided in ss. 733.607(2) and 736.05053.

(a) For purposes of this subsection, any trusts established as part of, and all payments from, either an employee annuity described in s. 403 of the Internal Revenue Code of 1986, as amended, an Individual Retirement Account, as described in s. 408 of the Internal Revenue Code of 1986, as amended, a Keogh (HR-10) Plan, or a retirement or other plan established by a corporation which is qualified under s. 401 of the Internal Revenue Code of 1986, as amended, shall not be considered a trust over which the decedent has a right of revocation.

(b) For purposes of this subsection, any trust described in s. 664 of the Internal Revenue Code of 1986, as amended, shall not be considered a trust over which the decedent has a right of revocation.

(c) This subsection shall not impair any rights an individual has under a qualified domestic relations order as that term is defined in s. 414(p) of the Internal Revenue Code of 1986, as amended.

(d) For purposes of this subsection, property held or received by a trust to the extent that the property would not have been subject to claims against the decedent's estate if it had been paid directly to a trust created under the decedent's will or other than to the decedent's estate, or assets received from any trust other than a trust described in this subsection, shall not be deemed assets of the trust available to the decedent's estate.

(e) For purposes of this subsection, a "right of revocation" is a power retained by the decedent, held in any capacity, to:

1. Amend or revoke the trust and revest the principal of the trust in the decedent; or
2. Withdraw or appoint the principal of the trust to or for the decedent's benefit.

History.—s. 1, ch. 74-106; s. 86, ch. 75-220; s. 35, ch. 77-87; s. 7, ch. 85-79; s. 69, ch. 87-226; s. 20, ch. 93-208; s. 11, ch. 93-257; s. 10, ch. 95-401; s. 1018, ch. 97-102; s. 3, ch. 97-240; s. 150, ch. 2001-226; s. 2, ch. 2010-122; s. 17, ch. 2012-100.

Note.—Created from former s. 733.20.

733.708 Compromise.—When a proposal is made to compromise any claim, whether in suit or not, by or against the estate of a decedent or to compromise any question concerning the distribution of a

decedent's estate, the court may enter an order authorizing the compromise if satisfied that the compromise will be for the best interest of the interested persons. The order shall relieve the personal representative of liability or responsibility for the compromise. Claims against the estate may not be compromised until after the time for filing objections to claims has expired.

History.—s. 1, ch. 74-106; s. 86, ch. 75-220; s. 151, ch. 2001-226.

Note.—Created from former s. 733.21.

733.710 Limitations on claims against estates.—

(1) Notwithstanding any other provision of the code, 2 years after the death of a person, neither the decedent's estate, the personal representative, if any, nor the beneficiaries shall be liable for any claim or cause of action against the decedent, whether or not letters of administration have been issued, except as provided in this section.

(2) This section shall not apply to a creditor who has filed a claim pursuant to s. 733.702 within 2 years after the person's death, and whose claim has not been paid or otherwise disposed of pursuant to s. 733.705.

(3) This section shall not affect the lien of any duly recorded mortgage or security interest or the lien of any person in possession of personal property or the right to foreclose and enforce the mortgage or lien.

History.—s. 1, ch. 74-106; s. 50, ch. 75-220; s. 36, ch. 77-87; s. 9, ch. 89-340; s. 152, ch. 2001-226.

Note.—Created from former s. 734.29(1).

This could be a good reason to use pay-on-death accounts, assets that pass by beneficiary designation, and to have LLC Operating Agreements and similar documents provide for automatic transfer on death in lieu of having assets pass via a revocable trust or through a probate estate.

As described in Chapter 2, assets held as tenants by the entireties between married spouses who reside in Florida will not be accessible to the surviving spouse's creditors, except to the extent that certain exceptions may apply.

HOMESTEAD LIMITATION ON DEVISE

A will or trust requiring that the homestead be sold, or transferred in trust and not passing outright to an heir, is discussed above in Section P entitled DEATH IS NOT THE END.

The Florida Constitution Article X, Section 4 and Florida Statutes Section 732.4015 limit the ability of a homestead owner who has one or more minor children or who is married, as further described below.

Many Florida residents place their homes under limited liability companies or mortgage them substantially to arm's-length lenders or related lenders in order to ameliorate or attempt to avoid the impact of these harsh rules.

If the homeowner is married with no children, then, on death, the surviving spouse will inherit the homestead as a matter of Florida law, unless this right has been waived. This applies even if the first dying spouse's Will states that the house would pass otherwise.

Please note that these rules do not apply if the house is being treated as owned jointly with right of survivorship or tenants by the entireties between a husband and wife. In that event the home will be completely owned by the surviving spouse, notwithstanding what a Will or Trust says. This will apply whether or not the married couple has children.

If the homeowner is married and has one or more children, then upon the homeowner's death, the surviving spouse can elect either a life estate, with a "remainder interest" held by the beneficiaries, or a fifty percent (50%) ownership interest as tenants in common with the beneficiaries. This fifty percent (50%) ownership option became effective for homesteads owned by decedents who died on or after October 1, 2010. The surviving spouse has six months from the decedent's death to elect to receive the undivided one-half interest.

If the spouse elects the life estate option, then he or she will have the exclusive right to use and ownership of the home during his or her lifetime, which includes the right to rent it out to third parties or to otherwise make use of it in any reasonable way. The children or grandchildren, as "remaindermen," have no right to occupy the property during the time that the surviving spouse, as owner of the life estate, is still alive; however, they become the sole owners of the property on the death of the surviving spouse. The life tenant has a duty to make and pay for ordinary and reasonable repairs to the house in order to prevent "waste." He or she is also responsible for paying property taxes and insurance.

If the surviving spouse instead elects a one-half ownership interest, the other joint owners will have equal rights of occupancy, but any joint owner also has the right to partition the property to be sold to the highest bidder "on the courthouse steps."

ELECTIVE SHARE

Changes made to Florida's Elective Share laws in 2016 and 2017 provide that (1) the elective estate includes homestead property; and (2) the surviving spouse who is the beneficiary of an irrevocable trust that will partly satisfy the elective share requirement will have the power to make trust assets productive, regardless of whether this is provided for in the trust agreement. Further, the surviving spouse will receive interest on the elective share amounts beginning two years after the date of the decedent's death.²¹⁴

²¹⁴ See Fla. Stat. § 732.2045.

Pursuant to Florida Statutes Section 732.201, the surviving spouse of a person who dies domiciled in Florida has the right to a share of the elective estate of the decedent. Florida Statutes Section 732.2065 provides that the elective share is equal to 30% of the elective estate.

While there have been efforts to change Florida Statutes Section 732.2065 so that the percentage will vary based upon the number of years that the couple has been married, the legislature has not accepted the proposals, perhaps because many individuals in the legislature have been married a long time, and fear having to pay a larger percentage of their estate than would otherwise apply.

One way to avoid the elective share is to fund 37.5% of the elective estate into an elective share trust, pursuant to Florida Statutes Section 732.2095. The trust will provide for the spouse to receive income plus principal as needed for health, education, maintenance and support, but only after taking into account other resources available to the spouse. The testator's children could be trustees of the trust and receive reasonable trustees' fees.

Floridians may also avoid the elective share by giving their spouse significant monies during the marriage in exchange for a waiver of elective share and homestead inheritance rights.

Another strategy to avoid or reduce the elective share is for the client to make a completed gift to an irrevocable trust for the benefit of his or her children, or other desired beneficiaries, with the client as a discretionary beneficiary of the trust, if the transfer to the trust is made within at least one year before the client's death.

Florida Statutes Section 732.2035(6)(c) provides that property transferred to a trust that has the grantor as a beneficiary is not included in the grantor's elective estate as long as the grantor's only interests in the property consist of one or more of the following:

- (1) The property could be distributed to or for the benefit of the grantor only with the consent of all persons having a beneficial interest in the property;
- (2) The income or principal of the property could be distributed to or for the benefit of the grantor only through the exercise or in default of an exercise of a general power of appointment held by any person other than the grantor;
- (3) The income or principal of the property is or could be distributed in satisfaction of the grantor's obligation of support; or
- (4) The grantor had a contingent right to receive principal, other than at the discretion of any person, which contingency was beyond the control of the grantor and which had not in fact occurred at the grantor's death.

Therefore, a father with three sons might establish three separate irrevocable trusts (one for each son) in a creditor protection jurisdiction, such as Nevada or Alaska. Each separate irrevocable trust can have the applicable son and the grantor as discretionary beneficiaries, provided that no distributions can be made

to the grantor without the consent of the son. This should prevent the assets of the trust from being included in the grantor's elective share estate upon his death.

1. What Property is Included in the Elective Estate?

Florida Statutes Section 732.2035 provides that the following is included when calculating the elective estate:

732.2035 Property entering into elective estate.—

Except as provided in s. 732.2045, the elective estate consists of the sum of the values as determined under s. 732.2055 of the following property interests:

- (1) The decedent's probate estate.
- (2) The decedent's interest in property which constitutes the protected homestead of the decedent.
- (3) The decedent's ownership interest in accounts or securities registered in "Pay On Death," "Transfer On Death," "In Trust For," or coownership with right of survivorship form. For this purpose, "decedent's ownership interest" means, in the case of accounts or securities held in tenancy by the entirety, one-half of the value of the account or security, and in all other cases, that portion of the accounts or securities which the decedent had, immediately before death, the right to withdraw or use without the duty to account to any person.
- (4) The decedent's fractional interest in property, other than property described in subsection (3) or subsection (8), held by the decedent in joint tenancy with right of survivorship or in tenancy by the entirety. For this purpose, "decedent's fractional interest in property" means the value of the property divided by the number of tenants.
- (5) That portion of property, other than property described in subsections (2) and (3), transferred by the decedent to the extent that at the time of the decedent's death the transfer was revocable by the decedent alone or in conjunction with any other person. This subsection does not apply to a transfer that is revocable by the decedent only with the consent of all persons having a beneficial interest in the property.
- (6) (a) That portion of property, other than property described in subsection (2), subsection (4), subsection (5), or subsection (8), transferred by the decedent to the extent that at the time of the decedent's death:
 1. The decedent possessed the right to, or in fact enjoyed the possession or use of, the income or principal of the property; or
 2. The principal of the property could, in the discretion of any person other than the spouse of the decedent, be distributed or appointed to or for the benefit of the decedent.

In the application of this subsection, a right to payments under a commercial or private annuity, an annuity trust, a unitrust, or a similar arrangement shall be treated as a right to that portion of the income of the property necessary to equal the annuity, unitrust, or other payment.

(6) (b) The amount included under this subsection is:

1. With respect to subparagraph (a)1., the value of the portion of the property to which the decedent's right or enjoyment related, to the extent the portion passed to or for the benefit of any person other than the decedent's probate estate; and
2. With respect to subparagraph (a)2., the value of the portion subject to the discretion, to the extent the portion passed to or for the benefit of any person other than the decedent's probate estate.

(6) (c) This subsection does not apply to any property if the decedent's only interests in the property are that:

1. The property could be distributed to or for the benefit of the decedent only with the consent of all persons having a beneficial interest in the property; or
 2. The income or principal of the property could be distributed to or for the benefit of the decedent only through the exercise or in default of an exercise of a general power of appointment held by any person other than the decedent; or
 3. The income or principal of the property is or could be distributed in satisfaction of the decedent's obligation of support; or
 4. The decedent had a contingent right to receive principal, other than at the discretion of any person, which contingency was beyond the control of the decedent and which had not in fact occurred at the decedent's death.
- (7) The decedent's beneficial interest in the net cash surrender value immediately before death of any policy of insurance on the decedent's life.
- (8) The value of amounts payable to or for the benefit of any person by reason of surviving the decedent under any public or private pension, retirement, or deferred compensation plan, or any similar arrangement, other than benefits payable under the federal Railroad Retirement Act or the federal Social Security System. In the case of a defined contribution plan as defined in s. 414(i) of the Internal Revenue Code of 1986, as amended, this subsection shall not apply to the excess of the proceeds of any insurance policy on the decedent's life over the net cash surrender value of the policy immediately before the decedent's death.
- (9) Property that was transferred during the 1-year period preceding the decedent's death as a result of a transfer by the decedent if the transfer was either of the following types:

- (a) Any property transferred as a result of the termination of a right or interest in, or power over, property that would have been included in the elective estate under subsection (5) or subsection (6) if the right, interest, or power had not terminated until the decedent's death.
- (b) Any transfer of property to the extent not otherwise included in the elective estate, made to or for the benefit of any person, except:

1. Any transfer of property for medical or educational expenses to the extent it qualifies for exclusion from the United States gift tax under s. 2503(e) of the Internal Revenue Code, as amended; and
2. After the application of subparagraph 1., the first annual exclusion amount of property transferred to or for the benefit of each donee during the 1-year period, but only to the extent the transfer qualifies for exclusion from the United States gift tax under s. 2503(b) or (c) of the Internal Revenue Code, as amended. For purposes of this subparagraph, the term “annual exclusion amount” means the amount of one annual exclusion under s. 2503(b) or (c) of the Internal Revenue Code, as amended.

(c) Except as provided in paragraph (d), for purposes of this subsection:

1. A “termination” with respect to a right or interest in property occurs when the decedent transfers or relinquishes the right or interest, and, with respect to a power over property, a termination occurs when the power terminates by exercise, release, lapse, default, or otherwise.
2. A distribution from a trust the income or principal of which is subject to subsection (5), subsection (6), or subsection (10) shall be treated as a transfer of property by the decedent and not as a termination of a right or interest in, or a power over, property.

(d) Notwithstanding anything in paragraph (c) to the contrary:

1. A “termination” with respect to a right or interest in property does not occur when the right or interest terminates by the terms of the governing instrument unless the termination is determined by reference to the death of the decedent and the court finds that a principal purpose for the terms of the instrument relating to the termination was avoidance of the elective share.
2. A distribution from a trust is not subject to this subsection if the distribution is required by the terms of the governing instrument unless the event triggering the distribution is determined by reference to the death of the decedent and the court finds that a principal purpose of the terms of the governing instrument relating to the distribution is avoidance of the elective share.

(10) Property transferred in satisfaction of the elective share.

2. What Property is Excluded from the Elective Estate?

Florida Statutes Section 732.2045, referenced in the above statute, states as follows:

732.2045 Exclusions and overlapping application.—

(1) Exclusions.--Section 732.2035 does not apply to:

(a) Except as provided in s. 732.2155(4), any transfer of property by the decedent to the extent the transfer is irrevocable before the effective date of this subsection or after that date but before the date of the decedent's marriage to the surviving spouse.

(b) Any transfer of property by the decedent to the extent the decedent received adequate consideration in money or money's worth for the transfer.

(c) Any transfer of property by the decedent made with the written consent of the decedent's spouse. For this purpose, spousal consent to split-gift treatment under the United States gift tax laws does not constitute written consent to the transfer by the decedent.

(d) The proceeds of any policy of insurance on the decedent's life in excess of the net cash surrender value of the policy whether payable to the decedent's estate, a trust, or in any other manner.

(e) Any policy of insurance on the decedent's life maintained pursuant to a court order.

(f) The decedent's one-half of the property to which ss. 732.216-732.228, or any similar provisions of law of another state, apply and real property that is community property under the laws of the jurisdiction where it is located.

(g) Property held in a qualifying special needs trust on the date of the decedent's death.

(h) Property included in the gross estate of the decedent for federal estate tax purposes solely because the decedent possessed a general power of appointment.

(i) Property which constitutes the protected homestead of the decedent if the surviving spouse validly waived his or her homestead rights as provided under s. 732.702, or otherwise under applicable law, and such spouse did not receive any interest in the protected homestead upon the decedent's death.

(2) Overlapping application.--If s. 732.2035(1) and any other subsection of s. 732.2035 apply to the same property interest, the amount included in the elective estate under other subsections is reduced by the amount included under subsection (1). In all other cases, if more than one subsection of s. 732.2035 applies to a property interest, only the subsection resulting in the largest elective estate shall apply.

3. How is the Value of the Elective Estate Calculated?

The value of property included in the elective estate is calculated pursuant to the following statute:

732.2055 Valuation of the elective estate.—

For purposes of s. 732.2035, “value” means:

(1) (a) In the case of protected homestead:

1. If the surviving spouse receives a fee simple interest, the fair market value of the protected homestead on the date of the decedent's death.

2. If the spouse takes a life estate as provided in s. 732.401(1), or validly elects to take an undivided one-half interest as a tenant in common as provided in s. 732.401(2), one-half of the fair market value of the protected homestead on the date of the decedent's death.

3. If the surviving spouse validly waived his or her homestead rights as provided under s. 732.702 or otherwise under applicable law, but nevertheless receives an interest in the protected homestead, other than an interest described in s. 732.401, including an interest in trust, the value of the spouse's interest is determined as property interests that are not protected homestead.

(b) For purposes of this subsection, fair market value shall be calculated by deducting from the total value of the property all mortgages, liens, and security interests to which the protected homestead is subject and for which the decedent is liable, but only to the extent that such amount is not otherwise deducted as a claim paid or payable from the elective estate.

(2) In the case of any policy of insurance on the decedent's life includable under s. 732.2035(5), (6), or (7), the net cash surrender value of the policy immediately before the decedent's death.

(3) In the case of any policy of insurance on the decedent's life includable under s. 732.2035(9), the net cash surrender value of the policy on the date of the termination or transfer.

(4) In the case of amounts includable under s. 732.2035(8), the transfer tax value of the amounts on the date of the decedent's death.

(5) In the case of other property included under s. 732.2035(9), the fair market value of the property on the date of the termination or transfer, computed after deducting any mortgages, liens, or security interests on the property as of that date.

(6) In the case of all other property, the fair market value of the property on the date of the decedent's death, computed after deducting from the total value of the property:

(a) All claims paid or payable from the elective estate; and

(b) To the extent they are not deducted under paragraph (a), all mortgages, liens, or security interests on the property.

FAMILY ALLOWANCE

In addition to the protections described above, Florida Statutes Section 732.403 provides a “family allowance,” whereby a surviving spouse can receive up to \$18,000 from the estate of his or her spouse for support purposes. The amount awarded to the surviving spouse must be “reasonable,” and the court will look to factors such as the previous standard of living, needs of the spouse and children, age and health of the spouse, and other resources. The right to receive a family allowance can be waived by a spouse in a prenuptial agreement or other document.

INSOLVENT CORPORATIONS.

Duties of Directors and/or Officers of Insolvent Corporations

An insolvent corporation's directors and officers may owe a fiduciary duty to the corporation's creditors (the "insolvency exception"). However, Florida courts applying different states' laws are split on whether, at insolvency, these duties are owed exclusively to creditors or also to shareholders.²¹⁵

Multiple judicial interpretations also exist in regards to the point in time in which a corporation is considered insolvent. *Toy King* and *Lynnais* both adopt the "vicinity," or "zone," of insolvency principle, but use different methods of defining the zone: the *Toy King* court employs balance-sheet insolvency- "liabilities in excess of assets"; *Lynnais* uses cash-flow insolvency- "inability to pay debts as they become due."²¹⁶

There is also split authority on what standard will be used to judge directors' actions when a corporation is within the vicinity of insolvency, the Business Judgment Rule or the Trust Fund Doctrine.²¹⁷ One can cite to ample support for either side of the vicinity definitions and standard of review issues.

Compensation Paid to Shareholders of an Insolvent Corporation

Florida Statutes Section 607.06401(3) prohibits distributions to shareholders that would result in the corporation's insolvency.²¹⁸ This provision of the statute includes insolvency both per the cash-flow definition, Section 607.06401(3)(a), and the balance-sheet definition, Section 607.06401(3)(b). A director who "votes for or assents to" such a prohibited distribution in violation of his duties per § 607.0830 becomes personally liable to the corporation in the amount over and above what would have been permissible under § 607.06401(3).²¹⁹

Distributions made to shareholders with the purpose of drawing down the assets of the corporation, but that do not violate § 607.06401(3), would almost certainly give rise to a creditor's or trustee's claim to avoid the transfers under Florida's fraudulent transfer statutes, §§ 726.105 and 726.016 and/or claims for preferential and fraudulent transfers under 11 U.S.C. §§ 547 and 548, respectively.²²⁰

Preferential Transfers

As discussed in Chapter 1, Section H, Florida's preferential transfer statute is under Florida Statutes Section 726.016(2), which provides that "a transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made, if the transfer was made to an insider for an antecedent debt, the

²¹⁵ See *In re Toy King Distributors, Inc.*, 256 B.R. 167, (Bankr. M.D. Fla. 2000) (applying Florida law, duties shift from shareholders exclusively to creditors exclusively); contra *Credit Lyonnais Ban Nederalnd, N.C. v. Pathe Communications Corp.*, 1991 WL 277613 at *1155 (Del. Ch. 1991) finding duty owed to the "corporate enterprise" that encompassed shareholders and creditors).

²¹⁶ Davis and Webb, *Directors of the Financially Troubled Company: Guidance for a Thankless Job*, Fla. Bar J., Vol. LXXVI, No. 7 (July/August 2002).

²¹⁷ *Id.*

²¹⁸ *Cox Enterprises, Inc. v. Pension Ben. Guar. Corp.*, 666 F.3d 697, 699 (11th Cir. 2012).

²¹⁹ Fla. Stat. § 607.0834.

²²⁰ See *In re Trafford Distributing Center, Inc.*, 431 B.R. 263, 267 (Bankr. S.D. Fla. 2010) (corporation's director, even though only the "titular head," breached fiduciary duty owed to creditors by participating in scheme to drain company of its assets).

debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

The five elements set forth above are as follows:

1. The creditor's claim arose before the transfer was made.
2. The transfer was made to an insider. The term "insider" is discussed above in Section H.
3. The transfer was made for an antecedent debt.
4. The debtor was insolvent at the time of the transfer.
5. The insider who received the transfer had reasonable cause to believe that the debtor was insolvent.

Florida Statutes Section 726.11 provides that an action to set aside such a preferential transfer must be filed "within one year after the transfer was made or the obligation was incurred."

Further, Bankruptcy Code Section 547 gives bankruptcy courts the power to set aside transfers that have been made in favor of creditors on account of an antecedent debt. Preferential transfers include debts paid to one or more creditors at a time when the debtor is insolvent. If the favored creditor is not related to the debtor or an "insider", then a 90-day set aside period will normally apply. A one-year period will apply if the debtor and favored creditor are directly or indirectly related as "insiders." Under state law, such transfers are governed by the fraudulent transfer statutes and the Florida Fraudulent Transfer Act, which contains a one-year lookback fraudulent transfer provision for certain payments to insiders.

As to whether a payment received for services rendered as an employee or independent subcontractor would be avoidable under 11 U.S.C. § 547, subsections (c)(1) through (c)(9) enumerate transfers that may not be avoided, as follows:

- (c) The trustee may not avoid under this section a transfer –
 - (1) to the extent that such transfer was –
 - (1) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
 - (2) in fact a substantially contemporaneous exchange.
 - (2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was –

- (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
 - (B) made according to ordinary business terms;
- (3) that creates a security interest in property acquired by the debtor –
 - (A) to the extent such security interest secures new value that was –
 - (i) given at or after the signing of a security agreement that contains a description of such property as collateral;
 - (ii) given by or on behalf of the secured party under such agreement;
 - (iii) given to enable the debtor to acquire such property; and
 - (iv) in fact used by the debtor to acquire such property; and
 - (B) that is perfected on or before 30 days after the debtor receives possession of such property;
- (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor –
 - (A) not secured by an otherwise unavoidable security interest; and
 - (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;
- (5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee cause a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of –
 - (A) (i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or
 - (B) the date on which new value was first given under the security agreement creating such security interest;
- (6) that is the fixing of a statutory lien that is not avoidable under section 545 of this title;
- (7) to the extent such transfer was a bona fide payment of a debt for a domestic support obligation;
- (8) if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than \$600; or

- (9) if, in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than \$5,000.

Florida Statute Chapter 727 – General Assignments for the Benefit of Creditors

Florida Statutes Section 727.105 – Proceedings against assignee states, “[p]roceedings may not be commenced against the assignee except as provided in this chapter, but nothing contained in this chapter affects any action or proceeding by a governmental unit to enforce such governmental unit’s police or regulatory power. Except in the case of a consensual lienholder enforcing its rights in personal property or real property collateral, there shall be no levy, execution, attachment, or the like in respect of any judgment against assets of the estate in the possession, custody, or control of the assignee.”

As far as the assignee conducting the business of the assignor, § 727.108(4) limits such operation to 14 days, or for longer if in the best interest of the estate and no objection is lodged with the court, but in no event longer than 45 days unless by court order.

Regarding the assignee paying the assignor’s tax filings, § 727.108(6) states that the assignee shall pay the estate’s administrative expenses. Assuming that the taxing authority places a tax lien on the assignor’s assets, that taxing authority would be in the highest-priority class of claims per § 727.114(1)(a).

The Doctrine of Successor Liability generally applies when a business enterprise or professional practice is moved from one entity to another where there is commonality as to identity, ownership, and operations to enable the creditor of one entity to reach the assets of the successor entity. It is not clear under Florida law whether this doctrine will apply if the assets and goodwill of the debtor entity are sold at arm’s-length to an affiliated party who funds and owns the successor entity in an Assignment for the Benefit of Creditors or simply at arm’s-length.

It does seem clear that under Bankruptcy Code Section 363(b) a bankruptcy court ordered sale with due notice to creditors will prevent the Doctrine of Successor Liability from applying.

Florida Statutes Section 727 contains 21 pages of rules, sample forms, and procedures for Assignments for the Benefit of Creditors.²²¹

EXCESSIVE EXECUTIVE COMPENSATION CAN BE A BREACH OF FIDUCIARY DUTY TO CREDITORS.

A claim for breach of fiduciary duty can be based on excessive executive compensation. Such a claim may succeed if the petitioner can show that excessive executive compensation equated to corporate waste. To be considered corporate waste, the compensation must lack a reasonable relationship to the services rendered. A three-tiered inquiry determines if a reasonable relationship exists:

- (A) Did the corporation benefit?

²²¹ See Florida Statutes Section 727.

(B) If so, was the compensation commensurate to the services?

(C) If so, did the compensation spring directly from the services?

A positive response to all three questions is needed to dispense of a corporate waste claim. For example, the court in *International Ins. Co. v. Johns*, examined Florida law on executive compensation plans and golden parachutes.²²² Per the *Johns* court, the fact-finder must first recognize the push-and-pull between Florida corporations' directors' ability to fix their own pay, Fla. Stat. § 607.0801, and Florida courts' acknowledgment of the business judgment rule.²²³

The presumptions of good faith and fair dealing inherent in the business judgment rule will be overcome only if the circumstances show evidence "of abuse of discretion, fraud, bad faith, or illegality."²²⁴ Without one of those factors the court will defer to the boards' or director's decision-making.²²⁵

In order to apply the business judgment rule to director and/or officer compensation systems, the *Johns* court held that the compensation must equate to corporate waste.²²⁶ This comparison leads to a long line of analytical steps that the court must take: corporate waste requires payment without adequate consideration; what constitutes consideration is up to a corporation's directors; courts cannot overrule such a decision by the directors unless the compensation does not bear a "reasonable relationship" to the services rendered; such a reasonable relationship exists if the payment "insures that the benefit provided by the services rendered will inure to the corporation."²²⁷

But the inquiry does not end there. Now the court must apply the 3-step "reasonable relationship" test discussed above. A negative answer to any of the three is indicative, if not probative, of corporate waste.

The court in *AmeriFirst Bank v. Bomar*, found that a director or officer's statutory fiduciary duty towards the corporation and its shareholders was "independent of his contractual obligations arising out of the employment contract."²²⁸ So holding, it allowed the plaintiff to proceed with the claim of tortious conduct by the director defendants by way of accepting "grossly excessive compensation in violation of federal regulations."²²⁹

Similar activity by directors can be argued to violate Florida Statutes Section 607.0830 regarding general standards for directors and impose personal liability upon directors per Section 607.0831 on the liability of directors.

BASIC STRATEGIES AND CONSIDERATIONS.

²²² 874 F.2d 1447 (11th Cir. 1989).

²²³ *Id.*

²²⁴ *Id.* at 1461 (referencing *Lake Region Packing Assoc. Inc. v. Furze*, 327 So.2d 212, 214 (Fla. 1976)).

²²⁵ *Id.*

²²⁶ *Id.* (citing *Rogers v. Hill*, 289 U.S. 582, 591-592 (1933)).

²²⁷ *Id.* (citing *Kauffman v. Shoenberg*, 91 A.2d 786 (Del. Ch. 1952)).

²²⁸ 757 F. Supp. 1365 1378 (S.D. Fla. 1991).

²²⁹ *Id.*

Coverage of all of the creditor and associated planning techniques that can be employed for Floridians would take hundreds of pages, but the following subsections should be useful, in addition to specific mention of techniques that apply with respect to various categories of exemption as further set forth in other sections of this book.

INDIVIDUAL AND BUSINESS CREDITOR PROTECTION PLANNING.

Creditor protection planning starts with coordination of assets, entities, and liabilities well before a creditor shows up on the horizon to threaten loss of assets, income, and disruption of personal and business situations. Smart estate, financial, and business planning assumes due regard to the risk of unlikely or unexpected creditor issues that would exceed the limits of prudently maintained liability insurance.

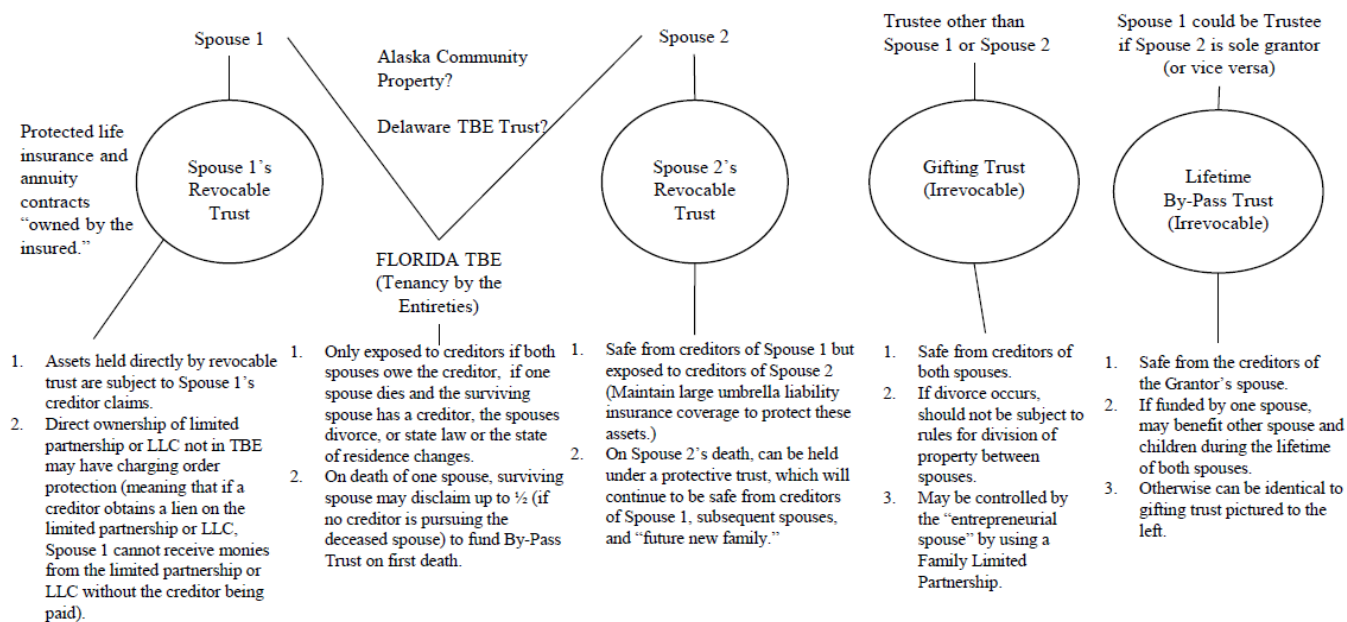
This section covers strategies that can apply for a typical married couple where one or both spouses may have significant liability concerns.

We believe that the best way to lay out these planning considerations and strategies is by reference to charts and mechanisms that are commonly used in estate and business planning. We have assumed that the individuals and businesses involved are located in Florida, unless otherwise indicated.

Determining Best How To Allocate Assets As Between A Married Couple | Part I

General Rules:

- Typically want each trust funded with at least \$5,450,000 worth of assets on death for estate tax planning.
- May be funded from ½ of tenancy by the entireties assets via disclaimer and probate or by life insurance/pension/IRA assets.



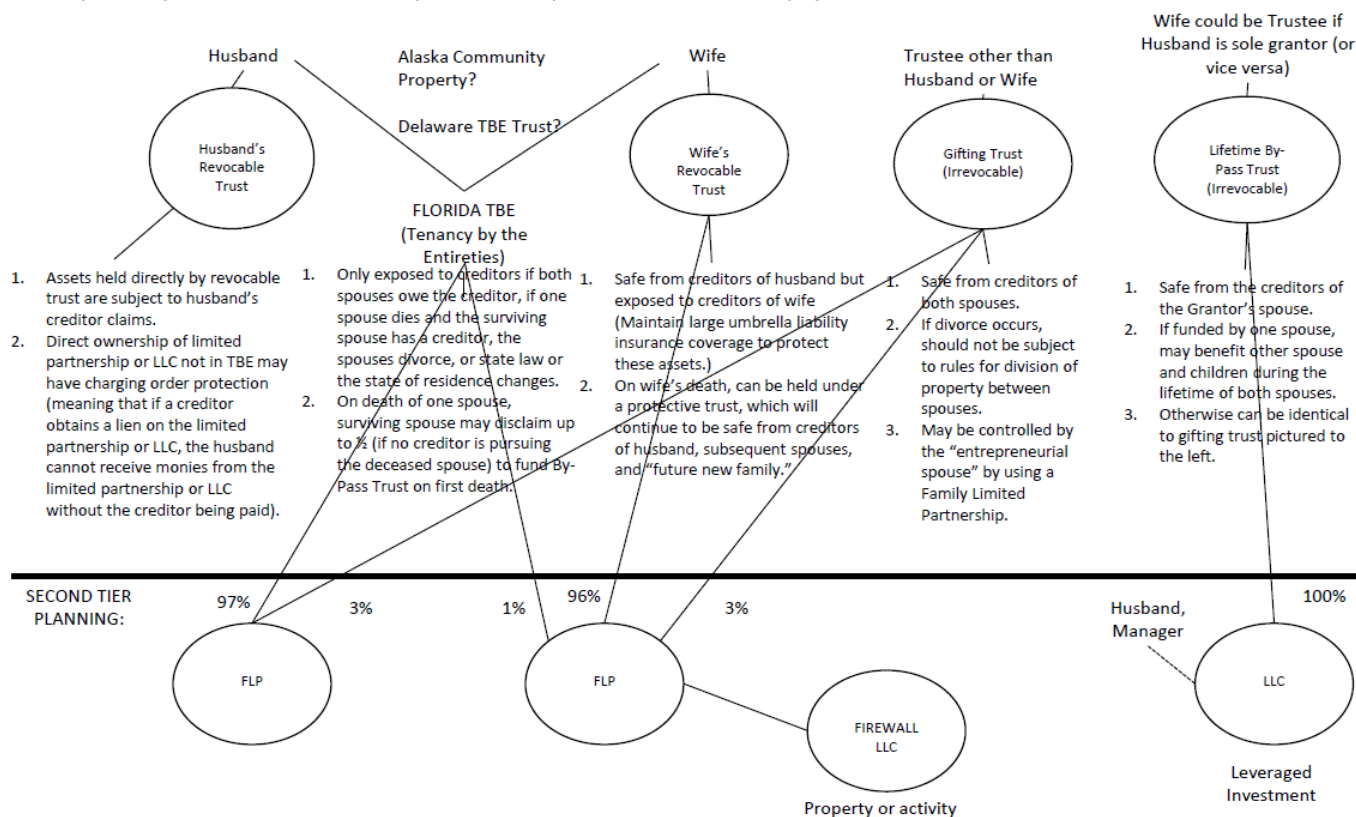
SEE NEXT PAGE FOR SECOND TIER PLANNING

A COMMON SOLUTION - to use a limited partnership or similar mechanisms and have no assets directly in the "high risk" spouse's trust, half to two-thirds of the assets held as tenants by the entireties, and half to two-thirds of the assets directly in the "low risk" spouse's trust.

Determining How To Best Allocate Assets As Between A Married Couple

Subsidiary Entity Techniques:

- Limited partnerships and LLCs can be used to facilitate discounts, for estate tax purposes, and for charging order protection.
- Limited partnerships and LLCs can also be used to provide "firewall protection" from activities or properties owned.



A COMMON SOLUTION - to use a limited partnership or similar mechanisms and have no assets directly in the "high risk" spouse's trust, half to two-thirds of the assets held as tenants by the entireties, and half to two-thirds of the assets directly in the "low risk" spouse's trust.

It is noteworthy that the vast majority of assets that we describe in this section are not immune from claims of the IRS, divorcing spouses, or other categories of "super creditors," which are described throughout this book.

Chart 1 shows a typical married couple consisting of “Spouse 1”, “Spouse 2”, 2 children, and joint, individual, trust, and entity assets. At the far left we show savings vehicles that will be creditor protected if properly formed and managed. This can be a pension account, a 401(k), an IRA, or one or more of the above.

Florida Statutes Section 222.21(2)(a) provides that these assets are exempt from creditor claims, and this continues in bankruptcy under most circumstances unless the transfer to the IRA or other retirement account asset occurred for the purpose of avoiding an existing or eminently expected creditor or creditors, in which event the fraudulent transfer statutes may apply.

It is noteworthy that the beneficiary of an IRA or pension account will also have immunity from that beneficiary’s creditors if the beneficiary is an individual who resides in Florida or another state that provides that IRA beneficiaries have creditor protection for inherited IRAs. Beneficiaries who reside in other states will not have creditor protection from their own creditors, and IRA owners are therefore well advised to consider having IRAs be made payable to irrevocable trusts that can benefit their beneficiaries without being subject to creditor claims thereof.

Below the 401(k) and IRAs we show an annuity contract owned by Spouse 1. Under Florida law a variable or fixed annuity contract owned by an individual will be exempt from the creditors of that individual, based upon the premise that the individual is considered to be the “beneficiary” of the annuity under Florida Statutes Section 222.14. Under this same statute the beneficiary who receives the annuity upon death should also have creditor protection for the ownership thereof, assuming that he or she is a Floridian.

Normally the beneficiary of an annuity contract will be the surviving spouse, because under Internal Revenue Code Section 72(s)(3) an individual spouse can roll an annuity with accumulated income tax deferred growth to that spouse’s own annuity to maintain continuation of both the creditor protection and the income tax deferral.

The alternate beneficiary to the spouse will typically be a trust for descendants, and the accumulated income within the annuity will typically have to be paid out within five years of the death of the owner where the beneficiary is not a surviving spouse.

The above discussion of annuities assumes that the contract is not a “qualified annuity”. A qualified annuity is the term given to an annuity contract which is considered to be an IRA for income tax purposes, but is invested with an insurance company under an annuity contract. An annuity contract owned under an IRA wrapper (known as a “qualified annuity”) is protected under the IRA rules, and not the annuity rules, and taxed like an IRA as opposed to being taxed as an annuity. Annuities are almost always more expensive than comparable mutual funds and are therefore often considered to be inappropriate to be held under an IRA pension or other qualified account.

It is noteworthy that annuities have a number of non-creditor protection disadvantages, including the following:

1. Annuities convert capital gains income that would be recognized when someone invests in equities or tax-free income when someone would invest in municipal bonds into ordinary income, which is taxable on withdrawal;
2. Income that is withdrawn from an annuity before the owner has reached age 59 1/2 is subject to an additional 10% tax; and
3. Financial advice commonly received with respect to annuity contracts is often negatively impacted by the high commissions that many financial advisors receive for placing these.

Below the annuity contract we show Spouse 1's life insurance as individually owned.

Florida Statutes Section 222.13 provides that creditors cannot reach the cash surrender value of a life insurance policy owned by the insured during the insured's lifetime. While creditors of a beneficiary can seize the policy proceeds made payable to the beneficiary, life insurance will typically be made payable to a trust that can benefit the beneficiary without being subject to claims of his or her creditors because of the protection accorded under the Florida Trust Code which applies when someone other than the debtor who is a beneficiary has funded the Trust.

Florida Statutes Section 222.14 indicates that creditors cannot reach the cash value of life insurance policies, but does not prevent creditors from seizing ownership of term life insurance policies, although these typically do not have very much value and might be sold by the insured owner to a family member or a trust for family members for fair market value well before a creditor would have a judgment. Creditors rarely pursue term life insurance policies unless the insured is elderly, or in poor health, but it is safest to have them owned by irrevocable life insurance trusts which do not have the insured spouse as the beneficiary, and facilitate avoidance of federal estate tax.

A flexible irrevocable trust that does not benefit the insured but is changeable for the benefit of the insured's family may be formed and funded by the insured to own life insurance policies without having the constraints or complexity that would typically apply for a conventional life insurance trust.

Another asset often owned by an individual spouse will be a 529 college savings plan that is being held for the benefit of one or more children, grandchildren, nephews, or nieces. This is also a creditor proof asset since the owner/contributor can cause the account to be used for his or her own benefit as a beneficiary. The growth inside the 529 college savings plan will never be subject to income tax as long as it is spent on permitted educational expenses, which now include up to \$10,000 a year for private school pre-college tuition beginning in 2018. The growth will be subject to a 10% excise tax upon withdrawal for purposes other than permitted education and educational living expenses.

A white paper that compares 529 plans to variable annuities can be obtained by request sent to agassman@gassmanpa.com.

Another asset that will often be owned individually by a married Floridian will be his or her car, or a lease of the car.

This is because the owner of a motor vehicle in Florida is responsible for the negligence of a permitted driver, although this can be limited to \$500,000 under a statute which will apply unless the owner was negligent or engaged in inappropriate conduct in allowing the driver to have the use of the car.

Cars are often financed under 48 or 60 month loans so that they have very little equity, or they may be leased under agreements that would cause a creditor to not have much interest in taking the car lease over.

Cars are often owned by business or professional corporations for income tax deduction purposes, but expose the company to potential liability for accidents, so this is rarely recommended by the author unless a subsidiary company is established and owned by the business company to own the automobile and appropriate formalities are used.

Sometimes cars are driven by children or others, and this is never recommended by the author. Cars can be owned by an 18 year old in Florida, so it is not uncommon for one 18 year old child to own the cars that are driven by the other children.

Car ownership needs to be coordinated with automobile and umbrella liability insurance coverage. Some carriers will require one of the parents to own a vehicle if a child is driving it and it will be a part of the family's umbrella coverage.

Clients with collectible vehicles may consider placing these in LLCs that might be owned jointed as Tenants by the Entireties or having the vehicles lien by Notes owed to creditor protected family member of other family entities.

Please note that each spouse has a revocable trust which is owned individually by that spouse, but will typically not have any assets owned by it.

Later in this section we discuss the utility of having assets owned by or payable to the revocable trust of the first dying spouse, which becomes irrevocable on that spouse's death and can be held for the health, education, and maintenance of the surviving spouse and descendants while being protected from federal estate tax and creditors of the surviving spouse and descendants. This is further discussed in depth in Chapter 11.

While the Florida Statutes are clear that permanent life insurance policies, annuity contracts, and homestead can be creditor exempt when owned by an individual, the law is not clear as to whether such assets will be exempt from creditors if owned by a revocable trust.

It is therefore normal to have these assets owned individually, but to have them be payable by beneficiary designation to the revocable trust of the owner, which can provide for protective trust provisions to apply after the owner's death to safeguard these assets for family members.

The protection of homestead owned by an individual is much more complicated and further discussed in this book, but when a non-married individual owns a homestead it may pass by "lady bird deed" to a

protective trust for descendants, assuming that there are no minor children and that any spouse has executed appropriate waivers or disclaimers.

Typically, investment assets are not owned by the revocable trust of a spouse who may also have creditor exposure.

We may assume that Spouse 1 is a professional with high risk exposure, and will therefore not own assets that are creditor exposed, other than as described above, and with respect to a professional corporation, if necessary.

Not shown on the chart are potential future inheritances that either spouse might receive.

We typically recommend that the client establish an irrevocable inheritance trust that the child can serve as trustee of and receive benefits as needed for health, education, and maintenance with respect to any inheritance or large gifts that he or she might receive from a family member.

Alternatively, family members can be asked to amend their estate planning documents to provide for any large dispositions to pass to an “inheritance trust” in lieu of outright to a child or other beneficiary.

Medical practices may also be owned in part by a trust or trusts for the spouse and a child or children of the doctor, but not a trust for grandchildren or to benefit any other individuals unless the medical practice is registered as a clinic under the Florida Health Care Clinic Act, Fla. Statutes Sections 400.990 to 400.995.

Between the two spouses we show joint assets which will typically be owned as tenants by the entirety.

CONSIDER DEBT PLANNING.

Commonly known as “equity stripping” in the asset protection community, the general rule is that a creditor cannot seize an asset that is subject to a lien or mortgage in favor of another legitimate creditor unless or until the other legitimate creditor is paid in full.

While there are some exceptions to this rule such as under the doctrine of “Marshaling of Assets,” and fraudulent transfer and preferential transfer rules, debt, when properly used, can be a good creditor protection mechanism. “The equitable doctrine of marshaling ‘rests upon the principle that a creditor having two funds to satisfy his debt, may not by his application of them to his demand, defeat another creditor, who may resort to only one of the funds.’”²³⁰

If and when a more “friendly” creditor can be given an enforceable lien or mortgage on a debtor’s otherwise exposed assets, the debtor will be in a better position to negotiate a favorable settlement. Nevertheless, advisors should be aware of the doctrine of “Marshaling of Assets,” whereby a court of equity, including the bankruptcy court, could find that a creditor is “over secured” and may thus be required to disgorge assets that have been lienied or even foreclosed upon in favor of a more junior creditor.²³¹

²³⁰ *In re Talmo*, 192 B.R. 272, 274 (Bankr. S.D. Fla. 1996).

²³¹ 53 Am. Jur. 2d Marshaling Assets § 1.

There are aggressive international programs promoted by certain members of the estate and creditor protection planning community that involve establishing an offshore asset protection trust, which is funded with the proceeds from borrowing. An international bank is used to loan money to the client and takes a mortgage on the client's U.S. properties. The international bank is secured by having liens both on the U.S. properties and on the assets of the asset protection trust in case the U.S. liens are not sufficient to fully satisfy the international creditor's mortgage positions. Good luck to any creditor who comes on the scene afterwards!

The following article, written by attorney Denis Kleinfeld, provides more information on equity stripping:

EQUITY STRIPPING – A FINE AMERICAN TRADITION

By: Denis Kleinfeld

The legal battle between debtors and creditors has two centuries of American tradition behind it. This was recognized on March 30 2000 by the New York Court of Appeals in deciding an international debt collection case. The fact that it was decided in New York has significant importance because of New York's prominence in the worldwide financial markets.

In *Credit Agricole Indosuez v. Rossiyskiv Kredit Bank*, 94 N.Y.2d 541 (N.Y. App. 2000), the debtors were attempting to put liens on assets prior to judgment. Creditors, as might be expected, sought the help of the New York courts by requesting preliminary injunctive relief. But New York's highest court, in overturning the decision of two lower courts, rejected the plaintiff's position and held that the New York courts cannot be used by general creditors to freeze globally the assets of a debtor. A great decision for those trying to protect assets.

In this case, three European banks were trying to collect on thirty million dollars in promissory notes which had been issued by Russia's sixth largest bank and its Dutch subsidiary, a securities company. In view of the financial crisis occurring in Russia, it is understandable that the creditors were concerned that assets that might otherwise be available to pay the debts would be stripped away.

The promissory notes provided for jurisdiction in New York in the event of default and, acting on those provisions, the creditors obtained a preliminary injunction from the lower court freezing the banks' assets in New York.

The Court of Appeals, in lifting that injunction, reviewed the historical legal principles of these forms of claims.

Under U.S. law, a creditor must usually have a judgment before taking actions to obtain ownership, force a sale, or obtain control over a debtor's assets. The court noted that since the 18th Century the American courts have "consistently refused to grant general creditors a preliminary injunction to restrain a debtor's asset transfers that allegedly would defeat satisfaction of any anticipated judgment." This certainly has a decided impact even when considering that creditors would have legal rights under fraudulent conveyance statutes or bankruptcy law.

The New York court relied on the 1999 U.S. Supreme Court case of *Grupo Mexicano*, 119 S.Ct. 1961 (1999), where a preliminary injunction was sought in a parallel factual situation. Plaintiffs in that case also asserted that the debtor was at risk of insolvency, if not already insolvent, and that dissipating its most significant assets would frustrate any judgment the creditors would obtain. In *Grupo Mexicano*, the U.S. Supreme Court stated that the law since the Federal Judiciary Act of 1789 provided that preliminary injunctive relief was beyond the traditional principle of equity jurisdiction, and the courts should not allow such actions. As the Supreme Court found, “a general creditor (one without a judgment) had no cognizable interest, either at law or in equity, in the property of his debtor, and therefore could not interfere with the debtor’s use of that property.”²³² A simple accurate statement of fundamental law.

Creditors’ lawyers, if nothing else, are ingenious at thinking up legal arguments. In *Credit Agricole*, they came up with a cause of action alleging that the defendant bank, being presently insolvent, owed a fiduciary duty to preserve assets for the benefit of general creditors. They alleged that when the bank transferred the principle assets to avoid the creditors, they breached their fiduciary duty and therefore the courts should award permanent injunctive relief to protect the expected money judgment.

The New York court didn’t buy that argument. As it observed, the fiduciary duty argument was only incidental to the enforcement of the primary relief sought the money judgment. “Making an exception on the basis that permanent equitable relief is sought in support of a suit essentially for money only would be too facile a way to avoid and undermine the settled proscription against preliminary injunctions merely to preserve a fund for eventual execution of judgment in suits for money damages.”²³³ That is, the mere danger of asset stripping is not a sufficient basis for the courts to make an exception to the general rule that has been recognized for two centuries in American law.

Although the lawyers for the creditors urged a change in the law, the New York court specifically rejected the idea of liberalizing and expanding the remedies that are already available under the American legal system. The Plaintiffs urged that they follow the example of the English courts and establish Mareva type injunctions which would allow worldwide freezing of assets. They stated that this would be necessary in response to the increased globalization of capital markets. This argument was also raised in the *Grupo Mexicano*, and like the United States Supreme Court, the New York court also rejected this argument.

There really is nothing new about these cases. For example, in Florida under *Bayview Estates Corporation*, 154 So. 894, 900 (Fla. 1934), the Supreme Court of Florida noted that “the mere fact that a person may be indebted to another does not render a conveyance of his property a fraud in law upon its creditors. The owner of property, whether real or personal, possesses the absolute right to dispose of all or any part of it as he sees fit.” The traditional view has always been that a creditor has no cognizable interest in the property in a debtor until the creditor obtains a judgment.

This of course has profound impact upon asset protection planning. For one thing, it makes it clear that a debtor has the absolute legal right to transfer his property so long as that property freely alienable and the transfer is not illegal. Even though a creditor apparently may be able to obtain a judgment on the debt, the fact remains that the creditor’s legal rights do not rise until that judgment is actually obtained. Cases such

²³² *Id.* at 1968.

²³³ 94 N.Y.2d at 542.

as *Grupo Mexicano*, which is the federal law of the United States, and *Credit Agricole*, which is the law in New York, provide support for many planners who for years have espoused the view that asset protection planning is not only perfectly legal, but is in the great American tradition.

CONSIDER CHARGING ORDER PROTECTION.

Generally, a creditor who has a judgment against a limited partner or a member of a multi-member limited liability company cannot seize ownership or control of the equity interest, but instead can only receive a charging order that entitles the creditor to court of equity oversight and a right to receive what the debtor partner or member would receive if and when there is ever a distribution.

The following language is from a broadly written Colorado District Court charging order. This charging order required the partnership to obtain court approval before making capital acquisitions, selling, encumbering or modifying any partnership interests. Additionally, the creditor was entitled to receive periodic tax and financial information on the partnership:

The partnership is directed to pay to the [plaintiff's] law firm, as for the petitioner's receiver, present and future shares of any and all distributions, credits, drawings, or payments to said law firm until the judgment is satisfied in full, including interest and costs.

Until said judgment is satisfied in full, including interest and costs, the partnership shall make no loans to any partner or anyone else.

Until said judgment is satisfied in full, including interests and costs, the partnership shall make no capital acquisitions without either court approval or approval of the judgment creditor herein.

Until said judgment is satisfied in full, including interests and costs, neither the partnership nor its members shall undertake, enter into, or consummate any sale, encumbrance, hypothecation, or modification of any partnership interest without either Court approval or approval of the Judgment Creditors herein.

Within ten days of service of a certified copy of this Order upon the registered agent of the partnership, the partnership shall supply to the Judgment Creditors, a full, complete, and accurate copy of the Partnership Agreement, including any and all amendments or modifications thereto; true, complete and accurate copies of any and all federal and state income tax or informational income tax returns filed within the past three years; balance sheets and profit and loss statements for the past three years; and balance sheet and profit and loss statement for the most recent present period for which same has been completed. Further, upon 10-day notice from Petitioners to the partnership, all books and records shall be produced for inspection, copying, and examination in the Petitioner's office.

Until said judgment is satisfied in full, including all costs and interest thereon, all future statements reflecting cash position, balance sheet position, and profit and loss shall be

supplied to Petitioners within thirty days of the close of the respective accounting period for which said data is or may be generated.²³⁴

Florida Statutes Section 608.433 was amended in 2011 to provide charging order protection for multiple-member LLCs after the Florida Supreme Court surprised the legal community by concluding that the previous statute did not provide charging order protection, although it was clearly intended to do so. The revised statute applies retroactively and specifically indicates that “a charging order is the **sole and exclusive remedy** by which a judgment creditor of a member or member’s assignee may satisfy a judgment from the judgment debtor’s interest in a limited liability company or rights to distributions from the limited liability company.” (Emphasis added.) Florida Statutes Section 608.433 also specifically provides for protection for multiple-member LLCs, stating that “in the case of a limited liability company having more than one member, the remedy of foreclosure on a judgment debtor’s interest in such limited liability company or against rights to distribution from such limited liability company is not available to a judgment creditor attempting to satisfy the judgment and may not be ordered by a court.” (Emphasis added.)

It is unclear whether charging order protection is available for multiple-member LLCs when all of the member interests are subject to charging orders and/or pledges that make it unlikely or impossible for any member to expect to receive any distributions from the entity. Florida Statutes Section 608.402(21) imposes a requirement that a “member” must have an “economic interest” in the LLC. If the judgment exceeds what would be reasonably expected to be derived from the member interest, does the member still have an “economic interest” if it is highly unlikely or even seems impossible that such member would ever receive a distribution from the entity? If the judgment creditor could receive all expected future distributions from the LLC, it seems that the individual members may no longer have an “economic interest” in the LLC. Thus, it is possible that the individuals would no longer meet the statutory definition of a “member” and could lose charging order protection if there is no reasonable expectation of ever receiving a distribution from the entity.

Single-member LLC ownership offers no substantive protection from a charging order standpoint under Florida law, but may help buy time where there is a judgment against the sole member. Under Florida Statutes Section 608.433(6), a charging order is not the “sole and exclusive remedy” available to judgment creditors of a single-member LLC where the court of equity concludes that there are no other sources to satisfy the applicable judgment.

Many planners therefore advise clients who wish to use single-member LLCs to have a separate member, which may be an irrevocable trust that is disregarded for income tax purposes so that the LLC can remain disregarded as well. Some planners have single-member LLCs formed in Delaware, Nevada, or other states that have legislation that is favorable to single-member LLC charging order protection, but there are no direct cases on point as to whether the law of another state can apply in a situation where the debtor (and the use, possession, and management of the underlying assets) are situated in a state that does not offer single-member LLC charging order protection.

While many advisors believe that the creditor holding a charging order can be taxed on income attributable to the member interest under partnership tax law, this is probably not the case. Louis Mezzullo’s

²³⁴ *Rothwell v. Fertman*, Order re Motion and Application to Charge Partnership Interest. Civil Action 92 Z 1881, District Ct Colo. 1994.

Family Limited Partnerships and Limited Liability Companies BNA Portfolio 812 correctly states as follows:

While some commentators, relying on a revenue ruling dealing with an assignee of a partnership interest, believe a creditor with a charging order will be taxed on the income allocable to the interest subject to the order, it is more likely that the creditor will not suffer unfavorable tax consequences. Because any distributions from the entity to the creditor should be treated as a reduction in the amount owed to the creditor by the owner of the interest, under general tax principles the owner of the interest would recognize the income.

The following is a 2013 article on charging orders, written by Alan S. Gassman, Michael C. Markham and Eric Moody:

**DO YOUR OPERATING AGREEMENTS OFFER CHARGING ORDER PROTECTION –
ALMOST EVERY LLC OPERATING AGREEMENT WILL LIKELY BE CONSIDERED AN
EXECUTORY CONTRACT IN A BANKRUPTCY PROCEEDING – A *SODERSTROM*
THUNDERSTORM FOR CREDITORS**

Determining whether an Operating Agreement is considered executory, and thereby prevents transfer of a management interest in an LLC or similar corporation, is a complex topic and sometimes comes down to the deciding judge's call. The Bankruptcy Court case of *In re Soderstrom*, 484 B.R. 874 (M.D. Fla. 2013), offered some degree of clarity as to the test a court should apply in determining whether an Operating Agreement is executory, but also left open some big questions. Below is our discussion of the case.

CASE DESCRIPTION:

Soderstrom involved husband and wife debtors (Soderstroms) who file a joint Chapter 7 bankruptcy petition. The schedules filed with their petition estimated slightly under \$1 million in assets and over \$11 million in liabilities, a large portion of which were business debts.

One of the Soderstroms' listed assets was a 50% ownership in an LLC named Plaza N. 15 Partners, LLC (Plaza). The Soderstroms listed the value of their interest in Plaza as unknown. The other 50% interest in Plaza was owned by an individual named Scott Buono (Buono).

During the bankruptcy proceedings, the trustee filed a Notice of Intent to Sell the Soderstroms' interest in Plaza and two 25% interests in affiliated LLCs for \$6,000 in total to a company named Horizons A Far, LLC. Buono and Plaza objected to the Trustee's Notice because Plaza's Operating Agreement only permitted the transfer of a membership interest with the written consent of the other members. Buono and Plaza argued that under Plaza's Operating Agreement the Trustee only had the ability to transfer the "right to share in such profits and losses; to receive distributions; and to receive such allocations of items of income, gain, loss, deduction or credit to which the assignor was entitled, to the extent assigned, and will not have any of the rights, power or authority of a Member." Buono and Plaza also objected to the sale because the Soderstroms did not have an interest in the affiliated LLCs, and because there were third parties, including Buono, who were willing to bid more than \$6,000 for the interests being sold.

In response, the Trustee argued that Section 541(c)(1)(A) of the Bankruptcy Code applied Section 541(c)(1)(A) states that “an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement . . . that restricts or conditions transfer of such interest by the debtor . . .” The Trustee argued that this Section rendered the Plaza Operating Agreement unenforceable and permitted Trustee to sell both the economic and non-economic (i.e. management) interests of Plaza. Buono and Plaza countered that the Operating Agreement forbade transfer of a management interest without permission of the other holders of the majority-in-interest. Further, the Trustee argued that even if the Operating Agreement was unenforceable as to the limitation on the transfer of the management interest, it was an executory contract under Section 365(c) of the Bankruptcy Code, and therefore the Trustee was only permitted to sell the economic interest.

Bankruptcy Code Section 541(c)(1)(A), the Trustee would obtain management and economic interests “subject to any applicable sale restrictions imposed by the Operating Agreement.” The Operating Agreement prohibited sale of a management interest without approval of the other members. In other words, the bankruptcy estate now held both the management and economic interests in Plaza, but was forbidden from selling the management interest because of the sale limitation in the Operating Agreement.

Despite sufficient grounds for denying sale of the management interest in Plaza because of the limitation in the Operating Agreement, the Court provided a second ground for its decision—that Section 365(c)(1)(A) also prevented the Trustee from obtaining a management interest because the Operating Agreement was an executory contract in that “it requires material continuing fiduciary obligations by its members, including additional capital contributions, loans, and guarantees.” Under Section 365(c):

The trustee may not assume or assign any executory contract or unexpired lease of the debtor whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; ...

Under Florida Statutes Section 607.0627, corporations are permitted to restrict transfer of their shares, providing the restriction is not manifestly unreasonable. Florida Statutes Section 608.422 allows limited liability companies to restrict managers to only those approved by the majority-in-interests of the members.

The Appellant, Horizons A Far (Horizons), objected to the order, on the grounds that as a creditor of Plaza they could compel the sale of 100% of Plaza under Bankruptcy Code Section 363(h). The Bankruptcy Court overruled Horizons’ objection for five reasons, including untimely filing, and that Section 363(h) was not applicable because the ownership arrangement was an LLC, not a tenancy in common or joint tenancy, which are the only ownership forms that Section 363 applies to. Horizons’ objection and subsequent appeal

did not address the Trustee's original grounds for the right to sell the Soderstroms' management interest, Section 541(c)(1)(A).

Horizons appealed to the United States District Court, Middle District Court of Florida, on two grounds:

- (1) The Court's Sale Order limiting the sale to the Soderstroms' economic interests on procedural grounds; and
- (2) The Court's finding that the contract was executory.

After rejecting Horizons' procedural appeal grounds, the Middle District Court addressed whether the Operating Agreement was an executory contract. Eschewing the traditional approach (a contract is executory if both parties have outstanding material obligations under the contract), the Court instead opted to go with the functional approach to determine if a contract is executory because the Court believed that the Eleventh Circuit had implicitly adopted the functional approach.

Under the functional approach, there does not need to be outstanding obligations on the part of both parties. Instead, a contract is executory "if its assumption [or] rejection would ultimately benefit the estate or its creditors." *Thompkins v. Lil' Joe Records Inc.*, 476 F.3d 1294, 1306 n. 13 (11th Cir. 2007).

If a contract at issue in a bankruptcy case is found to be executory, then Bankruptcy Code Section 365 applies. Under Section 365, if local law permits restrictions on transfer of a management interest and a contract contains such a clause, a Trustee cannot assume and transfer the debtor's management without consent of the other managing members, which was exactly what the Middle District Court found. The Bankruptcy Court decision was affirmed and Horizons' alternate arguments were rejected.

The Middle District elected not to rule on the Bankruptcy Court's Operating Agreement sale restrictions grounds.

Soderstroms' Impact

Soderstrom provided greater certainty to some extent as to which test is to be applied to determine whether a contract is executory under the Bankruptcy Code. However, *Soderstrom* failed to discuss the power of a sale restriction in an Operating Agreement.

While out in the trenches, many bankruptcy attorneys may still find that court decisions tend to be "results oriented." The *Soderstrom* decision at least elected to adopt the functional test for determining whether a contract is executory. Whether this new test, as opposed to the traditional test, helps or hurts a case will still depend on the individual case. However, at the very least, the clarity is welcome.

What *Soderstrom* did not clear up was whether a sale restriction on a management interest in an Operating Agreement is enough to prevent sale of such management interest in a bankruptcy proceeding. The Bankruptcy Court decision effectively allows a debtor to circumvent the plain language of Section 541(c)(1)(A) ("An interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement . . . that restricts or conditions transfer of such interest by the debtor . . ."). Without

the ability to sell a management interest, the interest has no value to a trustee. Query whether the estate's possession of the management interest opens the trustee up to new liabilities in terms of the trustee's management of the management interest?

Further, while a contract that still has a management interest would presumably still be executory and thus exempted from the estate by Section 365, what happens when a "results-oriented" court finds that an Operating Agreement is not executory? Would that same court prevent a trustee sale based on a sale restriction clause in an Operating Agreement? For now, we are left to wonder.

Our article on common mistakes with respect to drafting LLC Operating Agreements, which explains the executory contract exception in bankruptcy and other planning issues, is as follows:

COMMON LLC DRAFTING ERRORS

By Alan S. Gassman

Over and over again we review Operating Agreements prepared by lawyers, clients, and sometimes even accountants that pose significant problems for clients.

The top ten mistakes that we see are as follows:

1. Failure to have a properly signed Operating Agreement.

How do you verify ownership, tenancy by the entireties status, or the tax status of a limited liability company without having an Operating Agreement?

2. Failure to match the Operating Agreement with the tax treatment of the entity.

This is particularly perilous where an LLC that has elected S corporation status has a standardized Operating Agreement that makes S corporation status impossible because of provisions inadvertently creating a second class of stock or partnership tax treatment, or having buy-sell arrangements that are not permitted under the S corporation rules.

Anyone who drafts Operating Agreements for LLCs that may or will be taxed as S corporations needs to take these somewhat complicated rules into account.

A common example of a fatal flaw would be to have the ownership interest of a selling member valued at less than adjusted book value as defined in the second class of stock Treasury Regulations for buy-sell purposes.

3. Failure to assure that the six unities of tenancy by the entireties are provided.

Oftentimes, some or all of a limited liability company will be owned by a husband and wife who want to have tenancy by the entireties creditor protection. If any of the six unities (possession, interest, title, time, survivorship, and marriage) are inconsistent in the LLC Operating Agreement, then the creditor protection can be destroyed. A savings clause is also a very good idea.

4. Failure to have a legitimate member to facilitate having the LLC be a multiple member LLC under Florida Statutes Section 608.433.

Many clients expect to have charging order protection, meaning that a creditor holding a judgment against a member cannot levy upon the member's ownership interest.

After the *Olmstead* Florida Supreme Court case, the Florida legislature enacted new language for Florida Statutes Section 608.433, which provides for charging order protection in a multiple member LLC where the LLC has one or more members that are not debtors of the same obligation.

If creditors have judgments against all of the members and no member has a realistic chance of ever receiving a distribution, will any of the other owners be considered to have a membership interest?

And when a new member buys in, the new member should typically purchase his or her membership interest from the LLC itself, and not from any member who might have an insolvency issue. This helps to avoid an argument that the transfer of a membership interest to a new member is a fraudulent transfer that should be set aside.

5. Thinking that charging order protection is the answer to all potential problems.

While we have seen that a great many creditors will settle claims for nickels on the dollar when their only recourse to assets is a charging order, some creditors will put the charging order in place and ask the court of equity to allow monitoring and to limit loans, compensation, or other activities of the entity. This can work a significant hardship upon clients.

Why not place some or all of the LLC membership interests into an asset protection trust a few years after the LLC has been established? If a judge were to set aside the asset protection trust then charging order protection should still apply, so the asset protection trust is a "belt" and the charging order status is "suspenders." The new low cost of trusteeship services in asset protection jurisdictions, coupled with the estate tax purpose of establishing a creditor protection trust that can be a complete gift for tax purposes, (while possibly permitting the grantor to benefit from the trust under certain circumstances), can clearly present a home run scenario under proper circumstances.

Having assets set aside in an irrevocable creditor protection trust can also be helpful to make sure that those assets stay separate in the event of a subsequent marriage. Also, why not go to Las Vegas to visit your trustee?

Asset protection trusts are certainly not suited for the majority of clients, but those who are well suited should have the option to better protect their assets in this manner.

6. Failure to have the LLC Operating Agreement can be an executory contract under the bankruptcy rules in case the client ends up in bankruptcy.

The case law is clear that the bankruptcy courts can allow a trustee in bankruptcy to seize a membership interest in an LLC unless the LLC Operating Agreement is an executory contract that provides contractual obligations with a material business purpose that will apply to any member, creditor, or trustee that would take over the member's interest. It is therefore important to have legitimate and normal obligations requiring members to do things such as making additional capital contributions when capital calls are made, attending meetings, and taking an active interest in the LLC to the extent consistent with the general business objectives and responsibilities associated therewith.

7. Failure to update the Operating Agreement when changes take place with respect to ownership, tax treatment, buy-sell arrangements, or otherwise.

Modern technology allows a client or a non-lawyer to go to the Secretary of State website to establish an LLC and to receive Operating Agreement forms. This is often problematic because the client may not know which state works best for his or her particular situation, may incorrectly fill out the forms, or may even use the wrong forms. Further, many clients neglect to update these Operating Agreement forms, which could cause the Operating Agreement to improperly reflect the true intentions of the parties. Individuals, families, and companies who use these technologies without sound business tactics, estate planning, and creditor protection advice will often run into serious problems in the future.

8. Faulty discount planning.

Historically, a great many clients have used limited liability companies to facilitate obtaining discounts upon death for federal estate tax purposes, as well as for gifting purposes. Many complicated rules apply in this area, but, in many cases, clients and advisors are unaware of these opportunities and the rules that relate thereto.

Also, a reverse discount issue now applies whereby many clients who had LLCs structured to obtain discounts will now want to reverse the discounting mechanisms to obtain a full stepped-up basis for income tax purposes on death if the estate tax is less of a concern than the income tax.

It will be a mistake for many clients to not at least consider this option if they do not project to have taxable estates for estate tax purposes.

9. Vague provisions.

As lawyers, we are often asked to review agreements between parties to determine legal rights and obligations. When non-lawyers draft agreements, they often use language that is not clear or does not mean the same thing as intended. We often tell clients that if "we cannot understand what you mean or you cannot understand what you mean, how is a judge and jury to understand what you mean?" An Operating Agreement between multiple members becomes the constitution and foundation of their relationship. Oftentimes, it is forgotten that multiple individuals or entities engaged in business need to address the "what if" contingencies to avoid disputes and uncertainty in the future.

10. Failure to draft around a possible monetization event upon withdrawal of an LLC member.

One commentator has indicated that under the Florida law, a trustee in bankruptcy of a bankrupt limited liability company member could force that member's interest to be redeemed, unless the LLC's Articles of Organization or Operating Agreement explicitly prohibit such action. The relevant portion of the applicable statute, Section 608.4237, reads as follows:

A person ceases to be a member of a limited liability company upon the occurrence of any of the following:

608.4237 Membership termination upon events of bankruptcy.—A person ceases to be a member of a limited liability company upon the occurrence of any of the following:

(1) Unless otherwise provided in the articles of organization or operating agreement, or with the written consent of all members, a member:

(a) Makes an assignment for the benefit of creditors;

(b) Files a voluntary petition in bankruptcy;

(c) Is adjudged a bankrupt or insolvent, or has entered against the member an order for relief, in any bankruptcy or insolvency proceeding;

(d) Files a petition or answer seeking for herself or himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation;

(e) Files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the member in any proceeding of this nature; or

(f) Seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the member or of all or any substantial part of the member's properties; or

Further, Subsection (2) of Section 608.427 reads as follows:

(2) Upon withdrawal, a withdrawing member is entitled to receive any distribution to which the withdrawing member is entitled under the articles of organization or operating agreement, and, if not otherwise provided in the articles of organization and operating agreement, the withdrawing member is entitled to receive, within a reasonable time after withdrawal, the fair value of the withdrawing member's interest in the limited liability company as of the date of resignation based upon the withdrawing member's right to share in distributions from the limited liability company.

Apparently, the legislature intended that a bankrupt or insolvent LLC member would be bought out of the LLC. However, the amendment to Florida's LLC charging order statute (Florida Statutes Section 608.433(4)), which strengthens charging order protection for Florida LLCs, provides that the court may charge the LLC member with payment of the unsatisfied amount of the judgment, with interest. The judgment creditor would only have the rights of an assignee of such membership interest. The member is not deprived of any benefit of any exemption laws applicable to the member's interest. Fortunately, the concept of *ipso facto*²³⁵ would probably cause the bankruptcy code to invalidate the effect of the Florida Statutes for bankrupt debtors, but to prevent this from being an issue, an LLC's Articles of Organization and/or Operating Agreement can include language that overrides the undesired result. If an LLC is

²³⁵ Merriam-Webster Unabridged Dictionary (Online) defines *ipso facto* as follows: by that very fact or act: as an inevitable result, Merriam-Webster Unabridged Dictionary (Online).

established by an accountant or friend with an “office store form” Operating Agreement, members may find themselves in a trap!

Converting a Regular Corporation or Other Entity Into an LLC.

Often, it is advantageous to convert a regular corporation or professional corporation into a limited liability company or professional limited liability company. One reason for this is to enable the owners of the entity to have charging order protection.

While Florida Statutes Section 607.1112 permits the conversion of a regular corporation to an LLC, and specifically provides that the LLC will be considered to be a continuation of the company, as to identity, contractual rights, assets, liabilities, and other characteristics, third parties and some governmental agencies will not necessarily recognize or follow this statute.

Planners should consider the following in determining whether to convert a regular corporation to an LLC or other entity.

1. Whether the conversion may violate loan or other agreements with third parties that the company may have entered into.
2. Whether the conversion will be considered to be a transfer of a licensed business or professional practice for purposes of state Department of Business Regulation rules. For example, the Florida Department of Business Regulation has taken the position that the conversion of a construction firm from a regular corporation to an LLC constitutes a change of ownership, thus necessitating significant application and associated registration changes.
3. If the company owns an airplane, the Federal Aviation Association may need to be notified to pre-approve the transition.
4. Liability or casualty insurance policies may require notification of agencies and carriers.
5. A fictitious name notice whereby the LLC is doing business under its previous name will be advisable if the previous name will be used, and some state laws prevent a limited liability company from using a fictitious name that would imply that it is a regular corporation.
6. The IRS and any state tax law authorities should be notified of the name change.
7. If the entity is a medical practice, then Medicare and Medicaid should be informed, and will treat this as a name change.
8. If the company owns real estate, copies of the Articles of Amendment should be filed in the county records to change the name of record for the company.

TAX NOTE: When a regular corporation or P.A. is converted to an LLC, it will be considered for income tax purposes to have liquidated if there is only one owner, or to become a partnership if there are

multiple owners, unless a Form 8832 is duly filed to allow for continuation of C corporation or S corporation status. Otherwise, the company will be considered to have sold its assets at fair market value and to have distributed them to the owner or owners.

CONSIDER NON-TRANSFERABILITY OF CORPORATE, LLC, AND PARTNERSHIP INTERESTS.

When there are third-party shareholders or partners in a binding shareholder, LLC or partnership agreement that provides for certificates to be issued subject to restrictive endorsements that prohibit transfer other than as set forth in the arm's-length agreement, it would be expected that no creditor would be able to levy or execute upon such stock.²³⁶ It may therefore be important to issue stock certificates with proper ledger language on the certificate, although Florida law does not require that LLCs issue ownership certificates. When there are no ownership certificates issued, the member interest is considered "uncertificated."

The following article describes the issues that arise when foreign corporations have been used by U.S. debtors to protect assets from creditors.

ALAN GASSMAN & TRAVIS ARANGO ON *WELLS FARGO V. BARBER*: THE BARBER OF SEVILLE REPLACES NO TIME FOR SARGEANTS

By: Alan S. Gassman and Travis Arango

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EXECUTIVE SUMMARY:

In the 2014 Florida's Fourth District Court of Appeals case of *Sargeant v. Al-Saleh*, the stock in a foreign corporation could not be reached by the Florida court where the judgment creditor and the debtor were both subject to Florida jurisdiction. The appellate court properly applied conflict of laws analysis and logic to conclude that it would take a court in the jurisdiction where the company and the stock certificate were located to ensure that the right decision was made and not, thereby, prejudice other parties who might have involvement with the company and the stock.

Unlike a physical stock certificate, which is personal property that can be located in and thus subject to the jurisdiction of a foreign court, the federal judge sitting in Orlando (the home of "It's A Small World After All"), found in *Wells Fargo v. Barber* that a Nevis LLC interest was "personal property held by the debtor" in Florida, and thus subject to court order and transfer.

The judge's rational and explanation was as follows:

²³⁶ See *In re Six*, 80 F.3d 452 (11th Cir. 1996) (affirming the bankruptcy court's decision to disallow a deficiency judgment claim and a partial lien against Dr. Six's shares of stock in a Professional Association).

This goes to show that the use of out-of-state and/or offshore limited partnerships, LLCs, or other entities may not be the best asset protection tool when the owner of the interest is still going to reside in Florida or in the US, due to the fact that judges have the ability to apply Florida law in these situations under the Conflict of Laws Rules. Charging order protection will not be available for many Florida based situations where the debtor is the 100% owner of a foreign LLC, thus calling into question whether planners need to get back to clients and suggest additional members.

FACTS:

In the 1958 comedy film, *No Time for Sergeants*, Will Stockdale, the character played by Andy Griffith, could never get his arms around the situation. Wells Fargo (which has been around since 1852, long before anyone had heard of Andy Griffith), probably felt like Will Stockdale as they understood the *Sergeant* case, but pushed forward anyway. The famous quote from the movie “By dog, I just don’t think I’ll stand for it” was apparently uttered by Wells Fargo and heard by the judge, who moved Wells Fargo to *The Barber of Seville*, an opera that was written by Gioachino Rossini and Cesare Sterbini and first performed in 1861 at the Teatro Argentina in Rome, Italy. The judge in this gave Ms. Barber a haircut she will never forget.

To provide more detail, in *Wells Fargo Bank v. Barber*, [i] the plaintiffs, Wells Fargo, had a deficiency judgment against Barber for \$62,491,162.98. Before this judgment, the defendant had made a number of transfers. Here is a timeline of the transfers made:

- (1) Before April 13, 2009: Barber gets \$1 million for sale of marital home – deposited into “homestead” account at American Momentum Bank (AMB)
- (2) September 21, 2009: Barber closed AMB account (balance: \$1,066,776.85) and purchased a CD with AMB as “homestead” proceeds
- (3) February 17, 2010: Barber transferred CD to AIG Bank
- (4) April 15, 2010: Barber withdrew \$227,026.20 to buy home
- (5) January 10, 2011: Barber formed Blaker Enterprises, LLC
- (6) February 28, 2011: Barber withdrew \$870,000.49 from AIG and opened account at TD Ameritrade under Blaker Enterprises, LLC
- (7) September 9, 2011: Transferred \$275,000 from TD Ameritrade back to AIG
- (8) February 9, 2012: Transferred \$220,000 from AIG to an unknown location
- (9) April 2, 2012: Transferred \$110,000 from TD Ameritrade into a new TD Ameritrade account
- (10) October 2, 2013: A deficiency judgment was entered against Barber and another non-party for \$62,491,162.98 to Wells Fargo and Regions

The plaintiffs sought injunctive relief to foreclose on Barber’s membership interest in Blaker Enterprises, LLC, or seek a charging order against it and to avoid the fraudulent transfers made by Barber based on actual and constructive fraud. The court dismissed the injunctive relief claim stating that it is “a remedy that is [only] available upon a finding of liability on a claim.” [ii]

The second claim was an attempt to foreclose on the membership interest or to obtain a charging order. The court noted that the Florida Limited Liability Company Act reads as follows:

A judgment creditor to any member of a limited liability company may obtain a charging order against the member's interest in the company or foreclose that interest in the company under certain circumstances. [iii]

The charging order is like a lien on the membership interest that can never be foreclosed, and allows the creditor to receive distributions from the LLC that the member would have received. [iv] This is generally the only remedy available; however, when the LLC only has one member, the Florida LLC Act allows a foreclosure on the company. [v] This foreclosure remedy is available when there is only one member and when "a charging order will not satisfy the judgment within a reasonable time." [vi]

The defendants claimed that the court lacked jurisdiction to foreclose or to enter a charging order on the LLC because Blaker Enterprises, LLC was created under the laws of Nevis, relying upon the *Sargeant v. Al-Saleh* case mentioned above.[vii] In *Sargeant*, the trial court ordered the defendants to turn over stock they had in a foreign corporation to satisfy a judgment,[viii] but the court of appeals reversed the trial court and held that the court "may only exercise jurisdiction over property of a debtor located within the court's jurisdictional territory." [ix]

Wells Fargo contended that *Sargeant* had to do with interests in a corporation which is different than interests in an LLC, and the court hopped on the Wells Fargo's wagon, stating that "a membership interest in an LLC is intangible personal property, which accompanies the person of the owner." [x] Thus, since Barber resided in Florida, her membership interest was located in Florida. The court went on to say that:

Although Defendants repeatedly refer to Blaker Enterprises, LLC as a "foreign corporation", (see Doc. 32, pp. 6, 7), Blaker Enterprises, LLC is not a corporate entity but a limited liability company. (Doc. 1-1, Ex. J). Unlike stock certificates in a corporation, a membership interest in a limited liability company is intangible personal property, which "accompanies the person of the owner." [xi]

The court recognized that it was faced with a conflict of laws issue between the Florida LLC Act and Nevis law, i.e. the Nevis Limited Liability Company Ordinance of 1995. The Florida LLC Act allows a charging order and a foreclosure action against a single member LLC, while the Nevis ordinance only allows a charging order. When there is a conflict of laws question, "a federal court sitting in diversity must apply the forum state's choice of law rules." [xii] Since the issue in this case involves property, the court found that the law of Florida dictates that the *situs* of the property controls. Since Barber lived in Florida, so did her membership interest and thus, Florida law applied. [xiii] The court held that the plaintiffs were entitled to foreclosing the interest or charging the interest.

The next issue was whether the above noted transfers could be set aside based on actual and constructive "fraud" as that term is described in the Florida Uniform Fraudulent Transfer Act (FUFTA), which states that "a creditor may avoid a debtor's transfer where the creditor shows that the transfer was made 'with actual intent to hinder, delay, or defraud.'" [xiv] The statute provides a list of "badges of fraud" for the court to consider. The court finding a badge of fraud creates a *prima facie* case and a rebuttable presumption that the transfers are void if created. [xv] The court held that the complaint showed six badges of fraud:

1. Barber's transfers to Blaker Enterprises, LLC were transfers to an insider, as Barber is the sole member of Blaker Enterprises, LLC.
 2. Barber retained possession or control of the funds transferred to Blaker Enterprises, LLC because Barber is the sole member of Blaker Enterprises, LLC.
 3. Barber transferred the funds shortly after the state court entered summary judgment against her and shortly before Plaintiffs sued Barber for a deficiency judgment.
 4. Barber's transfers to Blaker Enterprises, LLC appear to constitute substantially all of Barber's assets.
 5. Barber did not receive any consideration from Blaker Enterprises, LLC for the funds transferred.
 6. Barber was insolvent at the time she made the transfers to Blaker Enterprises, LLC, as the summary judgment against her was in excess of \$66 million. [xvi]
]
- This established a prima facie case for avoiding the transfers.

COMMENT:

It is shocking that the difference between a Limited Liability Company's membership interest and stock in a corporation could yield such different results. In *Sargeant v. Al-Saleh*, the stock in a foreign corporation could not be reached by the court while *Wells Fargo Bank v. Barber* sent the creditor offshore to get a foreign court to allow seizure. In *Barber*, sole ownership of a Nevis LLC was considered to be like any other intangible personal property that a Florida judgment could be applied against.

The question remains: did the court get this right? The court stated, "Unlike stock certificates in a corporation, a membership interest in a limited liability company is intangible personal property, which 'accompanies the person of the owner.'" This would imply that stock certificates in a corporation are not intangible personal property but instead tangible. Is this because the stock is physically in a location? Would an LLC with certificates be classified in this way? The court did not go into much detail about the distinction; the court just stated that they are indeed different.

This goes to show that a foreign LLC may not be the best asset protection tool when the owner of the interest is still going to reside in Florida or in the US. This is especially true when the LLC only has one member, which gives the judgment creditor the opportunity to ask for foreclosure under the Florida LLC Act. The creditor, of course, would need to show that a charging order would not satisfy its claim in a reasonable time, but that does not seem to be a large hurdle to jump, especially when you are dealing with multi-million dollar judgments like the one in *Barber*.

One would think that ownership in a limited liability company would be equivalent to owning stock in a foreign corporation, and that may be the case because Judge Paul G. Byron, who sits at the

United States District Court for the Middle District of Florida, determined that because an LLC membership interest is not “certificated,” it is “intangible personal property” that attaches to the debtor.

Lawyers who have encouraged clients to use out-of-state and/or offshore limited partnerships, LLCs, or other entities need to realize that judges have the ability to apply Florida law in these situations under the conflict of laws rules. In such instances, charging order protection will not be available for many Florida-based situations where the debtor is the 100% owner of a foreign LLC, thus calling into question whether planners need to get back to clients and suggest additional members and other planning techniques.

One question is whether LLCs should be certificated (required to have stock certificates issued) and whether that would have changed the result for Ms. Barber, who may now have to trade her Rolls Royce in for a Cadillac Seville. A great many offshore and out of state LLC’s may not have their Articles of Organization amended to provide that ownership will be only by share certificates that must be issued and held in a safe place in the jurisdiction where the entity is formed and maintained. As lawyers and other advisors review how and whether to hold foreign LLCs and ownership interests in other entities personally or under trusts or other mechanisms, we should all keep in mind that the seamless web of asset protection law will never be completely predictable, and will often move quickly, and without warning.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

CITATIONS:

-
- [i] 2015 WL 470589.
 - [ii] *Id.*
 - [iii] *Barber*, 2015 WL 470589.
 - [iv] *Id.*
 - [v] *Id.*
 - [vi] *Id.*
 - [vii] 137 So.3d432 (Fla. Dist. Ct. App.2014).
 - [viii] *Id.* At 433.
 - [ix] *Barber*, 2015 WL 470589.
 - [x] *Id.*
 - [xi] *Barber*, 2015 WL 470589.
 - [xii] *Barber*, 2015 WL 470589.
 - [xiii] *Id.*
 - [xiv] *Id.*
 - [xv] *Id.*
 - [xvi] *Id.*

EXAMPLE CHARGING ORDER FORMS.

The following is a sample first lien charging order:

CHARGING ORDER

This Court has heard and considered the application of plaintiff _____ for a charging order [and the opposition of defendant _____ to the application, together with the affidavits, exhibits, testimony and arguments of counsel in support of and in opposition to the application].

The Court finds that on [date], plaintiff recovered in this case a judgment against defendant for \$ _____ plus costs now totaling \$ _____ [and an attorney's fee of \$ _____] with interest on the entire judgment at _____ % per year from its date until paid; that the judgment has become final; that it has not been satisfied; that plaintiff is entitled as a matter of right to a charging order against any interest of defendant in any partnership or joint venture in which he may be engaged; and that defendant appears to [be a partner with _____, a resident of _____ County, State,][own an interest in a partnership composed of _____ and _____] in a partnership business known as _____ which operates in _____ County, State.

NOW THEREFORE It Is Ordered by this Court that:

1. The interest of defendant _____ as a partner in _____ be and it is subjected to an encumbrance and charging order in favor of and for the benefit of plaintiff _____.
2. On or before [date], defendant shall file with the clerk of this court a sworn answer reporting to the court all amounts distributable or payable to defendant at the time of service of this order and at all subsequent times attributable to any interest owned in the partnership; and in such sworn answer and report defendant shall state the value, at the time of service of this order and at all subsequent times, of both the capital and income accounts attributable to the interest of defendant in the partnership.
3. Partners _____ and _____ of the partnership business of defendant shall not distribute to defendant any funds or assets whatsoever by virtue of defendant's interest as a partner in or owner of an interest in the partnership, but instead shall pay over to [plaintiff _____][_____ as receiver] all funds and assets whatsoever which, by virtue of defendant's interest as a partner in or owner of an interest in the partnership, would have been distributed to defendant in the normal course of business of the partnership.
4. _____ is hereby appointed as receiver of the partnership property encumbered by this order, with direction to hold such property subject to further order of the Court.

Dated: _____

Judge

The following is a sample second lien charging order:

STATE OF _____ CIRCUIT COURT BRANCH _____ COUNTY

PLAINTIFF

Address, Case No. _____

Plaintiff,

v.

DEFENDANT

Address, Defendant.

**CHARGING ORDER AGAINST DEFENDANT'S
INTEREST IN _____ PARTNERSHIP**

To: _____,
Defendant Partnership

The motion of _____, the Plaintiff herein and now a judgment creditor, for a Charging Order against the interest of Defendant _____, now a judgment debtor, in _____ Partnership (the "Partnership"), having come before the court for a hearing on the _____ day of _____, 20____, the Honorable _____ presiding, and the court having determined and found that the judgment herein in favor of Plaintiff and against Defendant is unsatisfied, that Defendant is a partner in the Partnership, the principal place of business of which is located at _____, _____, and that said partnership interest is available for application of a Charging Order in favor of Plaintiff there against,

NOW, THEREFORE, IT IS ORDERED that:

1. Plaintiff shall and does hereby have a Charging Order against Defendant's interest in the Partnership.
2. The Partnership is hereby directed to pay to the Plaintiff any and all partnership profits and distributions which henceforth may be, will be, or otherwise would have been due (including a share of the assets of the Partnership upon liquidation, or any return of Defendant's capital in the Partnership) to Defendant in his capacity as a partner of the Partnership, as a result of his interest and rights in the Partnership, which payments shall continue until the full amount of the judgment herein is paid and satisfied.
3. Plaintiff may apply to this court for an Order of foreclosure and/or judicial sale of Defendant's partnership interest in the Partnership should payments of profits and distributions as herein ordered be insufficient to satisfy the judgment.

4. Plaintiff shall have the right to apply to this court for the appointment of a receiver of the Defendant's share of the profits and distributions and of any other money due or to fall due to Defendant with respect to the Partnership and for any further Orders, directions and accountings which may be necessary and appropriate for purposes of carrying out this Charging Order and obtaining satisfaction of the judgment.

5. The Partnership is directed to provide a true and accurate accounting on a semi-annual basis during all such times at which there remains any balance of the judgment due and outstanding, which accounting shall be submitted to the court and to Plaintiff.

Dated this _____ day of _____, 20____.

BY THE COURT:

Circuit Court, Branch _____

BUY A TAIL.

The following letter was written to a client to explain the purchase of a tail malpractice insurance policy shortly before filing corporate and personal bankruptcies:

Dear Doctor Contemplating Bankruptcy;

This letter is to reiterate much of what we discussed with respect to procuring a tail malpractice insurance policy now. Malpractice insurance works based upon each yearly premium only covering what it costs to cover claims made by a patient through the end of the year.

If you purchase a tail policy, then you are completely covered for all work done in the past up through the effective date of the tail policy.

Then the next year, the premium is dramatically lower because the carrier is not charging you for the risk of patients suing for services rendered before the tail malpractice policy effective date.

Typically, the tail costs two and a half to three times the annual premium, but thereafter you have "first year rates," "second year rates," "third year rates," and "fourth year rates" that are dramatically lower than what the annual rate would normally be.

Please let me know what further information you might need. I would be glad to speak to your agent about this.

Typically, the tail premium costs more than the subsequent savings, but in your financial situation this may be a very good opportunity.

While _____ (the carrier) does give you a free tail on complete retirement, you would still have that benefit because you will still need to buy a tail based upon services rendered after your 2016 tail date.

For example, if you buy a tail this year your rates will be lower in the next four years, and ten years from now you will again be at standard rates, and upon retirement you would save the cost of buying another tail.

Best personal regards,
ATTORNEY

RESPONSE FROM AGENT:

The client is currently paying a premium of \$11,251. They could pay \$20,019 for a tail covering all of their past medical practice activities with this carrier. By purchasing a tail, they could continue to receive claim free discounts on the step years, so I'm showing you base rates year 1-5 and discounted rates year 1-5.

	UNDISCOUNTED	DISCOUNTED	SAVINGS FROM \$11,251 LEVEL
Year 1	\$4,441	\$3,375	\$7,876
Year 2	\$9,371	\$7,122	\$4,129
Year 3	\$13,131	\$9,980	\$1,271
Year 4	\$13,975	\$10,621	\$630
Year 5	\$14,804	\$11,251	\$0
TOTAL EXPECTED POST TAIL PREMIUM SAVINGS OF \$13,906			
The above does not take into account the time value of money.			

CONVERT A REGULAR IRA TO A ROTH IRA AND PAY THE INCOME TAX FROM OTHERWISE NON-EXEMPT ASSETS.

Some estate planning attorneys advise clients who have excess cash and possible creditor situations to consider converting their IRAs to Roth IRAs, and then paying the income tax on the conversion. Tax advisors know that Roth IRAs grow income tax-free, and that withdrawals from a Roth IRA are never taxable. To the contrary, taxable IRAs grow on a tax-deferred basis, but withdrawals are considered to be ordinary income. Many financial and tax advisors encourage their clients to convert taxable IRAs to Roth IRAs, which necessitates paying income tax as if the converted value was withdrawn. This is considered to be a good investment for many individuals, regardless of whether creditor protection is incidental, except that debtors should understand that they are paying income tax that might otherwise not have to paid, such as if they were to withdraw or convert the IRA in the year where they have year tax deductible losses, or nursing and home health related expenses.

LIABILITY INSULATION AND RISK REDUCTION LAWS AND TECHNIQUES.

Florida law includes a number of statutes that limit or effect potential liability for motor vehicles, independent contractors, and with respect to the use of liability shielding entities and arrangements.

There are also insurance and practical considerations that should be taken into account in structuring client matters. This Chapter reviews a number of these laws and considerations.

FLORIDA LIABILITY PLANNING.

VEHICLE LIABILITY.

Under Florida Statutes Section 324.021(9)(b)(3), the owner of a car can be held vicariously liable for the negligence of any permitted driver. However, the law limits liability of an individual owner where the driver has insurance with a large amount of coverage. If a driver has at least \$500,000 of liability insurance coverage, then the automobile owner is only liable for up to \$100,000 per person, up to \$300,000 per incident for bodily injury, and up to \$50,000 per incident for property damages, all of which will be satisfied by payment made by the liability insurance carrier providing the coverage described above.

However, if the permissive user does not have sufficient liability insurance coverage, then the vehicle owner may be liable for an additional \$500,000 in economic damages, but the economic damages responsibility is reduced by amounts actually recovered from the driver and from any insurance or self-insurance covering the driver. It is not clear under the statute whether joint owners will have any limitation on liability for one another's driving negligence even when there is \$500,000 of insurance in place. Also, this limitation statute does not apply to situations where an automobile has been "negligently entrusted" to an inexperienced or known dangerous driver, or where the accident occurs outside of Florida.

The above statute only limits liability for vehicles owned by individuals. Where corporations or other entities own cars, liability will be unlimited, without exception. This may occur when a vehicle is owned by a revocable trust!

PLANNING FOR BUSINESS AND PERSONAL USE OF MOTOR VEHICLES.

Oftentimes, vehicles are purchased for use in a business, and may be driven after hours, or in an unpermitted manner during business hours, to cause liability to the employer under circumstances where the employer would not be responsible if the vehicle were owned by the employee or contractor who has used it for personal purposes "outside the zone" of employment.

It is therefore often advantageous to place motor vehicles, including trucks and off-road heavy equipment, under separate companies, and to have employees or contractors enter into "scope of use" agreements which make clear that certain uses are not on behalf of the business entity.

Better yet, it may be possible to keep liability exposure for both the driver's negligence and the "to and from" location driving duties outside of the business entity using an independent contractor arrangement, as was the case in the *Kanes Furniture v. Miranda*, which is described in the section below. For example, a company that provides landscaping services might put its vehicles and drivers under a separate company that provides the vehicles and drivers to the landscaping company for arm's-length compensation to make it less likely that the core landscaping company and its assets would be lost if there were a horrendous accident on the way to or from a job location.

Sample agreements that have been used for these purposes can be obtained by readers by contacting agassman@gassmanpa.com.

Those who plan to utilize an independent-contractor relationship to shield themselves from any liability derived from the actions of an “employee” need to be careful not to accidentally effectuate an employee-employer relationship through the nature of their working relationship. This is discussed in greater detail below.

USING LLCs AND OTHER LIMITED LIABILITY ENTITIES TO INSULATE OWNERS FROM LIABILITY.

Commonly companies will establish subsidiary LLCs to own and operate vehicles, and engage in other activities that may cause liability, and the consequent loss of other assets and business operations, and then manage these LLCs separate and apart from associated commonly owned entities that have assets and operations to be protected. The Florida Supreme Court made it very difficult for creditors to pierce a related company that is held separately in the 1994 decision of *Dania Jai Alai Palace, Inc. v. Sykes*,²³⁷ where a customer of the Dania Jai Alai fronton in South Florida was hit by an apparently negligent valet parker who was working for a separate company owned and operated by the Jai Alai fronton to provide valet parking services. The Court held that actual fraud must be shown in order to pierce the corporate veil. As a result of this decision, a good many business owners will set up a new parent corporation to own their existing company, and will also set up one or more “brother/sister” companies also owned by the new parent company to become the owners and operators of various segments of a business or investment operation. The New Parent F Reorganization is commonly used to help assure that there will be no detrimental income tax purposes from such restructuring under Internal Revenue Code Section 368(a)(1)(A). A “New Parent Company” can be established and can make an S election to be treated as an S corporation and become the 100% owner of an existing S corporation, which can elect to be treated as a “qualified subchapter S subsidiary” (“Q-Sub”). The New Parent Company can also own other companies that can be disregarded for income tax purposes and receive assets from the original company without triggering income tax. See, *The Estate Planner’s Guide to New Parent F Reorganization* by Alan S. Gassman, Kenneth J. Crotty, and Michael O’Leary, Estate Planning May 2008. This can be found at <https://gassmanlaw.com/wp-content/uploads/2013/03/The-Estate-Planners-Guide-to-New-Parent-F-Reorganizations.pdf>.

The original company can keep its taxpayer identification number and name, while having its tax attributes reflected on the tax return of the New Parent Company.

The use of a subsidiary corporation to shield the parent corporation from liability is commonplace. However, a parent company may be held liable for the acts of its subsidiary "where the subsidiary is a mere instrumentality or alter ego of the parent, if it is also shown that the subsidiary is used to mislead the parent's creditors or to fraudulently avoid liability."

²³⁷ 450 So. 2d 1114, 1120 (Fla. 1984).

It is important to note, that using a corporate form to mislead or defraud creditors may cause a court to pierce the corporation's veil of limited liability. Piercing the corporate veil in Florida requires a plaintiff to prove that all three of the following requirements have been met:

- (1) The shareholder dominated and controlled the corporation to such an extent that the corporation's independent existence, was in fact non-existent and the shareholders were in fact alter egos of the corporation;
- (2) The corporate form must have been used fraudulently or for an improper purpose; and
- (3) The fraudulent or improper use of the corporate form caused injury to the claimant.²³⁸

As such, fulfilling the first factor of this test requires that the plaintiff prove that the corporation is a "mere instrumentality" or "alter ego" of the defendant. The "mere ownership of a corporation by a few shareholders, or even one shareholder, is an insufficient reason to pierce the corporate veil."²³⁹

In 1995, the Florida 3rd District Court of Appeal stated that "[t]here are at least fifteen factors that have been deemed to be relevant in a determination of whether a corporate entity" is a "mere instrumentality" or alter ego.²⁴⁰ These factors include, but are not limited to, the following:

- (1) the absence of the formalities and paraphernalia that are part and parcel of the corporate existence, i.e., issuance of stock, election of directors, keeping of corporate records and the like;
- (2) inadequate capitalization;
- (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes;
- (4) overlap in ownership, officers, directors, and personnel;
- (5) common office space, address and telephone numbers of corporate entities;
- (6) the amount of business discretion displayed by the allegedly dominated corporation;
- (7) whether the related corporations deal with the dominated corporation at arm's-length;
- (8) whether the corporations are treated as independent profit centers;
- (9) the payment or guarantee of debts of the dominated corporations by other corporations in the group;

²³⁸ *Seminole Boatyard, Inc. v. Christoph*, 715 So. 2d 987, 990 (Fla. 4th Dist. App. 1998).

²³⁹ *Gasparini v. Pordomingo*, 972 So. 2d 1053, 1055 (Fla. 3d Dist. App. 2008).

²⁴⁰ *Hilton Oil Transport v. Oil Transport Co., S.A.*, 659 So. 2d 1141 (Fla. 3d Dist. App. 1995).

- (10) whether the corporation in question has been properly used by others of the corporations as if it were their own;
- (11) financing of subsidiary by parent;
- (12) informal intercorporate loan transactions;
- (13) parent and subsidiary's filing of consolidated income tax returns;
- (14) whether subsidiary's directors act independently in interest of subsidiary rather than in interest of parent;
- (15) existence of fraud, wrongdoing or injustice to third parties.²⁴¹

With respect to the second and third factors, Florida courts “require proof of *deliberate* misuse of the corporate form—tantamount to fraud—before they will pierce the corporate veil.”²⁴² Negligence or even reckless conduct are not sufficient to establish improper conduct.²⁴³

Under Florida Law, a parent corporation can also be held liable for the actions of its subsidiaries under the theory of agency. This theory is on display in cases where the parent organization “exercises control over its subsidiary to the extent that the subsidiary manifests no separate corporate interests of its own, and functions solely to achieve the purposes of the parent corporation.” Three elements are required to establish such an agency relationship:

- (1) acknowledgment by the principal that the agent will act for the principal;
- (2) acceptance of the undertaking by the agent; and
- (3) control by the principal over the agent's actions.

Yet another way for a creditor to reach a company or other business entity for liability purposes where the options of an individual or individuals have caused harm or need to claim that the individual or individuals are employees of another company. Under the legal doctrine of Respondent Superior, an employer is responsible for the negligence or inappropriate actions taken within the scope of employment by an employee, but is generally not responsible for actions or inactions taken by an independent contractor unless the applicable activity is inherently dangerous.

A landmark Florida case with respect to the determination of when an individual is working for a company was *Kane Furniture Corp v. Miranda*, where the court determined “that a carpet installer was an independent contractor for Kane when, after leaving a bar where he had been drinking for hours, he hit and

²⁴¹ *Hilton Oil Transport v. Oil Transport Co., S.A.*, 659 So. 2d 1141, 1151 (Fla. 3d Dist. App. 1995).

²⁴² *In re Hillsborough Holdings Corp.*, 166 B.R. 461, 469 (Bankr. M.D. Fla. 1994), aff'd, 176 B.R. 223 (M.D. Fla. 1994).

²⁴³ *Id.* at 470.

killed another driver.²⁴⁴ Using the control test from agency law, the court determined he was not an employee of Kane, and therefore Kane could not be vicariously liable.”

In determining whether an individual is an employee or independent contractor, Florida courts follow the Florida Supreme Court decision of *Cantor v. Cochran*²⁴⁵ which approved the test set out in the Restatement²⁴⁶ for determining whether an individual is an employee or independent contractor. *Cantor* involved a grocery clerk’s claim for workmen’s compensation after he was injured by a falling trunk lid while helping a customer load their vehicle. The employer argued that the claimant was an independent contractor rather than an employee and was, therefore, ineligible for injury compensation. The court disagreed and adopted the test for employer-employee relationships laid out in the Restatement. The test asks a court to weigh the following factors:

- a. The extent of control which, by the agreement, the master may exercise over the details of the work.
- b. whether or not the one employed is engaged in a distinct occupation or business.
- c. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision.
- d. The skill required in the particular occupation.
- e. Whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work.
- f. The length of time for which the person is employed.
- g. The method of payment, whether by time or by the job.
- h. Whether or not the work is a part of the regular business of the employer.
- i. Whether or not the parties believe they are creating the relation of master and servant.
- j. Whether the principal is or is not in business.

The employer cited an agreement signed by the claimant years prior which purported to make his work “independent of and in no way under the control or direction of the Cantor Wholesale”, but the court found the weight of the evidence was contrary to the intended effect of the agreement. For example, the employer fired the claimant without notice or cause, the claimant’s schedule was set by the employer and he had to obtain approval for any time off, the employer provided the dollies the claimant would use at work, the claimant had worked for the employer for seven years, and the claimant’s income consisted entirely of gratuities from the employer’s customers.

Consider a commercial contract Jones clause. In some situations, individuals and entities present themselves to a planning advisor with circumstances that call for reconfiguration to protect from potential future creditors, but also circumstances where a known and expected creditor would be prejudiced by such action, and quite likely able to set aside the arrangement. It may be possible to make the changes that will protect the client against potential future creditors, but explicitly not protecting the client from present creditors, to avoid being considered to have made a “fraudulent transfer” or to have violated the law or

²⁴⁴ 506 So. 2d 1061, 1064 (Fla. 2d DCA 1987).

²⁴⁵ 184 So. 2d 173 (Fla. 1966).

²⁴⁶ 2nd of Agency Session 222 (1958)

contractual obligations by taking actions that would be considered to be the “avoidance or evasion” of a known creditor under applicable law or contracts in place.

A “Jones clause” is commonly used in the offshore trust world to provide that assets held by the offshore trustee must be used to pay any U.S. income taxes, or certain governmental obligations that might be owed by the grantor/contributor to the trust, so that such contributions are not considered to violate the law or subject the grantor/contributor to scrutiny or characterization of being a person who is “evading taxes,” or intending to do so.

A “Jones clause” that might be placed under an equipment or real estate lease where the lessor has received the asset being contributed by it to the lessee entity in order to protect preexisting creditors may read as follows:

Notwithstanding the foregoing, it is recognized that Lessor is receiving a capital contribution of furnishings and equipment, and leasing these assets back to Lessee. It is further recognized that at the present time, there are claims being made against Lessee that may in the future become judgments or financial obligations of Lessee.

Lessor agrees to maintain ownership of the subject assets received, and any replacements thereof, and to be responsible, jointly and severally, with Lessee in the event that a judgment or financial obligation from a lawsuit that has been filed against Lessor before the date of execution hereof were to ever occur, if there is a judgment resulting from such lawsuit which is considered to be enforceable by a court of competent jurisdiction against the assets of Lessee. In such event, Lessee will indemnify, hold harmless and repay Lessor for any liability, payment and costs reasonably incurred by Lessor as the result thereof.

CHAPTER 11 PLANNING TIP.

Consider separating businesses into separate entities so that a Chapter 11 of the business with most of the debt may not cause bad publicity and lost sales for the retail or “public face” end of the business that may remain outside of bankruptcy.

Clients in businesses that are somewhat likely to file Chapter 11 proceedings might consider having one operating entity that is the “face” of the business, which would not need to file bankruptcy, and having a separate company that would own most of the equipment and take on the majority of debt which would file a Chapter 11. All creditors are immediately informed of a Chapter 11 bankruptcy, and checks issued by a company in Chapter 11 have to say “Debtor in Possession” or “DIP”. If the retail arm of the business does not have to file a Chapter 11, revenues may not suffer as much. Many clients are well advised to divide their business activities into separate companies. An example would be a manufacturer who also has storefronts that sell the products. The manufacturing company may need to file a Chapter 11 bankruptcy, while the storefronts would continue without direct notification to customers or other third parties.

INSULATING LANDLORDS FROM LIABILITY OF TENANTS.

Florida case law permits a landlord to be insulated from the liabilities of a tenant, and the tenant's invitees. Oftentimes the authors will advise property owners to triple net lease their real estate to operating entities that can in turn become the landlord for third parties at the same time that the property owner may borrow on the property in order to have a mortgage that would provide further protection in case a tenant would be able to receive a judgment against the land owner.

Generally, a landlord's responsibility for injuries sustained on leased property "will depend upon the extent the landlord maintains a possessory interest or control over the instrumentality or land which contains a defect which is alleged to have been a proximate cause of the injuries suffered by the plaintiff." *Russ v. Wollheim*, 915 So. 2d 1285, 1287 (Fla. 2d DCA 2005). In *Russ*, the court found that the landlord had a possessory interest or control over the activity in question where the lease provided that any alterations, additions, or improvements were subject to the landlord's prior written approval.

We commonly have the property owner lease the right to use and contract with third party tenants to a "master leasing company" that will in turn contract with tenants under agreements where the tenant agrees to look only to the master leasing company for liabilities or obligations. The master leasing company will normally be reasonably capitalized and provide leasehold improvements and significant services to assure that it is a separately respected entity.

If a landowner has a triple net lease, then he or she most likely does not have control or a possessory interest over the property in question. However, the question of control is a fact-by-fact analysis that hinges on the exact cause of the third party's injuries. For instance, if a third party was harmed by a property defect due to lack of maintenance on the property and the landlord was required to pre-approve maintenance schedules or the cost of repairs to the leased premises as in *Russ*, then the court could find that the landlord controlled the leased premises. But if the tenant were responsible for all maintenance with no landlord oversight, which is common in a triple net lease, then the landlord may not be responsible. Further, landlords are generally not responsible for subtenant injuries. There should be no privity of contract or estate, and therefore the legal basis for suit is quite limited between these parties.

Giving a tenant carte blanche authority to make changes to property can be dangerous from a contractual standpoint, but is also necessary to insulate a lessor from premises liability. At the same time, do not let your clients give total control to a tenant who may cause significant financial liability as a result of this type of authority.

A provision to limit landlord liability that the author commonly uses in related party leases is as follows:

THIS PARAGRAPH SHALL APPLY NOTWITHSTANDING ANY PROVISION HEREIN TO THE CONTRARY. IT IS ACKNOWLEDGED THAT LESSEE IS SOLELY RESPONSIBLE FOR THE OPERATION, SAFETY, INSPECTION, USAGE AND WITH RESPECT TO ALL OTHER ASPECTS OF THE PROPERTY THAT RELATE TO OWNERSHIP, MAINTENANCE, SAFETY, REPAIR AND OCCUPYING AND MAKING USE OF THE PROPERTY AND ALL AMENITIES THERETO DURING THE LEASE TERM, AND THAT LESSEE SHALL HAVE THE FULL AND EXCLUSIVE RIGHT TO OCCUPY, MAINTAIN, IMPROVE, AND TO USE AND TO SUBLEASE THE PROPERTY. THEREFORE, LESSEE SHALL BE SOLELY RESPONSIBLE FOR ANY AND ALL LIABILITIES OR OBLIGATIONS

INCURRED RELATING TO THE PROPERTY AND TO THE USE THEREOF, AND SHALL INDEMNIFY AND HOLD HARMLESS LESSOR WITH RESPECT THERETO.

These clauses almost always make sense between related parties where there is complete trust.

Clients might consider other ways of protecting real estate from potential liability, including having plenty of liability insurance, checking regularly to make sure the tenant is maintaining the required liability insurance, keeping the property leveraged with debt, and making sure that the property is owned by a limited liability entity like an LLC or a limited liability limited partnership.

MARTY SHENKMAN'S WRITE-UP ON OTHER CREDITOR PROTECTION TECHNIQUES.

Our friend, Marty Shenkman, included the following in his 2017 Forty-Third Notre Dame Tax and Estate Planning Institute outline, crediting the authors with the ideas therein provided:

5. Asset Protection.

Business Asset Protection.

- i. **Take-Away.** Clients with closely held business interests may have many opportunities for asset protection planning. Below are a few ideas that some practitioners may not have considered.²⁴⁷

Discussion.

1. In the event of a creditor calamity, the lender having a lien on corporate assets will be paid first to the extent that money is owed and secured by the assets of the company.
2. While a typical investor with \$1,000,000 of real estate might have bank financing of \$700,000 to \$800,000, a comparable family business or investment entity may have no debt. Consider having that entity owe another family-related entity or trust, at arm's length and secured by the assets of the family entity, a debt. This may assure that in the event of a claim against that family business or investment entity, the family members or trust holding debt owed by the entity to them could be paid from a forced sale of the entity assets before a judgment creditor would be paid.
3. For a client owning a business or professional practice, have the business or practice guarantee debt that is owed by a related party. For example, the business or professional practice entity might guarantee a mortgage owed on real estate that is leased to the business or practice. Further, consider having the tenant's assets pledged as additional collateral for the loan so that in the event of a claim the bank holding the mortgage on the leased property would be able to call the loan and force a sale of the

²⁴⁷ The author acknowledges Alan Gassman, Esq. for the ideas listed in this section.

assets of the business entity or professional practice, resulting in the proceeds from sale reducing the amount of the mortgage on the real estate, and not being available to the creditor holding a judgment against the business or practice entity.

4. Another approach might be to have the business entity enter into a long-term lease with the landlord entity, and provide a lien against the corporate assets so that the landlord entity would be able to accelerate rents to be owed significant monies and force the sale of business or professional assets to pay for the accelerated rents. For example, the lease might provide that in the event of default all future rents during the lease term shall be accelerated.

Anyone leasing property should consider having a triple net lease from the landowner entity to a “master tenant”, and then having the master tenant company lease the property to the end user or users.

The lease with the end user or users can specify that causes of action will only be against the master tenant, and if the master tenant makes a substantial investment in leasehold improvements or otherwise, it may be possible that third parties who are injured on the property would only have a cause of action against the master tenant, and not the ultimate property owner.

Clients who own real estate “free and clear” may consider having related party debt placed on the real estate to provide further protection. For example, a company owning a shopping center worth \$10,000,000 might owe \$8,000,000 to a family limited partnership, and lease the shopping center to a master tenant company that in turn signs the leases with the tenants and owns significant leasehold improvements. A lawsuit by someone injured at the shopping center may then have to stop at the master tenant level.

5. Planners should be aware of the doctrine of marshaling of assets, whereby a court may require that a lender that is “over collateralized” to give up cross-collateralized assets. However, cases in this area are uncommon, and it may do no harm to have the assets of a business or professional practice cross-collateralized or given as security in the manner described above, so long as reasonable. This might result in encouraging plaintiff’s counsel to settle for malpractice or other insurance policy limits, or otherwise in a more favorable manner rather than competing with a related party creditor, or a third-party creditor, who might be allegedly over-collateralized.
6. Income tax may be incurred if an S corporation or C corporation issues a note to a shareholder. The note issued may be characterized for tax purposes as an amount distributed to the shareholder. In an S corporation situation, a shareholder receiving an actual or deemed distribution exceeding his or her basis in the stock of the S corporation, will recognize income as if a distribution was made. Therefore, it is common to have a note extended that is less than or equal to the amount of the basis in the stock to avoid imposition of income tax on the creation of the indebtedness.

An alternative method will be to establish a new company that can own the existing company and to have the subsidiary/existing company owe money to its parent company, which can generally be effectuated on an income tax free basis.

7. Example. Oldco may be an operating entity and John Smith, its shareholder, may have a basis in Oldco of \$50,000. Oldco may have \$300,000 worth of assets. John Smith may form Newco as an S- corporation and then transfer his ownership in Oldco to Newco in a tax- free capital F reorganization. Oldco may thereafter give a note to Newco in the amount of \$150,000. Since Newco will be considered to be a disregarded entity owned by Oldco, there will be no tax imposed by reason of the note being given. If Oldco were to be sued well after the note is given, then Newco would be able to foreclose upon the assets of Oldco and receive the first \$150,000 of value given, leaving very little, if anything, for a judgment creditor.
8. In addition to leveraging assets of professional and investment corporations, it may be possible to divide both assets and activities so that cause of action or lawsuit against one operating entity would not cause loss of all assets and other affiliated operating entities.

This excerpt only scratches the surface of asset protection opportunities that exist for informed advisors and their clients.

WHAT TO SAVE AND WHAT TO SPEND.

Quite often, the authors consult with debtors who have serious issues, and have been told that there is “nothing they can do,” without any guidance on how to handle what to save and what to spend from cash flow.

For example, a wage earner who is the head of household may be facing a lawsuit and may have assets in his or her name that would be subject to the claims of creditors, if they were to be transferred into an exempt asset. In this situation, it would make sense for the exposed assets to be spent for normal living expenses and defense costs, while the wages may be invested in exempt assets or placed into a tenancy by the entireties account, if the wage earner is the head of household.

By the same token, we commonly encounter situations where one spouse of a married couple has a creditor situation, and the spouses jointly own assets that are not protected under the tenancy by the entireties rules. In that situation, the spouses may want to divide the assets equally, so that the half owned by the spouse that does not have the creditor situation can be kept separate, and the half owned by the spouse who is the debtor can be spent to defend the claim, or to contribute towards the living expenses of the couple, or possibly even be transferred into a homestead.

Even in situations where avoiding a governmental creditor would be a crime, an advisor can give guidance on what can be spent in the normal course of living and what can legally be done with cash flow and applicable assets.

In situations where a corporation or other business entity is facing significant liability, but continues to earn significant revenues that exceed its operating expenses, pulling “profits” out of the company can result in a debtor holding “ill-gotten gains,” and potential loss of homestead protection if the ill-gotten gains are invested in a homestead. Some businesses may spend more on advertising and other things that could enhance the value of the personal goodwill of the professional, and legitimate post-bankruptcy earnings. The purchase of tail malpractice insurance is discussed at Section Y of this Chapter.

In many situations, the ill-gotten gains could be spent, and unrelated funds that would otherwise be lost to the creditor may be invested in a homestead, or otherwise situated without posing a risk of loss of the homestead, or the possibility of committing a crime.

Oftentimes, one member of a married couple will have the creditor issue and will want to place his or her money into the homestead by paying down the debt on a jointly owned home. This presents the risk of the homestead pay-down being considered to be one-half homestead pay-down and one-half a “fraudulent transfer” to the spouse. In this situation, it will be better to have the debtor spouse purchase part ownership of the homestead from the non-debtor spouse, and to reallocate debt accordingly.

There may be “close calls” with respect to individuals who can legitimately fund 529 College Savings Plans, retirement accounts, make charitable contributions, and do other things that they should have done in prior years and would be very well advised to do, regardless of whether a creditor situation exists. In addition, clients have weddings, bar mitzvahs, and other events to pay for out of moral obligation.

CAN I CONTINUE TO GIVE TO CHARITY?

Charitable donations may also be immune from fraudulent transfer rules, if they meet the requirements of Florida Statutes Section 726.109(7), which reads as follows:

(a) The transfer of a charitable contribution that is received in good faith by a qualified religious or charitable entity or organization is not a fraudulent transfer under s. 726.105(1)(b).

(b) However, a charitable contribution from a natural person is a fraudulent transfer if the transfer was received on, or within two years before, the earlier of the date of commencement of an action under this chapter, the filing of a petition under the federal Bankruptcy Code, or the commencement of insolvency proceedings by or against the debtor under any state or federal law, including the filing of an assignment for the benefit of creditors or the appointment of a receiver, unless:

1. The transfer was consistent with the practices of the debtor in making the charitable contribution; or
2. The transfer was received in good faith and the amount of the charitable contribution did not exceed 15% of the gross annual income of the debtor for the year in which the transfer of the charitable contribution was made.

Affluent families who have charitable aspirations will be well-advised to establish a private foundation which can be funded with cash or appreciated assets to yield income tax deductions in the year of formation, while the vast majority of the assets in the private foundation can be retained for many years and be used to pay reasonable compensation to family members if and when financial disaster strikes.

Alternatively, a non-tax deductible charitable corporation or a trust may be formed and dedicated under state law to charitable purposes without the need to file an IRS Form 1023, pay the IRS an \$600 fee with the Form 1023, or to file annual Form 990 tax returns, or meet required distribution standards, as described below in the article entitled *The Tax Neutral Dedicated Charitable Trust*:

THE TAX NEUTRAL DEDICATED CHARITABLE TRUST

A simple and inexpensive way for families to commit funds or assets to charitable purposes

By Alan S. Gassman, Esquire

Many taxpayers consider establishing charitable trusts and foundations to make a visible commitment to charitable purposes.

One advantage of having a family controlled charity is an immediate income tax deduction for contributions that may be held by the entity and used over time for charitable purposes.

Other advantages include recognition of the family's commitment, the ability to operate as a charitable organization, involvement of family members in charitable endeavors, and the sense of satisfaction that comes from making a commitment and following through on an individualized basis.

In many situations, the tax deduction from the contribution is not important, because the family may not be in a high income tax bracket, the family may already be using whatever tax deductions are available for donations, or the family may have losses or large deductions that make the charitable income tax deduction of little use, or better recognized in a future year where the donors may be in a higher income tax bracket.

A major "turnoff" for families establishing charitable foundations and trusts includes the need to pay a \$600 application fee to the IRS, and to file a Form 1023 Application to obtain 501(c)(3) status, which is generally more time consuming and expensive than forming the organization. Additionally, there is the need to file annual Form 990's, and other formalities that have to be followed by a 501(c)(3) organization, along with the knowledge that the Form 990 will be available to the general public on www.irs.gov/pub/irs-pdf/f990.pdf.

Another downside of operating a charitable foundation is the requirement that it distribute at least 5% of the foundation's assets each year to other charities, or to spend 4.25% of the foundation's assets each year on the active conduct of a charitable activity. Although the foundation's assets may grow faster than 5% per year, there is a chance that the investments may not reach this level of return, or the charitable donor may not want to distribute funds every year.

The foundation is also greatly restricted when it comes to dealing with related persons, even if such dealings are at arm's-length or benefit the foundation more than the related person.

As the result of the above, some charitable taxpayers will choose to establish a deferred deduction charitable trust, which can be recognized and exist as a charitable organization under state law, and for practical purposes, while being considered to be "disregarded" and continued as owned by the taxpayer for federal income tax purposes.

Other than the above, the only difference between a typical 501(c)(3) charitable trust and a trust that can be disregarded for federal income tax purposes can be that the disregarded trust benefits not only Section 501(c)(3) charities, but also tax exempt organizations that can include police and firemen benevolent associations (under Section 501(c)(8)) and cemetery associations (under Section 501(c)(13)). This entity will not need to meet annual distribution requirements and the grantor can exchange trust assets for assets of equal value and/or add charitable organizations as beneficiaries of the trust.

Let's take, for example, John and Molly DoGood, who are retired schoolteachers who have always wanted to use \$250,000 from a large inheritance that John received to set up a scholarship and mentorship program for disadvantaged high school students who would not go to college without having extra financial and moral support.

John and Molly are in the 24% tax bracket, and have \$120,000 of adjusted gross income, so they can donate up to \$72,000 to a private operating foundation, or \$36,000 to a private foundation, each year without their income tax deduction being limited based upon applicable adjusted gross income limitations. They would like to create a private foundation and donate \$36,000 each year to fund scholarships, saving up to \$8,640 in taxes each year.

John is in poor health, and wants to make sure that the funds are used for these purposes "no matter what happens," and they have been working with a local community college which can accept donations and award the scholarships, while giving recognition to John and Molly's charitable trust and efforts.

John and Molly form the John and Molly DoGood Charitable Foundation, and John places the \$250,000 into a trust account, and they receive recognition from the

community college and can operate as a “family foundation” from a publicity and community support standpoint.

John and Molly run the trust and receive an income tax deduction for the monies that pass from the trust to the community college, and do not have to file a Form 1023, Form 990’s or any other documents.

Their activities remain private, to the extent permitted under state law, and in compliance with the terms of the trust.

At a later time, they may choose to convert the trust to qualify as a 501(c)(3) charity by excluding non-501(c)(3) organizations from having possible benefits, filing a Form 1023 and then filing annual Form 990’s, and otherwise complying with the rules that apply for such organizations.

EXEMPTION PLANNING WITH REVOCABLE TRUSTS – OIL AND VINEGAR OR VINEGAR AND BAKING SODA?

Avoid providing that “all of my assets” are owned by a revocable trust in the trust language.

In the 2001 Bankruptcy Court case of *In re Bosonetto*, now deceased Judge Funk of the Jacksonville Division of the U.S. Bankruptcy Court found that a homestead deeded and held in the personal name of a debtor was considered to be owned by her revocable trust because of the trust language, which provided that “even though record ownership or title, in some instances, may presently or in the future, be registered in my individual name, in which event such record ownership shall hereafter be deemed held in trust even though such trusteeship remains undisclosed (P22).” Judge Funk further found that protection of a homestead from creditors under the Florida Constitution did not extend to property held under a revocable trust. Since then, there have been a number of cases finding that homestead held under a revocable trust is protected from creditors, as discussed in Chapter 5, Section I, but no case known to the authors has found that the above quoted language would not cause assets held outside of a revocable trust to be considered as held under the revocable trust. Since many of the creditor exemptions provide for an individual to be eligible for the exemption, it is unknown whether a court could determine that language, such as the above, or actual titling of wage accounts, annuities, permanent life insurance policies, 529 plans, and other assets, might not qualify for creditor exemption if considered to be owned under a revocable living trust.

UNPLEASANT SURPRISES – A BLANKET UCC CAUSES LOSS OF PROTECTION OF ALL IRAS?

Bankruptcy is a mode of litigation, and therefore somewhat unpredictable. Unpleasant surprises can certainly occur.

An example on point is the 2019 11th Circuit Case of *Kearney Construction Company, LLC, v.*

Travelers Casualty and Surety Company of America, where the 11th Circuit Court of Appeals found that a UCC-1 financing statement and security agreement which provided an LLC owned by Mr. Kearney's son a blanket lien on all of his assets caused disqualification from creditor protection of an IRA account that Mr. Kearney owned at the time, even though the parties had apparently not intended to have Mr. Kearney pledge the IRA, and the IRA was never touched by the creditor.

The case in point was brought by Traveler's Casualty and Surety Company of America, which had not had a lien on Mr. Kearney's IRA. This case is further discussed in Chapter 8, Section H.

CHAPTER 2

TENANCY BY THE ENTIRETIES

Florida has some of the most generous creditor exemption laws in the country by offering unlimited protection of homestead, annuities, and the cash surrender value of life insurance. Additionally, Florida provides protection for tenants by the entireties assets, wages, disability insurance, retirement plans, and other miscellaneous assets. Each exemption will be addressed in its own chapter at length. Lastly, legal articles are included to provide the reader with practical explanations of the current state of the law as to each exemption.

Since Florida has opted out of the federal exemption system, Florida residents are required to use the Florida exemptions in bankruptcy, which often provides greater protection.

Nevertheless, exemptions can be complicated, as there are many areas where the law is unclear. Accordingly, advisors and professionals working in this area need to understand Florida's exemption system and its implications thoroughly.

Please note that while many states do not recognize tenants by the entireties or provide creditor protection, the U.S. Bankruptcy Code does recognize tenancy by the entireties and the inability of the creditors of one spouse to reach tenancy by the entireties assets if both spouses are not responsible for the liability. As the result of this, many non-Floridians are well advised to hold Florida real estate or other assets as tenants by the entireties so that one spouse could file a bankruptcy anywhere in the country and not lose his or her half of the tenancy by the entireties assets. This is a greatly over simplified suggestion, but should be worthy of consideration. Section X of Chapter 5 of this book goes into significant discussion of bankruptcy law and the implications of homestead protection.

INTRODUCTION.

Tenancy by the entireties "immunity" dates back to the English common law and the time when a married woman could not hold property individually. Tenancy by the entireties is a form of property

ownership whereby a husband and wife can hold property as an indivisible fictional unit. An ownership interest in tenancy by the entireties property is non-severable without consent of both spouses, except in limited situations.²⁴⁸ The property is not divisible on behalf of one spouse alone, and therefore cannot be reached to satisfy the obligations of only one spouse.²⁴⁹ However, a creditor of both the husband and the wife can attach tenancy by the entireties property.

States other than Florida which recognize tenancy by the entireties, at least to some extent, include Alaska, Arkansas, Delaware, District of Columbia, Michigan, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Michigan, Missouri, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Hawaii, Vermont, Virginia, Washington, and Wyoming. Where one spouse lives in Florida and another spouse lives in one of the other states that recognize tenancy by the entireties property, it is likely the creditor protection will apply for the Florida resident spouse. The treatment of the other spouse will be subject to the law of the state where the other spouse resides.

There have been a great many cases and factual situations where a creditor has successfully challenged the tenancy by the entireties status of property. There have been, and will continue to be, many factual situations that will necessitate litigation in order to determine an outcome that is quite unpredictable.

DEFINITION OF TENANCY BY THE ENTIRETIES.

Tenancy by the entireties is created when the six “unities” are met, as follows:

Unity of possession - both spouses have joint ownership and control - it may be acceptable that a deposit agreement allows either spouse to withdraw independently of the other on the theory that the power to withdraw is an expression of an authority of agency given by each spouse to the other.

Unity of interest - each spouse has the same interest in the account - it is not a problem if one spouse deposits all or most of the funds into the account as long as each spouse has the same interest immediately after the deposit.

Unity of time - the interests of both spouses in the asset must originate simultaneously in the same instrument, such as on the signature card. **Do not try to convert an individual account into a tenancy by the entireties account. Instead, transfer assets from the individual account to a new tenancy by the entireties account.**

TRAP - If one spouse is the owner, do not just add the other spouse’s name to the title. At a minimum, make a complete transfer from the initial spouse as owner to both spouses as tenants by the entireties.

Unity of title - both spouses must have ownership under the same title.

²⁴⁸ See *Hector Supply Co.*, 254 So.2d 780 (Fla. 1971).

²⁴⁹ See generally *Winters v. Parks*, 91 So. 2d 649, 651 (Fla. 1956).

Survivorship - on the death of one spouse, the other spouse becomes the sole owner of the entireties property. A general power of appointment given to one spouse over joint assets may vitiate tenancy by the entireties status.

Unity of marriage - of course, the owners must be legally married under Florida law. Many clients become confused and believe that joint accounts with any third party or a significant other will be protected, but this is not the case.²⁵⁰ **NOTE:** In the case of *In re Caliri*, joint accounts created before marriage were found not to qualify as tenancy by the entireties where the couple did not overtly transfer their interests to themselves as tenants by the entireties after the marriage.²⁵¹

PLANNING OPPORTUNITY - Assets held jointly before the marriage should be re-transferred from the spouses jointly to themselves as tenants by the entireties. Couples who entered into non-recognized same-sex marriages should determine whether they need to re-convey their joint assets to tenancy by the entireties in order to have this protection.

DIRECT TRANSFERS FROM ONE SPOUSE TO TENANCY BY THE ENTIRETIES — IS A STRAWMAN NEEDED?

Before 1766, English Common Law required tenancy by the entireties ownership to originate from a person or entity other than one member of the married couple, and the law therefore required a “strawperson” to take title from one spouse and then transfer it to tenants by the entireties. Florida did not adopt this requirement, as evidenced in the 1939 Florida Supreme Court Case *Johnson v. Landefeld*, codified in Florida Statutes Section 689.911 in 1941.²⁵² This statute applies to real estate but does not mention non-real estate assets. Support for the proposition that non-real estate assets, such as stock certificates and bank and brokerage accounts, may be transferred from one spouse to tenancy by the entireties can be found in recent case law.

According to what the authors believe to be an inaccurate September 2011 Florida Bar Article cited below, the law in this area is still uncertain and legislative efforts to clarify the confusion in the statute have been unsuccessful.

The authors have concluded, however, that one spouse can transfer virtually any kind of asset into tenancy by the entireties, as the following letter to the editor of the Florida Bar Journal from December 2011²⁵³ shows:

A Florida Bar Journal article titled *Are Florida Laws on Tenancy by the Entireties in Personalty as Clear as We Think?*, [dated] September 2011 raised concern that Florida law is unclear on the question of whether a married couple can own personalty as tenants by the entirety (TBE) unless authorized under the Florida Statutes. The author also

²⁵⁰ *In re Caliri*, 347 B.R. 788 (Bankr. M.D. Fla. 2006).

²⁵¹ *In re Caliri*, 347 B.R. at 796.

²⁵² 138 Fla. 511 (Fla. 1939).

²⁵³ Alan S. Gassman, *Tenants by the Entirety*, FLA. B.J., Dec. 2011.

questioned the clarity of Florida law regarding the creation of an entireties estate in personalty after the 2001 Florida Supreme Court decision in *Beal Bank, SSB v. Almand & Assoc. Inc.*

Extensive research and review of several Florida Supreme Court cases, DCA opinions, and bankruptcy court decisions has lead us to conclude that the law with respect to these issues is much more settled than the article seems to imply. Practitioners will want to review the three Florida Supreme Court cases that were not referenced in the article, and other citations mentioned in this letter.

One of the author's favorite law professors left the following voicemail after the above letter came out, making the author's day:

Alan this is C.D. Miller, voice out of the past, College of Law and so forth and so on. I just wanted to call and say thank you for writing the letter to the Editor and straightening them out with respect to tenancy by the entirety law in this state. I was so tempted to do something but you know, I'm an old war horse, so I guess I just didn't have the hay anymore, but I appreciate what you wrote. It was a well written letter and it certainly laid it out in a way, that I think, most people would be able to now understand the law. Which was certainly misstated in the article. So, on behalf of everyone, thanks!

Florida law clearly permits a married couple to own all forms of personal property as TBE. As stated by the Florida Supreme Court in *Bailey v. Smith*, "[u]nder the law in force in this State there may be a tenancy by entireties in both real and personal property; and whether such an estate exists as the result of the acquisition of property by and in the names of both husband and wife, must be determined by a consideration of the nature and terms of the transaction as portraying the intent of the parties and of the rules of law applicable thereto".²⁵⁴ *Beal Bank, SSB* only modified *Bailey* by applying a presumption that jointly owned bank accounts are held as TBE unless there is evidence showing a contrary intent. Florida courts have consistently applied this presumption to all forms of personal property.

Furthermore, the case law confirms that one spouse is a separate entity from a TBE, and can, therefore, transfer property to the marital unit without the use of a strawman, as explicitly held in the 1939 Florida Supreme Court decision of *Johnson v. Landefeld*, 138 Fla. 511 (Fla. 1939). Florida courts have followed suit with respect to personalty. See e.g., *Hurlbert v. Shackleton*, 560 So. 2d. 1276 (Fla.1st D.C.A. 1990) (recognizing a spouse's right to transfer stock he owned individually to both himself and his wife as TBE); *In re Kossow*, 325 B.R. 478 (Bankr. S.D. Fla. 2005) (permitting a spouse to assign his interest in tangible personal assets he owned before marriage to TBE) for some of the several cases that reach the same conclusion.

Florida case law may not allow one spouse to add another spouse to an existing bank account or stock certificate, but that is much different than one spouse making a distinct

²⁵⁴ 89 Fla. 303, 307 (Fla. 1925).

transfer from himself or herself to facilitate the creation and funding of a new TBE account, stock certificate, or other asset.²⁵⁵

JOINT ACCOUNTS – BEAL BANK, SSB v. ALMAND AND ASSOCIATES.

NOTE TO READER: In 2008 the Florida Legislature passed Florida Statute § 655.79(1) which provides that deposit accounts opened by a married couple will be presumed to be tenancy by the entireties. This statute appears to eliminate the need to thoroughly review the 2001 Florida Supreme Court case of *Beal Bank* with respect to financial accounts, but the Supreme Court’s discussion will also have important implications for other assets. We have therefore left in the entire previous discussion that was written before the enactment of §655.79(1). This portion of the Statute reads as follows:

(1) Unless otherwise expressly provided in a contract, agreement, or signature card executed in connection with the opening or maintenance of an account, including a certificate of deposit, a deposit account in the names of two or more persons shall be presumed to have been intended by such persons to provide that, upon the death of any one of them, all rights, title, interest, and claim in, to, and in respect of such deposit account, less all proper setoffs and charges in favor of the institution, vest in the surviving person or persons. Any deposit or account made in the name of two persons who are husband and wife shall be considered a tenancy by the entirety unless otherwise specified in writing.

On March 1, 2001, the Florida Supreme Court issued its decision in *Beal Bank*²⁵⁶ after the Fifth District Court of Appeals certified that the question of whether certain bank accounts were considered as tenancy by the entireties was of great public importance.

The Florida Supreme Court endeavored to shed light on “what has been termed a morass in the common law...We hope to bring greater predictability and uniformity to the common law governing accounts held at financial institutions and to eliminate the confusion that has arisen from our prior decisions. . .”²⁵⁷ As the dissent in this opinion points out, however, the effect that this opinion will have on many different aspects of joint ownership will remain to be seen.²⁵⁸

The Court reviewed precedent wherein married couples had the burden of proving their intent to have a tenancy by the entireties where brokerage firm account agreements and bank account signature card agreements did not explicitly provide for tenancy by the entireties. The Court recognized that in a tenancy

²⁵⁵ Alan S. Gassman, *Tenants by the Entirety*, FLA. B.J., Dec. 2011 at 4; For an in-depth analysis of these issues and the current state of Florida law, please read our article, “Florida Supreme Court Cases Confirm Tenancy by Entireties in Personal Property and Ability of One Spouse to Transfer Assets to Tenancy by the Entireties,” available at the following website: Floridatenancybytheentiretiesjurisprudence/gassmanlaw.com.

²⁵⁶ 780 So.2d 45 (Fla. 2001).

²⁵⁷ *Beal Bank, SSB v. Almand and Associates*, 780 So. 2d 45, 62 (Fla. 2001).

²⁵⁸ *Id.* at 63.

by the entireties arrangement as between the spouses, the interest is non-severable by either spouse acting independently of the other.

The Court noted that Florida case law has long recognized that real property acquired in the name of a husband and a wife is considered to be held as tenancy by the entireties by rule of construction. The Court acknowledged that with personal property, it had applied a different standard by requiring that “not only must the form of the estate be consistent with entireties requirements, but the intention of the parties must be proven.”²⁵⁹

The Court’s primary holding was as follows:

As between the debtor and a third-party creditor (other than the financial institution into which the deposits have been made), if the signature card of the account does not expressly disclaim the tenancy by the entireties form of ownership, a presumption arises that a bank account titled in the names of both spouses is held as tenancy by the entireties as long as the account is established by husband and wife in accordance with the unities of possession, interest, title, and time and with right of survivorship.²⁶⁰

Thus, the burden will be on the creditor to prove by a preponderance of evidence that a tenancy by the entireties is not created.

The Court discussed the following examples of bank account titling:

- (1) An express designation on the signature card that the account is held as tenancy by the entireties ends the inquiry as to the form of ownership. Thus, extrinsic evidence may not be brought up by a creditor in those circumstances.
- (2) Depositors may sign an express statement that tenancy by the entireties is not intended, coupled with an express designation of another form of legal ownership. In that circumstance, no presumption of a tenancy by the entireties arises [and] this express disclaimer would end the inquiry as to whether a tenancy by the entireties was intended.
- (3) If the signature card does not expressly disclaim tenancy by the entireties, there is a rebuttable presumption that a tenancy by the entireties exists where the other unities are established.
- (4) If the financial institution does not offer a tenancy by the entireties form of account, and the signature card expressly states that the account is not held by tenants by the entireties, no presumption of tenancy by the entireties ownership arises, but the debtor and the spouse may prove by a preponderance of the evidence that there was an intent to own the account as tenants by the entireties.

²⁵⁹ *Id.* at 54.

²⁶⁰ *Id.* at 58.

- (5) If the financial institution offered the option of tenancy by the entireties ownership, and the debtor and spouse affirmatively disclaimed tenancy by the entireties ownership and elected another form of joint ownership, then there would not be tenancy of entireties ownership, and the inquiry would end.

As a result of the factual scenarios described above, it seems that the only way to be absolutely sure of tenancy by the entirety status is for the lawyer to review all applicable paperwork relating to a subject account or other assets, if feasible.

The specific questions certified to the Florida Supreme Court in this case and the court's answers were as follows:

In an action by the creditor of one spouse seeking to garnish a joint bank account titled in the name of both spouses, if the unities required to establish ownership as a tenancy by the entireties exist, should a presumption arise that shifts the burden to the creditor to prove that the subject account was not held as a tenancy by the entireties?

Florida Supreme Court Answer: Yes

In an action by the creditor of one spouse seeking to garnish a bank account jointly titled in the name of both spouses, if the unities required to establish ownership as a tenancy by the entireties exist, but the signature card expressly states that the account is owned as a joint tenancy with right of survivorship, does that statement alone constitute an express disclaimer that the account is not held as a tenancy by the entireties?

Florida Supreme Court Answer: No

In an action by the creditor of one spouse seeking to garnish a bank account jointly titled in the name of both spouses, if the unities required to establish ownership as a tenancy by the entireties exist, but the signature card expressly disclaims the tenancy by the entireties form of ownership, may the debtor resort to extrinsic evidence to prove that a tenancy by the entireties was intended if the debtor establishes that the financial institution did not offer a tenancy by the entireties form of account ownership?

Florida Supreme Court Answer: Yes

Caution -- Notwithstanding the *Beal Bank* case, spouses should be careful to establish tenancy by the entireties accounts by labeling them as such. Spouses who open accounts with institutions that do not offer a checkbox for tenancy by the entireties should put the actual letters "TBE" in the title of the account [example -- Dr. John and Mary Smith, TBE account]. Spouses will continue to tell their lawyers that they have explicitly checked the tenancy by the entireties box or that such a box did not exist to be checked, in situations where they have inadvertently checked another box, didn't see the tenancy by the entireties box, or performed some other unexpected act that could destroy tenancy by the entireties status and surprise their advisors.

For example, suppose the account registration form provides the following option:

☐

Joint with Right of Survivorship

☐

Other _____

In order to create a tenants by the entireties account in this situation, the clients should fill in the “Other” blank with “Dr. John and Mary Smith, as Tenants by the Entireties,” but under the *Mathews* case, which is described in Section E below, it should also be sufficient to check the “joint with right of survivorship” box, although this could lead to challenge if the creditor believes that the *Mathews* case could be overturned.

After the *Beal Bank* decision, there was some difference in opinion between bankruptcy courts as to whether the “Beal Bank Presumption” applied to tangible personal property, stock certificates, automobiles, and other assets.²⁶¹ However, it appears that the presumption applies to all personal property.

In *In re Matthews*, the court found that a debtor and his wife owned their boat slip as tenants by the entireties, “regardless of whether [a boat slip] is considered real property or personal property.”²⁶² The court in this case also found that the debtor and his wife owned their household goods and furniture as tenants by the entireties as well.

Will the Florida law of tenancy by the entireties apply to joint accounts held in Florida even though the owners live in another state? Case law and Florida Statutes seem to support the idea that the law of the “situs” of the property would apply, which should entitle bank accounts in Florida to tenants by the entireties protection, regardless of whether the owners of the account live in Florida, but it is doubtful that courts will agree and the result may vary from state to state, based upon conflict of law considerations.

Florida Statutes Section 655.55 states as follows:

1. The law of this state, excluding its law regarding comity and conflict of laws, governs all aspects, including, without limitation, the validity and effect of any deposit account in a branch or office in this state of a deposit or lending institution, including a deposit account otherwise covered by s. 671.105(1), regardless of the citizenship, residence, location, or domicile of any other party to the contract or agreement governing such deposit account, and regardless of any provision of any law of the jurisdiction of the residence, location, or domicile of such other party, whether or not such deposit account bears any other relation to this state, except that this section does not apply to any such deposit account:
 - a. To the extent provided to the contrary in s. 671.105(2); or
 - b. To the extent that all parties to the contract or agreement governing such deposit account have agreed in writing that the law of another jurisdiction will govern it.

²⁶¹ See *In re Matthews*, 360 B.R. 732 (Bankr. M.D. Fla. 2007).

²⁶² *Id.* at 744.

Further, the statute defines “deposit account” as “any deposit account in one or more names” and includes a “joint account.”

In the case of *Sanchez v. Sanchez*,²⁶³ the court cited to Florida Statutes Section 655.55 and found that Florida, rather than Venezuela law governed the rights of the beneficiaries to Totten trust bank accounts upon the trustee’s death, even though the trustee was domiciled in Venezuela.

The *Sanchez* court explicitly stated that “[i]t is well settled in Florida that the disposition of a joint bank account, including a Totten trust, is governed by the law of the situs of the account regardless of the domicile of any party to the account.”

Further, the court stated that “[i]n the instant case, the subject Totten *trust bank accounts are located in a bank in Miami, Florida*, and accordingly, *Florida law must govern* their disposition-even though (a) *Venezuela is the domicile of the decedent* who created the trusts, and (b) *Venezuelan law is contrary to Florida law* on the disposition of the trusts when, as here, the creator of the trust dies.”

Although this case does not explicitly deal with a tenants by the entireties account, it supports the position that Florida law would apply because Florida is the situs of the account.

In *McNeilly v. Geremia*,²⁶⁴ a First Circuit Bankruptcy Appellate Panel held that the “applicable non-bankruptcy law” that determined whether the funds in a tenancy by the entireties account were exempt was the law of Vermont (where the bank account was located) not the law of Rhode Island (where the debtors lived and filed for bankruptcy). The court specifically stated that “the state law at play in § 522(b)(2)(B) is not ‘keyed into the situs of the debtor’s pre-petition domicile,’ here Rhode Island, but is determined by the ‘situs of the asset that is held by a debtor in bankruptcy as a tenant by the entireties.’”

STOCK CERTIFICATES.

In the 2002 Florida’s Fourth District Court of Appeals case, *Cacciatore v. Fisherman’s Wharf Realty Ltd Partnership*,²⁶⁵ held that the presumption of tenancy by the entireties extends to **shares of stock held in certificate form titled in the joint names of spouses**. However, it is best to title all stock certificates explicitly as tenants by the entireties.

What if, when purchasing the stock, the debtor had a choice between joint with right of survivorship or “other” with a blank line to fill in where he or she could have written in “tenants by the entireties”, much like in the above example?

In 2009, the Eleventh Circuit Court of Appeals, in *In re Mathews*, found that a stock certificate titled “ROBERT L. MATHEWS & JOYCE M. MATHEWS JT TEN” was held as tenants by the entireties, despite

²⁶³ 547 So.2d 943 (Fla. 3rd DCA 1989).

²⁶⁴ 249 B.R. 576 (1st Cir. BAP 2000).

²⁶⁵ 821 So.2d 1251 (Fla. 4th DCA 2002).

the fact that they had the opportunity to check the “other” box and write in “tenants by the entirety,” as demonstrated above.²⁶⁶

“The Debtor signed a document titled ‘Stock Certificate Registration Instructions’, which provide the Debtor with five ownership options – (1) Individual, (2) Tenants in Common, (3) Other, (4) Joint Tenants with Rights of Survivorship, and (5) Uniform Gift to Minor. The blank next to ‘Joint Tenants with Rights of Survivorship’ was checked.”

The Eleventh Circuit found that “*Beal Bank* does not support the argument that the Debtor expressly disclaimed ownership of the stock as tenants by the entirety by checking the ‘Joint Tenants with Rights of Survivorship’ blank instead of checking the ‘Other’ blank and writing in ‘Tenancy by the Entireties.’” The selection of another form of ownership “is not an express disclaimer *unless* the documentation *affirmatively* provides the debtor with an option to select tenancy by the entirety.” The bankruptcy court decision that was overturned is described as follows:

The bankruptcy court in the case *In re Mathews*²⁶⁷ concluded that a bank officer who titled stock certificates as joint tenants with rights of survivorship with his wife should have known to title the certificates as tenants by the entirety and thus lost protection.

Debtor claimed that he never filled out any forms associated with the stock. He said either “the people at Florida National” typed up the registration for him, that “somebody else” wrote “JT TEN” on the election form, or that he merely received the items in evidence as they were titled and took no actions to change them.

The stock certificate for the stock of First National Bank of Orange Park was titled “Robert L. Mathews or Joyce M. Mathews (JTWROS)”.

The registration form was checked as “Joint Tenants with Right of Survivorship.”

The First National Bank stock certificate was titled the same as the first.

Though Debtor was a director of the bank, he never took steps to change how the original stock certificate was titled.

On the Ameris Bancorp merger Election form, Debtor wrote “Robert L. or Joyce M. Mathews” and the stock certificate issued is titled “Robert L. Mathews & Joyce M. Mathews JT TEN” and Debtor took no action to have it changed.

Debtor testified of his intent to own all property jointly with his wife because if he died before her, the property would go straight to her without probate.

The evidence supported the fact that Debtor did know about tenants by the entirety.

²⁶⁶ *In re Mathews*, at 742.

²⁶⁷ *Id.*

Therefore, the bankruptcy court concluded that the Debtor, a sophisticated businessman, knew what he was doing and fully intended to own the stock as joint tenants with right of survivorship and expressly disclaimed ownership as TBE.

PROVISIONS IN LLC SHAREHOLDER OPERATING AGREEMENTS AND PARTNERSHIP AGREEMENTS CAN CAUSE LOSS OF TENANTS BY THE ENTIRETIES STATUS.

Often, entities are intended to be owned as tenants by the entireties, with organizational documents inconsistent with the law of tenancy by the entireties. An example would be a shareholder agreement where a company is owned partly by a husband and wife as tenancy by the entireties, but the agreement states that on the death of any shareholder, the company would buy out the stock of that shareholder. Florida case law does not provide a clear answer on whether the parties' intention and titling of the company to be owned as tenants by the entireties would override the contradicting language in the shareholder agreement. It seems clear, however, that the only way to guarantee that the ownership will be given tenancy by the entirety status is to ensure that the shareholder agreement is consistent with the law of tenancy by the entireties, thus, the agreement should provide that on the death of any shareholder, the spouse has an automatic right of survivorship to all stocks owned by that shareholder.

Savings clause language that the author uses for LLC Operating Agreements is as follows:

16.17 Tenants by the Entireties Ownership. If and when any Membership Interest is owned by and between a husband and wife as tenants by the entireties, then the Florida Law of Tenants by the Entireties shall be controlling as between such husband and wife, in that upon the death of one spouse, the interest shall be automatically owned by the other spouse, and it shall require the joinder of both spouses to act with respect to a tenancy by the entireties ownership interest, notwithstanding any provision under this Operating Agreement to the contrary. Further, notwithstanding any provision under this Operating Agreement to the contrary, the Florida rules of tenancy by the entireties, and not the provisions under this Operating Agreement, shall apply with respect to any obligation herein imposed, such that any Florida resident married couple owning their Membership Interest as tenants by the entireties are considered as one entity until after the death of one of them. Therefore, such couple shall be considered one Member for all voting purposes, it shall require joint approval of married members owning their interests as tenants by the entireties to take any action with respect to such Membership Interest, and this Operating Agreement shall be construed accordingly. If one spouse is referred to as a Manager and the other spouse is not referred to as a Manager under this Agreement or by subsequent agreement or designation, then the spouse that is referred to as a Manager shall be considered a Manager, with the Manager designation being separate and apart from the tenancy by the entireties common membership status of both spouses.

TAX REPORTING CONSISTENCY – IRS INSTRUCTIONS CAUSE CONFUSION.

Federal and state taxes reflect the ownership of entities, and there are often inadvertent inconsistencies between the tax reporting documents and the intended ownership structure. For example, if ownership in an S corporation or a partnership is held as tenants by the entirety, the original S corporation Form 2553 and K-1 forms attached to S corporation or partnership tax returns should reflect such ownership.

The IRS instructions for Form 1065 state, “Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year.” By this instruction, the IRS appears to indicate that tenancy by the entirety owners of a partnership interest should receive two separate K-1 forms. The author sees no harm in issuing a single K-1 form to the spouses as tenants by the entirety and listing one of their social security numbers, particularly where the spouses file a joint return.

The instructions for Form 1120S do not provide any guidance on this.

Sometimes stock will be issued jointly to spouses as tenants by the entirety, but the initial IRS Form 2553 may show only one spouse as owner. An S election is not valid unless it is signed by each owner, so one spouse cannot sign for both spouses. Fortunately, the Treasury Regulations are somewhat lenient in allowing this mistake to be corrected.

If a shareholder is inadvertently not listed on the Form 2553, this results in the shareholder not consenting to the S Election. However, the regulations may allow a late filed S Election, even if this occurs many years after the original S Election was made.

The requirements under Treasury Regulation Section 1.1362-6(b) are as follows:

- 1 There was reasonable cause for the failure to file a consent;
- 2 The request for the extension of time to file the consent is made within a reasonable time under the circumstances; and
- 3 The interest of the government will not be jeopardized by treating the election as valid.

The Request for an Extension of Time to File the S Corporation Election Consents should be filed with the District Director or with the IRS Service Center that received the original Form 2553 Election for the Corporation.

CONTRACTS TO PURCHASE REAL ESTATE.

Oftentimes, spouses will simply put their names on real estate contracts with deposits, without clearly designating that they hold the contracts as tenants by the entirety. It is safest to have a contract to purchase real estate explicitly state that it is held by spouses as tenants by the entirety.

U.S. TREASURY BONDS.

Treasury Regulations indicate that United States Treasury Bonds cannot be placed in tenancy by the entireties. These may be owned by one individual or by the revocable trust of one individual, but it does not appear that they will qualify to be held directly as tenants by the entireties.

JOINT TAX REFUNDS.

The bankruptcy court case *In re Kossow*²⁶⁸ extended the holding in *Beal Bank* to conclude that a federal tax refund resulting from a joint tax return could be considered tenancy by the entireties property. The court stated that “a rebuttable presumption arises that all personal property, including a joint tax refund, is held as a tenancy by the entireties as long as the personalty is acquired by husband and wife in accordance with the unities of possession, interest, title, and time with right of survivorship.”

*In re Hinton*²⁶⁹ found that the tax refunds can be owned as tenants by the entireties, where the husband and wife filed joint returns, each refund check was jointly payable to husband and wife, and upon receipt of the refund check it was deposited into a joint account, expressly opened as a tenancy by the entireties account. *In re Freeman*²⁷⁰ also found that tax refunds can be owned as tenants by the entireties.

However, *In re Morine*²⁷¹ is consistent with the holdings in *Kossow* and *Hinton*. In *Morine*, the debtor did not deposit the tax refund into a tenancy by the entireties account before filing his bankruptcy petition. Therefore, the Court found that “**the tax refund check was not deposited into a tenancy by the entireties bank account before the date of filing as in *Hinton*, so this Court declines to extend its holding.**” (Emphasis added.) Interestingly, the Court did not mention the *Freeman* case described above.

After *Morine*, another Middle District case, *In re Gorny*,²⁷² relied upon *In re Hinton* and *In re Freeman* and held that the tax refund qualified for ownership as tenancies by the entireties. However, in *Gorny* there were joint creditors, so the tax refund was not exempt.

Subsequently, *In re Rice*²⁷³ followed the holding from *Morine* that the interest of each debtor in a joint refund is the amount attributable to his income. The court found that a debtor who had filed a joint income tax return with a non-debtor, income-earning spouse did not have an interest in entirety for the tax refunds.

In a December 2012 case *In re Newcomb*,²⁷⁴ the Bankruptcy Court for the Middle District of Florida addressed the conflict concerning this issue in Florida courts. The court cites to *Gorny*, *Freeman*, *Kossow*, and *Hinton* to support the proposition that joint tax refunds constitute tenancy by the entirety property. The court further cited to *Morine* and noted that “[n]ot every court, however, has agreed that joint tax refunds constitute tenancy by the entirety property. Indeed, a split of authority on this issue exists within the Middle

²⁶⁸ 325 B.R. 478 (Bankr. S.D. Fla. 2005).

²⁶⁹ 378 B.R. 371 (Bankr. M.D. Fla. 2007).

²⁷⁰ 387 B.R. 871 (Bankr. M.D. Fla. 2008).

²⁷¹ 391 B.R. 480 (Bankr. M.D. Fla. 2008).

²⁷² 2008 WL 5606583 (Bankr. M.D. Fla. 2008).

²⁷³ 442 B.R. 140 (Bankr. M.D. Fla. 2010).

²⁷⁴ 2012 WL 6043000 (Bankr. M.D. Fla. 2012).

District of Florida.” Here, the court declined to follow *Morine* and held that the joint tax refund was exempt as tenants by the entireties property.

It seems that tax refunds attributable in great part to one spouse as opposed to joint activities or investment losses will be considered to be tenancy by the entireties assets. The court, in *In re Garbett*,²⁷⁵ held that a presumption exists that each debtor has equal interest in a joint tax refund, regardless of each debtor’s respective contribution to the taxable income. The presumption is rebuttable, based on facts and circumstances.

DATE	CASE NAME	JUDGE & DISTRICT	AMOUNT OF TAX REFUND IN QUESTION	DID ONE SPOUSE HAVE MORE INCOME THAN THE OTHER IN THE YEAR IN QUESTION?	WAS THE UNEVENNESS DISCUSSED	ANY OTHER NOTES
4/28/2005	<i>In re Kossow</i>	Hyman, S.D., Fla.	\$3,670	Not mentioned	N/A	Remanded the Court found that the Prenuptial Agreement caused “genuine issues of material fact as to whether the 2003 income tax return is exempt as a tenancy by the entireties”
4/12/2006	<i>In re Kant [unreported case]</i>	Glenn, M.D., Fla.	\$6,117	Yes, the debtor was the only spouse with income and withholding for the year	Yes	

²⁷⁵ 410 B.R. 280 (Bankr. E.D. Tenn. 2009).

DATE	CASE NAME	JUDGE & DISTRICT	AMOUNT OF TAX REFUND IN QUESTION	DID ONE SPOUSE HAVE MORE INCOME THAN THE OTHER IN THE YEAR IN QUESTION?	WAS THE UNEVENNESS DISCUSSED	ANY OTHER NOTES
10/1/2007	<i>In re Hinton</i>	Jennemann, M.D., Fla.	Total \$483,292. The IRS issued a check for 1997 & 1998 totaling \$304,383. The IRS issued two checks for 2001, \$116,518 and \$62,391	Yes	The Court did not state the difference in income	
4/30/2008	<i>In re Freeman</i>	Jennemann, M.D., Fla.	\$1,339	Not mentioned	N/A	
5/6/2008	<i>In re Morine</i>	Paskay, M.D., Fla.	Not mentioned	Yes. "The refund is attributable solely to the debtor's income."	Yes	Does not mention <i>In re Freeman</i>
8/20/2008	<i>In re Gorny</i>	Briskman, M.D., Fla.	\$6,397	Not mentioned	N/A	Does not mention <i>In re Morine</i>
12/4/2012	<i>In re Newcomb</i>	McEwem, M.D., Fla.	\$6,235	Not mentioned	N/A	Noted the conflict in the Middle District regarding whether joint tax refunds can be held as tenants by the entirety. Declined to follow <i>In re Morine</i>

NOTE: This issue was also addressed by the Tennessee bankruptcy court case of *In re Garbett* in 2009, which concluded that refunds attributable to one spouse's losses are nevertheless tenancy by the entirety property.

TANGIBLE PERSONAL PROPERTY (PHYSICAL NON-REAL ESTATE ASSETS).

The Supreme Court in the *Beal Bank* case did not discuss whether tangible personal property "would be held" as tenants by the entirety without proof of that form of ownership. The aforementioned *In re*

*Kossow*²⁷⁶ and *In re Caliri*²⁷⁷ have concluded that the *Beal Bank* decision applies to tangible personal property acquired jointly by a husband and wife, unless an express disclaimer of entireties ownership occurs.

In *Kossow*, a grill and patio furniture was found to be transferred by the debtor to tenancy by the entireties, although there was no bill of sale or other formal document confirming this. In *re Mathews*, discussed previously, the court found that there is a trend towards recognizing a presumption of tenancy by the entireties for all personal property, not merely real estate. The court held that if all the unities are present, a presumption should arise that a married couple owns personal property as tenants by the entireties.

In 2015, *In re Nazeel Dumay* confirmed that one spouse can transfer an exempt asset, such as an automobile, to tenancy by the entireties.²⁷⁸ Under Florida law, a spouse holding title to property may convey that property to both spouses and create a tenancy by the entireties.²⁷⁹ However, the exemption is only applicable up to \$1,000.

Will Florida law apply where tangible or intangible property is owned outside of Florida? The case law is not consistent, but it appears from a number of cases that tangible personal property (physical assets) will not be protected as tenancy by the entireties assets if physically located in a state or jurisdiction that does not recognize tenancy by the entireties. On the other hand, intangible assets, such as stock, partnership interests, and promissory notes should qualify as tenancy by the entireties assets, notwithstanding where they, or the underlying entity involved, are located.²⁸⁰

AUTOMOBILES AND OTHER REGISTERED VEHICLES.

In Florida, an automobile title can be held by multiple parties with the designation of “AND” or “OR.” Pursuant to Florida Statutes Section 319.22(2)(a)(1)(b), “AND” means that both signatures are required to effectuate a transfer, therefore, tenancy by the entireties should apply. However, “OR” means that either spouse can sign, so tenancy by the entireties should not apply. Practically speaking, the Florida DMV will not permit titling between spouses in a way that would explicitly mention tenancy by the entireties or “TBE.”

Florida Statutes Section 319.22 will affect the ability of a vehicle titled in Florida to qualify as tenants by the entireties property. In *AmSouth Bank of Florida v. Hepner*,²⁸¹ a judgment creditor was permitted to levy on a jointly owned vehicle because the title stated “OR,” which the court found to mean that the vehicle was owned as joint tenants, and not tenants by the entireties. If the title had stated “AND,” then the court would have found that tenancy by the entireties existed. The court also indicated that the parties would not be permitted to use extrinsic evidence, unlike with other personalty, to establish that despite checking the “OR” box, that they really intended to own the vehicles as tenants by the entirety.

²⁷⁶ *Kossow*, at 478.

²⁷⁷ *Caliri*, at 788.

²⁷⁸ No. 15-10472-BKC-RAM-WL 3505233 (S.D. Fla. 2015).

²⁷⁹ Fla. Stat. § 222.25(1).

²⁸⁰ *In re Koesling*, 210 B.R. 487 (Bankr. N.D. Fla. 1997), *In re Siegel*, 350 So 2d. 89 (Fla. 4th DCA 1977).

²⁸¹ 647 So.2d 907 (Fla. 1st DCA 1994).

In 2001, the Supreme Court of Florida extended the presumption of tenancy by the entireties to include joint financial accounts and other personal property.²⁸² The *Beal Bank* case does not specifically address motor vehicles and the *Caliri* case found that vehicles (in this case, jet skis) using the word “OR” will not be considered as tenants by the entireties.²⁸³

Three years later, in *Xayavong v. Sunny Gifts, Inc.*,²⁸⁴ the court concluded that the presumption of tenancy by the entireties in *Beal Bank* did not apply to automobiles because of the provisions outlined in Florida Statutes Section 319.22(2), as explained above.

Race cars and other vehicles that are only driven “off of the road” and on private tracks generally do not have a title, therefore these vehicles need to be titled as tenancy by the entireties by a formal bill of sale, perhaps by intent.

Federally documented vessels can also be held as tenants by the entireties. In *Caliri*, the debtor and her husband acquired a catamaran under a bill of sale from the dealer setting forth their names as joint tenants with right of survivorship, and the catamaran was federally documented and thus not titled by the State of Florida. The Certificate of Documentation showed the owners simply as the husband and wife, and showed the husband as the managing owner. The bankruptcy court concluded that the catamaran was held as tenancy by the entireties because the husband and wife did not expressly disclaim entireties ownership.

Florida’s sales tax is generally imposed upon any transfer of a registered vehicle, boat, or airplane to a limited liability company or other entity. Floridians are therefore well advised to establish an LLC or other entity to own any such item from inception.

JOINT DEBT AND BANKRUPTCY.

While the general rule that a creditor owed money by only one spouse (“a sole creditor”) may not reach tenancy by the entireties assets, this may be challenged in bankruptcy if there is joint debt, because the joint creditor or creditors can force a sale of the tenancy by the entireties assets, and then single creditors may claim that half of any excess value will not be protected as tenancy by the entireties property.

It is clear “that an unsecured joint creditor” in bankruptcy can “have the automatic stay lifted in order to reduce its claim to judgment in state court and to enforce that judgment against property owned as tenants by the entireties by the debtor and his non-filing wife.”²⁸⁵

The Fourth Circuit Court of Appeals in the case of *Sumy v. Schlossberg*²⁸⁶ quoted the Florida 1988 Middle District of Florida Bankruptcy Decision of *In re Pepenella*²⁸⁷ for the proposition that “although there is a split between courts as to whether the presence of a joint creditor eliminates the [tenancy by the entireties] exemption entirely, . . . the most important rule, and seemingly the majority rule . . . is that the

²⁸² *Beal Bank, SSB v. Almand and Associates*, 780 So. 2d 45 (Fla. 2001).

²⁸³ 347 B.R. 788 (M.D. Fla. 2006).

²⁸⁴ 891 So. 2d 1075, 1076 (Fla. 5th Dist. App. 2004).

²⁸⁵ *Chippenham Hosp., Inc. v. Bondurant*, 716 F.2d 1057 (4th Cir. 1983).

²⁸⁶ 777 F.2d 921, 928 (4th Cir. 1985).

²⁸⁷ 103 B.R. 299, 302(M.D. Fla. 1988).

equity in the property may be used to satisfy the joint creditors, but the remainder of the equity is exempt as to the sole creditors of one of the tenants.

This issue has not been addressed by any other Circuit Court of Appeals, or by any decision known of by the authors in recent years.

STRATEGY I – maintain sufficient liquidity or access to liquidity to eliminate debt on joint non-exempt assets or have the debt owed by an entity other than the spouse's, although the spouse may guarantee the debt.

STRATEGY II – investment assets other than homestead to be secured by debt may be purchased under an LLC or family limited partnership which borrows the money with guarantees. Then there is not “individual joint debt” for purposes of bankruptcy planning.

STRATEGY III – before one spouse files bankruptcy, transfer tenancy by the entireties assets to the other spouse so that the debt is not “joint debt” at the time of filing.

REAL ESTATE OWNED OUTSIDE OF FLORIDA.

Does the state of location recognize tenancy by the entireties? If not, then the ownership of the real property may be converted to an intangible asset so that Florida law will apply. Many states, including Georgia, Colorado, and Washington, do not recognize tenancy by the entireties. Conversion can also be done by transferring the property to a separate entity in a tenancy by the entireties protective state, such as a limited liability partnership or an LLC, the interests of which will be held as tenants by the entireties between the spouses.

Some states recognize tenancy by the entireties, but do not provide “full protection” for those assets. For example, under Alaska law, the creditor of one spouse can attach the survivorship right that the debtor spouse owns in the share of the non-debtor spouse in the event of the death of the non-debtor spouse, so creditors routinely receive nominal payments in lieu of nothing from a tenancy by the entireties debtor.

A non-resident of Florida may be able to exempt non-homestead Florida real property, so long as the property is owned by the debtor and his or her spouse as tenants by the entireties. In *In re Cauley*,²⁸⁸ the Bankruptcy Court for the Middle District of Florida acknowledged that tenancy by the entireties protection can apply to individuals who reside in non-tenancy by the entireties states and own real estate in a tenancy by the entireties state, like Florida, pursuant to Bankruptcy Code Section 522(b)(3)(B). In this case, the court ruled that the debtor's interest in a Florida property was exempt in bankruptcy, even though the debtor did not live in Florida. Debtor and his wife purchased a home in Florida, which they lived in for approximately four months. In 2006, the debtor filed for Chapter 7 Bankruptcy in Delaware, claiming that the Florida property was exempt because it was held as tenancy by the entireties. AmSouth bank objected, arguing that tenancy by the entirety protection was only available if the debtor was a Florida resident. The

²⁸⁸ 374 B.R. 311 (Bankr. M.D. Fla. 2007).

court applied Florida law because the property was located in Florida, and the sole determinant of whether Section 522(b)(2)(B) of the Bankruptcy Code protects an asset from the claims of the bankruptcy estate is the asset's situs. The court noted that "tenancy by the entirety is a creature of Florida common law, not an exemption which is given to a resident of Florida by the Florida Constitution or the Florida Statutes." Thus, the court found that there was no requirement to be a resident of Florida in order to exempt the Florida property under tenancy by the entireties.

Other courts have followed *Cauley*, allowing non-residents to exempt Florida property held as tenants by the entireties. In the case of *In re Holland*,²⁸⁹ the court allowed an Illinois debtor who owned property in Florida as tenants by the entireties to exempt such property in her bankruptcy. Citing *Cauley*, the court noted that there is no requirement for the property owner to be a resident of Florida. The court specifically stated, "[i]t is therefore clear from Florida case law that, at least with respect to creditors who are not joint creditors of the husband and wife, Florida common law concept of tenancy in the entireties fits within the exemption provided by 11 U.S.C. § 522(b)(3)(B) [of the Bankruptcy Code]."

FUNDING A BY-PASS TRUST WITH TENANCY BY THE ENTIRETIES PROPERTY.

Many estate tax planners will want to provide that a first dying spouse is able to fund assets to a By-Pass Trust that can benefit the surviving spouse without being subject to federal estate tax on the estate. For those that die in 2017, the applicable exclusion amount is \$5,490,000. When an affluent couple owns most of their assets as tenants by the entireties, how can a By-Pass Trust be funded?

Can the surviving spouse disclaim a portion of the tenancy by the entireties property to facilitate the funding of a By-Pass Trust under the Will of the first dying spouse? Treasury Regulation Section 25.2518-1, effective December 30, 1997, permits a surviving joint tenant to disclaim the survivorship interest in joint tenancy property if certain technical steps are followed to comply with state and tax rules.

CAN A JOINT TRUST QUALIFY FOR TENANCY BY THE ENTIRETIES OWNERSHIP?

[ALAN TO WORK ON THIS SECTION.]

There are only four known cases discussing whether a married couple in Florida can maintain tenancy by the entireties protection with respect to assets held in a "joint revocable trust", and it seems clear, at least to the author, that a properly drafter and administered trust can qualify.

The most recent case on point includes the 2020 case *In re Givans* and the apparent view of bankruptcy court Judge Jennemann that assets held by a married couple which are held as Tenants by the Entireties lose such joint status if the assets are moved into a joint trust.²⁹⁰ It is important to provide that the entire beneficial ownership interest in the trust and all trust assets is a tenancy by the entireties asset, and to keep the trust provisions consistent therewith. An alternative would be to attempt to use a Delaware statutory tenancy by the entireties trust, but the authors are not absolutely sure that a Florida court will apply Delaware

²⁸⁹ 2009 WL 2971087 (Bankr. N.D. Ill. 2009).

²⁹⁰ *In re Givans*, No. 6:19-bk-01928-KSJ, 2020 Bankr. LEXIS 2912, at *2 (Bankr. M.D. Fla. Sep. 28, 2020)

law, even if the situs of the trust assets were in Delaware, if both spouses reside in Florida. Other states that have tenancy by the entireties trust laws include Virginia, Illinois, and Missouri.

In *Passalino v. Protective Group Securities, Inc.*,²⁹¹ Florida's Fourth District Court of Appeals held that the proceeds from a sale of property held as tenants by the entireties did not lose tenants by the entireties status when transferred to their attorney's trust account. Specifically, the court stated that "[t]ransferring the proceeds of the sale of entireties property to a trustee for the benefit of the husband and wife does not terminate the unities of title or possession, where the parties clearly intended their property to be held as a tenancy by the entireties by exercising beneficial ownership of the property and controlling the property's disposition."

Further, the *Passalino* court discussed *Rollins v. Alvarez*,²⁹² in which the Fifth District made the following comment in a footnote regarding the transfer of entireties property to a trust controlled by the husband: "There is no dispute that the effect of this transfer to the trustee destroyed any tenants by the entireties that may have existed in the property pre-transfer." The *Passalino* court noted that the *Rollins* case does not stand for the proposition that a transfer to a trustee of entireties property in and of itself terminates entireties status. Rather, the court indicated that entireties status is destroyed when the property is transferred to a trust controlled by only one spouse. The *Passalino* court further asserted that the intent of the property owners is relevant in determining whether entireties property retains entireties status after being transferred to a trust. The court noted that tenancy by the entireties ownership can be terminated by divorce, death of one of the owners, or by agreement between the owners. The court further noted that such agreement does not need to be explicit and can be inferred from the conduct of the parties. Thus, the intent of the parties is considered in determining whether an agreement to terminate entireties status was reached. In the case at issue, the court stated that "[t]he evidence in this case established that Mr. and Mrs. Molinari did not intend to terminate the tenancy by the entireties when they deposited the proceeds of the sale from their entireties property in the trust account. The money was held for their use and benefit, and only they could direct its disposition."

In the case of *In re Quaid*,²⁹³ the United States District Court for the Middle District of Florida found that "[w]hen assets held as TBE are transferred to a trust in which only one party maintains control, the terms of the trust eliminate any TBE protection." In this case, a couple transferred funds held in a tenants by the entireties bank account to a trust solely controlled by the wife. The court determined that these funds lost tenants by the entireties protection because the trust was solely controlled by the wife. However, the court did not allow the husband's creditors to reach the property held in trust because he was not a "settlor" under the Florida Trust Code because the husband did not have the power to revoke or withdraw the trust assets. Specifically, the court stated "[b]ecause [the husband] was not a settlor of the Trust, his beneficial interest in the Trust is protected from his bankruptcy creditors by the spendthrift provision."

Attorneys Richard O. Jacobs and Tye Klooster shared our view in their 2005 article entitled *Asset Protection Tools for Florida Professionals: Strategies to Pursue and Avoid*, which was published in Florida State University Business Review. They concluded as follows:

²⁹¹ 886 So.2d 295 (Fla. 4th DCA 2004).

²⁹² 792 So.2d 695 (Fla. 5th DCA 2001).

²⁹³ 2011 WL 5572605 (M.D. Fla. Nov. 16, 2011).

In such a trust, the legal title is vested in the trustees, and the husband and wife have beneficial title. The TBE trust differs from the joint trust in that both husband and wife must agree to alter, amend, modify, or revoke the trust, or to withdraw assets from the Trust Estate. If there are disbursements, the disbursements must benefit both spouses. The TBE trust can be utilized when assets cannot otherwise be titled as TBE property. For example, some banks refuse to recognize TBE bank account titles, but will recognize account titles in a trustee. Similarly, a TBE trust is an option, as would an LLC or other entity, to hold title to property located in another state that does not recognize TBE property as a form of ownership. As Florida residents, the interests of husband and wife in the entity is a beneficial interest. As such, it is personal property, subject to the laws of Florida, and can be titled as TBE property. While there is some disagreement among practitioners as to whether or not TBE status can be protected by use of such a trust, we believe TBE trusts should withstand creditor attack.²⁹⁴

The above conclusion is further supported by an article entitled *Trusts: TBE or Not TBE* by R. Craig Harrison, which was first published in The Florida Bar Journal, May 2013. Our summary of this article is as follows:

Attorney R. Craig Harrison's real property, probate and trust law sponsored article in the May 2013 Florida Bar Journal entitled – Trusts: TBE or Not TBE – provides an excellent discussion of the advantages and factors to consider in establishing and implementing a tenancy by the entireties trust. The article concludes that a married couple can transfer tenancy by the entireties property to a trust that will provide the couple with both the benefits of a trust and also creditor protection. The article further points out that a surviving spouse can be provided with the right to disclaim his or her interest into the TBE trust to be allocated to a credit shelter trust that can be provided for under the trust document.

Florida favors married couples holding their property as tenants by the entireties (TBE). Probate is avoided as the property passes to the surviving spouse by operation of law. Further, the tenancy provides creditor protection. In essence, the TBE property belongs to neither individual spouse, but both are collectively seized in the whole property. This indivisible interest cannot be severed by the actions of just one spouse. Because of this legal concept, the creditor of one spouse cannot sever the TBE property to satisfy the debt.¹ To avoid probate and to take advantage of estate tax exemptions, estate planners have traditionally split the TBE property to fund separate trusts for each spouse, which usually provide tax credit shelter and marital trusts upon the death of the grantor spouse. The division of the TBE property between the spouses (held in trust or otherwise) subjects the property held by a spouse to the reach of that spouse's creditors. With the increase of the federal exemption and portability, single-share joint trusts are becoming more popular; however, a creditor of one spouse may be able to reach the entire corpus of a single-share joint trust.

A tenancy by the entirety trust (TBE trust) can provide the married couple with both creditor protection and the various nontax benefits of a trust. The TBE trust with disclaimer provisions provides the same estate tax benefits as a complex joint trust or the typical separate trust formats. A review of the TBE

²⁹⁴ Richard O. Jacobs & Tye J. Klooster, *Asset Protection Tools for Florida Professionals: Strategies to Pursue and Avoid*, 4 Fla. St. U. Bus. Rev. 1 (2004-2005).

concept, historically and to the present day, together with an analysis of a beneficiary's interest in a trust supports the use of a TBE trust.

The TBE Property Roots

- *The Beginnings of Jointly Held Property* — The holding of property as joint tenants dates back to at least the 13th century. It was a mechanism to avoid the incidents of feudalism. The joint tenants were seized “per my et per tout.” In other words, the tenants held simultaneous ownership of an equal undivided fractional share (“per my”) of the entire estate (“per tout”). In the 14th century, partition actions developed to sever the joint tenancy and the concept of tenancy in common was born. Persons who hold property as tenants in common hold their respective interests as a separate and distinct estate, *i.e.*, an undivided one-half.

- *The Development of TBE Property: Married Women Could Not Hold Property Individually* — Tenancy by the entirety took form in the 14th century and the feudal system also played a role in its development as a married woman could not hold property in her individual name. However, it was not until the 18th century that tenancy by the entirety was actually described as a property interest in the ninth edition of William Blackstone's *Commentaries on the Laws of England*, in which he states:

If an estate in fee be given to a man and his wife, they are neither property joint-tenants, nor tenants in common; for husband and wife being considered as one in law, they cannot take the estate by moieties, but are seized of the entirety, per tout et non per my; the consequences of which is that neither the husband nor wife can dispose of any part without the assent of the other, but the whole must remain to the survivor.² Although a married woman held title to the TBE property, her husband had the right to exclusively control the estate and his creditors had the ability to reach the TBE property subject only to the wife's right of survivorship.

- *The Modern Concept of TBE: The Rule of Construction and Presumption of Intention* — By statutory and constitutional enactments, married women gained the right to own property in their individual names. In Florida, the right of a married woman to hold separate property slowly progressed. Finally, in 1968, Florida adopted Fla. Const. art. 10, §5, which abolished all distinctions between married men and women in the holding, control, disposition, or encumbering of property.

Because married women could own property in their individual name, the original reason for the development of tenancy by the entireties, that the wife lacked capacity to hold title, no longer existed. Many jurisdictions faced the issue as to whether the tenancy by entirety concept should still apply. The Florida Supreme Court, in a series of cases, held that the ancient reason for the establishment of estates by the entirety (*i.e.*, the incapacity of the wife to hold property) was no longer the common law basis of the estate by entirety concept. Rather, the common law evolved into a rule of construction based on the presumption of an intent to create TBE property and ownership of the TBE property as a single unit (per tout et non per my).³

First Nat'l Bank v. Hector Supply Co., 254 So. 2d 777 (Fla. 1971), addressing a bank account, held that a TBE interest was created in the account so long as the signature card was drafted in a manner consistent

with the essential six unities of the TBE estate. This standard was reaffirmed in *Beal Bank, SSB v. Almand and Associates*, 780 So. 2d 45 (Fla. 2001), which pronounced that strong public policy considerations favored the finding of a TBE interest in property — at least with respect to creditors.

Based on these common law standards, the TBE property interest is created by 1) the intention of the husband and wife to create the tenancy, and 2) the establishment of the six essential characteristics associated with TBE property.

The Creation of a TBE Trust

A trust can be drafted to meet the requirements set forth in *Hector Supply* and *Beal Bank*.

• *The Statement of Intent to Create TBE Property* — *Hector Supply*; *In re Lyons' Estate*, 90 So. 2d 39 (Fla. 1956); *Bailey v. Smith*, 103 So. 833 (Fla. 1925); and *Hagerty v. Hagerty*, 52 So. 2d 432 (Fla. 1957), all involved bank accounts and state that if the intent to create a TBE interest was set forth in the account signature card, the intent to create the TBE interest would be conclusive.

Beal Bank re-affirmed *Hector Supply* and concluded that if the signature card states the intent to create a TBE interest in the account, this “ends the inquiry as to the form of ownership” as to the tenancy.⁴

Beal Bank also cites the Fourth DCA holdings in *Sheeler v. United States Bank of Seminole*, 283 So. 2d 566 (Fla 4th DCA 1973), and *Morse v. Kohl, Metzger, Spotts, P.A.*, 725 So. 2d 436 (Fla. 4th DCA 1999), that the signature card designating the account as TBE property was conclusive and could not be challenged by extrinsic evidence.

Therefore, a simple statement in the trust agreement that the settlors intend to create a TBE interest for all property transferred to the trust provides the required intent to create a TBE interest in the trust property.

The TBE trust must also be consistent with the six essential unities of the TBE estate.

The Essential Unities of the TBE Estate — Tenancy by entirety must have the following six characteristics:

- 1) Unity of Possession — Both spouses must have joint ownership and control.
- 2) Unity of Interest — Each spouse must have the same interest in the property.
- 3) Unity of Title — The interest must have originated in the same instrument.
- 4) Unity of Time — The interest must have commenced simultaneously in the same instrument.
- 5) Survivorship — On the death of one spouse, the other spouse becomes the sole owner of the entireties property.
- 6) Unity of Marriage — The parties must be married. The unities of interest and survivorship can easily be incorporated into the trust agreement. The unity of marriage is simply an issue of fact. The unities of title, possession, and time also can be properly addressed in the trust agreement.

The Unity of Title: The Property Interest of Equitable Title — Some practitioners assert that the division of the TBE property into a legal interest (held by the trustee) and an equitable interest (held by the husband and wife) terminates the tenancy. They argue that the husband and wife no longer hold a unified title to the estate as a whole, and the tenancy by the entirety is destroyed.

“An estate by the entirety can be created in property capable of being held as an estate by the entirety where a conveyance of transfer is made to husband and wife without expressly specifying how they are to take.”⁵ It is the unity of title in the property interest that is relevant, not the quantity of the property interest. As discussed below, equitable title to trust property is a property interest and, therefore, is subject to TBE ownership.

In *In re McEwen's Estate*, 33 A.2d 14 (Pa. 1943), a Pennsylvania trust was established by a married couple with a bank as the trustee. The husband and wife made unequal contributions to the trust of securities. The trust provided for the distribution of the net income to the husband and wife during their joint lives and to the survivor during his or her life. After the death of the surviving spouse, the trustee was required to liquidate the trust and distribute the corpus to the remainder beneficiaries. The spouses held the right to revoke the trust during their joint lives, but upon the death of one spouse, the trust became irrevocable.

The Supreme Court of Pennsylvania held that the McEwens created a TBE interest in the corpus of the trust when they transferred the securities to the trust upon two separate grounds. First, the McEwens reserved the right to control the disposition of the trust corpus by revocation, termination, or modification of the trust during their lifetimes. Upon the revocation of the trust, the trust assets would have vested in the McEwens as tenants by the entirety. Although the trustee held the legal title to the trust property, the trustee held no beneficial interest therein. Second, the court reasoned that the McEwens held an actual property interest in the trust — an equitable ownership in the trust corpus — which was subject to the TBE interest. The Pennsylvania court noted that the early judicial concept considered a beneficiary as merely holding an in personam right in the trust — a right of action only against the trustee. The beneficiary did not own a property interest in the trust. The modern trend recognizes that the beneficiary has both the right of action against the trustee and an actual property interest in the trust — an equitable ownership in the trust corpus. The McEwens owned this equitable ownership interest as tenants by the entirety.

As in *McEwen*, Florida recognizes that a beneficiary of a trust owns equitable title in the trust property. *Barnett Nat. Bank of Jacksonville, et al. v. Murrey*, 49 So. 2d 535 (Fla. 1950), involved a challenge to a trust by the son of the settlor. One issue on appeal was whether the beneficiary son had to renounce his interest in the trust before filing his lawsuit. The trust corpus consisted of corporate stock. The son claimed that he was not required to renounce his interest in the trust because he had no legal title in the trust property (the corporate stock), but only an equity therein.

The Florida Supreme Court held that the trust vested legal title in the stock to the trustee, but the beneficiary held equitable title in the stock. The court found that the vested equitable title was property that could be alienated and subject to the claims of the beneficiary's creditors. Based on this property right, the beneficiary was required to renounce his interest in the trust, prior to filing the action challenging the trust.⁶

Like *McEwen*, Florida also recognizes the TBE property interest in a trust when the husband and wife retain the right to control the disposition of TBE property held by a trust. In *Passalino v. Protective Group Securities, Inc.*, 886 So. 2d 295 (Fla. 4th DCA 2004), the husband and wife sold property they held as tenants by the entirety and transferred the sale proceeds to their attorney's trust account. The creditor of the husband filed a writ of garnishment against the attorney's trust account claiming that the transfer of the sale proceeds to the trust account terminated the TBE interest because the couple no longer held the unity of title or possession. The creditor argued that the attorney was in possession of the funds and that he was the only person with the authority to sign on the trust account.

The Fourth District Court of Appeals disagreed and specifically held that the transfer of the TBE property to the trust account did not terminate the unities of title or possession:

Transferring the proceeds of the sale of an entireties property to a trustee for the benefit of the husband and wife does not terminate the unities of title or possession, where the parties clearly intended their property to be held as tenancy by the entireties by exercising beneficial ownership of the property and controlling the property's disposition.⁷

Therefore, the transfer of TBE property to a trust does not terminate the unity of title, especially when the husband and wife retain the power to amend, revoke, or terminate the trust.

- *The Unity of Possession* — Even though the TBE property interest is nonseverable and indivisible, a trust may provide a power in the trustee to remove assets from the trust as agent for the husband and wife without jeopardizing the TBE interest held by the trust.⁸

The transfer of TBE property to a trust in which one spouse is given the sole power to control the trust property may destroy the unity of possession and terminate the TBE character of the property.⁹

Nevertheless, *Passalino* makes it clear that *Rollins v. Alvarez*, 792 So. 2d 695 (Fla. 5th DCA 2001) (and therefore, *Quaid v. Baybook Home of Polk County, LLC et al.*, 2011 WL 5572605 (M.D. Fla. 2011)), is limited to trusts in which only one spouse has the power to control the trust.

In *Rollins*, a husband and wife funded an inter vivos trust with marital property. The wife transferred her interest in the property to the trust, on which her husband had sole control over the funds and had authority to amend, modify, or revoke the trust. The husband executed amendments changing the beneficiaries...

Although not in issue, in a footnote the district court stated, "There is no dispute that the effect of this transfer to the trustee destroyed any tenancy by the entireties that may have existed in the property pre-transfer. See *Hunt v. Covington*, 145 Fla. 706, 200 So. 76 (1941); 12 Fla. Jur. 2d Cotenancy and Partition 29 (1998)." 792 So. 2d at 696 n. 2.

Appellants suggested that *Rollins* stands for the proposition that a transfer to a trustee of entireties property in and of itself terminates the entireties. We disagree with this interpretation. *Rollins* ['] citation to *Hunt* is instructive. In *Hunt*, a husband's conveyance of properties to his wife terminated his interest in the

property and, thus, the entirety character of the property. Likewise, in *Rollins* the wife's transfer of marital property to the trust in which her husband maintained sole control and could direct the disposition of property terminated the entirety character of property. In other words, the unities of possession and interest were terminated, because the wife no longer exercised control over the property.¹⁰

Thus, when the married couple retains the power to control the trust by direction, revocation, or modification, the unity of possession is not terminated by the transfer of the TBE property to the trust. In order to maintain the unity of possession, the trust should require the consent of both spouses to amend, terminate, or revoke the trust. Therefore, the trust agreement and any power of attorney relating to the trust should authorize the agent to consent to a trust amendment, termination, or revocation.¹¹

- *The Unity of Time* — The unity of time can be easily met as well. The amendment of a separate trust to a TBE trust may not meet the unity of time. Instead, a new trust should be formed. Furthermore, it may be prudent to establish the TBE interest prior to transferring the asset into the trust. However, conceptually, this should not be necessary as the transfers of separate property to a TBE trust by a spouse is governed by the instrument and intent to create the TBE interest.¹²

Therefore, if the TBE trust provides that it is the intent for all property transferred to the trust be held as TBE property, it is the trust instrument and transfer that creates the tenancy interest, satisfying the unity of time.

Does the Florida Trust Code Prevent a Trust from Holding TBE Property?

Having established that under common law, TBE interests can be created in trusts, does the trust code abrogate this common law doctrine?

- *The Florida Trust Code is Silent as to the Treatment of TBE Property* — *Hector Supply* and the other Supreme Court cases addressing continued viability of TBE property in the wake of the statutory and constitutional provisions granting married women the right to own property individually looked to whether the legislation intended to abate or modify the common law TBE doctrine.

The Florida trust code does not specifically address tenancy by the entirety property interests in trusts, nor does it appear that the Florida trust code intended to modify the common law relating to the ownership of TBE property by a trust. In fact, F.S. §736.0106 states that the “common law of trusts and principals of equity supplement this code, except to the extent modified by this code or another law of the state.”

With that in mind, a few of the other Florida trust code provisions must be examined.

F.S. §736.05053(1) and the Duty of a Trustee to Pay the Expenses of the Estate — F.S. §736.05053(1) provides that a trustee of a trust described in F.S. §733.707(3) shall pay to the personal representative of a settlor's estate the amounts that the personal representative certifies in writing are required to pay the expenses of administration and obligations of the settlor's estate.

F.S. §733.707(3) states that any portion of a trust to which a grantor decedent, at the time of the decedent's death, has a right to amend, revoke, withdraw, or appoint, either alone or in conjunction with any other person, is liable for the expenses of the administration and obligations of the decedent's estate to the extent the decedent's estate is insufficient to pay them as provided in F.S. §733.607(2).

These provisions seem to expose the entire trust corpus of a TBE trust to a deceased spouse's estate administrative expenses and creditor claims. However, F.S. §733.707(3)(d) precludes exempt property from the reach of the probate estate. Therefore, it does not appear that the statute is intended to turn an exempt asset, such as a TBE property, into a nonexempt asset.

Nevertheless, the trust drafter should avoid language directing the trustee to pay the estate administrative expenses or creditors of the first spouse to die. This could be deemed a waiver of the statutory exception or assent by both spouses for the payment of such claims.¹³

- *F.S. §736.0505(1): The Liability of a Settlor to His or Her Creditors* — Florida does not exempt self-settled trusts from the reach of the settlor's creditors. F.S. §736.0505(1)(a) provides that assets of a self-settled trust are subject to the claims of creditors to the extent the property would not be otherwise exempt by law if owned directly by the settlor.

F.S. §736.0103(16) defines a settlor to mean a person who creates or contributes property to a trust. If more than one person creates or contributes property to a trust, each person is a settlor of the proportion attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion. This definition is simply a restatement of the generally accepted common law of trusts.¹⁴ Because the husband and wife are considered "one in law" and hold the property as a single moiety, together they are the "settlor" of the TBE trust. Since the TBE property held by the trust would be exempt if owned by them directly, the TBE trust property remains exempt from the creditors of either the husband or the wife. Based on the above, the Florida trust code does not expressly or by implication abrogate the common law to prevent a trust from holding TBE property with its creditor claim protection.

Surviving Spouse of a TBE Trust Can Disclaim TBE Interest to a Tax Credit Shelter Trust

Based on the current federal estate tax exemption of \$11.7 million (plus indexing) for each spouse and portability, a married couple can transfer more than \$23 million of TBE property first to the surviving spouse, then their children free of federal estate tax consequences. No separate trust is needed. Nevertheless, the estate tax picture is always unpredictable. To protect the married couple from future estate tax changes, the TBE trust can provide the surviving spouse with the right to disclaim all or part of the deceased spouse's estate tax imputed one-half interest in the TBE trust property. The TBE trust could provide that the disclaimed interest be allocated to a tax credit shelter trust so that the disclaimed interest will not be part of the surviving spouse's estate, and continue creditor protection on the disclaimed portion. Further, probate continues to be avoided.

Conclusion

A married couple can transfer TBE property to a trust that provides the couple with both the benefits of a trust and creditor protection. If federal (or other) estate taxes need to be addressed, the surviving spouse

can be provided with a right to disclaim his or her interest in the TBE trust to be allocated to a tax credit shelter trust. With the estate tax exemption \$11.7 million (plus indexing) and the portability option, the TBE trust is certainly a viable estate planning tool for a married couple.

Endnotes:

[1] *Winters v. Park*, 91 So. 2d 651 (Fla. 1956); *Beal Bank, SSB v. Almand and Associates*, 780 So. 2d 45 (Fla. 2001); *First Nat'l Bank v. Hector Supply Co.*, 254 So. 2d 777 (Fla. 1971).

[2] William Blackstone, 2 Commentaries on the Laws of England 179 (9th ed. 1783).

[3] *English v. English*, 63 So. 822 (Fla. 1913); *Hagerty v. Hagerty*, 52 So. 2d 432 (Fla. 1957); *Bailey v. Smith*, 103 So. 833 (Fla. 1925); *In re Lyons' Estate*, 90 So. 2d 39 (Fla. 1956); *Hector Supply*, 254 So. 2d 777.

[4] *Beal Bank*, 780 So. 2d at 60.

[5] *Matthews v. McCain*, 170 So. 323, 325 (Fla. 1936).

[6] *See also Miller v. Kresser*, 34 So. 3d 172 (Fla. 4th DCA 2010) (the trustee holds legal title in the trust and the beneficiary the equitable title).

[7] *Passalino*, 886 So. 2d at 297.

[8] *See Haggerty*, 52 So. 2d 432; *Hector Supply*, 254 So. 2d 777; and *Beal Bank*, 780 So. 2d 45.

[9] *Rollins v. Alvarez*, 792 So. 2d 695 (Fla. 5th DCA 2001); *Quaid v. Baybook Home of Polk County, LLC et al.*, 2011 WL 5572605 (M.D. Fla. 2011).

[10] *Passalino v. Protective Group Securities, Inc.*, 886 So. 2d 295, 297-8 (Fla. 4th DCA 2004).

[11] Fla. Stat. §702.2202(1)(b); Fla. Stat. §736.0602(5).

[12] *See Haggerty*, 52 So. 2d 432.

[13] *Morey v. Everbank*, 93 So. 3d 482 (Fla. 1st DCA 2012).

[14] *Rollins*, 792 So. 2d at 696.

Notwithstanding that there appears to be over a 99% confidence level that a Joint Revocable Trust can be a tenancy by the entireties asset, would it not be safer to have assets held under a limited liability company owned as tenants by the entireties, with a pay on death provision in the limited liability company Operating Agreement to provide that unless the surviving spouse otherwise designates, the LLC will be owned by the Revocable Trust on the second death? This avoids probate and also gives a higher level of assurance as to exemption.

MORE ABOUT JOINT TRUSTS.

The following discussion focuses primarily upon joint trusts that will not qualify as tenancy by the entireties. Clients and advisors must weigh the advantages and disadvantages of tax and inheritance protection against creditor protection considerations. Oftentimes, a non-TBE trust or trusts will be used in conjunction with other creditor protection planning mechanisms, such as by having a non-TBE revocable trust own a percentage of a limited partnership that would qualify for charging order protection.

The Internal Revenue Service has promulgated Private Letter Rulings which generally confirm that a joint trust held by a non-community property couple can be structured to have all of the assets held under such a joint trust used to fund the By-Pass Trust on the first death to the extent necessary to fully use the

first dying spouse's full estate tax exemption. It is possible for the ownership of a joint trust interest to qualify as a tenants by the entireties asset, as described below, but special drafting and implementation is necessary, and most joint trusts will not qualify.²⁹⁵

Advisors interested in the use of joint and single revocable trusts for estate planning purposes should realize that they typically do not provide creditor protection during the lifetime of the grantors, as further described below.²⁹⁶

Important Note: The following article was written *before* the invention of the "JEST" (joint exempt step-up trust), which fits under category 5) below, but provides greater income tax benefits, as described in the subsequent article:

SELECTING REVOCABLE TRUST SYSTEMS FOR CLIENTS

By Alan S. Gassman, Christopher J. Denicolo, and Kristen O. Sweeney
Reprinted with permission from Leimberg Information Services 02-Apr-09
Steve Leimberg's Estate Planning Newsletter – Archive Message #1439

NOTE – The below article was drafted before the "invention" of the Joint Exempt Step-Up Trust ("JEST" Trust), which is discussed in the next article, and will not qualify as a tenancy by the entireties trust

EXECUTIVE SUMMARY:

Advisors have a wide variety of revocable trusts at their disposal, and there are a number of important factors that must be carefully considered. This commentary will review:

- (1) "Protective Beneficiary" Trusts,
- (2) "All to Survivor" Joint Trusts,
- (3) "First Death Lock-Up" Trusts,
- (4) "Separate Trust for Each Spouse" Trusts,
- (5) "Joint 100% Lock-Up" Trusts, and
- (6) "Joint 50% Lock-Up" Trusts

FACTS:

Many estate plans involve revocable trusts, and selection and implementation of an appropriate plan is more of an art than a science.

Factors that should be considered when selecting a revocable trust system include:

- 1) Whether a surviving spouse or beneficiary should have total control or protective advantages that may be available;
- 2) Whether income tax savings for a surviving spouse may be desirable, and

²⁹⁵ See Leimberg Services Archive Message #243 – JOINT TRUSTS: A SECOND (AND CLOSER) LOOK, January 31, 2001.

²⁹⁶ For more information on joint trusts, see Leimberg Information Services Newsletter No. 1439, published April 2, 2009, and Leimberg Information Services Newsletter No. 2086, published April 3, 2013, both of which are reproduced here.

3) What assets and beneficiary designation situations the client may have.

NOTE: Revocable trusts can be used to avoid probate and guardianship, but during the lifetime of the grantor, who establishes and owns the trust, there is no creditor protection, Medicaid protection, or income or estate tax savings. After death, such protections and savings may apply, depending on the revocable trust system selected.

COMMENT:

CONSIDERATIONS FOR A SINGLE INDIVIDUAL

Many unmarried individuals establish and maintain revocable trusts primarily to avoid probate and guardianship of their estate. Probate is the process whereby assets owned in individual names must be processed through the Probate Court System, in order to ensure that:

- 1) The proper Will has been identified and approved,
- 2) Accountings are received by the beneficiaries,
- 3) Creditors are paid, and
- 4) A fiduciary is appointed as personal representative to execute and monitor all of the above.

Many clients choose to bypass the “red tape” and expenses associated with the probate system by placing their assets under a revocable trust. Immediately upon its formation, the trust is controlled and administered by a non-court appointed relative, friend, professional or trust company.

Life insurance, annuities, and even pension benefits can be paid to the revocable trust upon death to facilitate the uniform distribution of assets. For pension plan purposes, it may be advantageous to instead name individuals who are able to withdraw the pension benefits out of an inherited IRA ratably over their life expectancy. Such ratable withdrawals may also apply under an appropriately drafted revocable trust agreement, but special technical language and planning is required to effectuate this.

Some clients choose to place their homestead under a revocable trust, which does have certain advantages. For instance, in Florida, as long as the client is alive, the homestead can qualify for the Florida \$50,000 homestead exemption and the 3% cap on increases in value.

However, placing the homestead under a revocable trust also presents a potential *danger* from creditors. There is one bankruptcy court decision which has indicated that *the constitutional protection of homestead from creditors will not apply when the homestead is owned under a revocable trust*.

While other bankruptcy court decisions have not found this to be the case, our office generally suggests the more conservative approach of leaving the homestead *outside of* the revocable trust.

Clients who still wish to avoid probate of their homestead may be able to use a “Lady Bird Deed,” which maintains creditor protection while still avoiding probate.

PROTECTIVE BENEFICIARY TRUSTS

A revocable trust will commonly provide that upon the death of the client, the trust assets will divide into separate protective trusts for any children or other beneficiaries. Each child or other beneficiary may serve as sole or co-trustee for his or her benefit, and receive amounts deemed reasonably appropriate to maintain his or her standard of living as well as to benefit his or her children.

The advantages of such a continuing trust include protection from:

- 1) Estate tax at the child's level,
- 2) Creditor and divorce claims that the child might have in the future, and
- 3) Inappropriate or risky spending and investments, which may be curtailed by mandating that the child serve with a co-trustee; i.e., a trusted relative, family friend, professional, or trust company.

REVOCABLE TRUST SYSTEMS FOR MARRIED COUPLES

Revocable trusts for married couples incorporate the above principles, but married couples have a number of configurations to choose from:

“ALL TO SURVIVOR” JOINT TRUST

The simple “All to Survivor” joint revocable trust. A married couple who would typically own their assets jointly with right of survivorship may prefer to use a revocable trust in order to facilitate avoiding probate upon the second death, and avoiding guardianship over trust assets if a spouse is declared by a court to be incompetent.

Although most couples who would use right of survivorship as their primary estate plan can simply have assets pass by Will on second death, using an All to Survivor Joint Trust assures that there would be a revocable trust in place after the first death. The All to Survivor Joint Trust eliminates the surviving spouse's need to engage in estate planning and decision-making regarding the use of a revocable trust after the first death.

NOTE: Clients should be careful to confirm that the joint revocable trust with survivorship can be considered to be a tenancy by the entireties ownership vehicle for the married couple.

Under Florida law joint assets held as tenants by the entireties between a husband and wife are not subject to the creditor claims of an *individual* spouse, unless *both* spouses owe the creditor. This is a very good reason to keep assets jointly as tenants by the entireties where spouses are creditor exposed.

Most joint revocable trust forms used by lawyers will not qualify the trust assets to be considered as held by tenancy by the entireties, but with proper drafting this can be accomplished.

“FIRST DEATH LOCK-UP TRUSTS”

There are several good reasons that a married couple might wish to have some or all of their assets “locked up” in a protective trust upon the first death, including:

- 1) Avoidance of federal estate tax upon the second death.
- 2) Creditor protection for the surviving spouse upon the first death.
- 3) Securing a Co-Trustee for the surviving spouse to help prevent loss of assets to undue influence, poor investments, or unwise distributions or loans to friends or family members. The surviving spouse can serve as Co-Trustee with the power to select and replace the other Co-Trustee, and can receive benefits as needed for the spouse and descendants.

The “All to Survivor” Joint Trust described above will not provide these protections. Therefore, the married couple wishing to have the protections provided by a “Lock-Up Trust” may choose one of the following three revocable trust systems:

- 1) “SEPARATE TRUST FOR EACH SPOUSE” TRUST SYSTEM
- 2) COMPLEX JOINT TRUST: “JOINT 100% LOCK-UP” TRUST SYSTEM
- 3) COMPLEX JOINT TRUST: “JOINT 50% LOCK-UP” TRUST SYSTEM

These three trust systems are described in more detail below:

“SEPARATE TRUST FOR EACH SPOUSE” TRUST SYSTEM

Each spouse will have a separate trust that “locks up” upon the first death to benefit the surviving spouse with those assets held by such trust and those assets made payable to the trust by beneficiary designation.

The “Separate Trust for Each Spouse” system is the most popular, and traditionally has been the only revocable trust system used by most estate planning lawyers. In this system, a “bypass trust” or “family trust” can be established upon the first death to be held for the surviving spouse without the assets under such trust being subject to federal estate tax, creditor claims of the surviving spouse, or claims of the future spouses and the descendants of future spouses.

Most of the married couple trust work that our office performs uses the Separate Trust for Each Spouse trust system with separate trusts for each spouse, but there are other alternatives.

“COMPLEX JOINT LOCK-UP” ALL ASSETS

Clients who may instead be better suited for a “Complex Joint Trust” would typically have one or more of the following characteristics:

- 1) Clients who prefer a simpler plan with assets under one trust as opposed to two.
- 2) Clients who wish to “lock up” more than the assets of the first dying spouse upon the first death (which is the case under the Separate Trust for Each Spouse trust system).

The surviving spouse would become Co-Trustee of the trust holding these assets. Similar to the Separate Trust for Each Spouse trust system, these assets are held without being subject to federal estate tax, creditor claims of the surviving spouse, or claims of future spouses and the descendants of future spouses.

- 3) Clients who have had an All to Survivor Joint Trust in the past and do not wish to retitle to separate revocable trusts when updating their planning.

As stated above, clients who elect to have a Complex Joint Trust may choose between a “JOINT 100% LOCK-UP” trust system and a “JOINT 50% LOCK-UP” trust system.

Most wealthy clients who use a revocable trust system choose a “JOINT 100% LOCK-UP” trust system in order to achieve the following:

- 1) The ability to claim a “stepped up” basis for income tax planning purposes on all assets held under the joint revocable trust. For example, a stock purchased for \$200 that’s worth \$1,100 with capital gains tax only owed on \$100 worth. With a typical joint revocable (ATS) trust there is only a “step up” for half of the value upon death, so the capital gains tax would be based upon the excess of \$1,100 over \$100, plus \$500.
- 2) The ability to “lock up” as much in assets as possible to avoid estate tax upon the second death. For example, a married couple with good earnings may have \$4,000,000 worth of assets and may wish to lock up a full \$3,500,000 worth of assets in a bypass trust upon the first death, with the expectation that the surviving spouse will have future earnings and the possibility that the estate tax exemption will be reduced in the future.

The Joint 100% Lock-Up Trust has special design features that allow the trust assets to be considered for federal income and estate tax purposes to have passed from the first dying spouse into the surviving spouse’s trust upon the first death.

This is done by giving each spouse the right to execute a separate document directly how the trust assets would pass if that spouse was to die first. To ensure that the first dying spouse does not appoint assets to somebody other than the surviving spouse or the Joint 100% Lock-Up Trust, the tax law permits the appointment of “Trust Protectors,” who have the power to disapprove any exercise of such “power of appointment” by the first dying spouse.

For example, a husband and wife could appoint one or two close family friends or advisors as Trust Protectors under the trust. Their sole function would be to have the power to disapprove either spouse’s decision to direct assets anywhere besides the Joint 100% Lock-Up Trust or the surviving spouse, unless the surviving spouse also approves of such direction of assets.

The tax law does permit the entire Joint 100% Lock-Up trust to be held upon the first death for the surviving spouse, without being subject to federal estate tax upon the surviving spouse’s death. The tax law is not clear on whether all the assets of the trust receive a “stepped up” basis upon the first death.

Many tax commentators, myself included, believe that *all* assets inside a revocable trust should receive the “stepped up” basis. But the IRS has disagreed.

“JOINT 50% LOCK-UP” TRUST SYSTEM

The other Complex Joint Trust that can be used for estate tax and/or protective trust planning would be the “JOINT 50% LOCK-UP TRUST.” This is a simpler document than the Joint 100% Lock-Up Trust, but only allows the lock-up of 50% of the assets of the couple upon the first death.

The Joint 50% Lock-Up Trust does provide a “stepped up” income tax basis for the 50% of the assets that are locked up, but there is no stepped up basis for the other 50% of the assets. Under the Joint 50% Lock-Up Trust, the spouse who dies first cannot override the mutually agreed trust document, as he or she could under the Joint 100% Lock-Up Trust system, and therefore the language used in the trust document is not as complicated.

BE SURE TO CONSIDER MEDICAID ISSUES:

Medicaid planning for a married couple adds one more twist to revocable trust structuring. Unfortunately, the Medicaid regulations provide that assets passing by revocable trust into a protective trust for a surviving spouse can qualify, unless such assets have passed through the probate estate of the first dying spouse.

We may therefore suggest to clients who wish to help ensure that their spouse will qualify for Medicaid without using trust assets place the assets in their personal names, to pass into a revocable trust system by a “Pour Over Will” upon the first death.

PLANNING TIPS:

Obviously, revocable trust planning is varied and complex. We hope that this commentary will open up planning opportunities, as well as common configurations, to clients and advisors.

As with most estate planning techniques, “one size does not fit all.” It is best to structure a joint trust (or any trust for that matter) that is appropriate for the client’s needs and circumstances.

An article on the Joint Exempt Step-Up Trust (“JEST”) is as follows:

IT'S JUST A JEST, THE JOINT EXEMPT STEP-UP TRUST

By: Alan Gassman, Thomas Ellwanger & Kacie Hohnadell

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Steve Leimberg's Estate Planning Newsletter – Archive Message #086

“There are two primary concerns that arise when dealing with joint trusts in non-community property states: 1) whether, upon the first dying spouse's death, all joint trust assets (including those contributed by the surviving spouse) can be used to fund a credit shelter trust for the benefit of the surviving spouse without later being included in the surviving spouse's estate, and 2) whether, upon the first dying spouse's death, it is possible to obtain a step-up in basis for all trust assets, no matter which spouse contributed them to the trust.

After extensively researching these issues and reviewing alternative structures, we have designed a joint trust planning technique, entitled the ‘Joint Exempt Step-Up Trust (JEST).’ The JEST should allow a married couple in a common law state to make maximum use of the first dying spouse's unused estate tax exemption by fully funding a credit shelter trust upon the first dying spouse's death, even if this requires using assets contributed by the surviving spouse. We also believe that with proper structuring, the joint trust can provide a full step-up in basis for all of the trust assets.

Although not without risk or some uncertainties, clients who want a stepped up basis for all ‘joint’ assets, and to maximize use of credit shelter trust funding on the first death should have the opportunity to consider this strategy. While the risks herein described do exist, there is also the risk that the family will ask the planner why these techniques were not used to avoid capital gains taxes and facilitate making full use of the first dying spouse's estate tax exemption amount. *Practitioners will have to invest significant time to understand issues, to develop trust documents that take the above and many other considerations into account, and make sure that clients understand the risks and possible advantages of the system.”*

Now, Alan Gassman, Tom Ellwanger and Kacie Hohnadell provide members with their commentary on the Joint Exempt Step-Up Trust. The authors sincerely thank Howard Zaritsky, Michael Mulligan, John Meier, Christopher J. Denicolo and Kenneth J. Crotty for words of wisdom and contributions made in prior literature, and for their input on previous editions of this article.

EXECUTIVE SUMMARY:

Many legal scholars and practitioners have considered whether a married couple living in a non-community property state can contribute assets to a joint trust, which upon the first spouse's death would be used to fund a credit shelter trust and to facilitate a full step-up in basis. LISI commentators Alan Gassman, Tom Ellwanger and Kacie Hohnadell analyze the many issues that arise with respect to joint trusts, and present an innovative joint trust design strategy that can be used to avoid or reduce issues at hand. In addition to letting members in on this new innovative technique, this letter describes a number of interesting concepts that relate to joint trust planning and also concepts that related to joint trust planning and its impact upon estate tax, gift tax, and creditor protection objectives.

FACTS:

There are two primary concerns that arise when dealing with joint trusts in non-community property states: 1) whether, upon the first dying spouse's death, all joint trust assets (including those contributed by the surviving spouse) can be used to fund a credit shelter trust for the benefit of the surviving spouse without later being included in the surviving spouse's estate, and 2) whether, upon the first dying spouse's death, it is possible to obtain a step-up in basis for all trust assets, no matter which spouse contributed them to the trust.

After extensively researching these issues and reviewing alternative structures, we have designed a joint trust planning technique, entitled the "Joint Exempt Step-Up Trust (JEST)." The JEST should allow a married couple in a common law state to make maximum use of the first dying spouse's unused estate tax exemption by fully funding a credit shelter trust upon the first dying spouse's death, even if this requires using assets contributed by the surviving spouse. We also believe that with proper structuring, the joint trust can provide a full step-up in basis for all of the trust assets. This technique is clearly explained in our JEST chart that can be found at www.gassmanlaw.com/articles-symposiums.

The basic structure of the JEST is as follows: a married couple funds a jointly established revocable trust, with each spouse owning a separate equal share in the trust. Either spouse may terminate the trust while both are living, in which case the trustee distributes 50% of the assets back to each spouse. If there is no termination, the joint trust becomes irrevocable when the first spouse dies.

Upon that first death, the assets of the first dying spouse's share will be applied this way:

- 1) First, assets equal in value to the first dying spouse's unused estate tax exemption will be used to fund **Credit Shelter Trust A** for the benefit of the surviving spouse and descendants. These assets will receive a stepped-up basis and will escape estate tax liability upon the surviving spouse's death.
- 2) Second, if the first dying spouse's share exceeds his or her unused exemption, then the excess amount of that share will be used to fund **Q-TIP Trust A** for the benefit of the surviving spouse and descendants. The assets will avoid estate tax because of the marital deduction. They will receive a stepped-up basis on the first dying spouse's death, and again on the surviving spouse's death, at which time they will be potentially subjected to estate tax.

If the first dying spouse's share is less than his or her exemption amount, then the surviving spouse's share will be used to fund **Credit Shelter Trust B** with assets equal to the excess exemption amount. We believe that the assets of Credit Shelter Trust B should avoid estate taxation at the surviving spouse's death, although the surviving spouse originally contributed these assets to the JEST.

We also believe that the assets of **Credit Shelter Trust B** should receive a full stepped-up basis at the first death. IRS opposition on this issue can be expected, at least for the time being, but how this trust is structured may help obtain a favorable result.

Finally, the remainder of the surviving spouse's share (if any) will be used to fund **Q-TIP Trust B**, under which the surviving spouse will be at least an income beneficiary. We believe that there is a good chance that these assets will also get a basis step-up if the surviving spouse retains only the right to receive income; again we think more rights for the surviving spouse will somewhat lessen the chance of that result.

The tax and other issues raised by this technique are further discussed below.

COMMENT:

Over the last 20 years, the IRS has issued five significant rulings touching on joint trust arrangements, three private letter rulings and a TAM.²⁹⁷

The first was TAM 9308002, which was issued in 1992. The facts indicated that both spouses funded a joint revocable trust, which granted each spouse a general power of appointment over the entire trust in the form of a right to direct payment of his or her debts and taxes from any of the trust assets. The IRS determined that all trust assets were included in the first dying spouse's estate under IRC Section 2041. However, the IRS ruled that assets contributed by the surviving spouse were in effect gifted to the first dying spouse upon the spouse's death; since those assets passed back to the surviving spouse within one year, those assets could not receive a basis step-up because of IRC Section 1014(e).

PLRs 200101021 and 200210051 addressed the same issues. In both PLRs, married couples formed joint revocable trusts. In one ruling, each spouse had a lifetime power to withdraw the income and principal; in the other, the first-to-die spouse was given a testamentary general power of appointment over the entire trust. In both rulings, upon the first spouse's death, the assets of the joint trust were used first to fund a credit shelter trust (in the amount of the first dying spouse's unused exemption) for the surviving spouse's benefit. Both PLRs made the following determinations:

- All of the joint trust assets were included in the first dying spouse's estate. The assets contributed by the first dying spouse were included under IRC Section 2038; the assets contributed by the surviving spouse were included under IRC Section 2041.
- Upon the death of the first dying spouse, the surviving spouse made a completed gift to the first dying spouse of the assets contributed by the surviving spouse. The gift qualified for the gift tax marital deduction.
- Because of Section 1014(e), only the assets contributed by the first dying spouse could receive a step-up in basis.

PLR 200403094 addressed similar issues in a slightly different context. Rather than a joint trust, the ruling dealt with a revocable trust to be created and funded by a husband. If the wife died first, the trust agreement provided her with a testamentary general power of appointment over trust assets equal in value

²⁹⁷ See PLRs 200101021, 200210051, 200403094, and TAM 9308002.

to her remaining exemption, less her own assets. In that case, the wife will exercise the power by appointing assets to set up a credit shelter trust for the husband's benefit. The IRS ruled as follows:

- 1) The husband's creation of the power of appointment would constitute a gift to the wife which would be considered completed at her death if she died before him. The gift from him would qualify for the gift tax marital deduction.
- 2) If the wife died first, assets contributed by the husband to the trust but appointed by the wife to a credit shelter trust for the husband would not be included in the husband's estate for estate tax purposes at his later death.

No basis issue was discussed.

PLR 201429009, released on July 18, 2014, addresses a husband and wife who created a joint revocable trust and who contributed their joint property to the trust. The trust instrument, however, provided that each of them held their interests in the trust as "tenants in common" and not as joint tenants. After the wife's death, the trustee was to divide the joint trust into a Family Trust and a Survivor's Trust and the husband was to retain the power to withdraw the greater of \$5,000 or 5% of the value of the Family Trust per year (commonly referred to as a "5 and 5" power). When the husband died sometime later, the executors of his estate requested that the Family Trust not be included in the estate. The IRS determined that the property and assets in the trust that were able to be "identified as specifically attributable to Wife and allocable to the Family Trust would not be includible in Husband's gross estate, except to the extent of [the] Husband's 5 and 5 power."

These rulings sparked renewed interest in using joint trusts as a way to make sure that both estate tax exemptions of a married couple would be fully used, without having to split up assets and set up a living trust for each spouse. Although no ruling allowed a total basis step-up for the marital property at the first death, there was speculation about weaknesses in the IRS arguments on that point and potential ways to rebut those arguments.

However, some commentators have expressed concern about the favorable results of the rulings, none of which has any value as precedent. The estate tax laws at the time of the rulings did not give a surviving spouse the benefit of any exemption not used by the first spouse to die – i.e., there was no portability. Thus, the commentators pointed out, the IRS was being lenient in these rulings so as to permit a simpler way to achieve basic estate tax savings. But the IRS was not giving the comfort of a Revenue Ruling, which practitioners could rely upon, meaning that it could change its position on some or all of the favorable decisions in the rulings.

After extensively reviewing these issues, we believe that our JEST technique can be used to maximize the use of both spouse's estate tax exemptions, as well as setting up a situation to provide the best possible arguments in favor of getting a total basis step-up on all assets at first death. Nevertheless, because it is an area without binding precedent, any practitioner should carefully consider the concerns that commentators have raised. Where practitioners (or clients) are particularly risk-adverse, thought might be given to getting an IRS ruling.

Using a joint trust arrangement can complicate creditor protection aspects of trusts. Throughout this article we touch on that issue.

Below, we provide an in-depth explanation of the “mechanics” of the JEST and discuss the various issues surrounding this technique.

JEST Creation

In implementing the JEST, the married couple first establishes a joint revocable trust. Each spouse will have a separate share consisting of any assets contributed to the trust by that spouse. To avoid having to retitle assets, pre-existing revocable trusts can become separate shares of the joint revocable trust by amendment and restatement.

The trust agreement will give each spouse an equal share of the trust assets. While both spouses are living, either spouse can revoke the agreement and terminate the trust, in which case the trustee will transfer the trust assets back to the spouses in equal shares.

Unequal funding of the trust raises the possibility of a gift on funding. A spouse who contributes more than 50% of the assets but only has the power to get back 50% in a unilateral termination has presumably made a completed gift of the difference. Transferring property held in a tenancy by the entireties would result in such a gift if, as is generally the case, the tenancy can only be severed by joint action of the parties. The severance occurring when entireties property is added to the trust would be a gift by the younger spouse, who has a greater actuarial interest in the property.²⁹⁸

Estate planning attorney, Michael Mulligan, has suggested that any gift on funding is incomplete until the first death, whether or not a spouse can terminate the trust and take back assets. He states that “[u]nder the laws of most states, the retained right to distributions of income and principal would cause any contribution by a beneficiary to the trust to remain subject to claims of the beneficiary’s creditors. If applicable state law permits a settlor’s creditors to reach property conveyed to a trust, such conveyance does not constitute a gift for Federal gift tax purposes.”²⁹⁹

If a gift on funding does occur, so long as both spouses are U.S. citizens, one might assume that the gift tax marital deduction should eliminate tax concerns (unless a spouse is a non-citizen, where the marital deduction does not apply). This is the position the IRS has taken in the rulings. However, as discussed below, questions have been raised by commentators as to whether the IRS is correct in applying the marital deduction in this situation.

Mr. Mulligan’s comment as to funding touches on another issue. Holding properties in tenancy by the entireties usually provides creditor protection because the properties can only be reached by creditors

²⁹⁸ See IRS Reg. Section 25.2511-2(c). In PLR 200101021, the IRS held that the contribution of tenants by the entireties assets to a joint trust did not constitute a gift by either spouse under this regulation, because each spouse retained the right, acting unilaterally, to revoke his or her transfer and revest title in himself or herself, rendering the gift incomplete. Much as we like the result, we think it ignores the actuarial difference between the interests of the spouses.

²⁹⁹ Michael D. Mulligan, Is It Safe to Use a Power of Appointment in Predeceasing Spouse to Avoid Wasting Applicable Exclusion Amount? 23 Tax Mgmt. Fin. Plan. J (Sept. 18, 2007).

with a claim against both spouses. Tenancy by the entireties property transferred into a joint trust will lose the entireties status and this creditor protection unless (1) the joint trust satisfies all unities required by tenancy by the entireties law (which will not be the case with a JEST), or (2) the governing law explicitly provides that trust assets can be designated by a married couple to be treated as tenancy by the entireties property, even if the unities are not satisfied. Delaware, Virginia, Hawaii and Illinois are examples of jurisdictions having such statutes.

When the First Death Occurs

Upon the first dying spouse's death, the joint trust becomes irrevocable. The trust assets are still in two equal shares – one attributable to the first dying spouse, and one attributable to the surviving spouse. We will assume that the first dying spouse has not exercised his or her general power of appointment.

Assets of the first dying spouse's share equal in value to the first dying spouse's unused estate tax exemption will be used to fund **Credit Shelter Trust A** for the benefit of the surviving spouse and descendants (or surviving spouse, then descendants). If the first dying spouse's share exceeds his or her unused exemption, then the excess amount can be used to fund **Q-TIP Trust A** for the lifetime benefit of the surviving spouse, and later for the couple's descendants.

All of these assets receive a stepped-up basis at the first death, unless they were gifted to the first dying spouse by the surviving spouse within a year before the first dying spouse's death, when IRC Section 1014(e) denies the step-up.

Turning to the surviving spouse's share, if the first dying spouse's share is less than the first dying spouse's exemption amount, then the surviving spouse's share is used in **Credit Shelter Trust B**. Like **Credit Shelter Trust A**, this can be for the benefit of the surviving spouse and descendants (or the surviving spouse, then descendants), although including the spouse as a beneficiary may imperil getting a basis step-up for these assets at the first death.

If there are assets remaining in the surviving spouse's share after fully funding **Credit Shelter Trust B**, the remainder of the surviving spouse's assets will be used to fund **Q-TIP Trust B**, with the surviving spouse as lifetime beneficiary and the descendants as remainder beneficiaries. Again, the extent of the surviving spouse's interest may affect the basis argument.

The results of this technique are as follows:

Credit Shelter Trust A.

The assets of **Credit Shelter Trust A** will be treated as coming from the first dying spouse. They will be included in the first dying spouse's gross estate for estate tax purposes pursuant to IRC Section 2038, because of the first dying spouse's lifetime right to revoke the trust and receive back these assets. These assets are sheltered from estate tax liability at the first death by the first dying spouse's estate tax exemption.

Unless the Section 1014(e) one year rule applies, the inclusion of these assets in the first dying spouse's gross estate will provide a stepped-up basis.³⁰⁰

A spendthrift provision in **Credit Shelter Trust A** will provide creditor protection to the surviving spouse because the first dying spouse (rather than the surviving spouse) will be deemed the grantor/transferor of the trust. Increased creditor protection could be provided by limiting the surviving spouse to distributions in the discretion of the trustee according to an "ascertainable standard," such as distributions for health, support, maintenance, and education. In most jurisdictions, limiting discretionary distributions to the surviving spouse by such a standard prevents creditors of the surviving spouse from being able to reach the trust assets or demand trust distributions.

Q-TIP Trust A.

Similarly, the assets of **Q-TIP Trust A** will also be included in the first dying spouse's estate under IRC Section 2038. They will avoid estate tax at that time because of the estate tax marital deduction. These assets will receive a stepped-up basis on the first dying spouse's death unless Section 1014(e) applies. Since the assets remaining at the surviving spouse's death will be includable in the surviving spouse's estate under Section 2044, those assets will receive another basis step-up then.

Even with a spendthrift provision, **Q-TIP Trust A** cannot provide total creditor protection for the surviving spouse because qualifying for the marital deduction requires that all trust income be paid to that spouse. Creditors will be able to reach the income distributions after they are received by the spouse. However, the principal can be further protected by making principal distributions discretionary and limited by an ascertainable standard.

The trustee can potentially minimize or eliminate the surviving spouse's income exposure by investing in low or zero dividend stocks or other cash neutral investments. Of course, this will require implicit consent of the surviving spouse because of the surviving spouse's right to have marital trust assets be productive.³⁰¹

Credit Shelter Trust B and Q-TIP Trust B.

Let's look at how the first death affects the surviving spouse's share of the JEST.

Issue 1: Estate Tax on Credit Shelter Trust B

Credit Shelter Trust B is designed to use up the first dying spouse's estate tax exemption if the first dying spouse's share of the trust is smaller than that exemption amount. This requires having assets from the surviving spouse's share go into **Credit Shelter Trust B** after having been includable in the estate of

³⁰⁰ PLRs 20010102 & 200210051; See also Mulligan, *supra* n. iii (stating that "[p]roperty which is contributed by the predeceasing spouse and included in such spouse's estate under §§ 2036 and 2038 rather than § 2041 is unaffected by § 1014(e), and acquires a new income tax basis under § 1014(a)"). Of course, Section 1014(e) could apply if the first dying spouse receives the property from the surviving spouse and dies within a year after contributing it to the trust.

³⁰¹ Treas. Reg. 20.2056(b)-5(f)(5).

the first dying spouse for estate tax purposes, even though these assets are from the surviving spouse's share of the JEST.

By providing the first dying spouse with a testamentary general power of appointment over all of the trust assets, we make the assets of **Credit Shelter Trust B** includable in the first dying spouse's estate under IRC Section 2041, as was the case in most of the rulings.³⁰²

The rulings to date made clear the IRS's view that with proper drafting, **Credit Shelter Trust B** would not be considered as funded by the first dying spouse and would not be includable in the gross estate of the surviving spouse, even if the surviving spouse is a beneficiary of that trust.

Risks: Taxable Gift Treatment on Funding of Credit Shelter Trust B and Inclusion in Surviving Spouse's Estate

The IRS rulings are promising, but they are not binding on the Service and cannot be cited as precedent. It is certainly possible for the IRS to come to different conclusions in the future.

One concern expressed by Mr. Mulligan is that Section 2041 may not apply to the joint trust assets because the first dying spouse's power of appointment is effectively contingent upon the surviving spouse's failure to withdraw his or her share of the trust assets before the first death. His fear is that the contingency may turn the testamentary power of appointment into a power only exercisable in conjunction with the creator of the power – something which is not considered a general power of appointment under IRC Section 2041(b)(1)(C)(i).³⁰³

That would mean that assets of the surviving spouse's share could not be applied to use up the first dying spouse's exemption if the first dying spouse's share is insufficient. It opens the door to an argument that the assets in **Credit Shelter Trust B** are includable in the gross estate of the surviving spouse under IRC Sections 2036 and 2038.

According to Mr. Mulligan, the Service could reach the same result by a "conduit" or "step transaction" argument by looking at the entire transaction as one in which the surviving spouse is viewed as the actual contributor of the assets of **Credit Shelter Trust B**, again triggering Sections 2036 and 2038 rather than Section 2041. He cites several cases in which, for example, one party who transferred assets to a second party is deemed to be the actual grantor of a trust created by the second party with those assets.³⁰⁴

³⁰² The same conclusion was reached in PLR 200210051, where each spouse had the power to withdraw all of the trust assets while both were living. We do not recommend that approach because it would most likely subject all of the trust assets to creditor claims against either spouse prior to the first death. Otherwise, claims against one spouse should only imperil that spouse's share of the trust.

³⁰³ Mulligan, *supra* n. 3.

³⁰⁴ Footnote 14 of Mr. Mulligan's article supports this concept by citing the cases of *Mahoney v. U.S.*, 831 F. 2d 641 (6th Cir. 1987); *Marshall Estate v. Commissioner*, 51 T.C. 696 (1969); *Sinclair Estate v. Commissioner*, 13 T.C. 742 (1949); and *Schwartz Estate v. Commissioner*, 9 T.C. 229 (1947). In each of these cases, the IRS successfully showed that trust assets were included in the beneficiary's estate, even though the beneficiary did not directly contribute the assets to the trust. In *Mahoney*, a father created a trust for his son's benefit and funded it with stock. The son then executed a promissory note to his father in an amount equal to the stock's value. The son died and the IRS concluded that the trust assets were included in the son's estate because

In the end, however, Mr. Mulligan points out that the lifetime Q-TIP rules justify ignoring these arguments where spouses are involved. Spouse A can set up a lifetime Q-TIP for Spouse B with Spouse A's assets; the trust can benefit Spouse A after the death of Spouse B; but Sections 2036 and 2038 do not bring the assets back into Spouse A's estate. Apparently inclusion in the estate of Spouse B under Section 2044 "cleanses" the trust assets, so that Spouse B is considered to be the source of them. Mr. Mulligan sees no reason why the same concept should not apply in the joint trust arena.

In their 2008 article, Mitchell Gans, Jonathan Blattmachr and Austin Bramwell share Mr. Mulligan's concern about the step transaction doctrine. They fear that the IRS could determine that the surviving spouse is the transferor of the Credit Shelter Trust B assets, causing inclusion under Sections 2036 (if the surviving spouse had the right to receive income from **Credit Shelter Trust B**) or 2038 (if the surviving spouse has a special power of appointment over the trust). They note that even if the surviving spouse has neither an income interest nor a power of appointment over the trust assets, being merely a discretionary beneficiary, Section 2036 could apply for one of two reasons: (i) the Service could find an "implied understanding" that the surviving spouse would receive distributions from the trust or (ii) the Service could decide that the ability of creditors of the surviving spouse, under state law, to reach assets of the trust because it is considered to be self-settled.³⁰⁵

Some planning may be possible to minimize the risk of estate tax inclusion. Perhaps careful drafting can negate an "implied understanding." Drafting to avoid creditors (such as by setting up **Credit Shelter Trust B** in a jurisdiction which protects self-settled trusts) can be helpful both for tax and non-tax reasons (the non-tax reasons being discussed below).

One could always try to structure the funding of the joint trust to minimize the need for a **Credit Shelter Trust B** created with assets from the surviving spouse. Of course, this eliminates one advantage of joint trust planning, the ability to ensure full use of both spouses' exemptions without having to split assets up or move them around.

In the end, the PLRs and TAM are a weak bulwark against a later IRS attack on these issues unless there are strong reasons for the IRS to continue to support the same reasoning. Messrs. Gans, Blattmachr and Bramwell fear that the reasoning in the rulings could invite abuse by taxpayers seeking to overcome the step transaction doctrine in other contexts. Mr. Mulligan seems to feel that the Q-TIP analogy will continue to support the rulings. Planners forced to confront this issue and seeking certainty may consider getting rulings of their own.

he was the party who in substance transferred assets to the trust by paying consideration to his father at the time the stock was transferred to the trust. Citing to *Marshall*, *Sinclair*, and *Schwartz*, the court concluded "that although [the father] nominally created the Trust, the decedent must be considered the effective grantor of the Trust to the extent of his contribution." a trust created by the second party with those assets. In *Sinclair*, the decedent transferred assets to her father, and her father funded a trust for the decedent using those assets before her death. The Tax Court found that the trust assets were included in the decedent's estate, noting that "in substance and reality decedent was the settlor of the trust and that her father acted only as her agent in its creation."

³⁰⁵ Mitchell M. Gans, Jonathan G. Blattmachr & Austin Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?* 42 Real Prop. Prob. & Tr. J. 413, 422 et. Seq. (2007-2008).

Two alternative questions can be asked:

- 1) Does inclusion of **Credit Shelter Trust B** in the surviving spouse's estate cause a significant problem? If the alternative to a joint trust arrangement would not result in full use of both exemptions anyway, then what is the harm if that aspect of the joint trust arrangement doesn't work?
- 2) Is there a way to minimize the harm caused by inclusion?

On the second point, consider the result if **Credit Shelter Trust B** is structured as a defective grantor trust with the surviving spouse as grantor. This might be done by giving the surviving spouse the power to replace Credit Shelter Trust B assets with assets of equal value. The surviving spouse would owe income taxes for trust income left in the trust or distributed to other beneficiaries, and the tax payments would reduce her taxable estate without being considered gifts.

For example, if **Credit Shelter Trust B** is funded with \$2 million worth of assets and the surviving spouse has a \$5.25 million estate tax exemption, it would seem that, at worst, the surviving spouse would have been deemed to have made a \$2 million gift to the trust. If the trust is moved to an asset protection jurisdiction and the spouse does not have a power of appointment over trust assets, all growth in the trust that occurs during the surviving spouse's remaining lifetime can escape federal estate tax, notwithstanding that the trustee may have discretion to make distributions to the surviving spouse.

Issue 2: Creditor Protection

Risk: No Creditor Protection from the Surviving Spouse's Creditors

Where an individual transfers assets to a trust for his or her own benefit, the British common law (and most states which follow it) allows the individual's creditors to reach those assets. Just as there is a risk that the surviving spouse may be considered to have transferred assets to the trust for estate tax purposes, there is a risk that the surviving spouse could be considered the transferor of the assets for creditor purposes. This could allow creditors of the surviving spouse to reach the assets of **Credit Shelter Trust B** if the surviving spouse is the beneficiary.

Note that the two issues would arise in different contexts, probably in different legal jurisdictions, and the decisions might not be consistent. Depending on the outcome, the estate tax could take part of **Credit Shelter Trust B** on the surviving spouse's death, but even worse, creditors could take all of the assets.

The best way to minimize the risk of actual creditors would be to situate **the Credit Shelter Trust B** in an "asset protection trust jurisdiction" such as Nevada, Alaska, Delaware, or Nevis, where creditor protection is available for self-settled trusts.

An alternative that could help for creditor protection purposes, but not federal estate tax purposes, would be to have the trustee invest in a family LLC or limited partnership to obtain charging order protection so that creditors of the surviving spouse would have a more difficult time obtaining assets from **Credit Shelter Trust B**. But, just as an IRS determination does not apply to creditors, taking actions which as a

practical matter deter creditors by using LLC and limited partnership structures does not prevent the IRS from concluding that creditors of the surviving spouse can reach into Credit Shelter Trust B, and thereby cause its assets to be considered as owned by the surviving spouse for estate tax purposes.

Issue 3: Marital Deduction

Risk: The Gift May Not Qualify for the Marital Deduction.

Under our proposed JEST, gift tax consequences may arise at two points in the life of the trust.

First, because each spouse will have individual rights, while both spouses are alive, to terminate the trust and receive back half of the assets, a gift would occur upon funding the trust if the spouses do not contribute equal amounts or, in most cases, if the spouses contribute property held as tenants by the entireties. Unless the recipient spouse is not a citizen, the gift tax marital deduction should eliminate any gift tax consequences.

Second, in the rulings, the IRS concluded that upon the first spouse's death, the surviving spouse would make a completed gift to the deceased spouse of the assets that the surviving spouse contributed to the joint trust.³⁰⁶ This is because as of the first death, the surviving spouse relinquishes dominion and control over those assets, either by losing the power to revoke those assets or because the assets are subject to the first dying spouse's testamentary general power of appointment (or, under our suggested arrangement, for both reasons). The rulings go on to conclude that this completed gift by the surviving spouse would qualify for the estate tax marital deduction (assuming the first deceased spouse was a citizen).

Common sense suggests that the IRS is correct on the marital deduction issue. Of course, common sense is not always a reliable guide to the workings of the tax laws. While the IRS rulings don't go into detail on the marital deduction question, the Service must have reached two conclusions:

- 1) That the gift occurred at a time when the spouses were married, and
- 2) That the gift did not involve a non-deductible terminable interest.

Reminding us again that this determination has been made in non-binding rulings, the commentators have suggested that these are conclusions the IRS may later abandon.³⁰⁷

They point out that whether the gift was made when the spouses were married turns on exactly when it was made. If it was considered made after the moment of death, the parties were not then married, and the marital deduction would not apply. If it was considered made before or at the moment of death, then the first requirement of the deduction is met.

³⁰⁶ See PLRs 200101021, 200210051 & 200403094.

³⁰⁷ Mulligan at 9 et seq.; Mitchell M. Gans, Jonathan G. Blattmachr & Austin Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?* 42 Real Prop. Prob. & Tr. J. 413, 422 et seq. (2007-2008).

Messrs. Blattmachr, Gans and Bramwell take comfort from the authorities dealing with the death of spouses in common disasters.³⁰⁸ There it has been held that a gift occurs at the moment of death, rather than after death. These commentators opine that “no policy justification exists for refusing to extend this rationale to the [joint trust] strategy.”³⁰⁹

Blattmachr, Gans and Bramwell also bring up the Ninth Circuit Court of Appeal’s 1935 decision in *Johnstone v. Commissioner*,³¹⁰ in which the court suggested that a transfer occurs the moment before death rather than after death. However, their discussion reveals that later cases have cited *Johnstone*, with the result not always being consistent. On the other hand, *Johnstone* did not involve spouses, while the simultaneous death authorities do. We believe that practitioners can be fairly confident that the gift at death will be deemed to be made during the marriage.

The terminable interest issue is more problematic. The facts in the rulings show no outright gifts or Q-TIP election. The question is whether the surviving spouse receives enough rights in the gifted property to satisfy IRC Section 2523(e): a right to receive lifetime income and a general power of appointment over the applicable interest.

In PLR 200210051, each spouse had the right to demand distributions of income and principal while both were living, effectively having a lifetime general power of appointment. In the others, the first spouse to die received only a testamentary general power of appointment with no particular income rights. Under the rulings, the IRS allows a marital deduction, but there is no discussion of the terminable interest issue.

To Blattmachr, Gans and Bramwell, getting the marital deduction would seem to require relying on case law allowing a marital deduction where a spouse may elect whether to accept a gift and does accept it.³¹¹ Finding acceptance here would seem to require that the surviving spouse exercise a testamentary power of appointment. One ruling did involve the exercise of the power; the rest did not. And, these commentators feel that even exercise may not be enough, since the relevant cases all involve spouses who personally accept outright gifts, not just spouses who receive a power of appointment.

Clearly, we hope that the IRS will not change its position on the marital deduction issue and will eventually issue a definitive ruling. In the meantime, short of requesting a ruling for each joint trust we prepare, how can we increase our chances of avoiding a marital deduction problem on **Q-TIP TRUST B**?

Certainly, there is no harm in using language so closely identified with the marital deduction that the Service may grant the deduction without giving the subject much thought. As an example, one of the rulings made the first deceased spouse’s testamentary general power of appointment “exercisable alone and in all events.” This language added nothing, but it does scream out, “marital deduction”!

More substantively useful may be the inclusion of a joint trust provision allowing both spouses to withdraw principal from the trust while both are living, as found in PLR 200210051, which could help bring

³⁰⁸ *Id.* at 422-430.

³⁰⁹ *Id.* at 424.

³¹⁰ 76 F.2d 55 (9th Cir. 1935).

³¹¹ Gans, Blattmachr & Bramwell at 429.

the gift within the statutory requirements of Section 2523(e).³¹² Having **Credit Shelter Trust B** set up and funded by exercise of the testamentary power of appointment should improve the odds of coming within the case law on gifts made by election.

If all else fails, a savings clause in the trust agreement could provide that should the gift tax marital deduction not apply, **Credit Shelter Trust B** would be funded only to the extent of the surviving spouse's estate tax exemption (or to an amount slightly less than the surviving spouse's exemption to permit future gifting and a cushion for valuation issues that could apply in later years). That way the surviving spouse could avoid a gift tax on assets going into that trust at the first death. So long as the terms of **Credit Shelter Trust B** don't subject the remaining assets to estate tax at the second death, the parties should be no worse off than if they had not tried to use a joint trust to protect both exemptions. Of course, description of the contingency could alert the Service to the marital deduction issue if it is not otherwise aware of it.

Stepped-Up Basis

In its rulings, the IRS has denied that the assets of the surviving spouse's share of the joint trust will get an IRC Section 1014(a) basis step-up in non-community property jurisdictions at the first death, even though the assets are includable in the gross estate of the first dying spouse.

We believe the IRS is wrong. We believe that a basis step-up should be available. The risk to practitioners would seem minimal, since it is confined to not getting a step-up which would not have been otherwise available for clients not living in community property states. Although we expect the Service to continue to contest the issue, we also think there are ways to significantly increase the chances of a successful outcome.

In the rulings, the IRS denied a step-up to assets which, prior to the first death, were in the surviving spouse's share of the trust. The IRS asserted that the step-up was prohibited by IRC Section 1014(e).

Section 1014 generally provides that the basis of property in the hands of a person acquiring the property from a decedent, or to whom the property passed from a decedent, is the fair market value of the property at the date of the decedent's death. However, Section 1014(e) provides the following exception to this rule:

If appreciated property was acquired by the decedent by gift during the one-year period ending on the date of the decedent's death, and the property is acquired from the decedent by, or passes from the decedent to, the donor of such property, the basis of such property in the hands of the donor is the adjusted basis of the property in the hands of the decedent immediately before the death of the decedent.³¹³ [Emphasis added.]

For Section 1014(e) to apply, the property must be "acquired by" or "pass to" the original contributor of such property – in this case the surviving spouse. How does this language apply when the property does

³¹² Each spouse would seem to have a lifetime general power of appointment, which eliminates the need for income payments to qualify for the marital deduction. See Treas. Reg. Section 25.2523(e)-1(f)(6). (Whether each spouse is comfortable with the other spouse having such a power is another question.)

³¹³ PLR 200101021 (p. 4), PLR 200210051 (p. 4).

not pass directly to the surviving spouse, but instead passes to a trust for the benefit of the surviving spouse? The Service thinks it does, but does not have an explanation. We share the belief of many others that the Service has stretched the literal language of the law in so concluding. To us, “acquired by” or “pass to” should apply only if full ownership is transferred back to the surviving spouse.

Assets originating with the surviving spouse will wind up in Credit Shelter Trust B or Q-TIP Trust B. The less interest the surviving spouse has in these trusts, the easier it is to argue that Section 1014(3) should not bar a step-up.

For example, we think it is clear that a step-up should be allowed if the surviving spouse is not a beneficiary of the Credit Shelter Trust B. of course, economic considerations may require that the surviving spouse be a beneficiary. Some planners have asserted that Section 1014(e) should not apply if the surviving spouse is only a discretionary beneficiary. There have not been any ruling or cases that explicitly confirm this conclusion, but it’s difficult to say that property “passed to” or was “acquired by” a discretionary beneficiary, who by definition has no certain rights to the property.

The requirements of the estate tax marital deduction require that the surviving spouse be an income beneficiary of Q-TIP Trust B. Again, we and others feel that should not bar a step-up; nor should the right to receive principal in the discretion of the trustee, or a special power of appointment. But, the fewer rights the surviving spouse has, the better the argument for a step-up may be.

Conclusion:

The JEST technique eliminates many of the concerns that have prevented estate planners in non-community property states from using joint trusts in the manner approved by the IRS in PLR’s 200101021 and 200210051. Although not without risk or some uncertainties clients who want a stepped up basis for all “joint” assets, and to maximize use of credit shelter trust funding on the first death, should be offered this strategy. While the risks herein described do exist, there is also the risk that the family will ask the planner why these techniques were not used to avoid capital gains taxes and facilitate making full use of the first dying spouse’s estate tax exemption amount.

Practitioners will have to invest significant time to understand issues, to develop trust documents that take the above and many other considerations into account, and make sure that clients understand the risks and possible advantages of the system. We hope that every law firm reading this article implements at least 23.8 JESTs this year, and we are not jesting!

CAN A THREE-WAY ACCOUNT BE TENANTS BY THE ENTIRETIES AS TO MARRIED PARTIES?

Not according to *In re Planas*,³¹⁴ where putting the mother-in-law on a joint account with a married couple, among other things, caused the loss of assets otherwise asserted to be protected as tenants by the entireties. The court stated that the mother-in-law’s power to “individually alienate the assets” of the account “is inconsistent with the essential unity of possession, or control.”

³¹⁴ 199 B.R. 211 (Bankr. S.D. Fla. 1996).

Deeds are commonly used to transfer property to a surviving spouse and one or more other individuals with “right of survivorship.” In such circumstances, it may not be clear whether the spouses inherit only from each other, or whether they also inherit from the third person. It is also unclear whether the third person will inherit a share from a spouse.

TENANCY BY THE ENTIRETIES PROPERTY CAN BE FREELY TRANSFERRED TO A NON-DEBTOR SPOUSE.

In *In re Blatstein*,³¹⁵ the Third Circuit Court of Appeals held that a transfer from tenants by the entireties to the non-debtor spouse will not be considered a fraudulent transfer as to the creditors of the debtor spouse. **NOTE** – Transfers of homestead between spouses may implicate the 1,215-day waiting period under the Bankruptcy Code.

TRANSFERS TO NON-RESIDENT ALIEN SPOUSES.

A U.S. citizen/resident may incur gift tax liability if transfers to tenancy by the entireties with a non-citizen spouse exceed a total gift transfer value of \$308,000 per year. (For 2021, the annual gift limit is \$159,000, unless the account is of such a nature that the donor has the right to withdraw all assets without permission of the non-citizen spouse, even if the spouse is a green card holder!) Because only a half interest in property is deemed to be transferred where a spouse transfers solely owned property to tenants by the entireties with his or her spouse, a transfer of property worth \$308,000 corresponds to a taxable gift of \$159,000. However, not needing permission to withdraw the assets would vitiate tenancy by the entireties status, so basically only \$308,000 per year in wealth generated by or owned by one spouse can be transferred without U.S. gift tax implications under tenancy by the entireties. The above amounts apply in 2021 and are adjusted annually for inflation.

Under Treasury Regulation Section 25.2511-1(h)(4), the creation and funding of a joint bank account is generally treated as an incomplete gift for gift tax purposes when both spouses retain the right to unilaterally withdraw funds without the consent of the other spouse.

FRAUDULENT TRANSFERS AND USING MONEY BORROWED ON TENANCY BY THE ENTIRETIES PROPERTY TO PURCHASE OR PAY DOWN DEBT ON OTHER TENANCY BY THE ENTIRETIES PROPERTY.

In the case of *In re Mathews*,³¹⁶ Judge Funk found that borrowing monies on tenancy by the entireties property and using such funds to purchase other tenancy by the entireties property is not a fraudulent transfer. In this case, the actual loan documents and closing statement showed the husband-debtor as the sole borrower, but the wife did sign the mortgage document, and the husband and wife owned the mortgaged property as tenants by the entireties. The debtor used the money to buy two properties as tenants by the entireties with his wife. The properties purchased were owned by BMC, the corporation that the debtor was president of since the inception of the business. The Trustee argued that if the debtor had not transferred

³¹⁵ 192 F.3d 88 (3rd Cir. 1999).

³¹⁶ 360 B.R. 732 (Bankr. M.D. Fla. 2007) (reversed on other grounds).

the properties, then they would have been subject to execution by the creditors of BMC and the debtor. The Trustee argued that the transfer was fraudulent and sought to avoid it.

The court found that irrespective of the statutes at hand, the properties involved were mortgaged by exempt tenants by the entirety property. A transfer of exempt property (or the loan proceeds thereof) to other exempt property is not a fraudulent transfer. Additionally, even if the transfers were not from exempt to exempt, the Trustee failed to prove that the transfers were fraudulent by a preponderance of the evidence. The court found that the Trustee did not establish that BMC was insolvent at the time of the transfer, that the purchase price was inadequate, or that the monies paid to BMC for the properties ended up in the debtor's pocket. Therefore, the two properties were not acquired via fraudulent transfer and were exempt as tenants by the entirety.

In addition to using the loan proceeds to purchase the two properties, the debtor also used the proceeds to pay off the mortgage on homestead property. The Trustee attempted to argue that the loan proceeds were not held as tenants by the entirety because only the debtor signed the promissory note and loan statement, and the checks were made payable to the debtor only. The court disagreed and found that the property pledged as collateral was owned as tenants by the entirety, and the fact that the debtor alone signed the documents did not make the loan proceeds non-exempt. The loan proceeds were deposited into a joint checking account and used to pay off or acquire other tenants by the entirety property and the transactions did not trigger Bankruptcy Code § 522(o).

While exempt assets may be used to purchase other exempt assets or pay down the indebtedness associated therewith, the use of exempt assets to pay a creditor within 90 days of filing bankruptcy will be considered a preferential payment that may be avoided by the Trustee in bankruptcy.³¹⁷

It is also important to note that the Florida Supreme Court has found that proceeds from the sale of a homestead will only be protected if they are invested in another homestead.³¹⁸ Therefore, there is a risk that a Floridian who sells his or her protected homestead and places the proceeds into an exempt asset could be considered to have made a fraudulent transfer into the exempt asset if it can be shown that he or she had the requisite intent to avoid creditors.

WAIT A MINUTE – IS THIS COMMUNITY PROPERTY?

In states that recognize community property, such as California, the normal rule is that all property acquired during the marriage is community property.³¹⁹ The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Unlike property held as tenants by the entirety, community property is subject to liability for the debts of either spouse. Couples who move to Florida with community property assets may be surprised to later find that those assets were not successfully converted into tenancy by the entirety property pursuant to the law of the community property state where the ownership originated.

³¹⁷ See *Tavener v. Smoot*, 257 F.3d 401, 406 (5th Cir. 2001).

³¹⁸ *Orange Brevard Plumbing & Heating Co. v. La Croix*, 137 So. 2d 201 (Fla. 1962).

³¹⁹ See e.g. Cal. Family Code § 760.

CALIFORNIA RULES:

There are two ways to overcome the classification of community property. According to a 2002 bankruptcy case applying California law, *In re Summers*,³²⁰ spouses can indicate their intent with respect to the character of the property (a) initially by specifying the form of title in which it is held or (b) later by “transmuting” the character of the property by taking appropriate steps.

Therefore, in order to overcome the presumption of community property and take advantage of the creditor protection of tenancy by the entirety property, spouses should be sure to title bank accounts and other property initially as tenancy by the entirety. If spouses did not do this initially, in California at least, this can be remedied by executing a postnuptial transmutation agreement.³²¹ Notwithstanding the above, transmutations can be subject to fraudulent transfer rules.³²²

California case law indicates that any transmutation must be clearly expressed in writing for most categories of assets, and must apply across the board for all purposes. For example, a transmutation agreement which indicates that all community property assets owned by one spouse will be considered non-community property.

NEVADA RULES:

In order to effectively transmute property in Nevada, spouses must do so explicitly in a properly recorded and memorialized writing which contains clear language indicating a right of survivorship.

When initially acquiring property, spouses may “opt out” of Nevada’s statutory community property scheme by written agreement to create a joint tenancy or a tenancy in common in that property.³²³ Pursuant to Nevada Statutes 123.280, 123.290, and 123.300, such an agreement is not effective against third-party creditors unless the agreement is properly recorded.³²⁴ For example, a valid deed showing that a title to real property is held in joint tenancy is a properly recorded memorialized agreement sufficient to overcome the presumption of community property.³²⁵ However, a joint bank account that is absent of written language creating a right to survivorship will not suffice to establish a joint tenancy under the Nevada statutes.³²⁶

Pursuant to Nevada Statutes 111.064 and 111.065, spouses may transmute community property into a tenancy in common or joint tenancy at any time. In order to properly reclassify the character of that property, spouses must do so in writing, and that writing must contain language creating a right of survivorship.³²⁷ The Nevada Supreme Court in *McKissick* found that a bank deposit issued in the name of “husband and/or wife” did not create a joint tenancy in the bank deposit between the spouses because there

³²⁰ E.g. Cal. Family Code § 910(a).

³²¹ See Cal. Family Code § 850-853 and Fla. Stat. § 732.225.

³²² Cal. Family Code § 851.

³²³ *Hardy v. U.S.*, 918 F. Supp. 312, 317 (D. Nev. 1996) (citing Nev. Rev. Stat. § 123.220 (1997)).

³²⁴ *Jansen v. U.S.*, CV-S-90-253-RDF (RJJ), 1992 WL 121368 at *2 (D. Nev. Feb. 4, 1992).

³²⁵ *Forrest v. Forrest*, 668 P.3d 275, 277 (Nev. 1983).

³²⁶ *Starr v. Rousselet*, 110 Nev. 706, 712 (Nev. 1994).

³²⁷ *McKissick v. McKissick*, 93 Nev. 139, 146 (Nev. 1977).

was no writing that contained a right of survivorship.³²⁸ Parol evidence is not admissible to prove the existence of a joint tenancy, although it may be admissible to prove the non-existence of one.³²⁹

Spouses can also transmute community property into separate property by gift inter vivos as long as that property is not subject to creditors.³³⁰ In other words, a spouse can just give the other spouse his or her half of the community property, but such a transmutation must be of a clear and convincing character to stand up in court.³³¹ The Nevada Supreme Court in *Milisich* ruled that there was sufficient evidence showing that an effective transmutation when a husband gave his wife community funds that she placed in bank accounts that were under her exclusive dominion and control.³³² Another way that spouses can transmute community property into separate property via gifts is by agreeing in writing to retain their respective earnings as separate property.³³³

Spouses can constructively transmute community property into separate property by naming the other spouse as a *sole* beneficiary of a life insurance policy.³³⁴ In *Peters*, the Supreme Court of Nevada held that “[w]hen one spouse is named the beneficiary in the life insurance policy of the other spouse, and remains so at the time of the insured’s death, all proceeds vest at that moment in the surviving spouse as separate property, even though the premiums had been paid with community funds.”³³⁵

TEXAS RULES:

In Texas, it is accepted that when a husband and wife explicitly demonstrate their desire to create a joint tenancy with right of survivorship (or tenancy by the entireties), and do so in writing, that desire will be upheld, as stated in *Shroff v. Deaton*.³³⁶ In *Shroff*, the husband and wife held a joint bank account comprised primarily of community funds. However, because they made a clear and explicit contract creating a joint tenancy with right of survivorship and there was no evidence of fraud or undue influence, the court upheld the principle that this contract should take effect notwithstanding a Texas statute stating that where a joint owner of property dies, his interest descends to his lawful heirs.

It is important to note that in Texas unlike in California, there is significant debate over whether parol evidence may be used to determine the intent of a husband and wife to create a tenancy by the entireties.³³⁷ Thus, if a couple intends to create a joint tenancy with right of survivorship or tenancy by the entireties, they should ensure the effectiveness of their transmutation with a clear and explicit contract stating their intent.

³²⁸ *Id.* at 145-146.

³²⁹ *Starr*, 877 P.2d at 529.

³³⁰ *Stockgrowers’ & Ranchers’ Bank of Reno v. Milisich*, 283 P. 913 (Nev. 1930).

³³¹ *Id.* at 914.

³³² *Id.* at 915.

³³³ *Hardy*, 918 F. Supp. At 317 (citing Nev. Rev. Stat §§ 123.220, 123.190).

³³⁴ *Peters v. Peters* 557 P.2d 713, 716-717 (Nev. 1976).

³³⁵ *Id.*

³³⁶ 220 S.W. 2d 489 (Tex. Civ. App. 1949).

³³⁷ *Belkin v. Ray*, 176 S.W. 2d 162 (Tex. 1943).

Furthermore, a husband and wife's agreement to convert community property into separate property is ineffective when dealing with property that has not yet come into existence, or which has not yet been acquired.³³⁸ As a result, transmutations of property from community property into joint tenancies with right of survivorship or tenancies by the entireties are allowed and valid in Texas, provided two requirements are met: (1) the property being transmuted is in existence and possessed by the spouses at the time of the conversion; and (2) there is clear evidence of the spouses' intent to transmute the property preferably in an explicit written contract.

In other community property states, however, it may be even more difficult to overcome the classification of community property. For example, in Louisiana, spouses may enter into a matrimonial agreement which modifies or terminates their community property interest. But after the first year of moving to Louisiana, this may be done "only upon joint petition and a finding by the court that this serves their best interests and that they understand the governing principles and rules."³³⁹

WISCONSIN RULES:

Wisconsin also allows creditors to pursue community property where only one spouse owes the creditor if the obligation arose during the marriage. Wisconsin Statute Section 766.31 provides for classification of property as follows:

(10) Reclassification. Spouses may reclassify their property by gift, conveyance, as defined in s. 706.01(4), signed by both spouses, marital property agreement, written consent under s. 766.61(3)(e) or unilateral statement under s. 766.59 and, if the property is a security, as defined in s. 705.21(11), by an instrument, signed by both spouses, which conveys an interest in the security. If a spouse gives property to the other spouse and intends at the time the gift is made that the property be the individual property of the donee spouse, the income from the property is the individual property of the donee spouse unless a contrary intent of the donor spouse regarding the classification of income is established.

As a Gift or Conveyance: 706.01(4) . . . satisfies requirements of 706.02:

- 1) Transactions under s. 706.001(1) shall not be valid unless evidenced by a conveyance that satisfies all of the following:
 - a. Identifies the parties; and
 - b. Identifies the land; and

³³⁸ *Chandler v. Alamo Mfg. Co.*, 140 S.W. 2d 918 (Tex. Civ. App. Austin 1940) (finding the agreement between spouses that all income from rental property would be separately held was invalid because they did not possess the income at the time the agreement was constructed); *Davis v. Davis*, 108 S.W. 2d 681 (Tex. Civ. App. Fort Worth 1937) (holding that a husband and wife's agreement to place wife's personal earnings in a separate account was ineffective for removing community property status).

³³⁹ See Louisiana Civil Code Article 2329.

- c. Identifies the interest conveyed, and any material term, condition, reservation, exception or contingency upon which the interest is to arise, continue or be extinguished, limited or encumbered; and
- d. Is signed by or on behalf of each of the grantors; and
- e. Is signed by or on behalf of all parties, if a lease or contract to convey; and
- f. Is signed, or joined in by separate conveyance, by or on behalf of each spouse, if the conveyance alienates any interest of a married person in a homestead under s. 706.01(7) except conveyances between spouses, but on a purchase money mortgage pledging that property as security only the purchaser need sign the mortgage; and
- g. Is delivered. Except under s. 706.09, a conveyance delivered upon a parol limitation or condition shall be subject thereto only if the issue arises in an action or proceeding commenced within 5 years following the date of such conditional delivery; however, when death or survival of a grantor is made such a limiting or conditioning circumstance, the conveyance shall be subject thereto only if the issue arises in an action or proceeding commenced within such 5-year period and commenced prior to such death.

2) A conveyance may satisfy any of the foregoing requirements of this section:

- a. By specific reference, in a writing signed as required, to extrinsic writings in existence when the conveyance is executed; or
- b. By physical annexation of several writings to one another, with the mutual consent of the parties; or
- c. By several writings which show expressly on their faces that they refer to the same transaction, and which the parties have mutually acknowledged by conduct or agreement as evidences of the transaction.

TENANCY BY THE ENTIRETIES ASSET PROTECTION TRUSTS.

Attorney Jonathan Gopman, who is a contributor to this book, led in the process of drafting statutes for Delaware and Nevis which provide that married couples can transfer tenancy by the entireties assets to trusts, and then receive the assets back as tenants by the entireties to provide protection for situations where there would be a creditor having a judgment against one, but not both, spouses.

For example, a married couple consisting of two OB-GYNS who practice together and might both be sued by the same patient would like to maintain tenancy by the entireties protection for the most likely scenario of one of them being sued by a patient, while also having asset protection trust (“APT”) protection in case a common creditor sues both of them.

While we cannot predict what a Florida judge might do if a common creditor has a judgment against both spouses and they have funded an asset protection trust in advance of the problem occurring, it would be helpful to be able to claim tenancy by the entireties protection as to the asset protection trust assets if there is a creditor pursuing only one spouse. Time will tell whether Florida courts will recognize these statutes and the protection of “tenancy by the entireties” in situations where the six traditional unities discussed in Chapter 2, Section B of this book.³⁴⁰

A TAX ADVANTAGED ALTERNATIVE – CONSIDER THE ALASKA OR TENNESSEE COMMUNITY PROPERTY TRUST.

In 1998, Alaska implemented the Alaska Community Property Act, which allows both resident and non-resident married couples to create Alaska Community Property Trusts. The property transferred to the trust will be deemed community property under Alaska law so long as the statutory requirements are met.

There are significant benefits to using an Alaska Community Property Trust, namely that all community property assets will receive a stepped-up basis for federal income tax purposes on the first death, and that the assets should be protected from the spouses’ creditors under Alaska Trust law, as is further discussed in the sections of this book that discuss domestic creditor protection trusts.

According to Jonathan Blattmachr, who helped draft this law, Alaska Community Property Trusts cannot qualify as tenants by the entireties property.³⁴¹ These trusts may, however, provide more significant creditor protection than tenants by the entireties assets because creditors of both spouses should not be able to reach the property under Alaska’s asset protection trust law.

It is also important to note that the conversion of assets from separate to community property will be deemed a gift for tax purposes to the extent that the value of a spouse’s separate property exceeds the value in the community property, subject to complex rules that should be carefully reviewed. However, if both spouses contribute equal amounts of separate property or if the spouses transfer joint property, then there will be no gift tax purposes upon contribution. Even if one spouse is deemed to have made a gift, this gift will likely qualify for the marital tax deduction. Beware of the step transaction doctrine, which can apply when one spouse transfers assets to the other spouse or into joint names, followed by having the other spouse or the spouses jointly transfer those assets to another entity.

³⁴⁰ Jonathan Gopman, Esquire, is the originator of the idea for the statutory tenancy by the entireties trust (commonly referred to as a “STET”, a term he coined) that is set forth in § 3574(f) of Title 12 of Chapter 35 of the Delaware Statutes. This statute was enacted into law in Delaware in July of 2010 and became effective on August 1, 2010. Jonathan’s articles, commentaries and presentations have also served as the impetus for changes to the trust laws of several states. In 2011 and 2012, Jonathan assisted the government of Nevis in revising its trust laws (including the Nevis Rule Against Perpetuities) set forth in the Nevis International Exempt Trust Ordinance by rewriting almost the entire Ordinance. He was the only attorney in the United States selected by the government of Nevis to work and consult on this project. SEE “Nevis Introduces New Asset Protection Trust for Tenancy by the Entirety Property”, Co-Author, 270 Offshore Investment 24, (October, 2016) and LISI Asset Protection Planning Newsletter #297, Co-Author, “Safanda v. Castellano; District Court Tells Bankruptcy Court to Cast-away-no,” (May 26, 2015).

³⁴¹ See Jonathan G. Blattmachr, Howard M. Zaritsky and Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska’s New Community Property Law*, 33 REAL PROPERTY, PROBATE AND TRUST JOURNAL, 4 (1999).

Tennessee passed its Community Property Trust Statute in 2010, which presently reads as follows:

§ 35-17-101. This chapter shall be known as the “Tennessee Community Property Trust Act of 2010”.

§ 35-17-102. As used in this chapter:

(1) "Community property" means property owned by a community property trust during the marriage of the settlor spouses;

(2) "Community property trust" means an express trust that complies with § 35-17-103;

(3) “Decree” means a judgment or other order of a court;

(4) “Dissolution” means either:

(A) Termination of a marriage by a decree of dissolution, divorce, annulment or declaration of invalidity; or

(B) Entry of a decree of legal separation maintenance;

(5) “During marriage” means a period that begins at marriage and ends at dissolution or the death of a spouse;

(6) "Qualified trustee" means either: - 2 - 01326976

(A) A natural person who is a resident of this state; or

(B) A company authorized to act as a fiduciary in this state pursuant to § 45-2-1001; and

(7) “Settlor spouses” means a married couple that establishes a community property trust.

§ 35-17-103. An arrangement is a community property trust if one (1) or both spouses transfer property to a trust, that:

(1) Expressly declares that the trust is a Tennessee community property trust;

(2) Has at least one (1) trustee who is a qualified trustee whose powers include, or are limited to, maintaining records for the trust on an exclusive or a nonexclusive basis and preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. Both spouses, or either spouse, may be a trustee;

(3) Is signed by both spouses; and

(4) Contains the following language in capital letters at the beginning of the trust:

THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE.

§ 35-17-104.

(a) In the agreement establishing a community property trust, spouses may agree on:

(1) The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located;

(2) The management and control of the property transferred to the trust;

(3) The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event;

(4) The choice of law governing the interpretation of the trust; and

(5) Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty.

(b)

(1) Either spouse may amend a community property trust regarding the disposition of that spouse's one-half (1/2) share of the community property in the occurrence of such spouse's death.

(2) Except as provided in subdivision (b)(1), a community property trust may not be amended or revoked unless the agreement itself provides for amendment or revocation.

§ 35-17-105.

(a) Whether or not both, one (1), or neither is domiciled in this state, spouses may classify any or all of their property as community property by - 4 - 01326976 transferring property to a community property trust and providing in the trust that the property is community property.

(b) A community property trust is enforceable without consideration.

(c) All property owned by a community property trust will be community property during marriage.

(d) The right to manage and control property that is transferred to a community property trust is determined by the terms of the trust.

(e) When property is distributed from a community property trust, it shall no longer constitute community property.

§ 35-17-106.

(a) An obligation incurred by only one (1) spouse before or during marriage may be satisfied from that spouse's one-half (1/2) share of a community property trust.

(b) An obligation incurred by both spouses during marriage may be satisfied from a community property trust of the spouses.

§ 35-17-107. Upon the death of a spouse, one-half (1/2) of the aggregate value of the property owned by a community property trust established by the spouses reflects the share of the surviving spouse and the other one-half (1/2) reflects the share of the decedent. Unless provided otherwise in the trust agreement, the trustee has the power to distribute assets of the trust in divided or undivided interests and to adjust resulting differences in valuation. A distribution in kind may be made on the basis of a non pro rata division of the aggregate value of the trust assets, on the basis of a pro rata division of each individual asset, or by using both methods.

§ 35-17-108. Upon the dissolution of the marriage of the settlor spouses, the community property trust shall terminate and the trustee shall distribute one-half (1/2) of the trust assets to each spouse, with each spouse receiving one-half (1/2) of each asset, unless otherwise agreed to in writing by both spouses. SECTION 2. This act shall take effect on July 1, 2010, the public welfare requiring it.

Alan Gassman & Jonathan G. Blattmachr: STEPPING UP EFFORTS TO STEP-UP BASIS FOR MARRIED COUPLES

EXECUTIVE SUMMARY:

The capital gains tax may be the most formidable tax challenge for surviving spouses who need to sell assets to support themselves. The increase in this tax from 15% to 20%, with the additional 3.8% Medicare tax for those with high income in the year of sale makes this a very important topic to cover with clients and their families.

The primary estate planning goal of most married couples is to provide as well as possible for the surviving spouse, but most of them do not recognize that 23.8% of the lifetime appreciation of family investments including in many cases on a large residence will have to be paid to the government in order to produce money for the surviving spouse.

For some survivors, this will be a devastating reality that must be faced when the cost of an adult congregate living facility and proper care is compared to the net proceeds that can be derived from the liquidation of assets. Even a modest investment portfolio owned by a retired married couple can be significantly impacted by these taxes, and the more modest the asset basis, the more crucial it is to protected against lost value due to capital gains taxes.

FACTS:

There are three primary ways that the typical non-community property state couple can attain a full step-up in basis for assets on the first death (understanding that some assets, such as those in pension plans or IRAs never receive a step up when the owner dies):

Have the assets owned by the first dying spouse more than one (1) year before he or she dies, or if

the one (1) year period cannot be met, have the spouse leave the assets to a trust that may benefit the surviving spouse and not trigger the one (1) year rule under Internal Revenue Code Section 1014(e), which denies a step up in basis with respect to assets the spouse dying first received by gift from the survivor within a year of death and that are re-inherited back by the spouse who made the gift. Trying to guess who dies first and even having to talk about this can be a difficult and risky proposition.

The couple can amend their estate planning documents to either provide that each of them will have a testamentary power of appointment over assets held in on another's separate revocable trusts or form one joint JEST (Joint Estate Step-up Trust), in which event Private Letter Rulings 200101021, 200210051, and 200403094 and TAM 9308002 support the proposition that assets owned jointly under a JEST Trust or under the revocable trust of a surviving spouse may be considered to have passed through the taxable estate of the first dying spouse, although there are Section 1014(e) one (1) year rule and fundamental issues associated with this (such as whether the private letter rulings and the technical advice memorandum are correct). These issues and possible drafting solutions are discussed at length in LISI Estate Planning Newsletter No. 2086 and the October and November 2013 issues of Estate Planning Magazine that were co-written by Alan S. Gassman, Tom Ellwanger, Christopher J. Denicolo, and Kacie Hohnadell.

This technique has its downsides, as described in the chart below but the JEST Trust itself has no annual cost associated with it unless there are changes in the client's estate plan. Many clients prefer to have their assets under a single trust created by and for both of them, and preexisting separate trusts can be amended and restated to be considered a part of the single JEST Trust so that re-titling of assets is not required. It will take the planner a few hours to draft and thoroughly review their initial trust draft. See Estate Planning Newsletter No. 2086 for a discussion of some of the provisions Alan Gassman includes in his documents.

The most reliable way to achieve a full step up on the first death, with potential incidental asset protection features is to establish a conventional Alaska Community Property Trust with an Alaskan Co-Trustee. The Alaskan community property statute was enacted in 1998 to allow both Alaskan couples and non-Alaskan couples to form trusts there to comply with Internal Revenue Code Section 1014(b)(6), which provides that community property will receive a full step up on the death of one spouse. This technique has been endorsed by not only Jonathan Blattmachr, who originated the concept, but also by Howard Zaritsky and a number of other well respected experts. It is essentially a joint revocable trust which will be used as the principal estate planning document as the spouses die. The Alaska Trust Company provides the trust form to professionals who use these, and an Alaskan lawyer is available to review and approve the trust document for only about \$1,000.

COMMENT:

Assume that a married couple in their late sixties has \$500,000 of investments with a cost basis of \$100,000, and their home's worth is \$100,000.

If one spouse dies owning one-half (2) of the assets or the assets are jointly owned in a non-community property state and one of them dies, his or her half of the assets will receive an automatic change in income tax basis to its estate tax value (even if no estate tax is due) and the inherent gain in those assets are forgiven. That result is known as the income tax free "step up in basis" at death. But the inherent

gain in the survivor's half of their wealth will not be stepped up. That means then that there is \$200,000 worth of untaxed gain that will cost, depending upon several factors including whether the couple lives in a jurisdiction with state and local taxes of, perhaps, over \$50,000 in capital gains tax in order to liquidate their wealth to provide cash to support the surviving spouse or to buy into a retirement center unit.

Contrast that couple's situation with one if they live in a community property state, such as Texas or California. For that couple, all of the inherent gain is "forgiven" when the first spouse dies. Therefore, the survivor would face no capital gains tax in liquidating the couple's wealth.

A couple with \$2,000,000 of assets and a \$500,000 home with the same ratios of growth face a much larger tax which could be \$450,000 or more. The above assumes that tax rates will not rise and that there will be no state income tax to be paid.

Why do so many planners fail to discuss this with clients, much less put mechanisms in place to assure a complete step-up in basis of all of a couple's assets on the first death? One reason is that the full impact of the large capital gains tax increase has not yet been felt by many clients. Another is that the complexity of the recent estate tax changes, and especially the attention given to wealthy clients during 2012 to use their large gift and generation-skipping transfer tax exemptions. Now estate planners can get their eyes on the capital gains avoidance ball.

Conclusion:

Planners need to become accustomed to stepped-up basis planning being in the forefront of objectives and structuring. The Alaska community property trust is extremely under-utilized, and the JEST trust or stepped-up basis power of appointment arrangements can be considered for those clients who for whatever reason would not prefer to use an Alaska community property trust.

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PRACTICAL PROBLEMS WITH TENANTS BY THE ENTIRETIES AND WHY FAMILY LLCs AND LIMITED PARTNERSHIPS ARE COMMONLY USED.

- (1) What if both spouses get sued?
- (2) What if the non-debtor spouse dies while the debtor spouse is waiting for the jury to come in?
- (3) What if the spouses are divorced and the debtor spouse receives an outright disposition?
- (4) What if the law changes?

A common solution to these concerns is to establish a Family Limited Partnership or a Limited Liability Company to own the tenancy by the entirety assets, so that there would at least be charging order protection if the tenancy by the entirety protection was compromised.

Another common solution is to keep an expensive term life policy owned by a spouse who may die first, and make this payable to a trust that will be irrevocable that will benefit the surviving spouse, to hopefully replace assets that might be lost by reason of outright ownership by the surviving spouse.

SAME SEX COUPLE IMPLICATIONS.

A good number of same sex couples who are now married owned property jointly before marriage, and now have to re-convey the property to themselves as tenants by the entirety in order to have protection. Florida did not recognize the marriage of same sex couples until it was required to do so by the 2015 U.S. Supreme Court Case of *Obergefell v. Hodges*.³⁴² Nevertheless, same sex couples who were married in states that recognized their marriage before June 26, 2015 can be expected to argue that their marriages were considered to be effective, and that tenancy by the entirety should apply, notwithstanding that Florida did not recognize the marriage until June 26, 2015.

³⁴² 135 S. Ct. 2584 (2015); see also *Brenner v. Scott*, 2016 WL 3561754 (N.D. Fla. Mar. 30, 2016) (holding Florida Statutes Section 741.212, which prohibits the recognition of same sex marriage, as unconstitutional).

CHAPTER 3

ANNUITY CONTRACTS

INTRODUCTION.

Florida and several other states offer unlimited protection of permanent life insurance and the cash values of annuity contracts. The life insurance and annuity industries have come to market with mutual fund wrapped products that provide income tax deferral and creditor protection for policyholders and their families. And while these protections are sweeping there are nuances that individuals have to be aware of regarding beneficiaries, declaring bankruptcy, income tax, guaranty fund rules, settlements, and lottery arrangements. This chapter will also explore the different instrumentalities that can be used to create annuities and best planning practices. Florida Statutes Section 222.14 provides as follows:

The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such annuity contract, unless the insurance policy or annuity contract was effected for the benefit of such creditor.

BENEFICIARIES.

The statute only protects the proceeds of annuity contracts when the debtor is the beneficiary of the contract. It would be assumed that the owner of an annuity contract is its beneficiary, although by the terms of the contracts, the “beneficiary” is typically the party designated to receive the payout of the annuity upon the death of the initial owner. In the bankruptcy court case of *In Re Zeitz*,³⁴³ the court found that while beneficiaries of life insurance policies are not accorded creditor protection for policy proceeds, the reference in Florida Statutes Section 222.14 to “any creditor of the person who is the beneficiary of such annuity contract” protects both a lifetime payee and remainder interest beneficiaries under a commercial annuity contract. The court quoted the 2nd Restatement of Trusts which defines beneficiary as “the person for whose benefit property is held in trust.”

The holding in *Zeitz* was clarified by *In re Turner*, stating that the determination of whether an individual is a beneficiary of an annuity contract or whether a settlement agreement constitutes an annuity contract is settled in Florida law.³⁴⁴ As the law currently stands, individuals may receive exempt proceeds under a settlement agreement if those individuals were named beneficiaries in an annuity contract.

The 2019 Bankruptcy Court decision of *In re Rensin* involved Cayman Islands-based annuity contracts that were purchased by the trustee of an offshore trust for the benefit of an insolvent debtor, who was given the ability to borrow money from the annuity contracts, but only with consent of the trustee of

³⁴³ 171 B.R. 903 (Bankr. S.D. Fla. 1994).

³⁴⁴ 332 B.R. 461 (Bankr. N.D. Fla. 2005) (holding that a settlement agreement that did not specify beneficiaries was not sufficient to grant exempt proceeds under an annuity contract).

the asset protection trust. The trustee purchased two annuity contracts that were custom written, and apparently had errors in drafting. One contract was “annuitized” and paying a fixed monthly amount to Mr. Rensin, and found to be protected as an annuitized domestic annuity contract would be. The other contract was not yet making payments to Mr. Rensin, but the trustee had the right to require that payments be made.

Judge Kimball of the United States Bankruptcy Court found that Mr. Rensin was the beneficiary of an annuity contract that had been activated to pay him \$15,000 per month for his lifetime, with the remainder of the contract to be held by the offshore asset protection trust on his death, and found that a second annuity contract that had not yet begun paying money to Mr. Rensin was also not available to his creditors even though the judge opined that Florida law should apply to allow creditors to reach trust assets. The trust apparently had no assets but the annuities, and the court found that the trustee’s decision to invest the trust’s assets in annuities after Mr. Rensin had a large judgment against him by the FTC was a decision and transfer made by the trustee, not by the debtor, and therefore not subject to the Florida or federal fraudulent transfer statutes. Specifically, the judge had the following to say about the annuity contracts:

APPLICABLE PROVISIONS OF THE ANNUITY CONTRACTS:

Under the variable annuity, Mr. Rensin is the annuitant with the right to receive monthly payments during his life, commencing on the annuity starting date. Prior to the annuity starting date, the funds are invested. The Joren Trust is the owner of the variable annuity as well as the beneficiary entitled to receive payments after Mr. Rensin dies. The variable annuity contract becomes irrevocable on the annuity starting date. The variable annuity contract itself is silent on the annuity starting date. Based on Mr. Rensin’s deposition testimony, the annuity starting date has not occurred. Because the annuity starting date has yet to occur, the Joren Trustee has the power to surrender the variable annuity, thereby canceling it, and also has the power to make withdrawals. In addition, prior to the annuity starting date, Mr. Rensin may borrow from the investment pool up to 90% of its value. But because the Joren Trustee can cancel the variable annuity at any time during the same period, the right to borrow is effectively subject to veto.

As with the variable annuity, under the fixed annuity Mr. Rensin is the annuitant with the right to receive monthly payments during his life, commencing on the annuity starting date. Unlike the variable annuity, the annuity starting date for the fixed annuity has occurred and the issuer makes regular monthly payments directly to Mr. Rensin. The Joren Trust is the owner of the fixed annuity as well as the beneficiary entitled to receive payments when Mr. Rensin dies. Unlike the variable annuity contract, the fixed annuity contract omits section 6.4, the operative provision for surrender of the contract or withdrawal of funds. The references to surrender and withdrawal in sections 6.1 and 6.2 are surplusage in light of the deletion of section 6.4 from the form of the fixed annuity contract. The fixed annuity contract includes section 6.3, permitting borrowing, but that right terminated upon the annuity starting date. Under section 4.3, the fixed annuity contract became irrevocable on the annuity starting date. The overall effect of these provisions is that the rights of the Joren Trust and Mr. Rensin are permanently established under the fixed annuity contract, subject to minor adjustments not relevant here.

Section 11.1 of each annuity contract states that if the annuitant is not also the owner, “all of the Annuitant’s rights, title, interest and obligations under this policy vest in such

Owner(s) and in such case the policy shall be read substituting ‘Owner’ in place of ‘Annuitant’ as respectively required.” Reading just this provision, one might assume that the Joren Trust, as owner, is to be substituted in each instance where the annuity contract uses the word “annuitant.” But the inclusion of the phrase “as respectively required” suggests that the substitution of terms is not universal. It is obvious from a review of the annuity contracts that substituting the owner for the annuitant in every instance does not make sense. Among other things, the Joren Trust has no “birthday” nor will it ever suffer “death” in the obvious meaning of that term in the annuity contracts.

Section 2.0 of each annuity contract provides for payments to the annuitant. If the owner is substituted for the annuitant under this provision, during Mr. Rensin’s life the issuer would make payments to the Joren Trustee rather than to him. After receiving such payments, the Joren Trustee could exercise discretion whether to provide any of such funds to Mr. Rensin but would not be required to pay anything to him. On the other hand, if Mr. Rensin is entitled to receive direct payments from the issuer of the annuity contracts, neither the right to such annuity payments nor the funds themselves ever become part of the Joren Trust.

With regard to the fixed annuity, the issuer has been making and continues to make monthly payments directly to Mr. Rensin. This supports the conclusion that Mr. Rensin, as annuitant, has the right to receive such payments and retains that right until his death under the now irrevocable fixed annuity. Mr. Rensin’s right to receive payments under the fixed annuity contract is not part of the Joren Trust but represents his personal right under the contract. The Joren Trust holds only the remainder interest under the fixed annuity contract, after Mr. Rensin’s death.

With regard to the variable annuity, the annuity starting date has not occurred, and so no monthly payments are being made. The Joren Trustee may surrender the variable annuity or withdraw funds. Mr. Rensin may borrow up to 90% of the investment pool, but this right is constrained by the Joren Trustee’s right to surrender. One might argue that Mr. Rensin’s right to borrow under the variable annuity is property of the bankruptcy estate, but if the plaintiff attempted to exercise that right the Joren Trustee could simply terminate the contract.

MR. RENSIN’S ANNUITY PAYMENT RIGHTS ARE EXEMPT FROM ADMINISTRATION IN THIS CASE.

Mr. Rensin scheduled his rights to payment under the annuities as exempt, conceding that such rights are property of his bankruptcy estate if not exempt. Mr. Rensin holds irrevocable payment rights under the fixed annuity. He holds payment rights under the variable annuity, subject to the Joren Trustee’s right to surrender that contract prior to the annuity starting date. Mr. Rensin claims all of these payment rights as exempt under Fla. Stat. § 222.14.

Florida Statutes § 222.14 provides, in relevant part: “The ... proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of ... any creditor of the person who is the beneficiary of such annuity contract, unless the ... annuity contract was effected for the benefit of such creditor.” In this statute, the term “beneficiary” means a person who receives payments under an annuity contract. The creditors of such a payee may not execute

on the annuity payments. Mr. Rensin is a “beneficiary” under this provision as he is entitled to payments under the annuities.

The Florida annuity exemption protects Florida citizens and residents who receive payments under annuity contracts. At least one court has ruled that section 222.14 requires that the annuity contract also be issued to, and thus owned by, a Florida citizen or resident, even if that person is not receiving the annuity payments. The issue is material here because the Joren Trust, a resident of Belize, owns the contracts.

The statutory phrase “issued to citizens or residents of the state” is the key to this question. One court, cited by Mr. Rensin, initially ruled that this phrase modifies the term “annuity contracts” and so the annuity contract must be issued to a citizen or resident of Florida. *In re Pizzi*, 153 B.R. 357 (Bankr. S.D. Fla. 1993). That same court later ruled that the phrase “issued to citizens or residents of the state” modifies the word “proceeds” and so the proceeds must be payable to a citizen or resident of Florida. *In re Belue*, 238 B.R. 218 (Bankr. S.D. Fla. 1999) (noting that the issue was not critical to the same court’s prior decision in *Pizzi*); accord *In re Bennett*, 217 B.R. 654 (Bankr. M.D. Fla. 1998); *In re Benedict*, 88 B.R. 387 (Bankr. M.D. Fla. 1988). The latter view is the majority view and most closely reflects the obvious intent of the statute.

It does not matter that the Joren Trust is the owner of the annuity contracts. Mr. Rensin is a citizen and resident of Florida. Mr. Rensin’s rights to payment under the annuities are exempt under Fla. Stat. § 222.14.

The plaintiff argues that to permit a debtor to exempt rights under an annuity contract that is owned by a non-Florida person or entity would only encourage fraudulent or inappropriate behavior. It is hard to see how this is the case. The statute protects payment rights under annuity contracts. The Florida legislature determined that, except when acquired with fraudulent intent in violation of Fla. Stat. § 222.30 or if the exemption results from a fraudulent transfer or conveyance in violation of Fla. Stat. § 222.29, all payment rights under an annuity contract are exempt from process. When an annuity contract provides for payments to a citizen or resident of Florida, it does not matter who owns the contract. There are a variety of valid reasons why an annuity contract may be owned by a person other than those entitled to payment. For example, an estate plan may include an annuity contract providing payments to the testator while alive with the remainder paid to a trust that is also designated the owner of the contract. If section 222.14 is interpreted to require the owner of the annuity contract to also be a Florida citizen or resident, this would greatly restrict the selection of a trustee, without any valid purpose. In any case, Fla. Stat. §§ 222.29 and 222.30 address the concerns raised by the plaintiff by limiting the effect of the exemption provisions where fraud is involved.

THANK YOU DR. GOLDBERG.

In *Sawczak v. Goldenberg*,³⁴⁵ Dr. Goldenberg filed for bankruptcy the same day a malpractice suit was to begin trial against him. The doctor filed bankruptcy schedules showing \$3,751,678 out of \$3,791,119 in assets as being exempt.

³⁴⁵ 791 So.2d 1078 (Fla. 2001).

This included \$355,894 in annuity contracts, which were single premium deferred annuities for which Dr. Goldenberg had paid a single premium for a contract that accumulated earnings until the maturity date.³⁴⁶ Each of the contracts provided for a future date as to which sums owed would become payable to Dr. Goldenberg or his survivors, and each of them contained a provision for surrender of the contract in exchange for a specified lump sum payment.

The bankruptcy court held that the cash surrender value of a variable investment annuity contract was protected from creditor claims under Florida Statutes Section 222.14, but on appeal, the Court found that Dr. Goldenberg did not have annuity contracts “until the funds in the annuity account reached maturity. He had instead, option contracts to buy annuities at a future date which options could be revoked by him at any time prior to the maturity date” This sent shudders through the annuity and creditor protection community in 2000 and 2001.

The Eleventh Circuit Court of Appeals certified this case to the Florida Supreme Court and the Florida Supreme Court decided in a 7-0 decision that if the Florida legislature had wanted to limit what would qualify as an annuity, they would have so stated in the statute. The exact language of the holding was as follows:

The terms of Section 222.14 are clear. No reliance on legislative history is needed to determine intent where the statutory language is clear. The statutory addition in 1978 simply added “annuity contracts” to the existing statute. *Sawczak* would have us define the term “proceeds” to include only those payments that commence at the maturity date of *Goldenberg’s* policies. In other words, *Sawczak* maintains that moneys received by surrendering an annuity contract are not proceeds. We do not find a basis for such a narrow definition of “proceeds” in the statute or in the commonly accepted definition of proceeds. The dictionary definition of proceeds is “the net amount received after deduction of any discount or charges.” The only difference between receiving payment streams after maturity and a settlement payment before maturity is the surrender charge. Thus, we conclude that the “proceeds of annuity contracts” include moneys received from surrendering an annuity contract prior to maturity.³⁴⁷

Although the Supreme Court decision made mention that the annuity contracts that were owned by Dr. Goldenberg were subject to substantial penalties for early withdrawal, this statement should not be read to mean that no load variable annuities would have any less protection than the typical commissioned loaded annuity arrangement. No load annuity companies charge ongoing administrative, maintenance, and mortality fees that may cost significantly less than other comparable annuity products.

INCOME TAX ASPECTS.

Tax deferral offered by commercial annuity contracts may result in greater after-tax returns. But consider whether the client would be better off paying a 20% capital gains tax as opposed to ordinary rates

³⁴⁶ *In re Goldenberg*, 253 F.3d 1271, 1273 (11th Cir. 2001).

³⁴⁷ *Sawczak* at 1083 (internal citations omitted).

if appreciated stocks are the primary underlying investment. Consider the penalty imposed upon taxable income withdrawn before age 59 1/2.

FLORIDA GUARANTY FUND RULES.

Florida has a Guaranty Fund that covers failed annuity contracts for up to a certain dollar amount per contract. This is generally based upon up to \$100,000 per contract, and up to 3 contracts per carrier. This is why many Floridians purchase 3 separate \$100,000 or less contracts with each applicable carrier and diversify among carriers for Guaranty Fund and practical purposes.

It is important to note that the protection provided by the Florida Guaranty Fund against the insurer's insolvency will not guarantee any portion of a variable annuity contract that is not guaranteed by the insurer. It is therefore important to understand any variable annuity contract that the client establishes with the expectation of qualifying under the Guaranty Fund. Section 631.713 provides:

- A. This part shall apply to direct life insurance policies, health insurance policies, annuity contracts, and supplemental contracts with or without life contingencies issued by persons licensed to transact such insurance in this state.
- B. This part shall not apply to...that portion or part of a variable life insurance contract or variable annuity contract not guaranteed by an insurer.

STRUCTURED SETTLEMENTS CAN QUALIFY IF PROPERLY DRAFTED.

Structured settlements should be considered for any clients settling a personal injury claim because they are creditor protected assets under Florida law.³⁴⁸ Under a structured settlement, annual fixed payments received based upon a specified settlement will all be tax free, notwithstanding the interest income element inherent in such contracts.³⁴⁹

In *In re McCollum*,³⁵⁰ the Florida Supreme Court found that Section 222.14 exempted an annuity that was created in lieu of a defendant paying a lump sum settlement. This case stands for the proposition that the conversion of a cause of action in a personal injury suit to a structured settlement annuity will not be considered a fraudulent transfer. The Supreme Court noted that annuities have been defined as "the right to receive fixed, period payments for a term of years of life." The Court also looked at Florida Statutes Section 238.01(15), which is part of the State Teachers' Retirement System Law, which defines annuity as "annual payments for life . . . from the cumulated contributions of the member."

In *In re Solomon*,³⁵¹ the Eleventh Circuit found that where a structured settlement is arranged whereby the defendant insurance company has all legal and equitable interest in an annuity contract and

³⁴⁸ See *In re McCollum*, 986 F.2d 436 (11th Cir. 1993).

³⁴⁹ See Alan S. Gassman & Randal E. Gassman, *Structured Annuities: What Every Plaintiffs Lawyer Should Know*, The Practical Litigator (May 1997).

³⁵⁰ 612 So.2d 572 (Fla. 1993).

³⁵¹ 95 F.3d 1076 (11th Cir. 1996).

agrees to make payments over time to the plaintiff/debtor, such arrangement was not exempt under Section 222.14. The court stated that “the statute does not shield all debts or “accounts receivable” structured to resemble annuities from a debtor’s bankruptcy estate.”

In *In re Turner*,³⁵² the Court found that an annuity contract did not exist under Florida Statutes Section 222.14 where the litigant released her claims against the insurance company in order to receive a structured settlement. The agreement did not specify that settlement proceeds were to be paid under an annuity contract, and did not refer to the litigant as the beneficiary or payee.

In *Ministri Family LLC v. Bell*,³⁵³ the United States District Court for the Middle District of Florida held, in an extremely thorough and well-written opinion, that a structured settlement annuity “owned” by the defendant insurance company that listed the plaintiff as the irrevocable payee was exempt from creditor claims under Section 222.14, based upon the premise that this was in substance an annuity contract that the debtor/former plaintiff was a beneficiary of. The Court confirmed that the actual technical “ownership” of the annuity contract for issuance purposes is irrelevant, and that the “beneficiary” for purposes of Section 222.14 is the person or people entitled to receive payments. For conventional annuity contracts, the owner, who has the right to withdraw and/or to receive payments during his or her lifetime would be considered the “beneficiary” under Florida law, while the “beneficiary designation” under the annuity contract might be in favor of a trust or other person as the “survivor owner or beneficiary.” In this case, the “payee” was considered to be the beneficiary, even though the contract itself did not specifically list a “beneficiary.”

Structured settlement agreements should still be reviewed carefully for creditor protection purposes before implementation. However, the *Ministri Family* case which was denied appeal to the 11th Circuit of the United States Court of Appeals and the Florida Supreme Court case of *In re McCollum* provide clarity that if the annuity contract is properly structured, it will be fully exempt from the claims of creditors.

LOTTERY ARRANGEMENTS.

As presently structured, Florida Lottery payments will not be considered as exempt assets for the reasons described below. In *In re Pizzi*,³⁵⁴ the Bankruptcy Court of the Southern District of Florida held that a lottery contract made payable to the State of Connecticut, which in turn makes payments to the lottery winner, is not creditor protected as an annuity under Section 222.14.

Similarly in *In re Bruce*,³⁵⁵ the Bankruptcy Court for the Middle District of Florida found that lottery winnings were not exempt under Florida Statutes Section 222.14, even though the debtor received his lottery payments in installments. The court emphasized that in order to qualify for this exemption, there must be an actual annuity contract, and the Florida lottery does not purchase annuity contracts. Instead, the Florida Department of Lottery invests sales proceeds in “zero coupon bonds” and pays the winners from the funds it receives from these bonds.

³⁵² 332 B.R. 461 (Bankr. N.D. Fla. 2005).

³⁵³ 2015 WL 6445954, (M.D. Fla. 2015), appeal dismissed (Apr. 27, 2016).

³⁵⁴ 153 B.R. 357 (Bankr. S.D. Fla. 1993).

³⁵⁵ 224 B.R. 505 (Bankr. M.D. Fla. 1998).

However, in *Dixon v. Dixon*,³⁵⁶ the Bankruptcy Court for the Middle District of Florida allowed the debtor's Arizona lottery winnings, which were paid by annuity contract, to be exempt under Florida law. To pay the debtor, the State of Arizona purchased an annuity contract, under which the debtor would receive proceeds for seventeen years. In determining that the annuity qualified for the Florida exemption, the court focused on the "broad application" of Section 222.14 and held that "the annuity at issue is properly included within the purview of such exemption."

Therefore, it seems that lottery winnings in some states may be exempt under Florida law, so long as the state where the distributions are being made actually purchases an annuity. According to the December 2016 Florida Lottery website, the Florida Lottery still purchases zero-coupon bonds and therefore Florida Lottery winnings will not normally be protected.

PRIVATE ANNUITY AND GRANTOR RETAINED ANNUITY TRUST ("GRAT") PLANNING.

Private Annuities can be used as an Estate Tax savings device, especially when an older client has adverse health conditions, but is reasonably expected to live more than one year. Standard life expectancy tables can be used as long as the Seller/Payee has a better than 50% chance of living at least one year at the time the transaction is entered into. There will be an irrefutable presumption that the good health requirement is satisfied if the person lives at least eighteen months.³⁵⁷

Consider having a client receive a life annuity or other annuity payment rights from a Defective Grantor Trust in exchange for a joint and survivor annuity. Not only is the joint and survivor annuity protected from creditors, but there are significant estate tax savings results that will occur, particularly if the rate of return on the installment obligation and subsequent reinvestment thereof exceeds the Section 7520 rate assumptions implicit in the second-to-die annuity tables.

The 1988 Bankruptcy Court Case of *In re Mart*³⁵⁸ held that a private annuity agreement whereby the debtor established an Irrevocable Trust for children, nieces, and nephews and made a \$2,000 gift, followed by an annuity agreement funded by a \$350,000 transfer by the Debtor and his spouse to the Trust in exchange for a return stream of annuity payments, was exempt from the claims of creditors under Florida Statutes Section 222.14. In this case, the annuity was established thirteen months before the debtor filed bankruptcy. The court found that the statutory exemption is not restricted to annuities provided by unrelated entities and that there was no intent to defraud creditors found in the circumstances. The case is further discussed in the article that follows at the end of Section I below.

A Grantor Retained Annuity Trust ("GRAT") is a trust that pays its grantor a set amount each year for a term of years. Lawyers drafting GRATs should use language to confirm that the payments to be received should qualify as a contractual annuity right, and might consider having the GRATs situated in asset protection trust jurisdictions that would enable the Trustee to make the GRAT payments to other trusts for

³⁵⁶ 153 B.R. 594 (Bankr. M.D. Fla. 1993).

³⁵⁷ Treasury Regulation Section 25.7520-3(b)(3), issued in 1995, has more information and examples regarding sales for private annuities and self-cancelling installment notes.

³⁵⁸ B.R. 436 (Bankr. S.D. Fla. 1988).

the benefit of the grantor to satisfy the requirements of Internal Revenue Code Section 2702 and the Treasury Regulations thereunder.

Estate tax planning specialists know how effective a Grantor Retained Annuity Trust (GRAT) is for estate tax planning purposes. In *Audrey J. Walton v. Commissioner of Internal Revenue*,³⁵⁹ the Tax Court held that a two year GRAT could be zeroed out for estate and gift tax purposes. In this case, Sam Walton's widow (the founder of Wal-Mart) transferred approximately \$100,000,000 of Wal-Mart stock to a GRAT for the right to receive 49.35% of the initial value 12 months after inception, and 59.22% for the second 12-month term.

A 2009 Florida Bar Journal article entitled "Unraveling the Mysteries of the Florida Exemptions for Life Insurance and Annuity Contracts, Part Two" concluded that a private annuity arrangement will not be protected from creditors and that the creditors of the grantor of a GRAT would be able to reach into the trust to the extent of payments owed to the grantor. The authors, and many others, disagree with these conclusions, as explained in the article "Creditor's Rights Under Private Annuities and Grantor-Retained Annuity Trusts in Florida" 83 Fla. B.J. 49 (July/August 2009) by Alan S. Gassman, David L. Koche & Michael C. Markham.

An excerpt from the 2009 article explains what the authors consider to be the primary issues and our conclusion, which has not changed or been supported or distinguished by any case or significant commentary since 2009, to our knowledge.

Creditor's Rights Under Private Annuities and Grantor-Retained Annuity Trusts in Florida
By: Alan S. Gassman, David L. Koche and Michael C. Markham

The second part of a recent two-part Florida Bar Journal article titled "Unraveling the Mysteries of the Florida Exemptions for Life Insurance and Annuity Contracts, Part Two" discusses the creditor protection elements of annuity contracts.³⁶⁰ The article discusses inter alia the exemption granted by F.S. §222.14. Under this statute, the proceeds of an annuity contract issued to a Florida resident are statutorily exempt from the beneficiary's creditors.³⁶¹

The article reaches the conclusion that a private annuity arrangement *should* not qualify for protection under the Florida Statute as an exempt asset because the legislature did not intend to protect private contracts.³⁶² The authors respectfully disagree with this perspective in light of the analysis and authority cited below, which includes general rules of statutory construction and the bankruptcy decision in

³⁵⁹ 115 T.C. 589 (2000).

³⁶⁰ Jonathan E. Gopman, Mathew N. Turko & Howard M. Hujsa, *Unraveling the Mysteries of the Florida Exemptions for Life Insurance and Annuity Contracts, Part 1*, 82 Fla. B.J. 52 (Dec. 2008); *Part 2*, 83 Fla. B.J. 55 (Jan. 2009).

³⁶¹ Fla. Stat. §222.14 states in relevant part: "the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person...who is the beneficiary of such annuity contract, unless the...annuity contract was effected for the benefit of such creditor."

³⁶² We have purposely italicized the word "should" given that the authors did not necessarily conclude that such arrangements "did" not qualify, but rather suggest that they "should" not qualify for the statutory exemption.

In re Mart, 88 B.R. 436 (S.D. Fla. 1988), which specifically held that a private annuity contract entered into between a debtor and a trust established by the debtor was a protected annuity under F.S. §222.14.

Statutory Construction

The article refers to legislative history and concludes that the legislature intended only to provide protection for commercial annuities, because commercial annuities were apparently mentioned in the legislative history. If the legislature considered private annuities during its legislative sessions but did not address them in the statute, then the failure to omit them from the final versions of the statute that was enacted would be a clear acknowledgment that they fall within the purview of the statute. A reference to commercial annuities in the legislative history, without more, is hardly sufficient to change the clear meaning of a statute.

On the other hand, if the legislature did not contemplate private annuities when passing this legislation, then one could posit that they would still be protected, because the statute provides protection for *all* annuities without limiting the types of annuities protected. Put another way, it would take a legislative clarification to modify the clear language of the statute, which is quite expensive in its literal scope, as it refers to annuity contracts “upon whatever form.”

This statutory construction argument is supported by established concepts of judicial construction. In the 1989 case of *U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (U.S. 1989), the U.S. Supreme Court found that the interpretation of a statute should be based upon the wording thereof, unless the clear intent of the legislature is other than as set forth in the statute.³⁶³ If the language of a statute is plain, courts must enforce the statute according to its clear and unambiguous terms.³⁶⁴

Furthermore, the law is well-settled that creditor exemptions are to be construed liberally in favor of providing the benefits of the exemptions to debtors.³⁶⁵ In *In re Mart*, the court stated that “there is no basis in this statute to restrict the exemption to annuities provided by completely unrelated, public entities.”³⁶⁶ In *LeCroy v. McCollum*, 612 So. 2d 572 (Fla. 1993), the Florida Supreme Court noted that the statute does not limit the exemption to any particular type of annuity contract. “This holding suggests that even ‘private’ arrangements not involving ‘commercial’ annuities will qualify for the exemption.”³⁶⁷

To limit F.S. §222.14 so that it does not apply to private annuities is to create a distinction that does not exist in the statute, and would be tantamount to rewording the statute by changing the references to “annuity contracts” to “commercial annuity contracts” as shown below:

The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of *commercial* annuity contracts issued to citizens or residents of the state, upon

³⁶³ *U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (U.S. 1989); see also *U.S. v. Northrop Corp.*, 811 F. Supp. 333 (S.D. Ohio 1992).

³⁶⁴ *In re Griffith*, 206 F.3d 1389, 1393 (11th Cir. 2000) (citing *U.S. v. Ron Pair Enter.*, 489 U.S. 235, 241 (1989)).

³⁶⁵ *Havoco of Am., Ltd v. Hill*, 790 So. 2d 1018, 1021 (Fla. 2001) (quoting *Milton v. Milton*, 58 So. 718, 719 (1912)). See also *In re Solomon*, 95 F. 3d 1076 (1996) (special Florida exemption for proceeds of debtor’s annuity contracts is to be broadly construed to reach *all* annuity contracts).

³⁶⁶ *In re Mart*, 88 B.R. 436, 438 (S.D. Fla. 1988).

³⁶⁷ RIA, Asset Protection and Tax Aspects of Annuities §13.06.

whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such *commercial* annuity contract, unless the insurance policy or *commercial* annuity contract was effected for the benefit of such creditor. (Additional, hypothetical verbiage italicized.)

It is not appropriate to add words to a statute that were not placed there by the legislature (to do so would be an impermissible abrogation of legislative power). Such an interpretation of the statute not only would be strained, but also seems illogical in light of the last phrase, which clearly interposes a limitation on the exemption for proceeds of annuity contracts when they were “effected for the benefit of such creditor.”³⁶⁸ Certainly, the concept of a private annuity existed and the legislature could have expressly excluded such an annuity if it so chose (in the same way it excluded annuity contracts effected for the benefit of creditors).

The article refers to the verbiage of the statute that indicates “annuity contracts *issued* to citizens or residents” are protected and makes the case that, because commercial carriers “issue” annuity contracts, and because the definition of “issuer” under the Florida securities statutes refers to arm’s-length parties issuing securities, the use of the word “issued” in the statute supports the position that the exemption for proceeds of annuity contracts should *not* include private annuity arrangements. The authors of this article believe that this reads more in the verb “issue” than should be the case, and would again suggest that the cardinal rule of statutory construction is to give words their plain meaning.³⁶⁹

In this vein, the common meaning of “issue” (*i.e.*, its ordinary dictionary definition), when used as a verb is “to give or come out” or to “circulate or to distribute in an official capacity.” In common parlance, there is no restriction on what type of person the issuer can be. Accordingly, whether the annuity contract is issued by a commercial carrier or a private individual is less important than whether and an annuity contract is properly issued in the first instance. Moreover, if one looks to the use of the word “issued” in other legal contexts, it is clear that a person or entity may properly issue something to himself or herself (notwithstanding the absence of an arm’s-length relationship). Indeed, garden variety transactions routinely involve a non-arm’s-length party issuing a certificate of ownership or an employment agreement to another person. There is no reason why a private party cannot issue a contract such as an annuity contract in the same form and fashion as an institutional carrier. In fact, the very securities statute referenced in the article, F.S. §517.021, contemplates that a person can be an issuer of its own securities.³⁷⁰ Frankly, the article disregards the fact that the Internal Revenue Code recognizes that a self-settled trust can, indeed, be a separate and distinct legal entity.³⁷¹

The article then discusses self-settled trusts which enter into annuity contracts to the grantors thereof. The article concludes that an annuity contract payable to the grantor of an irrevocable trust should not protect

³⁶⁸ As the authors of the article point out, Fla. Stat. §222.30 (the fraudulent asset conversion statute) also limits the applicability of the exemption under §222.14.

³⁶⁹ *Southwest Florida Water Management District v. Save the Manatee Club, Inc.*, 773 So. 2d 594 (Fla. 1st D.C.A. 2000).

³⁷⁰ *Umbel v. Foodtrader.com, Inc.*, 820 So. 2d 372, 374 (Fla. 3d D.C.A. 2002).

³⁷¹ The article specifically states that “in context of self-settled trusts, there is no act whereby one party issues anything of value to another party.”

the grantor or the trust assets from creditor claims despite the holding in *In re Mart*. The article discusses grantor-retained annuity trusts (GRATs) in this context.³⁷²

The article quotes F.S. §736.0505, which was enacted in July 2007, for the proposition that creditors can freely reach into a self-settled irrevocable trust where the grantor has contracted for the right to receive payments from the trust. F.S. §736.0505(1)(b) states that a creditor may reach assets held under a self-settled irrevocable Florida trust to the extent of “the maximum amount that can be distributed to or for the settlor’s benefit.” The scrivener’s summary to the statute indicates that the provision was intended to simply codify the Florida common law, which has allowed creditors of a self-settled irrevocable trust to reach payments to the extent that a trustee has the discretion to pay monies to the grantor.³⁷³

The article then cites the case of *In re Brown*, 303 F.3d 1261 (11th Cir. 2002), which is a 2002 11th Circuit Court of Appeals bankruptcy decision that held that the creditors of a self-settled charitable remainder unitrust, which paid seven percent of the value of trust assets to the grantor each year for life (with the remainder passing to charity), could attach the unitrust payments as they came due each year, but could not attach the remainder interest.

The court in *Brown* found that petitioners had not timely asserted that the unitrust payments could be protected as proceeds of an annuity contract under F.S. §222.14.³⁷⁴ The court held that the creditors could not reach the trust corpus, but could attach the income stream. The court held that the remainder interest, as well as future payments not yet due, were protected from the creditors under Florida law. Based on the authors’ review, this result is consistent with the common law in most other states.

The *Brown* decision cites a number of consistent cases which state that an income interest reserved to a settlor entitle the creditor to receive the income from the trust, on an annual basis, but not the remainder interest.

The authors are unaware of any well-publicized, reported decision in the United States which indicates that a creditor can reach assets held in a self-settled irrevocable trust, except to the extent actually payable to the grantor at the time of levy.³⁷⁵

Even trusts established by grantors who retain the right to income and additionally retain the power to appoint how trust assets would be devised could not have trust principal seized by creditors where the power of appointment was limited to not being exercisable in favor of the grantor/power holder or his or her estate, creditors, or creditors of the estate.³⁷⁶

When a grantor establishes an irrevocable trust and enters into a private annuity contract with the trust, there is an arm’s-length arrangement between the grantor and the trustee of the trust, and the annuity

³⁷² GRATs are a popular estate tax planning tool whereby a grantor contributes assets to a trust in exchange for the right to a stream of payments defined by the Internal Revenue Code as a “qualified interest.” The term “qualified interest” in Code §2702(b)(1) means any interest, which consists of the right to receive fixed amounts payable not less frequently than annually.

³⁷³ Florida Trust Code Scrivener’s Summary 28-29.

³⁷⁴ *In re Brown*, 303 F.3d 1261 at n. 4.

³⁷⁵ See also Robert T. Danforth, *Rethinking the Law of Creditors’ Rights in Trusts*, 53 Hastings L. J. 287 (2002).

³⁷⁶ See *U.S. v. Baldwin*, 283 MD. 586 (MD 1978).

payments made to the grantor should not be regarded as “benefits” payable to the grantor as a beneficiary of the trust. Similarly, with a GRAT, the Internal Revenue Code requires that the payments made back to the grantor be set at the time of establishing the trust based upon appropriate actuarial calculations or a fixed dollar amount, which, by definition cannot exceed the value of assets placed in the trust at the time that the GRAT is established.

Based upon the above, the authors believe that a self-settled trust that enters into a private annuity contract or is a GRAT theoretically should have its assets exempt from claims of creditors of the grantor, and that the annuity payment rights held by the grantor should as a normative matter, be exempt from creditor claims under F.S. §222.14. Obviously, an exception to the above would apply if the funding of the trust were considered a fraudulent transfer under this interpretation, in what would be a case of first impression, or that the legislature could rewrite the statute to restrict the scope of the statutory exemption.³⁷⁷

If the above-referenced article is correct and a court were to find that the proceeds of an annuity contract were not exempt from creditor claims, then the most a creditor could attach or garnish would be the annuity payments then due to the extent that the trustee has not applied the annuity payment “for the benefit of” the grantor as permitted under Treasury Regulation §25.2702-3(b)(i).

The bottom line is that private annuity contracts and GRATs are legitimate estate planning tools (particularly in a low interest rate environment)³⁷⁸ that might also have secondary asset protection benefits if a court were to construe Florida law in accordance with the plain meaning of the statute as written.

A QUALIFIED PERSONAL RESIDENCE TRUST (QPRT) MAY BE CONVERTED TO AN ANNUITY TRUST.

A Qualified Personal Residence Trust is an Internal Revenue Code specific entity that enables a homeowner to place a primary or vacation home residence under a trust that allowed the grantor/contributor to have access and control for a term of years, after which the trust is held solely for a spouse and/or descendants, and not subject to federal estate tax in the estate of the grantor. Under the estate and gift tax law, the contribution of the home to the trust is considered to be a gift, but the value of the gift is reduced pursuant to IRS provided actuarial tables which take into account the limited value of the right to only have use for a term of years.

There is much concern that a creditor could take over the right to occupy a home held under a QPRT for the term of years that the grantor retained use for, but under Treasury Regulation Section 25.2702-5(c)(8)(i), if the home is sold while in the QPRT, the trust ceases to be a QPRT and the trustee must either: (1) distribute the proceeds outright to the grantor; or (2) the interest of the grantor should be converted into an annuity interest.

³⁷⁷ A court decision would likely be retroactive, *i.e.* it would unwind the challenged transaction – whereas legislation is typically prospective.

³⁷⁸ Certain techniques, like grantor-retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs), and private annuities do better in low interest rate environments, whereas others, most notably, qualified personal residence trusts (QPRTs) and charitable remainder annuity trusts (CRATs) fare worse.

Although the QPRT regulations provide that the Trustee can be given the choice of distributing the proceeds to the grantor or converting the grantor's interest into an annuity, the authors strongly recommend that QPRT Trust documents should be drafted to require a conversion to an annuity interest, and to not offer the choice of an outright distribution to the grantor. The authors recommend that the Trust document require conversion to an annuity interest, and do not offer the conversion option. Under the annuity option, the trust will make an annual annuity payment to the grantor, which if properly drafted, should qualify as an exempt asset under Florida Statutes Section 222.14. Sample language that has been used in QPRTs to facilitate this process for those who reside in states that protect annuity payments from creditors is as follows:

If the Trust ceases to be a Qualified Personal Residence Trust with respect to certain property, such property shall, within thirty days, be held in a separate share and the interest of the grantor shall be converted into a qualified annuity interest (as defined by Tres. Reg. § 25.2702-3 and the requirements for such interest shall be deemed incorporated into this Article) with the smallest fixed annuity payments permitted by Treas. Reg. § 25.2702-5(c)(8)(ii)(C) to be made to the grantor each calendar month for the balance of the Retained Possession Term, provided that the Trustee is authorized to make the conversion at an earlier time. The commencement date of the qualified annuity interest shall be determined in accordance with Treas. Reg. § 25.2702-5(c)(8)(ii)(B), and the Trustee may defer and determine the payment of any annuity amount as provided in that Regulation. If the Trust ceases to be a Qualified Personal Residence Trust with respect to certain property, the intent of the grantor is to provide for issuance of an annuity contract to the grantor based on the terms of this Agreement.

Federal Regulation Section 25.2702-5(c)(8)(i) reads as follows:

(8) Disposition of trust assets on cessation as personal residence trust – (i) In general. The governing instrument must provide that, within 30 days after the date on which the trust has ceased to be a qualified personal residence trust with respect to certain assets, either-

(1) The assets be distributed outright to the term holder;

(B) The assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest; or

(C) In the trustee's sole discretion, the trustee may elect to comply with either paragraph (c)(8)(i)(A) or (B) of this section pursuant to their terms.

In *Nolte v. White*,³⁷⁹ the Florida Fourth District Court of Appeals affirmed the trial court's decision granting final summary judgment in favor of the debtor, who claimed a homestead tax exemption in property that she conveyed to a qualified personal residence trust (QPRT) and in which she retained a right to reside for a term of eight years.

³⁷⁹ 784 So.2d 493 (Fla. 4th DCA 2001).

It is important to note that by definition, a QPRT will end a certain number of years after formation, and at that time, the grantor will no longer have a possessory interest for property tax purposes. The grantor, however, may wish to lease the property from the QPRT, and if a 99-year lease is put into place at the time the possessory interest term ends, then the Florida homestead property exemption and 3% cap may continue to apply. A 99-year lease may be considered a sale for income tax purposes, but possibly not if the lease contains provisions which allow termination upon certain events (such as upon the death of an elderly tenant) and rent amount readjustment clauses so that the economics of the 99-year lease are not substantially equivalent to that of a sale.

THE PRIVATE ANNUITY TRUST.

The “private annuity trust” was heavily marketed before the issuance of a 2006 Revenue Ruling which basically invalidated the ability to convert ordinary income to capital gains treatment using what was considered by many to be a highly aggressive and unproven strategy. Trusts that employed that strategy prior to the issuance of the ruling may be grandfathered if the technique was valid.

CONSIDER GOING OFFSHORE.

Life insurance and annuity products offered by offshore jurisdictions may allow the underlying investments to be managed by selected money managers or a broad range of mutual funds, and many offshore jurisdictions have creditor protection statutes which may require that a creditor obtain a judgment in the offshore jurisdiction before such an annuity contract would be susceptible to creditor claims.

Offshore annuity policies are very similar to offshore life insurance policies, which are discussed extensively in Leimberg Information Services Newsletter No. 485 entitled “Offshore Life Insurance: A Potent Wrapper for Ordinary Income Investments,” which is provided below in Chapter 4, Section E.

Reputable offshore trust and insurance companies can provide customized annuities, modified endowment contracts, and traditional life contracts that may qualify for tax deferral or complete income tax avoidance under applicable income tax law, with the client having the ability to choose a money manager or possibly even the client’s broker to oversee investment of the product. This helps to bring new meaning to the word variable. However, the Treasury Regulations make deferral on offshore annuity products somewhat doubtful in many situations.

Foreign bank account disclosure requirements do not apply to investments in offshore life insurance and annuity products.

Since such policies can qualify under the tax and state law without fulfilling expensive and strenuous requirements imposed by state insurance commissioners, clients investing large sums may be able to save money in large policies and have more flexibility as to investments by going offshore.

DOES THE 10-YEAR BANKRUPTCY TRANSFER AVOIDANCE RULE APPLY TO ANNUITIES AND LIFE INSURANCE?

The 2005 revisions to the Bankruptcy Code make transfers to self-settled trusts “or similar devices” subject to avoidance or set aside in bankruptcy when made within ten years of filing. Are annuities and life insurance products considered to be “similar devices” that would be protected in bankruptcy? The answer is probably no, given that no court case has extended the ten-year rule to any self-settled asset protection trusts, such as life insurance policies, multiple corporation, LLCs, and partnership structures. At one point in the legislative process, this asset protection trust 10-year set aside provision was to specifically exclude qualified retirement plans, but this exclusion language was taken out of the legislation when enacted.

The only known case discussing this is favorable to the debtor. In the Southern District of Illinois bankruptcy court case of *In re Porco*,³⁸⁰ a company was entitled to receive real estate from a third party, and instead allowed the real estate to go to a separate company owned by the same shareholder, thereby creating a resulting or constructive trust. The creditors that were owed money by the first company attempted to set aside the transfer of rights under the ten-year fraudulent transfer statute, claiming that the arrangement was to “a self-settled trust or similar device.” The court determined that the “**similar device**” language “require[d] an express trust.” The court stated that the purpose of Bankruptcy Code Section 548(e) was to thwart the protection of “the domestic asset protections trusts” enacted in some jurisdictions.

ABUSIVE SALES AND COMMUNICATIONS TACTICS.

The life insurance industry has been harshly criticized by many for lack of disclosure and truthfulness in how it describes certain annuity products. A good example of this can be found in the YouTube video entitled “Alan Gassman’s Presentation to the 2014 Notre Dame Tax & Estate Planning Institute on Annuities.” In addition, letters sent by Senator Elizabeth Warren to several life insurance carriers in 2015 point out that using incentives such as lavish vacations and gifts could cause agents to put their own interests before that of their clients. These letters can be found on the Internet at <https://www.warren.senate.gov/files/documents/AnnuitiesLetters.pdf>.

³⁸⁰ 447 B.R. 590 (Bankr. S.D. Ill. 2011) (finding that resulting or consecutive trusts were remedial in nature and arose by operation of law, rather than by the settlor’s express grant).

CHAPTER 4

LIFE INSURANCE

INTRODUCTION.

The statutory language exempting life insurance is contained in Florida Statutes Section 222.14, which reads:

The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such annuity contract, unless the insurance policy or annuity contract was effected for the benefit of such creditor.

This is a shield against the insured creditors. However, the statute does not protect a debtor who is the beneficiary of another's life insurance policy, and neither does it protect the beneficiaries of the debtor's life insurance policy.³⁸¹ Thus, it is better to have the policy payable to protective trusts than individuals or other entities.

The statute makes no mention of term insurance policies, which have values to the extent of prepayment, and may also be marketable for sale purposes.

Many of the same considerations that apply to annuities, discussed in Chapter 3, apply equally to life insurance products, including the ten-year Bankruptcy Code look back provision. Clients with large investment portfolios can get custom designed private placement policies, including customizable offshore life insurance programs.

A life insurance policy that meets the minimum corridor requirements can qualify both for tax free loans that can be made during the life of the policy and income tax free payments of cash and loan forgiveness upon death to policy beneficiaries.

When purchasing a "permanent value life insurance," individuals should consider that life insurance products oftentimes include significant sales and administrative charges in their premiums.

MODIFIED ENDOWMENT CONTRACT.

A Modified Endowment Contract (MEC) is a special type of cash value life insurance policy that fails to meet the seven-pay test which distinguishes between policies purchased primarily for tax advantages

³⁸¹ See *In re Zesbaugh*, 190 B.R. 951 (Bankr. M.D. Fla. 1995) (holding that the debtor, as beneficiary, was not entitled to the exemption for proceeds of life insurance policies).

and policies purchased for death protection. While most life insurance policies are appropriately designed to qualify under the “TEFRA guidelines” to permit tax-free borrowing, it is easier to satisfy the “Modified Endowment Contract” guidelines, which involve having less mortality risk component in a policy, and still allow for the policy proceeds to be received income tax free on death. For example, where the insured is age 80 or over, the death risk portion of a life insurance policy needs to be only 5% of the principal amount invested to qualify the policy for income tax proceeds received upon death. An 80-year-old investor who holds assets that may quickly increase in value might consider paying an offshore life insurance carrier a reasonable fee to “wrap” the investment into a life insurance policy so that all growth under the fund would pass as income tax free to the descendants upon the death of “insured.” However, for your average person, a MEC is not the recommended form of life insurance.

LOAN PROCEEDS.

In the Fourth District Court of Appeals case of *Technical Chemicals and Products, Inc. v. Porchester Holdings, Inc.*,³⁸² the court determined that the protection provided by Florida Statutes Section 222.14 is not lost simply because an insured requests the cash surrender value of the policy in the form of loan proceeds. The appellate court agreed with the trial court’s determination that the cash surrender value of life insurance policies is protected both in the hands of the insurer and insured. However, the court declined to decide whether the creditor would be able to proceed against the funds once the debtor received them. Subsequent cases have not resolved this issue, therefore, it is unclear whether a creditor can reach loan proceeds after the debtor has received them. Only time will tell whether this issue will ever be brought before the Florida Supreme Court.

CASH SURRENDER VALUE CONVERTED TO ANOTHER FORM.

In *Faro v. Porchester Holdings, Inc.*,³⁸³ the 4th District Court of Appeals held in 2001 that the cash surrender value of a life insurance policy continued to be statutorily exempt from garnishment even after the debtor took possession of a portion of the proceeds and converted it into another form by purchasing a certificate of deposit (CD) with the proceeds. In this case, the creditor received a judgment against the debtor in 1994. In 1997, the debtor requested a withdrawal of part of the cash surrender value of two life insurance policies. He then used the proceeds to purchase a CD from a bank, and used the CD as collateral for a loan. Relying on *Goldenberg*,³⁸⁴ the court held that the proceeds were still exempt from garnishment even though part of the cash surrender value had been converted into a CD.

The court reiterated that “Florida has a long-standing policy that favors liberally construing exemption statutes so as to prevent debtors from becoming public charges” and explained how the language “upon whatever form” contained in the statute must be broadly construed. Specifically, the court stated that “the clarity of these words indicate[s] that the form of payment is not relevant for purposes of having the exemption apply.”

Notably, in this case, as well as many others construing this statute, the court does not focus its analysis on what type of life insurance policy is at issue. The broad language of the statute, combined with

³⁸² 785 So.2d 636 (Fla. 4th DCA 2001).

³⁸³ 792 So.2d 1262 (Fla. 4th DCA 2001).

³⁸⁴ 791 So.2d 1078.

the lack of detail paid to this issue in the case law, indicates that all types of life insurance will likely be covered by this statute.

OFFSHORE PRIVATE PLACEMENT LIFE INSURANCE POLICIES.

OFFSHORE LIFE INSURANCE: A POTENT WRAPPER FOR ORDINARY INCOME INVESTMENTS

By: Alan S. Gassman, Esq., Steven Holub, CPA, and Jeffrey M. Gad, Esq. Reprinted with Permission from Leimberg Information Services 04-Dec-02 Steve Leimberg's Estate Planning Newsletter – Archive Message #485

INTRODUCTION

Although offshore policies have been around for many years, more and more individuals and businesses are utilizing them for several good reasons. Offshore life insurance has become an effective way of structuring personal and financial planning investments based on a number of factors:

BENEFITS TO USING OFFSHORE INSURANCE CARRIERS:

One important factor is a competitive offshore industry that is willing to be cost effective and flexible in its planning in operation and parameters.

A second factor is the flexibility made possible by not having to comply with regulatory requirements which are imposed by the fifty states and the District of Columbia domestically. This assures that the structure will cover death claims.

Most carriers use recognized and respected United States actuarial and legal firms to assure that the policies offered comply with United States tax law rules, and in particular, the minimum corridor rules and modified endowment contract ("MEC") criteria. (The minimum corridor rules control how much life insurance element must be present with reference to the investment value of the policy, and the modified endowment contract rules provide stricter standards of minimum death benefit element which must be provided in order for the policy holder to be able to take interest free loans from the policy. The MEC standard used to be the "Four out of Seven" rule).

No client should invest in an offshore life policy unless there are solid opinions letters from A-V rated U.S. legal counsel and reputable United States actuarial firms confirming that the policy meets applicable corridor and MEC requirements.

Offshore life insurance carriers will typically charge an administrative expense based upon a percentage of the "cash value" of the policy. Additionally, the policy issuer will contract with a re-insurance company to provide the death benefit element, and this premium will typically be passed on as a direct cost to the policy without markup by the offshore carrier. (It has been reported that there may be a commission "kicked back" from the reinsurance carrier to the offshore carrier, and this is something that may need to be investigated when the policy is negotiated.)

Administrative expenses can run 1% to 2% of value, but may be negotiable depending on the company and the particular circumstances. Commissions paid to individuals who refer or coordinate these arrangements as between the client and the carrier usually do not exceed 3% of premiums. Any commission should be disclosed to the client and may be paid out of the policy contributions.

Offshore policies can only be sold outside of the United States. Consequently, most insurance carriers will insist that the application for the policy and preferably the medical examination necessary for underwriting purposes take place outside of the United States. Few, if any, reputable offshore carriers will meet directly with, or talk directly to, a client in the United States. The carrier will, however, meet with a client's advisors in the United States, provided the client is not present at the meetings. One role of the lawyer is to facilitate United States communications with the insurance carrier and the applicable professional, without the client interacting in the United States with the insurance carrier.

Virtually, all of the offshore carriers also offer annuity products which may provide tax deferral, although the Treasury Regulations make deferral with offshore annuity products both complicated and uncertain. Such annuities do not typically require significant life insurance or mortality cost elements within the policy.

SOME VERY BASIC LIFE INSURANCE TERMINOLOGY

Most advisors are aware of variable life insurance products, where there are investments held by the insurance company which can be accessible to the owner of the policy, and which grow in a tax free manner assuming that the policy remains intact until the death of the insured. For example, an individual might invest \$100,000 in a life insurance policy that would provide a \$250,000 death benefit. The individual may borrow from the policy tax free and the policy investments may grow to be worth \$300,000 by the time the individual dies. No tax would be paid on the growth within the policy or on the loan that would be forgiven on death if the insured dies with the policy intact. If the insured terminates the policy while alive, then the growth becomes taxable income in the year of termination. It may be possible to withdraw up to \$100,000 from the policy tax free during the insured's lifetime without paying income tax.

A traditional "seven pay policy", which really doesn't take seven annual payments to qualify, must meet certain tests in order to qualify as a life insurance policy under the Internal Revenue Code so that loans can be taken on a tax free basis. A MEC is a life insurance policy that does not meet the "seven pay test". Although the growth and proceeds from the policy on death will generally be tax free if the policy is kept intact for the lifetime of the insured, loans or any other withdrawals from the policy will be taxable to the extent of income within the policy if they occur during the lifetime of the insured.

For the sake of terminology, we will refer to the underlying value of investments within the policy as the "asset value" and the mortality element, which is generally furnished by a third party re-insurance company or guaranty of additional benefit by the insurance company issuing the policy will be referred to as the "mortality coverage". Most of the offshore insurance companies accept very little of the risk. For example, Mass Mutual's Bermuda subsidiary will hold the cash value, have a re-insurance company agree to pay money into the policy if the insured dies based upon agreed tables, and will add \$5,000 to the policy on the death of the insured and otherwise not be at risk.

YOU HEARD IT HERE FIRST – REDUCING MORTALITY COSTS – THE “DEDICATED MORTALITY ACCOUNT”

The mortality risk element is an expense that becomes greater as the insured becomes older. Typically, offshore insurance products pass the cost of the re-insurance on to the policyholder by withdrawing this from the policy values, and the re-insurance for offshore policies is apparently significantly more expensive than typical domestic re-insurance.

The significant advantage that can be enjoyed by offshore policies with respect to mortality charges, however, related to something which may be referred to as a “Dedicated Mortality Account.” The concept is that growth in cash value can be earmarked to a separate account under the policy that will be held for mortality risk purposes only, thus significantly reducing the re-insurance mortality element.

For example, assume a 77-year-old man wishes to invest \$1,000,000 in a variable life policy to be treated as an MEC. Satisfying what is known as the 105% test which applies under IRS Tables, there would need to be mortality risk insurance based upon no less than 5% of the cash value of the policy until the insured reaches age 90, and then this would be reduced to 4% at age 91, 3% at age 92, 2% at age 94, and no mortality element would be needed at age 95.

Therefore, if the policy were to grow to \$3,000,000 in cash value, there would need to be at least \$150,000 of mortality re-insurance available, which would not be inexpensive to procure at the time the policy is first purchased. If the policy values might grow to \$10,000,000, then insurance commitments for \$500,000 would have to be procured upon inception, which is expensive. If the policy values grow beyond the required re-insurance, then a “force out” occurs, meaning that monies would have to be paid out. The “forced out” money would be taxed at ordinary incomes rates during the life of the insured.

Using a Dedicated Mortality Account, however, once the increase in value to \$1,150,000 has occurred, instead of additional insurance, the policy can provide that excess value from growth, or a specific percentage thereof, will be designed to be held under a separate account in lieu of the additional insurance element. Thus, the 77-year-old may only need to wait until the investments under the policy grow by at least 5% before mortality charges substantially decrease or vanish, although some level of re-insurance is going to be necessary in case the investments go back down below 105% of original cost.

While the Dedicated Mortality Account concept may sound somewhat aggressive, a number of reputable law firms with expertise in this area believe it is in absolute conformance with the Internal Revenue Code and are willing to opine on its viability, based upon the tax law as it is now written. The fact that the client does not have direct access to policy values allocated to the Dedicated Mortality Account may help to support this position.

Where there is concern as to constructive receipt and control issues, which are described briefly below, the use of a Dedicated Mortality Account should alleviate the risk to the extent that the policy owner could not access policy growth as a matter of contract.

DIVERSIFICATION AND CONTROL ISSUES

Prior to December 31, 1983, the IRS generally required that the life insurance policy owner not have control over the investments and general conduct of investing with respect to the cash values under the life policy. In an attempt to address this concern, Congress added a diversification requirement by enacting Code Section 817(h) effective January 1, 1984. Section 817(h) generally requires specific levels of diversification to occur within the first year of policy funding.

Diversification Tests: Section 1.817-5(b)(1)(i) of the Treasury Regulations, a contract will only be considered adequately diversified if the following conditions are satisfied:

First, no one investment constitutes more than 55% of the value of the total assets of the account;

Second, no two investments constitute more than 70% of the value of the total assets of the account;

Third, no three investments constitute more than 80% of the value of the total assets of the account; and

Fourth, no four investments constitute more than 90% of the value of the total assets of the account.

The fact that the diversification requirements do not have to be met during the first year provides a significant planning opportunity in the case of an initial potential investment with prospective substantial increase in value during the first year, as long as the diversification requirements can be met by the end of that first year.

The Section 817 test must be met every calendar quarter after the first year. Once this test is met for a particular period, however, the arrangement will be considered to meet the diversification requirements if investments are unchanged based upon a “frozen allocation.” Notwithstanding the percentage of investment tests, these rules will not be violated by reason of value growth in existing policy investments. The rules will only be violated where additional investments or withdrawals of investments cause the percentages to become unaligned.

The Control issue: A big question in the tax law is whether the policy owner can now control policy investments to such an extent that the income derived therefrom would be subject to income as if directly received. While, as a practical matter, policyholders under United States variable life policies have absolute control to the extent that they choose between various mutual funds and control timing with respect thereto, can the policyholder or their family direct the insurance company to invest in specific stocks, businesses, or to even form offshore banks and loan monies or actually operate active business endeavors?

The tax law on this is not completely settled, and the IRS was successful in one case *Christoffersen v. U.S.*, 749 F.2d 513 (8th Cir. 1984), where a taxpayer bought an annuity contract that allowed him to change the underlying funds at any time within the policy, and had the right to withdraw all of the investments on seven (7) days’ notice. In this case the taxpayer erroneously reported the income from the investment on his personal return, but later filed an amended return requesting a refund. There is some

support, however, for the proposition that policy owners should not be considered the owners of the underlying account assets, particularly where they can only receive cash back from liquidation of the policy and do not have contractual rights to control the investments outside of being able to suggest investments to the insurance carrier. See *Investment Annuity, Inc. v. Blumenthal*, 442 F. Supp. 681 (D. DC), which was reversed on other grounds at 609 F.2d 1 (D.C. Cir. 1979).

In Revenue Ruling 81-225 the IRS found a program whereby a Savings and Loan directed its customers to a variable annuity company where the money the customer invested would buy a CD from the Savings and Loan itself was found to be the equivalent of direct ownership of the CDs by the contract holders under an alter ego theory.

It is the position of the ABA section of taxation, Committee on Insurance Companies that the legislation passed to amend Section 72 in enacting Section 817(h) on diversification supersedes the IRS/*Christoffersen* theory, and there is some support for this in the Blue Book issued by the Treasury Department after the passage of the Deficit Reduction Act of 1984. This topic is very well covered by BNA in portfolio #546, Chapter VI.

MORE POLICY STRUCTURE CONSIDERATIONS

With reference to the structure of holding investments, insurance companies licensed in Caymans or Bermuda operate under the separate account legislation which clearly earmarks the investments held under the policy to not be subject to creditor claims of the insurance company. The insurance company will generally have the policy owner appoint a custodian and an investment manager. The custodian can actually hold the investment assets, and the investment manager can direct how the assets will be invested.

While the actual insurance policy language used by the offshore carriers prevents control over investments by the policyholder, in actuality the insurance carrier may be able to accommodate the investment goals of the owner of the policy, if the investments are handled by a reputable trust company. The trust company may form an International Business Corporation (“IBC”), where the family of the policyholder might have significant input or even a partial interest in the IBC. The life insurance tax law provisions do not have prohibited transaction or related party restrictions that would explicitly prevent an insured or policy owner from working for, lending money to, or borrowing money from a business owned by a life insurance policy.

Where the insurance contract is an MEC and the owner is unable to make withdrawals from the policy itself without triggering tax, an IBC may under certain circumstances be able to loan money to the policyholder without triggering tax.

MARVELOUS THINGS THAT CAN BE DONE SINCE THERE ARE NOT PROHIBITED TRANSACTION RULES IN THE INTERNAL REVENUE CODE CONCERNING LIFE INSURANCE.

Leverage can also be used in two major ways:

A. First, to help reduce mortality costs and re-insurance needs, the client may loan money to the IBC and then withdraw the money later as a repayment of the loan, with interest that may be charged at the applicable federal rate. Then if the investments in the IBC do poorly, the client may have a bad debt deduction. A loss on investment in a life insurance policy itself is generally not income tax deductible. This also keeps a lot of the ultimate investment out of the hands of the insurance company, and can help reduce administrative charges with respect to insurance carriers who would charge a percentage of all assets under management, since the amount owed to the insured or their affiliate would reduce the ultimate net cash value.

Clients who would like to receive payments from the IBC exceeding simple interest and principal loaned might consider selling property to it in return for a private annuity. If the annuity payments end when the client dies and the client outlives his or her life expectancy, the ultimate payments to be received will generally be greater than would apply with principal and interest under a promissory note. Also, payments received on a loan are considered to be interest to the extent then earned and then principal, while payments received under an annuity arrangement are characterized as interest and principal in a more advantageous manner. Conversely, if the client does not live beyond his or her life expectancy, the amount that would otherwise be included in his or her estate has the obligation been in the form of a promissory note may, if properly structured, pass outside of his or her estate.

B. Finally, clients with appreciated assets that they would like to have held under a life policy to avoid tax on further appreciation may sell much assets to the IBC in exchange for a private annuity. While there will be some income tax recognized as annuity payments are received by the contributor, a good part of each payment will be considered a return of principal, and future growth of the assets may be shielded from the income tax system.

These loan techniques and “control” over policy investments by individuals or entities designated by the policyholder may be considered aggressive from an income tax standpoint. But they are not uncommon and have some probability of withstanding IRS scrutiny and even litigation that might ensue as a result of the use of these techniques.

OTHER OPPORTUNITIES

In addition to the use of offshore life insurance as referenced above, offshore life insurance may also be particularly well suited for a non-United States citizen or resident who is planning on moving to the United States so that wealth accumulated prior to entering the United States may remain offshore and nontaxable. Similarly, in the case of a non-United States client who has intended United States beneficiaries, it may be feasible to structure an offshore life insurance policy which could be used in conjunction with offshore trusts that would keep this wealth offshore without subjecting it to United States taxes. Such trusts often provide both wealth preservation and asset protection (and give you just one more reason to visit the tropics once a year during winter!)

RISK OF TAX DISALLOWANCE: IF IT SOUNDS TOO GOOD TO BE TRUE

As discussed above, are a number of potential issues that arise when offshore life insurance is used. Failure to satisfy the diversification test or a violation of the control test (if it is a viable test), could make the owner of a policy currently taxable on investment growth.

Also, the life insurance rules will not neutralize and eliminate income tax on certain types of income, such as unrelated business taxable income, income from U.S. sources effectively connected with a U.S. trade or business, and income from certain fixed or determinable annual or periodic U.S. sources, such as rent, royalties and certain dividends derived from the U.S.

It does appear, however, that U.S. source gains emanating from real property sale activities will be subject to the U.S. tax regime, whether short term or long term. Interest paid on loans to real estate development entities, however, should escape taxation if the payee is an offshore policy that is properly structured.

Another issue that could be asserted by the IRS would be that contracts issued by offshore insurers cannot qualify as “variable contracts” in the most technical sense. An issuer must allocate amounts received with respect to a variable contract pursuant to State law or regulation [to a segregated asset account]. Code Subsections 7701(a)(9) and (10) define the terms “State” as the States of the United States and District of Columbia. Thus, a contract based on a segregated asset account under the laws of a non-U.S. jurisdiction may not constitute a “variable contract.” One defense to this position is that the diversification requirements of Section 817 may not apply to such contracts.

There will also doubtlessly be practical abuses of life insurance policies by aggressive and/or uneducated life insurance companies, clients, and unscrupulous business people, as can apply with any vehicle.

The offshore industries have had more than their share of Ponzi schemes and misled or intentionally errant taxpayers who are looking to be aggressive or are somehow convinced that something too good to be true could be true.

There are obviously a number of potential issues that arise when offshore life insurance is being placed. While a plain vanilla wrapper with standard and appropriate amounts of reinsurance for a hedge fund investment will probably not be considered controversial, the fact that the industry will still typically recommend opinion letters and confidentiality with respect to the arrangement demonstrates that there is less than complete certainty as to tax results.

Where the policy has dedicated business, international business companies controlled by entities other than the life insurance carrier, loan arrangements with the insured or family members of the insured, and/or private annuity arrangements, potential challenges by the IRS seem more likely, but whether the Service can be successful in dismantling these arrangements when they are based upon law written in favor of an insurance industry without related party rules or prohibited transaction restrictions is highly questionable. For instance, if the control test described above is not satisfied, then the owner of the policy can be taxable.

Finally, as offshore planning becomes increasingly popular, it is likely to receive even more scrutiny by the Treasury Department and will not have the lobby that the domestic insurance industry keeps at its disposal to protect specific arrangements they promote.

The authors believe that it is likely that there will eventually be legislation specifically limiting offshore insurance activities, but hopefully any such legislation will leave a place for the use of offshore life insurance in tax planning and preexisting activities will be grandfathered or allowed to continue under limited parameters.

The authors' conclusion is that the sophisticated client who may save taxes and achieve non-tax planning objectives by using offshore life insurance should be made familiar with the concept and educated sufficiently in order to determine whether the client believes that this is something worth pursuing.

JEFFREY T. WEBBER'S TAX VICTORY WITH OFFSHORE PRIVATE PLACEMENT LIFE INSURANCE

While the case of *Jeffrey T. Webber versus the Commissioner of Internal Revenue* is commonly referred to as an example of a situation where courts will disregard a trusteeship or other fiduciary relationship where the fiduciary simply follows the exact instructions of a grantor, the end result of the situation was that a \$735,046 investment grew to become worth \$12,300,000 as the cash value of an offshore private life insurance policy, with an income tax cost of only \$536,948, plus attorneys fees.³⁸⁵

Webber is a U.S. based venture-capital investor and private-equity fund manager. He has a bachelor's degree from Yale and also took some courses at the Stanford University MBA School before joining a technology consulting firm and a series of private equity partnerships that provided seed capital to startup companies. Because of his continuing success and accumulating wealth, Mr. Webber was referred to William Lipkind, a partner in the law firm of Lampf, Lipkind, Prupis and Petigrow, in order to establish a wealth and estate plan. Mr. Lipkind, is a well-respected tax and estate planning lawyer who introduced Mr. Webber and a handful of other clients to offshore private placement life policies.

Private-placement life insurance is usually sold through a private-placement offering to high net-worth individuals who qualify as accredited investors under the Securities Act of 1933. By making these products variable, both the premiums and death benefit may fluctuate. The assets held for the death benefit of the policy are held in separate accounts that are separate from the general assets of the insurance company. The policy does not earn a fixed rate of return, but instead a rate of return that is dictated by the actual performance of the investments in the account. Therefore, if the assets held in the separate account perform extremely well, as they did in this case, the value of the policy may substantially exceed the minimum death benefit.

In 1999, by the recommendation of Mr. Lipkind, Webber used \$700,000 from his Alaska Trust to purchase two private placement variable life insurance policies from a Cayman life insurance carrier, Lighthouse Insurance. Lighthouse was established in 1996 and issued seventy to one hundred policies in 1999 with a total outstanding face value of \$250,000,000 to \$300,000,000. The carrier had no direct or

³⁸⁵ 144 T.C. No. 17.

indirect ownership relationship with Mr. Webber, and is managed by a major London-based insurance company.

Webber's Alaska trust owned the policies from October 28, 1999 until October 8, 2003, at which time he formed an irrevocable trust in the Bahamas. The Alaska trust then assigned all of its assets, including the private placement variable life insurance policies, to the offshore trust. The purpose of the trust was intended to produce tax benefits with no income tax on dividends, as well as interest and capital gains and federal estate tax avoidance. The Bahamas trust owned the policies from October 9, 2003 to March 6, 2008.

While the separate account assets were worth \$12,300,000 by 2007, the amount of cash that Webber was able to receive by surrender or policy loan was capped at the \$735,046 in premiums paid, which was presumably the result of a provision under the life insurance policy that allowed growth in assets to be used to replace mortality arrangements and thus reduce or eliminate annual mortality expenses.

For the majority of 2006 and 2007, a Bahamian bank was the investment manager for the policies. The policies stated that no one but the investment manager may direct investments for a separate account. Under the policies, the policyholder was allowed to propose investment objectives and guidance to the investment manager, who in turn would comply within that framework. The Trusts specified that 100% of the assets in the separate accounts should consist of high-risk investments, which included private-equity and venture capitalist assets. The majority of the investments in Webber's policies' separate accounts consisted of non-publicly traded securities, and there was no indication of due diligent research with respect to Webber's investment directives by the investment manager.

Nevertheless, Webber sold shares of three start-up companies to the policy in exchange for \$2,240,000, had one of his companies borrow \$450,000, and had the policy purchase a promissory note for money owed to him for \$50,000. Then another six other promissory notes were purchased from him for \$186,600, among other transactions.

1999	\$700,000 used to purchase two PPLI policies	Petition filed Form 709 – US Gift Tax Return
2003	Alaska Trust assigns assets to Bahamas Trust	Petition filed Form 3520 – Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts

Mr. Lipkind explained to Webber that it was essential that Webber did not appear to exercise any control over the investments purchased for the separate accounts for tax reasons and avoidance of the Investment Control Doctrine. Mr. Lipkind had reviewed opinion letters from several law firms, in which three specifically addressed the Investor Control Doctrine. These opinion letters were provided from reputable law firms that concluded that the policies' investments would comply with U.S. tax law and avoid application of the Investment Control Doctrine for tax purposes. Therefore, Webber never communicated directly with Lighthouse or the investment manager. However, over 70,000 emails were sent to or from Mr. Lipkind, the investment manager, and/or Lighthouse regarding Webber's recommendations for investments by the separate accounts. Mr. Lipkind charged time at the traditional hourly rates and did not receive any bonus or special compensation of any kind from Lighthouse or the investment manager.

Due to the reasons mentioned above, the court held that Webber was the owner of the assets in the separate account, and was taxable on the income earned on those assets during the taxable years at issue, though no additional penalties would be imposed.

The court found that Webber had the unfettered ability to select investments for the separate accounts by directing the Investment Manager to buy, sell and exchange securities and other assets that he wanted the carrier to hold for him. Mr. Lipkind came up with what he thought was a clever protocol to place a buffer between Webber and the investments so that it would appear that Webber did not exercise any control over the investments. However, the court found that there was no documentation to establish that the carrier or the investment manager engaged in independent research or meaningful due diligence, and found that the carrier exercised “bare bones know your customer” review and occasionally requested organizational documents.”³⁸⁶ The court did find, however, that Webber reasonably relied upon his tax lawyer, Mr. Lipkind, who was a competent tax advisor and an expert in income and estate tax who had diligently researched the relevant legal issues and received accurate and complete information about the arrangements in setting up Mr. Webber’s estate plan. Therefore, the Court did not impose the accuracy-related penalty for any of the years in question. The court also found that the tax lawyer was not a “promoter upon whom petitioner could not reasonably rely.”³⁸⁷

The court found that within a period of twelve months he was able to indirectly extract more than \$1,000,000 in cash for personal use and therefore had no need to surrender the policies or to use policy loans to obtain cash.

While the income tax part of Webber and Mr. Lipkind’s plan was not successful, Webber was able to get a large amount of growth out of his own estate. The income tax penalties assessed by the court will instead come out of his other assets. There were no additional penalties, as it was clear to the court that Mr. Webber did not attempt to hide his estate plan from the IRS.

DECEPTIVE INDUSTRY PRACTICES.

It is believed by many that the life insurance industry employs deceptive marketing and disclosure practices with respect to many products that are sold on a commission basis. Alan Gassman’s materials prepared for the 2014 Notre Dame Tax Institute can be received upon request, and provide significant discussion on the issues.

The following are considered to be “essential definitions” that each reader should be at least somewhat familiar with in regards to life insurance.

TERM	DEFINITION
1035 Exchange	A tax-free exchange of an existing insurance or annuity contract for a new one on the same insured/annuity.
Accelerated Death Benefit Rider	A rider which allows the terminally ill insured to receive the death benefit during their lifetime.

³⁸⁶ *Id.*

³⁸⁷ *Id.*

TERM	DEFINITION
Accidental Death Benefit Rider	This rider increases the death benefit if death is caused by an accident. The increase is usually double or triple the face amount.
Account Value	The value of the cash value account before deduction of early termination penalties.
Agent of Record	The life insurance agent assigned to a contract who will receive commissions and be able to provide information and advice.
Benchmark	An independent point of reference (i.e. the S&P 500) that may be used for comparison or by formula in communications for policy terms. The most common Benchmarks are the S&P 500, the NASDAQ and the Dow Jones Industrial Average.
Bureau	The Medical Information Bureau (M.I.B.) defined below
Cash Surrender Value/Cash Value	The cash amount available to the policyholder if the policy is surrendered, less any loans outstanding.
Cash-value-based “wrap fees”	Charges that are calculated as a percentage of either the policy account value or the policy cash surrender value. While a set percentage is typically disclosed in either the policy prospectus, product guide and/or in the footnotes of the illustration, these percentages can and often do vary from year-to-year.
Commissioned Target Premium	Used in universal life products, target premiums are equal to the annual premium amount needed to endow policy cash values in an amount equal to the policy face (death) amount, and thus make policy death benefits permanent based on the insurer’s current actuarial expectations as to mortality experience and operating expenses, and based on the historical performance for the asset classes underlying policy cash values. This is significant, because commissions are commonly a larger percentage of the commissioned target premium than upon premiums contributed in excess thereof.
Convertibility Option	A rider that enables the owner of the term life policy to convert to a permanent policy, notwithstanding the health of the insured.
Cost of Insurance Charges (COI)	Charges to cover the insurer’s “cost” of providing death benefits. Current or expected COI charges are based on current or expected mortality experience, often including a margin for expenses or adverse deviations and profits.

TERM	DEFINITION
Cost of Living Rider	A contractual term that allows the death benefit under a policy to increase by a specified annual percentage in order to plan for inflation.
Death Benefit	The total amount payable to the beneficiary upon the death of the insured.
Dialed Down Commission	A less than maximum commission that can be selected by the selling agent to reduce policy costs.
Dividend	A defining characteristic of whole life products. Dividends may (1) be paid to the policyholder; (2) applied against the premium to reduce premiums paid in cash to the policyholder; (3) left on deposit with the insurer and credited with some rate of interest; or (4) used to purchase paid-up additional amounts of insurance.
Expense Charges	Charges against accumulation-type policies to compensate the insurer for issuing and maintaining the policy (in addition to COI, Fixed Administration, M&E, and other expenses).
Extended Maturity Rider	Allows the owner to extend the time at which the policy would otherwise mature.
Equity Index Universal Life Insurance	Permanent life insurance where the return on investment is geared to complicated formulas designed to emulate specified indexes.
Face Amount	The death benefit provided by a life insurance policy. This term most often applies to the amount of insurance specified on the “face” of the policy at the time of issue and may not include post-issue changes in total death benefits, such as those arising from paid-up additions or death benefit increases caused by growth in account values. However, some illustrations use “face amount” to apply to the total policy death benefit at any given time.
FINRA	The Financial Industry Regulatory Authority is a quasi-governmental organization that enables the life insurance industry to be somewhat self-regulating.
FINRA Illustration Requirements	Defined in Rule 2210, which must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service.

TERM	DEFINITION
Fixed Administration Expenses	Fixed administration expenses are generally calculated as either a fixed rate per period (e.g., \$100 per month) or a fixed rate per \$1,000 of policy face amount (e.g., \$1.00 per \$1,000 of policy face amount), or some combination of the two. These rates are generally disclosed as a fixed formula in either the policy prospectus, product guide and/or in the footnotes of the illustration, but may vary with either the policy face amount and/or the amount of total death benefit if different.
Fixed premiums	Payments of a fixed, equal amount paid to an insurance company for insurance or an annuity.
Flexible premiums	Non-fixed (Flexible) payments permitted under universal policies which are designed to adapt premiums to the policyholder's changing needs and financial conditions.
General Account	All the assets of a life insurance company other than those held in separate accounts. Separate accounts, or subaccounts, are typically used for variable products, which pass actual investment experience including all capital gains and losses through to policy cash values. The assets backing all other products are held in the General Account.
Guaranteed Performance	Policy illustrations show guaranteed figures, which will be honored by the insurance company regardless of the carrier's future financial experience. What is guaranteed will depend on the type of life insurance policy.
Guaranteed Universal Life Insurance	A Guaranteed Universal Life insurance policy where the death benefit is guaranteed if specified premiums are timely made for a given period of years (age 121).
In-force Ledger	A computer-generated illustration of a cash value life insurance policy's current, projected, and guaranteed values.
Informal Application	An application for coverage that is not signed nor officially finalized so as not to be reported to the Medical Information Bureau (MIB).
Interpolated Terminal Reserve Value	The estimated fair market value of a life insurance policy, which is determined by the carrier upon request based upon what it would charge to replicate the given policy, assuming that the insured(s) is of average health for the population that the specific policy was issued for.

TERM	DEFINITION
Investment in the Contract (Income Tax cost base with adjustments)	The aggregate amount of premiums paid into the contract, less any amount received under the contract (and less amounts of income from the contract that are spent to provide benefits under riders for extra death benefit in the event of accidental death, waivers of premium upon disability, or policy loans), to the extent that the amount was not included in the gross income (i.e. dividends). See Internal Revenue Code Section 72E.
Life Expectancy	An actuarially projected period of time a person is expected to live. Life expectancies are averages based on factors such as the gender and current age of an individual. Although illustrations may sometimes be provided for durations only up to “life expectancy,” roughly half the population would be expected to live beyond life expectancy.
Medical Information Bureau (M.I.B.)	An organization that enables life insurance carriers to share application information.
Minimum Corridor 7-Pay Test	The 7-pay test limits the cumulative amount of premium that may be paid into the policy for each of the first seven years, but may permit payments over fewer than seven years. The dollar amount is required to be clearly identified in life insurance contracts issued on or after June 21, 1988. Any policy that exceeds the cumulative premium guidelines (the 7-pay test rules) becomes a modified endowment contract.
Modified Endowment Contract	A contract between a life insurance company and a policyholder that will typically not qualify as life insurance for tax purposes but will meet the requirements of Internal Revenue Code Section 72 to allow for deferral of income tax and the requirement of paying income tax at ordinary rates upon eventual withdrawals and/or payments of profits within the contract.
Mortality and Expense risk charges (M&E)	A separate charge made on variable products, which is normally based upon a percentage of the account balance. This transparency does not apply to General Accounts policies.

TERM	DEFINITION
Mortality Cost	The cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk. With term insurance, the insurance company is generally exposed to risk of loss for the entire face amount of the policy; with permanent insurance, the net amount at risk for the insurance company is the difference between the policy's death benefit and the cash value.
Non-Guaranteed Performance	An estimate of future results of the policy's cash value and death benefit, (and surrender values are estimated as well). The non-guaranteed performance reflects changes in the interest credits <u>that can be halfway between the guaranteed and nonguaranteed assumptions</u> , but it is a random point for the hypothetical and solely based on the insurer's current practices. The mortality charges do not change for either guaranteed or non-guaranteed.
Option A Death Benefit	A universal life policy where the death benefit remains stable.
Option B Death Benefit	A universal policy where the death benefit may increase over time if certain requirements are met with each premium payment.
Option C Death Benefit	The death benefit will increase with each premium so that the initial death benefit plus an amount sufficient to repay all premiums will be received upon death.
Ordinary Life Insurance	A type of whole life insurance contract that provides for premiums to be payable until the earlier of age 100 or the death of the insured.
Permanent life Insurance	Insurance intended to provide life insurance protection for the entire life of the insured. Permanent insurance differs from term insurance in that its premium structure includes a savings component. Permanent insurance policy premiums have two components, the insurance cost (mortality cost, administrative fees, sales loads, etc.) and the savings component.
Prudent Delegatee	An individual who accepts the duty of acting in a fiduciary manner to evaluate and opine that a life insurance contract is a prudent investment for a trustee or other owner having a fiduciary relationship, as authorized under the Uniform Prudent Investor Act in Section 9.
Return of Premium Rider	A rider which assures that the death benefit will at least be equal to the cumulative premiums paid.

TERM	DEFINITION
Spousal or Children's Death Protection Rider	This rider provides life insurance for the insured's spouse or children. It occurs in group life insurance, and proof of insurability is not required.
Surrender Charge	An amount deducted from the accumulation value to yield its cash surrender value. These charges, typically found in the first 10 to 20 policy years, enable the insurer to cover a portion of unrecouped issue costs on policies that surrender early.
Tabular Cash Value	The guaranteed value of a whole life policy that can never be withdrawn except by borrowing or cashing the policy in.
Tax Free Access	Monies received as a return of basis (investment on the contract) and from borrowing will not be subject to income tax as long as a qualifying policy is maintained until death, unless the Transfer For Value Rules have been violated.
Term Blend Universal Life Contract	To reduce commissions and cost of insurance charges, some carriers permit a portion of a life policy to consist of term insurance that is expected to be supported by the increasing cash value. While these blend policies were widely criticized in the 1980s for being less reliable than a pure universal policy, present industry standards require that a term blend universal policy have the same actuarial durability as a non-term blend universal policy, with the result being better for the policyholder, and a lower commission than traditional whole life.
Term Life Insurance	Provides coverage at a fixed rate of payments for a limited period of time.
Traditional Whole Life	A whole life policy with a level guaranteed premium and death benefit.
Transfer for Value Rules	Internal Revenue Code Section 101 provides that the death benefit of life insurance will not be tax free if the policy has been "transferred for value" and no exceptions apply.
Two Year Contestability	State laws require policies to prevent the carrier from denying benefits after the insured has lived 2 years from when the policy was issued.

TERM	DEFINITION
Universal Life Insurance	A type of flexible permanent life insurance designed to offer competitive death benefit protection as well as a savings element which is invested to provide cash value buildup. The primary varieties of Universal Life are variable Universal Life, equity index Universal Life, and conventional Universal Life.
Variable Universal Life Insurance	A type of permanent life insurance with no endowment age in which the cash value can be invested in a wide variety of separate accounts, similar to mutual funds, and the choice of which of the available separate accounts to use is entirely up to the contract owner. FINRA will allow carriers to illustrate rates of return as high as 12% before reduction for fund costs, but most carriers require their agents to illustrate it at no more than a 10% gross rate of return.
Viatical Settlement	An arrangement whereby a person with a terminal illness sells their life insurance policy to a third party for less than its death benefit amount.
Waiver of Premium Rider	This rider provides economic benefits if the insured becomes disabled by waiver of certain expenses within the policy or considering premiums to be paid in lieu of requiring actual premium payments.
Whole Life Insurance	A life insurance policy which is guaranteed to remain in force for the insured's entire lifetime, provided required premiums are paid, or to the maturity date. Premiums are fixed, based on the age of issue, and usually do not increase with age.

CHAPTER 5

HOMESTEAD PROTECTION

INTRODUCTION AND NON-WAIVEABILITY.

The Florida Constitution provides an almost supernatural protection for homeowners against creditors, which has been found to trump the Florida Fraudulent Transfer Statute, but is subject to The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which prevents the use of the homestead exemption under certain circumstances if the homeowner is in bankruptcy. The Florida Constitution protects up to one half of an acre if within city limits, or up to 160 acres if outside of the municipality, provided that the owner is an individual (or perhaps a revocable trust) who resides on the property and is a U.S. citizen or “permanent” green card holder.³⁸⁸ The person must be a permanent resident of Florida and intend to make the property his or her permanent residence.

Besides real estate, it is possible for recreational vehicles, mobile homes, houseboats, co-ops, and long-term leases to qualify for the homestead protection, as indicated in Section S of this Chapter, and it may also be possible to allow seasonal rentals of the homestead as long as the homestead owner who moves out occasionally to facilitate this maintains her homestead status most of the time.

As noted in Chapter 1, the Florida Supreme Court held that an individual could not waive Florida’s homestead protection via a general waiver in a loan agreement.³⁸⁹ While the court noted that case law had not prohibited a waiver of the homestead protection, the Florida Constitution mandates that any waiver must be accomplished by mortgage, sale, or gift. The Court’s analysis commenced with a statement that “the homestead exemption has been enshrined in our state constitution for over 100 years.”³⁹⁰ The Court noted that many decisions by Florida courts have acknowledged that the public policy behind not upholding waivers of creditor rights is to promote both the stability and welfare of the state for a homeowner and his or her heirs. The Court stated that while it has permitted a surviving spouse to waive homestead inheritance rights, “we have repeatedly refused to find an exception to the protection from forced sale. . .”³⁹¹

Clients and advisors should not forget that Florida also recognizes tenancy by the entireties, so that creditors having a judgment against only one spouse may not be able to penetrate the homestead, even if one spouse files bankruptcy and the bankruptcy law exceptions to homestead protection apply.

Caution should be exercised, however, with respect to exceptions provided for under this chapter, which include “super creditors”, divorce situations, and under certain other circumstances.

³⁸⁸ See *In re Fodor*, 339 B.R. 519 (Bankr. M.D. Fla. 2006) (holding that “an alien can satisfy this residency requirement only if he has obtained permanent resident status or a ‘green card’ as of the petition date”); see also *In re Charania*, 2015 WL 12086, at *3 (finding that a nonresident alien could not formulate the legal intent necessary to claim homestead exemption without a permanent visa).

³⁸⁹ 972 So.2d 850, 862 (Fla. 2007).

³⁹⁰ *Id.* at 852.

³⁹¹ *Id.* at 854.

In addition, planners must be aware that a homestead will be less protected than many other categories of exempt assets in bankruptcy if there has been a “fraudulent transfer” into the homestead, it has not been owned a prerequisite period of time, or a white collar crime or grossly negligent conduct exceptions apply.

There is often confusion with respect to when the rules relating to property tax exemptions disallow homestead characterization, notwithstanding that the creditor protection rules are completely separate and apart from the *ad valorem* tax rules.

BROAD INTERPRETATION – TRUMPING THE FRAUDULENT TRANSFER STATUTE.

Article X, Section 4 of the Florida Constitution establishes the right of Floridians to homestead their property. This right provides that homesteaded property is exempt from any type of forced sale or creditor proceeding. The Florida Supreme Court has been very liberal in interpreting this protection. In the Florida Supreme Court case *Havoco of America, Ltd. v. Hill*,³⁹² the Court confirmed the broad interpretation of Florida’s homestead exemption. The Court held that even a homestead acquired by the debtor with specific intent to hinder, delay, or defraud creditors qualifies for homestead protection.

In this case, Havoco obtained a \$15,000,000 judgment against Hill, which became enforceable on January 2, 1991. Just three days before the enforcement date, Hill purchased a \$650,000 property, claiming that he intended to make this property his homestead. His creditors argued that the property should not fall under the Florida homestead exemption because Hill converted nonexempt assets into the homestead with the intent to defraud his creditors. Despite Hill’s obvious intent to defraud, the Court found that the homestead exemption protected Hill’s property from creditors.

The Court reasoned that the “plain and unambiguous” language of Florida Constitution Article X, Section 4 provides that a homestead is *only* subject to forced sale for: 1) the payment of taxes and assessments thereon; 2) obligations contracted for the purchase, improvement or repair thereof; or 3) obligations contracted for house, field or other labor performed on the realty.

Additionally, the court held that the Florida homestead exemption trumps and preempts the fraudulent transfer statute. Here, the bankruptcy court found that the creditor did not satisfy its burden of showing “by the preponderance of the evidence” that Mr. Hill purchased the home with the intention of hindering, delaying, or defrauding the creditor.

EXCEPTION FOR JUDGMENT RECORDED BEFORE PROPERTY BECOMES THE DEBTOR’S HOMESTEAD AND THE “TIE GOES TO THE DEBTOR” RULE.

A judgment recorded in the county where the debtor has property that is not yet homestead will prevail over homestead protection, but what if the homestead is acquired by inheritance or purchase and will qualify as homestead under the Constitution at the moment of acquisition?³⁹³

³⁹² 790 So. 2d 1018 (Fla. 2001).

³⁹³ 381 So.2d 1344, 1348 (Fla. 1980).

In Florida, courts have held that “the rule accords priority to the homestead right, where the homestead right and the lien attach simultaneously, as in the case of purchase of inheritance of land by a judgment debtor.”³⁹⁴ This rule is also referred to as the “tie goes to the debtor”. *In re Bowers* is the first case which applied the “tie goes to the debtor” rule. Here, the debtor’s parents owned the property in question as homestead. The debtor’s father became ill and passed away, leaving the property to his mother and children. Upon hearing this news, the debtor sold his business in March of 1963 and moved back home with his mother. Before the mother transferred the property to herself and the son in 1964, the appellee, a creditor, obtained and recorded her judgment lien against the debtor. The court held that a lien cannot attach to property until the debtor obtains ownership, which in this case was after the lien against the debtor was recorded. Essentially, the lien and homestead right attached at the same time and the “tie goes to the debtor” rule applied.

More recently in the September 2016 decision of *In re Cole*³⁹⁵, a mother died leaving her homestead to her son, who was a debtor who lived in the home before she died. The creditor claimed that its judgment attached to the home at the moment of death, before the debtor owned it as “homestead,” but Judge Michael Williamson of the Middle District of Florida found to the contrary and summed up the “tie goes to the debtor” rule beautifully, as he often does, as follows:

Where, like here, a judgment lien and homestead status attach to property at the same time, the homestead exemption defeats the hypothetical judgment lien.³⁹⁶

To be sure, the Florida Supreme Court has previously held that the homestead exemption must give way to a judgment lien where the judgment lien went into effect before the homeowner became eligible to claim the homestead as exempt.[21] In *Pasco v. Harley*, for instance, Pasco (a bank receiver) obtained a judgment against Harley and recorded the judgment in the county where Harley owned property.[22] Because Harley was not married at the time, he could not claim the homestead exemption under then Florida law.[23] Shortly after the judgment lien was recorded, however, Harley married and became eligible for the homestead exemption.[24] Ultimately, the Florida Supreme Court held that Harley acquired the homestead exemption subject to Pasco’s lien since he was not eligible for the homestead exemption at the time Pasco’s judgment lien was recorded.[25]

Similarly, in *First National Bank of Chipley v. Peel*, the Florida Supreme Court rejected a homestead claim where a bank filed suit and obtained a judgment against the judgment debtor before the judgment debtor and his wife occupied — or took any steps toward occupying — the property at issue as their homestead.[26] There, the Florida Supreme Court observed that the final judgment would establish the rights of the parties as of the date the lawsuit was filed.[27] So if the judgment debtor did not move into the property until after the lawsuit was filed, it could not have the effect of making the property

³⁹⁴ *Bowers v. Mazingo*, 399 So. 2d 492, 494 (Fla. Dist. Ct. App. 1981); see also *Perez*, 391 B.R. 190, 190 (Bankr. S.D. Fla. 2008).

³⁹⁵ *In re Cole*, 559 B.R. 920 (Bankr. M.D. Fla. 2016).

³⁹⁶ *Id.* at 919.

homestead with respect to the bank's judgment lien. According to the Florida Supreme Court, the homestead exemption may not be established to the exclusion of preexisting liens or conveyances.[28]

There is one fatal flaw with that argument as applied to this case. In *Harley and Peel*, the creditor's judgment lien attached to the property at issue before the judgment debtor was eligible to claim the homestead. That is not so here. While the Trustee's hypothetical judgment lien existed as of the petition date, it could not attach to the Brookhaven Drive property until the Debtor acquired an interest in it — i.e., when her mother passed away two weeks after the petition date. So the Trustee's hypothetical lien on the Brookhaven Drive property is not a preexisting lien. Here, the Trustee's hypothetical lien and the Debtor's homestead exemption attached to the property at the same time.

Those were the facts in *Milton v. Milton* — albeit not in the bankruptcy context — where the Florida Supreme Court held that an heir who took title to property upon his mother's death was able to assert the homestead exemption as to judgments entered against *him* before his mother's death.[29] The issue in *Milton* was whether the heir could claim the homestead exemption even though he did not occupy the property at the time of his mother's death. The Florida Supreme Court held he could because he did occupy it within a reasonable time afterward. The significance of *Milton* to this case is that there was no question in *Milton* that the homestead exemption applied to the heir's preexisting debts:

An occupancy of land as a homestead by an heir within a reasonable time, under all the circumstances, will prevent the forced sale under a judgment against the occupying heir of his interest in the land that is lawfully and in good faith occupied and claimed by him as his homestead.[30]

In short, *Milton* stands for the proposition that the usual rule that the homestead exemption cannot be used to extinguish preexisting liens does not apply where an heir, who has existing judgment creditors, inherits homestead property.[31]

Conclusion

By virtue of Bankruptcy Code § 544(a), the Trustee had all of the rights of a hypothetical judgment lien creditor as of the petition date. When the Debtor acquired the Brookhaven Drive property under her mother's living trust, the Trustee's hypothetical judgment lien attached to the property. But the homestead exemption also attached at the same time. In essence, it was a tie. Under the Florida Supreme Court's decision in *Milton*, a tie goes to the heir. Accordingly, the Court will enter a separate order overruling the Trustee's objection to the Debtor's homestead exemption as a matter of law.

Cited:

21. *Pasco v. Harley*, 73 Fla. 819, 75 So. 30, 33 (1917); *First Nat'l Bank of Chipley v. Peel*, 107 Fla. 413, 145 So. 177, 178 (1932).

22. 75 So. at 31.
23. *Id.*
24. *Id.* at 31-32.
25. *Id.* at 33-34.
26. 107 Fla. 413, 145 So. 177, 178-79 (1932).
27. *Id.* at 178.
28. *Id.*
29. 63 Fla. 533, 58 So. 718, 719 (1912).
30. *Id.*
31. Even the Florida Bar Journal article the Trustee relies on in support of her argument acknowledges that a decedent's heir can use the homestead exemption to protect against a forced sale by the heir's preexisting creditors. Doc. No. 46 (citing Rohan Kelley, Homestead Made Easy, Fla. Bar J. at 17 (March 1991)).

Notwithstanding the above, title companies cannot be expected to write title insurance for a homestead owner who wants to sell or finance the property where there is a judgment in place that should not attach by reason of being recorded after the property became homestead, or by reason of the property being homestead from the moment of purchase.

Florida Statutes Section 222.01 enables a homestead owner to give specific notice of homestead status to a creditor. The creditor will then have forty-five days to file an action in the county circuit court where the property is located. If the creditor does not file the action, then the title company can safely write an owner's or lender's policy, and typically will. The Statute and notice form can be found at Section 222.01.

WHAT IF YOU EXCEED ONE-HALF OF AN ACRE WITHIN CITY LIMITS?

A key fact for individuals that own homestead property within city limits is that the property must be one-half acre or less to be eligible for homestead protections. For example, in *Englander v. Mills*,³⁹⁷ a debtor took the position that a center circle of his property, which had no outside access, was not used as homestead and that a donut shaped piece of property that fit within the one-half acre exemption was his homestead. The judge disagreed and ordered the whole property sold and the proceeds apportioned between exempt and non-exempt assets.

In the 2002 appeal of a Bankruptcy Court decision, *In Re Quraeshi*,³⁹⁸ the debtor owned more than half an acre in the municipality of Wellington, Florida, and the Court allowed for the sale of the entire parcel and allocation of the proceeds based upon 50/269ths going to the debtor as exempt homestead and 219/269ths going to the creditors.

The court noted that there was no controlling 11th Circuit case or Florida case law dealing explicitly with whether the homestead exempt funds would be calculated based on the net proceeds of the sale, after the payment of liens and mortgages, or the gross sales price.

³⁹⁷ 95 F. 3d 1028 (11th Cir. 1996).

³⁹⁸ *In re Quraeshi*, 289 B.R. 240 (S.D. Fla. 2002).

The court concluded that the debtor's homestead exemption portion would be based upon a pro rata share of the net proceeds. The court made mention of the 1983 8th Circuit Court of Appeals case of *O'Brien v. Heggen*, which yielded a similar result for a Minnesota homestead case.

In the December 21, 2017 Bankruptcy Court decision of *In re Gamboa*,³⁹⁹ a 73 year old debtor living alone in a trailer located on 14 acres outside of city limits was permitted to keep the trailer and the property as his homestead, notwithstanding that he was violating a county ordinance by living there.

Under the county ordinance, Mr. Gamboa would have been allowed to live in the trailer if he had a building permit to show that he was building a house, which he could not afford to do so. The court noted that he had made efforts to obtain the approval of several necessary county departments, but still needed approval from other departments to begin construction of a house that he was not able to afford to build.

The court noted that the property was zoned as agricultural, and that the county would require him to reclassify a portion of the property to be residential if he wished to legally live there. In this case, the lawyer for the creditor "tipped off" Miami-Dade County as to the situation, and the county issued a citation against the debtor.

The court found that notwithstanding the county law violation, the debtor had an actual intention to make the property his permanent residence and actually lived there. The court recognized that several courts in the past have allowed the homestead exemption to apply where the debtor occupied the property in violation of city, county or state law, or local zoning ordinances, and cited the case of *In re Kain*, where a debtor lived in a portion of property that was zoned commercial and housed his medical practice. The court also cited other cases that have occurred outside of Florida that led to similar results, including the 1994 case of *In re Heard*, where a Connecticut debtor lived on his boat even after the creditor apparently caused the government to require the boat to be dry-docked, and the debtor continued to live there with no certificate of occupancy and in violation of state statutes, the public health code, and zoning regulations. The decision implies that creditors who "turn in a debtor" for living illegally on a property will not be rewarded.

The court in *In re Gamboa* pointed out that the only facts that ultimately matter are that "debtor has made the property his permanent residence since he moved into the trailer in 2013, and he intends to stay on the property as his permanent residence."⁴⁰⁰ Ultimately, the court held that the fact that the debtor was living in a trailer in violation of a county ordinance did not preclude him from claiming the Florida homestead exemption.

In *In re Kellogg*, the court held that it can order the sale of a homestead when such property exceeds the acreage limitations and cannot be practically or legally subdivided.⁴⁰¹ However, if the property can be properly subdivided, then the court cannot order a sale of the homestead. In the *Kellogg* case, the debtor owned a 1.3-acre piece of property within the city limits of Palm Beach. The debtor argued that his home should not be sold, but rather, he should be able to remain in his residence with one half of an acre of the 1.3-acre tract being protected, so that the creditor would only be able to take the 8/10ths of an acre that did

³⁹⁹ *In re Gamboa*, 578 B.R. 661 (Bankr. S.D. Fla. 2017).

⁴⁰⁰ *Id.* at 669.

⁴⁰¹ 197 F.3d 1116 (11th Cir. 1999).

not include the house itself. Unfortunately for the debtor, the Palm Beach zoning regulations did not allow the debtor to subdivide his property, so the court ordered a sale of the homestead property.

The judge apportioned the net proceeds, after payment of the mortgage, pro-rata to land size.

The judge also found that the mortgage debt would not be apportioned to the protected or unprotected property. For example, a debtor with a two-acre lot inside the city limits with a \$1,000,000 house on half an acre and landscaping on an acre-and-a-half would have the net proceeds from a forced sale allocated 25% to exempt and protected proceeds that the debtor could keep, and 75% to proceeds available to satisfy the obligations of creditors.

However, if the property is annexed into the city while the client owned it, the property may be over a half acre and retain its homestead character. See Part R of this chapter for a more detailed explanation.

EQUITABLE LIENS, CONSTRUCTIVE TRUSTS AND ILL-GOTTEN GAINS.

Florida law is developing quickly with respect to identifying what “ill-gotten gains” or “tainted funds” may have been used to purchase, improve, or pay down a mortgage on homestead, with the result being that the applicable creditor from whom these ill-gotten gains were taken may impose an equitable lien, a constructive trust finding, or both upon the homestead, with the result being that a court of equity can decide whether to force a sale of the home to satisfy the equitable lien or constructive trust, or whether it is more equitable to wait until the home is sold, or someone other than the debtor who may reside in the home and own an interest will no longer need protection

The following chart summarizes the elements of and differences between a constructive trust and an equitable lien:

Constructive Trust vs. Equitable Lien

Constructive Trust	Equitable Lien
Imposed when defendant: Is reaping benefit from property that he acquired unfairly. ONLY APPLIES WHEN DEFENDANT OWNS THE PROPERTY AT ISSUE Plaintiff must establish that: A. The defendant wrongfully obtained legal title to property which, as an equitable matter, properly belongs to the plaintiff; B. That retention of the property would result in unjust enrichment; and C. There is no adequate remedy at law Effect: Turns the defendant into a trustee, charged with holding and managing the property, but unable to reap any benefit from it. Equity intervenes to declare the defendant's apparent title to the property invalid, and instead orders the defendant to make restitution of both possession and any other title interest of the property.	Imposed when defendant either: 1. Wrongfully acquired someone else's property; <i>OR</i> 2. Has made improvements to a piece of property using funds he obtained unfairly. Plaintiff must establish that: • The defendant wrongfully obtained property or services from the plaintiff which, as an equitable matter, the defendant should either return or pay for; • The defendant used the plaintiff's property or services to invest in another piece of property; and • There is no adequate remedy at law. Effect: Uses the property to secure the debt. Equity intervenes to declare that the defendant's property is subject to a lien in the plaintiff's favor.

While the Supreme Court's decision in *Havoco of America Ltd. v. Hill* confirmed that a debtor can use funds to acquire a creditor exempt homestead with the specific intent of avoiding the creditor, the Court noted that an equitable lien can be imposed "where the funds obtained through fraud or egregious conduct were used to invest in, purchase or improve the homestead."

Certainly stolen funds, or funds received as the result of a crime perpetrated by the homeowner, will not be protected just because the debtor used those funds to pay down a mortgage loan or to buy a homestead, but what about situations where the debtor received the funds from a criminal activity that the debtor was not aware of, or as the transferee of a conveyance that was intended by the transferor to avoid a creditor?

Discussion of what happens when “ill-gotten gains” are mixed with non-tainted monies that find their way into a homestead or elsewhere can be found after the below discussion in the subsection entitled **WHEN ILL-GOTTEN GAINS ARE CO-MINGLED WITH NON-TAINTED MONIES BEFORE BEING PAID INTO HOMESTEAD -- THE “LOWEST INTERMEDIATE BALANCE RULE” APPLIES.**

The following is a 2017 Leimberg Information Services write up on a well-written Florida Bankruptcy Court decision that does a good job of summarizing this area, and a chart and “white paper” on the cases that have developed since the Florida Supreme Court’s *Havoco* decision, notwithstanding that the authors disagree with the conclusion that monies received by a debtor who does not know that they are “ill-gotten gains” will be tracked and considered to establish an equitable lien against the unknowing debtor’s homestead under the circumstances described below:

EXECUTIVE SUMMARY

On June 22, 2017, the Bankruptcy Court for the Middle District of Florida, Tampa Division, in *Wiand v. Lee*⁴⁰² (herein referred to as the “*Lee*” case), held that the innocent victim of a Ponzi scheme who used monies received from the bankrupt Ponzi entity to purchase a homestead, lost the homestead exemption to the extent of fraudulently transferred funds, even though he had no knowledge whatsoever that the funds came from a Ponzi scheme, he was not accused of any wrongdoing in connection with the scheme, and it was admitted that he did not engage in any fraud or egregious conduct. The authors believe that this decision was in error because the Florida Supreme Court case of *Havoco of America, Ltd. v. Hill*, discussed below, provides a limited exception to homestead protection which only applies if the funds used to buy a homestead or pay down a homestead mortgage were “obtained through fraud or egregious conduct.”

The *Lee* court imposed an equitable lien on the home, and also imposed a “constructive trust” so that the home could be sold to satisfy the equitable lien. In doing so, the Florida bankruptcy court relied on four decisions.

First, the court cited the Florida Supreme Court’s decision in *Havoco of America, Ltd. v. Hill*, which held that even if a debtor used funds to acquire a homestead with the specific intent to defraud a creditor, the Florida homestead exemption still prevailed and protected the home. In *Havoco*, the Florida Supreme Court noted the narrow exception that an equitable lien may be imposed “where the funds obtained through fraud or egregious conduct were used to invest in, purchase, or improve the homestead.” However, the *Lee* court’s discussion of *Havoco* ended there. Moreover, the *Lee* court made no mention of its earlier decision in *In re McClung* which noted that the equitable lien remedy has been “narrowly construed” and subject to a “high standard.”

Second, the *Lee* court cited *Palm Beach Savings & Loan Association, F.S.A. v. Fishbein*, to support the imposition of an equitable lien. In *Fishbein*, the co-owner of the subject homestead fraudulently obtained funds through a forged mortgage, and used those funds to satisfy three existing mortgages. While the other

⁴⁰²*Wiand v. Lee*, No.: 8:15-bk-01038-KR, slip op. (Bankr. M.D. Fla. June 22, 2017).

co-owner of the home was innocent, she no doubt benefited from the fraud of her spouse and the satisfaction of three mortgages for which she was responsible. In *Fishbein*, unlike *Lee*, the subject funds were fraudulently obtained by the spouse and used to satisfy mortgages on the homestead.

Third, the *Lee* court cited the bankruptcy case of *In re Fin. Fed. Title & Trust, Inc.* to support the imposition of an equitable lien and constructive trust. In *FinFed*, like in *Fishbein*, the co-owner of the home fraudulently obtained funds from a Ponzi scheme that *he* was directly operating, and such funds were used to acquire a homestead. Again, while the co-owner spouse was innocent, the court focused on the “fraudulent nature of the funds which is of utmost importance.” In *FinFed*, unlike *Lee*, the subject funds were fraudulently obtained by the spouse.

Lastly, the *Lee* court cited the Fifth Circuit Court of Appeals decision in *Crawford v. Silette* to support the imposition of an equitable lien. In *Crawford*, the funds were fraudulently obtained by the homeowner’s boyfriend, who was actively involved in a Ponzi scheme, and he then “gifted” the funds to the homeowner. Contrary to the bankruptcy court’s statement in its decision in *Lee*, the subject funds in *Crawford* were not “false profits” received by an innocent investor in the Ponzi scheme. Instead, the funds were “obtained” through the boyfriend’s active defrauding of investors. The facts in *Crawford* are substantially different from the facts in *Lee*.

In *Lee*, the spouse is really irrelevant to the fact pattern as she did not come onto the scene until *after* Mr. Lee had innocently received the funds as an investor, and *after* he used them to buy a homestead. Neither Mr. Lee nor his after-the-fact spouse had any involvement in any fraud, and neither engaged in any “fraud or egregious conduct” as required by *Havoco*. The holding and result in *Lee* are directly contrary to the Florida Supreme Court’s decision in *Havoco*. The proper question should have been whether the homeowner, Mr. Lee, an innocent investor in the Ponzi scheme, “obtained” funds “through fraud or egregious conduct.” Clearly, he did not. Mr. Lee obtained the funds through a return on his investment in the scheme of which he had no knowledge or involvement. Moreover, the funds representing his false profits were not obtained, directly or indirectly, through fraud or egregious conduct by anyone connected to Mr. Lee.

In *Fishbein*, the funds were fraudulently obtained by the spouse and used to pay existing mortgages thereby creating an issue of subrogation not present in *Lee*. In *FinFed* and *Crawford*, the funds were fraudulently obtained through direct, active involvement in a Ponzi scheme. In *Lee*, the funds were “passively” obtained through an investment. Passive conduct cannot satisfy the “fraud or egregious conduct” requirement in *Havoco*.

In support of its imposition of a constructive trust, the *Lee* court noted that the “rightful owner of misappropriated trust property may trace whatever has been bought.” However, Mr. Lee did not misappropriate anything, particularly any trust property. If anyone did any misappropriation, it was the operator of the Ponzi scheme – just like the bad actors in *Fishbein*, *FinFed* and *Crawford*. But neither Mr. Lee nor anyone connected to his homestead had any involvement whatsoever in the scheme. In further support of its constructive trust remedy, the *Lee* court stated, without citation of authority, that Mr. Lee “did not have rightful ownership of those funds, which must be considered as being held in trust for the benefit of the receivership.” This statement fails to recognize the distinction between a void and voidable transaction. See *O’Halloran v. First Union National Bank*, 350 F.3d 1197 (11th Cir. 2003) (noting distinction

between void and voidable title). The transfer to Mr. Lee by the Ponzi scheme operator was not void; it was merely voidable. Without question, Mr. Lee had rightful ownership of those funds upon receipt and at the time he used those funds to acquire a homestead.

A troubling aspect of the Lee court's conclusions is that narrowly construed equitable remedies were imposed against a Florida homestead in favor of a fictional entity (a receiver) that is acting for the benefit of other innocent victims of the same Ponzi scheme who could not have obtained the same remedies. Innocent victims of Ponzi schemes often try to assert an equitable lien or constructive trust against assets of a Ponzi scheme entity, but are unsuccessful because the victim's funds were commingled with the funds of other innocent investors. Why should a receiver acting for a group of creditors who voluntarily invested in a Ponzi scheme have greater rights than the creditors themselves? In essence, the *Lee* court created a "Ponzi scheme exception" to the Florida homestead exemption.

It is important to note that *Lee* is not a case of stolen property. The other innocent victim-investors in the Ponzi scheme voluntarily parted with their funds in hopes of receiving the same return that Mr. Lee received. Under Florida law, where an owner has voluntarily parted with property, even though induced by a criminal act, a bona fide purchaser can acquire good title to the property, under the theory that where one of two innocent parties must suffer because of the wrongdoing of a third person, the loss must fall on the party who voluntarily, but unwittingly, participated in the criminal scheme. *Anderson Contracting Company v. Zurich Insurance Company*, 448 So.2d 37, 38 (Fla. 1st DCA 1984). For example, what if it were a simple three person scheme where innocent Investor A voluntarily gives money to the criminal actor, and then the criminal actor repays innocent Investor B with what was essentially Investor A's money. If Investor B used those funds to acquire a homestead, could Investor A get an equitable lien or constructive trust against Investor B's homestead? We think not. There is simply no public policy reason to grant a receiver greater rights than those possessed by his constituent investor group.

The *Lee* decision is on appeal to the District Court and may ultimately reach the Eleventh Circuit Court of Appeals or the Florida Supreme Court.

CONCLUSION

The *Lee* decision should be reversed because the false profits paid to the innocent homeowner were not obtained, directly or indirectly, through fraud or egregious conduct as required by *Havoco*. In the meantime, individuals who buy homes or pay down homestead mortgages should be careful if they have received large distributions or gifts from sources that might be considered to be inappropriate, whether as fraudulent transfers or profits or other distributions received from otherwise insolvent or fraudulent sources. Any such funds should be held separate and apart from legitimate monies, and should not be commingled. It may be preferable to pay normal living expenses from potentially questionable funds, and to use earnings and other legitimate funds to purchase homestead and other exempt assets.

High risk investors who are not able or willing to determine whether their "hedge fund profit" may consist of "ill-gotten gains" will be well advised to carefully plan what they do with these monies, and how they handle other income and funds from an investment, debt reduction, and living expense standpoint.

The following pages include a chart that summarizes the case law in this area, and the *Bifani* case, which is described in detail after the chart.

The Florida Constitution states that a homestead may not be used to satisfy court judgments except in the following instances:

3. Unpaid property taxes for the homestead itself;
4. Mortgages for the purchase or improvement of the homestead itself; or
5. Mechanics' liens for work performed on the homestead

However, equitable liens and constructive trusts may also be “invoked to reach beyond the literal language of the above exceptions, [but] only where the funds used to invest in, purchase, or improve the homestead were obtained through fraud or egregious conduct, or in order to prevent unjust enrichment.”

This distinction can be difficult to spot. An equitable lien and constructive trust will be imposed where fraudulent or otherwise egregious conduct was used to obtain monies that were used to purchase, payoff or improve an otherwise protected homestead. [*Havoco; In re Thiel*].

The Florida Constitution will continue to “exempt Florida homestead, even where the debtor acquired the homestead using non-exempt funds with the specific intent of hindering, delaying, or defrauding creditors.” [*Havoco*] However, when it comes to imposing an equitable lien or constructive trust on a homestead, such relief “is limited to [only those] cases in which the homestead was purchased with the fruits of fraudulent activity.” [Palm Beach Savings and Loan Ass’n].

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
FL Homestead Exception Involving No Fraudulent Transfers			
<i>Havoco of Am. v. Hill</i> , 790 So. 2d 1018, 1027 (Fla. 2001)	Homestead property is exempt from any type of forced sale or creditor proceeding. However, an equitable lien can be imposed “where the funds obtained through fraud or egregious conduct were used to invest in, purchase or improve the homestead.”	Debtor’s creditors argue that disputed property should not fall under the Florida homestead exemption because the debtor converted nonexempt assets into the homestead with the intent to defraud his creditors.	Despite a debtor’s intent to defraud, the funds obtained were not used to invest in, purchase or improve the homestead, therefore the Florida homestead exemption will protect the debtor’s property from creditors. The “plain and ambiguous” language of Florida Constitution X Section 4 provides that a homestead exemption is only subject to forced sale for: 1) the payment of taxes and assessments thereon; 2) obligations contracted for the purchase, improvement or repair thereof; or 3) obligations contracted for house, field or other labor performed on the realty.
Distinguished by the Following Three Cases:			
<i>Callava v. Feinberg</i> , 864 So. 2d 429, (Fla. Dist. Ct. App. 2003)	A Debtor’s conduct does not amount to “fraudulent or egregious conduct” when acting consistently with the main intent of a court order.	In an underlying divorce action, the trial court ordered the transfer of a home to the Debtor that was to be used to satisfy child support, alimony, and legal expenses. Debtor used the proceeds to purchase a new home and failed to pay legal expenses. Debtor’s attorney sought an equitable lien against Debtor’s homestead.	The primary intent of the dissolution court order transferring the original property was to provide the Debtor with the means to support herself and her children. Payment of legal fees was deemed a “secondary purpose” for the transfer. Therefore, Debtor’s conduct in selling the transferred property and moving into a more affordable residence, but not paying her legal fees, was not viewed as “fraudulent or egregious.”
<i>In re Adell</i> , 321 B.R. 562, (M.D. Fla. 2005)	If it can be proven that a Debtor “claiming Florida homestead exemption acquired [the] homestead by fraudulently obtained funds or embezzlement”	Debtor was found liable in Michigan bankruptcy court 11 U.S.C.S. §303(i) for money damages for filing a bankruptcy petition against a creditor in bad faith. Two	11 U.S.C.S. §303(i) does not trump the constitutional protection of the Florida homestead of a Debtor. The Florida Constitution clearly outlines three limited exceptions, these include: “(1) taxes owed by the

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
	then it is appropriate to impose an equitable lien or constructive trust on the Debtor's homestead.	weeks after the judgment was entered, the Debtor moved to Florida, purchased the homestead, and took various steps to establish Florida residency with the intent to claim the Florida homestead exemption. Debtor's creditor argued that 11 U.S.C.S. §303(i) trumped Florida's constitutional homestead protection.	homesteader; (2) obligation incurred by the owner which created the lien on the property by consent, i.e. by contact; and (3) claims on laborer and material men who contributed to the repair and improvement of the homestead ...” The court held that the Debtor did not meet any of exceptions, nor was it proven that the Debtor purchased the homestead with “embezzled funds or funds obtained through fraud,” therefore the homestead was protected.
<i>Willis v. Red Reef Inc.</i> , 921 So. 2d 681 (Fla. Dist. Ct. App. 2006)	The imposition of equitable liens on homesteads is limited to cases in which the homestead was purchased with the “fruits of fraudulent activity.”	Debtor and Red Reef Inc. entered into a lease agreement. Later, a third party plaintiff sued the debtor for breach of lease and was awarded damages. During the lawsuit, Debtor sold the commercial property and used the proceeds from the company to pay off his homestead mortgage.	Even though the Debtor fraudulently transferred the proceeds from the sale of commercial property to their personal accounts, and used such proceeds to pay down a mortgage on their homestead, the conduct did not give rise to an equitable lien.
FL Homestead Exception Involving Fraudulent Transfers			
<i>LaMarca v. Jansen (In re Bifani)</i> 580 F. App'x 740, (11th Cir. 2014)	An equitable lien may be imposed on a homestead property acquired with proceeds of a fraudulent transfer. Although the Florida homestead exemption is liberally construed, it should not be used as “an instrument of fraud or imposition on creditors.”	Debtor transferred property to his girlfriend who then sold the property and used the proceeds to purchase a home in Florida. These steps were taken by the Debtor with the actual intent to hinder, delay, or defraud creditors under Florida Statutes Sections 726.105(1)(a) and 726.106(1).	The purpose of the lien is to prevent unjust enrichment. The court held that it was unjust to allow the Debtor to use the proceeds from a fraudulently transferred property to purchase a home to avoid creditors.

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
FL Homestead Exception and Fraudulent Asset Conversion			
<i>Dowling v. Davis</i> , 295 F. App'x 322, 323 (11th Cir. 2008)	Transfer of nonexempt assets into an exempt homestead with the intent to hinder or defraud creditors is not one of the three exceptions to the homestead exemptions affirmed in <i>Havoco</i> , and are protected under the Florida homestead exemption.	Debtor had a judgment against him in the amount of \$535,550.29. To avoid liability, the Debtor purchased a home in Florida with his wife as tenants by the entirety and transferred other funds to his wife with the intent to hinder, delay and defraud his creditor.	The three Florida homestead protections were affirmed and include: 1) the payment of taxes and assessments thereon; 2) obligations contracted for the purchase, improvement or repair thereof; or 3) obligations contracted for house, field or other labor performed on the realty. These exceptions are strictly construed and do not contain an expressed exception for real property that is acquired in Florida for the sole purpose of defeating the claims of out-of-state creditors.
FL Homestead Exception and Construction Fraud			
<i>Hirchert Family Trust v. Hirchert</i> , 65 So. 3d 548, 2011 Fla. App LEXIS 8979, 36 Fla. L. Weekly D 1290.	Where a trustee breaches fiduciary duty by conveying Florida real property to an undeserving third party, constructive fraud may be the basis of a constructive trust, resulting in an equitable lien being placed on a homestead.	Appeal involving a Debtor's residential Florida property. The property was subject to a constructive trust because the trustee committed constructive fraud emanating from his breach of fiduciary duty.	Breach of fiduciary duty was the equivalent of fraud resulting in an exception to the homestead protection afforded by the Florida Constitution.
FL Homestead Exception- Recent Treatment			
<i>Fed. Trade Comm'n. v. Am. Precious Metals LLC</i> , 726 Fed. Appx. 729 (11th Cir. 2018)	An equitable lien is appropriate "where fraudulently obtained funds are used to invest in, purchase, or improve the homestead." However, it is not required that a plaintiff prove that fraudulently obtained funds were used for both "improvement" and "purchase" of a homestead.	The Federal Trade Commission (FTC) brought an action against a Debtor for operating a deceptive investment scheme, where money from the scheme went into the homestead. The FTC was granted its motion to have an equitable lien placed on the Debtor's home.	To obtain an equitable lien on the homestead, the FTC was required to show the following by a preponderance of the evidence: (1) the Debtor "engaged in conduct"; and (2) that the "funds from the conduct [could] be directly traced to the purchase of, investment in, or improvement of, the homestead." The court held that the FTC met both of these elements.

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
<i>In re Lee</i> , 574 B.R. 286 (Bankr., M.D. Fla. 2017)	The Florida homestead exception does not require that the fraud or egregious conduct be committed by the homeowner who is claiming the exception.	An individual unknowingly received false profits from a Ponzi scheme, and used the money to purchase a home. At no point did this individual and his spouse engage in any fraud or egregious conduct.	An equitable lien can be imposed on a Florida homestead to prevent the homeowner from being unjustly enriched as the recipients of fraudulent transfers made in furtherance of a deceptive investment scheme, even though there was no knowledge of any wrongdoing by the homeowner or his wife. The court held that a constructive trust could be imposed on the Florida homestead to the extent of profits paid to the homeowners that could be traced to their home.

The Bankruptcy Code prohibits the discharge of debts that have been “obtained by... false pretenses, a false representation, or actual fraud.” 11 U.S.C. Section 523(a)(2)(A). There is an existing split among circuits of “whether ‘actual fraud’ requires a false representation or whether it encompasses other traditional forms of fraud ... such as a fraudulent conveyance of property made to evade payment to creditors.” *Husky*, at 1585.

In order for a debt to be non-dischargeable under Section 523(a)(2)(A), the debt must be obtained by fraud. Thus, when a transferee receives a fraudulent transfer and meets the requisite intent, the debt will be incurred by actual fraud. (Fraud + wrongful intent = actual fraud). This applies when a debtor is seeking to discharge a specific debt.

Case	Does “actual fraud” encompass a fraudulent transfer? Was debt <u>obtained by</u> fraud?	Case Description	Court Analysis
<i>Husky Int’l Elecs., Inc. v. Ritz (In re Ritz)</i> , 832 F.3d 560, 562 (5th Cir. 2016).	A debt is obtained by actual fraud “only if the debtor’s fraud involves a false representation to a creditor.” The ruling in <i>Husky</i> added to the existing split among	A company owed Husky money for electronic components. Instead of paying Husky, the Debtor who was director and part owner at the time, drained the company’s assets and transferred the money to other	The Florida Supreme Court held that “the term ‘actual fraud’ in Section 523(a)(2)(A) encompasses forms of fraud, like fraudulent conveyance schemes that can be effected without a false representation.”

Case	Does “actual fraud” encompass a fraudulent transfer? Was debt <u>obtained by</u> fraud?	Case Description	Court Analysis
	Circuits of “whether ‘actual fraud’ requires a false representation or whether it encompasses other traditional forms of fraud, such as a fraudulent conveyance of property made to evade payment to creditors.”	entities the Debtor controlled. Husky filed a complaint against the Debtor claiming that debt was non-dischargeable because Ritz’s “intercompany-transfer scheme constituted ‘actual fraud’ under 11 U.S.C. Section 523(a)(2)(A).”	“Transferor does not ‘obtain’ debts in a fraudulent conveyance. But the recipient of the transfer—who, with the requisite intent also commits fraud—can obtains assets by his or her participation in the fraud.” The transferee who later files for bankruptcy will not receive a discharge under Section 523(a)(2)(A). It is important to note that in <i>Husky</i>, the Plaintiff moved to hold the Debtor personally liable for the debt under Texas law, which allows creditors to hold shareholders responsible for corporate debt. Tex. Bus. Orgs. Code Ann. §21.223(b).
Supported by the Following Case:			
<i>Siverio v. Rodriguez (In re Siverio)</i> , 253 F. Supp. 3d 418 (D.P.R. 2017)	Yes – “actual fraud” as a dischargeability exception, “includes fraudulent conveyance schemes, even when those schemes don’t involve false representation.”	Plaintiff’s grandmother loaned him \$30,000. Plaintiff’s wife agreed to transfer title of property she owned to her grandmother-in-law to serve as a form of security for the loan. To do so, Plaintiff’s wife executed a deed of sale” purporting to sell the property for \$12,000. When Plaintiff failed to pay the full \$30,000 owed, his grandmother sold the property to her other granddaughter (Debtor) for the remaining debts. The granddaughter obtained the property	The debt owed to the Plaintiff was found to be non-dischargeable as money obtained through actual fraud. The Supreme Court further held that Defendant-Debtor and her husband were not bona fide purchasers of the real property because they were aware of the nature of the agreement between Plaintiff and Defendant Debtor’s grandmother, and that Plaintiff remained the true owner of the property.

Case	Does “actual fraud” encompass a fraudulent transfer? Was debt <u>obtained by</u> fraud?	Case Description	Court Analysis
		knowing that the title was invalid and participated in the fraudulent transactions.	
<i>Sauer Inc. v. Lawson (In re Lawson)</i> , 791 F.3d 214, 220 (1st Cir. 2015)	Yes – The continued inclusion of actual fraudulent conveyance within § 523(a)(2) is consistent with Congress’s “conclu[sion] that preventing fraud is more important than letting defrauders start over with a clean slate.”	Debtor received a fraudulent conveyance from her father with the intent to prevent creditor from receiving judgment against him (the father).	The transferee must be “guilty of intent to defraud not merely be the passive recipient of a fraudulent conveyance.” The requisite intent can be met from the acceptance of a transfer that transferee knew was made with intent to hinder creditors.
<i>Reed v. Zak (In re Zak)</i> , 573 B.R. 13, 43 (Bankr. D. Mass. 2017)	Yes – The recipient of a transfer “who, with the requisite intent, also commits fraud – can obtain assets by his or her participation in the fraud.” If the recipient later files for bankruptcy, debts “traceable to” the fraudulent conveyance are nondischargeable.	Debtor breached fiduciary duty and duty of loyalty to Loan Modification Group, Inc. (LMG) by taking revenues and transferring them into an entity Debtor controlled.	The court held that Debtor’s actions “constituted fraudulent conveyances and actual fraud when the [Debtor]...transferred all the revenues, assets, and business of LMG to an entity he controlled for no consideration, enabling him to reap considerable financial benefit he was not entitled to in light of the partnership agreement.”
<i>In re Korn</i> , 567 B.R. 280 (2017).	Yes – The court established that <i>Husky</i> did not change the law with regard to what is needed for fraud; rather it clarified that the element of justifiable reliance does not need to be met in a fraudulent conveyance.	A judgment creditor and former business associate of a Chapter 7 Debtor filed a complaint seeking determination that his debt of over \$1.9 million arising out of a Michigan state-court action was nondischargeable.	To establish actual fraud Plaintiff must show the following: (1) a course of conduct intended to deceive; (2) justifiable reliance; AND (3) proximate causation.

Case	Does “actual fraud” encompass a fraudulent transfer? Was debt <u>obtained by</u> fraud?	Case Description	Court Analysis
<i>Browne v. Lombard (In re Lombard)</i>, 2016 Bankr. LEXIS 998, at *1 (Bankr. D.N.H. Mar. 30, 2016)	Yes – <i>Husky</i> allows a claim of “actual fraud” to hold a debt non-dischargeable; however, the plaintiff must include a <u>legal claim</u>, either under state or federal law, to recover the fraudulently transferred debt.	Debtor’s husband was the sole owner of a café through which he obtained loans. Rather than using the loans for the café, the husband transferred money to the Debtor, which the Debtor used with fraudulent intent to fund her new business. The transfers were so that the Debtor could fund her new business. The Debtor filed for bankruptcy. The Plaintiffs included factual detail about the fraudulent transfer and sought to have the debt’s dischargeability determined. The plaintiffs did not include <u>a legal claim</u> that would allow them to recover from the alleged fraudulent transfer.	The Court agrees that because this is a fraudulent conveyance there is no need to show that there was a misrepresentation for “actual fraud” to apply. The Court distinguished from <i>Husky</i> and found that “Section 523(a)(2)(A) does not provide a cause of action that simultaneously creates a debt and renders it non-dischargeable.” See below, <i>Zacharakis v. Melo (In Re Melo)</i>, 558 B.R. 521, 561 (Bankr. Mass 2016).
<i>United Supply Co. v. Crivaro (In re Crivaro)</i>, Nos. 15-23020 (JNP), 15-2262, 2017 Bankr. LEXIS 1133, at *2 (Bankr. D.N.J. Apr. 24, 2017)	Yes — The Court agreed that in order to have actual fraud the element of fraud must be met as well as the element of wrongful intent.	Debtor sold and installed heating and air conditioning equipment that he purchased from numerous vendors, including United Supply Co. Debtor executed a credit application and personal guarantee to United Supply Co. Debtor later filed bankruptcy after failing to make any payments to the company. As a result, the company filed a complaint alleging that its claim for	The court distinguished this case from <i>Husky</i> by highlighting that United Supply was unable to show that the debtor took part in a scheme to fraudulently transfer assets. More specifically, the “element of fraud – assets transfers intended to impair the creditor’s ability to collect a debt – was not proven.”

Case	Does “actual fraud” encompass a fraudulent transfer? Was debt <u>obtained by</u> fraud?	Case Description	Court Analysis
		reimbursement should be non-dischargeable.	
<i>World Bus. Lenders, LLC v. Barry (In re Barry)</i> , 559 B.R. 654, 663 (Bankr. M.D. Pa. 2016)	Yes – “...a transfer alone is not enough to show actual fraud.”	Plaintiff, World Business Lenders, LLC (WBL), filed a complaint requesting that its debts with Debtor be non-dischargeable. WBL claimed that the transfer itself was proof of fraudulent intent. The Plaintiff alleged that the false statements made by Debtor was actual fraud.	The Court applied <i>Husky</i> and found that Plaintiff failed to show that the transfer constituted actual fraud. Plaintiff also failed to allege that the conduct was actual fraud or that the daughter accepted the transfer of the car with intent to commit fraud.
<i>Prado v. Erickson (In re Erickson)</i> , 2017 Bankr. LEXIS 3343	Yes – Connection between the pre-existing debt and the transfer must be shown.	Plaintiffs sold their company assets to Debtor, which included a promissory note guaranteed by Debtor. Plaintiff and Debtor later agreed to reduce the debt and a note was signed granting a lien on Debtor’s vacation home. Debtors filed bankruptcy and Plaintiffs allege their claim should be non-dischargeable “on the basis of certain allegedly fraudulent transfers.”	Similar to <i>Husky</i> , the debtors obtained the property through a fraudulent transfer scheme. However, the Plaintiff did not allege there was a connection between the pre-existing debt and the transfers, thus the dischargeability of the debt must be determined by a bankruptcy court proceeding.
<i>Argyle v. Harkin (In re Harkin)</i> , 2017 Bankr. LEXIS 916	Yes – If wrongful intent cannot be shown, then the debt was not obtained by actual fraud.	A loan was secured by mortgages on properties owned by the Debtor. In 2014, the Debtor defaulted on the loan and the two parties reached a settlement agreement. Subsequently, Plaintiff filed a complaint	Court follows <i>Husky</i> analysis of the term “actual fraud.” However, the Plaintiff did not succeed in having the debt non-dischargeable because they failed to prove by the preponderance of the evidence

Case	Does “actual fraud” encompass a fraudulent transfer? Was debt <u>obtained by</u> fraud?	Case Description	Court Analysis
		alleging unaccounted debts. Debtor filed bankruptcy and Plaintiff requested the claim be deemed non-dischargeable.	that the Debtor acted with <u>wrongful intent</u> .

**Way Down Upon the Bifani River 1: Setting Aside Fraudulent Transfer
Into Florida Homesteads
(Debtor’s Transferee Who Received Pre-Bankruptcy Fraudulent Transfer
Ends Up All Wet)**

By Alan S. Gassman, Esq., Travis Arango and Dena Daniels

The Florida Supreme Court, in *Havoco of Am., Ltd. v. Hill*, 790 So.2d 1018 (Fla. 2001), held that the homestead protection afforded under the Florida Constitution trumps the Florida Fraudulent Transfer Statute, and therefore a debtor subject to an impending or actual judgment can use monies to purchase or pay down the mortgage on a homestead owned by the transferor, with the creditor having no remedy against the homestead unless or until the debtor files for bankruptcy by reason of the provisions of the 2005 revisions to the Bankruptcy Code “Mansion Law.”³

But what if the debtor, knowing that he or she may be going into bankruptcy, gives the monies to a close friend who puts them into a homestead and then intends to hunker down and remain judgment proof, and outside of bankruptcy, so that the creditor is not able to recover the funds? And the debtor is able to live with the close friend and enjoy the benefit of the home. Will this boat float?

This exact factual pattern has occurred more than once, leading the courts to look for a way to reach the home equity and prevent this type of conduct, as opposed to waiting for Congress to endorse an appropriate remedy by amending the Bankruptcy Code.

Judge Michael Williamson, a very well-respected bankruptcy judge of the Middle District Bankruptcy Court sitting in Tampa, came to the conclusion in 2013 that a fraudulent transfer, directly or indirectly, to the debtor’s cohabiting and apparent significant other before filing bankruptcy rose to the level of being considered a secretion of “ill-gotten gains” under the Florida case law, saying specifically that: Here, LaMarca’s Sarasota house was acquired with ill-gotten proceeds. LaMarca used the nearly \$670,000 from the sale of the Golden Eagle Road property to purchase her Sarasota house. It would be inequitable and unjust to allow the Debtor [Bifani] to fraudulently transfer property to LaMarca to keep it from his creditors.⁴

The Federal District Court sitting in Tampa found that the decision did not hold water, and overturned it,⁵ but the Eleventh Circuit Court of Appeals agreed with the judge, finding that: Under Florida law, homestead property purchased with funds obtained by fraud is not exempted from equitable liens. *See Havoco*, 790 So.2d at 1028. The facts of this case do not fall within *Havoco*'s exception because the funds used to purchase the Sarasota property were obtained through Bifani's fraudulent transfers....That the fraud occurred in a bankruptcy proceeding rather than a criminal offense is irrelevant.⁶

It is almost certain that the U.S. Supreme Court will have no interest in hearing this case, and the Florida Supreme Court will not have jurisdiction because bankruptcy court cases pass through the federal system, and not the state system.

The Eleventh Circuit Court of Appeals could have requested guidance from the Florida Supreme Court by certifying the issue as a question of importance but apparently chose not to do so.

Floridians and their advisors will now most likely need to wait for a number of years before similar factual patterns occur in circuit courts and become subject to circuit court decisions that are appealed to District Courts of Appeals, and then eventually to the Florida Supreme Court.

A prominent bankruptcy attorney has had this to say about the case: If you think it through, the whole idea of getting around the federal Bankruptcy law by doing something through an apparent straw man that you cannot do directly, you can certainly conclude that at least the spirit of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (closing the so-called mansion loophole via new sections 522(o) and (p)) was violated. That doesn't really shock me. If you're going to try to take advantage of the Florida homestead law, you need to follow the centuries old method of buying your own house, and if this is a fraudulent transfer you also have to stay out of bankruptcy for 10 years thereafter. It's not escaping taxes or domestic relations liability, it's not money you stole from somebody else, but a well-respected bankruptcy judge, with affirmation from the highest federal court overseeing Florida federal courts have found that it is the equivalent of transferring ill-gotten gains into homestead. Debtors and advisors are going to have to stick with the patterns that worked, at least for the foreseeable future. It could be a decade or more before the Florida Supreme Court or the US Supreme Court ever look at this.

Judge Williamson had this to say after the 11th Circuit Court of Appeals opinion was published: While *Havoco* attracts the most attention in allowing a fraudulent conversion of non-exempt property into a homestead, what is often overlooked is that *Havoco* itself recognizes the *Fishbein* exception, 619 So.2d 267 (Fla. 1993), which allows the imposition of an equitable lien where there are two frauds: (1) the permitted fraudulent conversion into the homestead, and (2) the initial wrongful conduct that taints the proceeds as being ill-gotten, e.g. the funds were stolen or obtained through fraud. The 11th in *Bifani* simply confirms what has long been the law in this area.⁷

While this case will be rightly criticized as judicial legislation, and seems to also add to the longstanding confusion among some courts and advisors that a fraudulent transfer somehow constitutes fraud, it also shows that conventional knowledge will sometimes be turned on its ear, without warning, and that clients and advisors should not rely upon any one creditor protection technique when multiple techniques are available.

For more information, in the *Tax Management Portfolios*, see *Rothschild and Rubin*, 810 T.M., *Asset Protection Planning*, and in *Tax Practice Series*, see ¶6350, *Estate Planning*.

Cited:

¹The Suwannee River is a 246-mile black water river that can take you much of the way from the Bankruptcy Court in Tampa to the 11th Circuit Court of Appeals in New Orleans, which is where this case went before the debtor's raft sank. Made famous by Stephen Foster's song, *The Old Folks at Home* (Foster never saw the river but read about it). Mr. Gassman owns two lots on this river that he bought in 2007 and would gladly sell for half of what he paid, and no extra charge for the alligators who live there. See *Way Down Upon the Suwannee River Far Far Away, LLC* on the Sunbiz Website, and also *Hey Hey Santa Fey (river), LLC*, and *Withlacoochiecoochicoo, LLC*, which own his other failed river investments.

This article is dedicated to the memory of Joan Rivers, who performed in Tampa Bay shortly before her death at age 81 with great energy and physical strength.

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³See 11 U.S.C. §522(o), §522(p).

⁴*In re Bifani*, 493 B.R. 866, 871 (Bankr. M.D. Fla. 2013).

⁵*In re Bifani*, No. 8:13-cv-02197-JDW, Order of Feb. 13, 2014 (M.D. Fla. 2014).

⁶*In re Bifani*, 580 F. Appx. 740, 747 (11th Cir. 2014).

⁷ In *Havoco*, the Florida Supreme Court held that an intentionally fraudulent transfer into homestead would not be set aside because the protection of homestead under the Florida Constitution trumps the Florida Fraudulent Transfer Statute. In *Fishbein*, however, the Florida Supreme Court held that when ill-gotten monies are transferred into homestead, the transfer can be set aside. In *Bifani*, the 11th Circuit agreed with Judge Williamson that a fraudulent transfer made by someone contemplating bankruptcy will be considered as ill-gotten gains for purposes of recapturing the transfer from the homestead of the transferee that was funded thereby.

WHEN ILL-GOTTEN GAINS ARE COMMINGLED WITH NON-TAINTED MONIES BEFORE BEING PAID INTO HOMESTEAD --- THE "LOWEST INTERMEDIATE BALANCE RULE" APPLIES:

What if "ill-gotten gains" are commingled with non-tainted funds? How do the courts determine what portion will be tainted? These questions were addressed by the *Wiand v. Lee* decision discussed above. In short, the intermediate balance rule is applied. The courts want to preserve the ill-gotten gains in any account where they exist so that if a person receives ill-gotten gains and puts them in an account with other monies, the other monies come out first. That way, the ill-gotten gains sink to the bottom and the legitimate gains float to the top so that the legitimate funds are used first. Therefore, recovery of the ill-gotten gains stays available to the creditor, if any funds remain. This approach backfires on creditors when the first

monies held under an account that contains both ill-gotten gains and legitimate funds are used to buy a homestead or pay down a mortgage thereon.

The *Wiand* Court analyzed these rules and concluded that all monies from an account that was used to buy an otherwise creditor protected homestead would be considered as tainted, as long as (1) the amount of tainted funds put into the account equaled or exceeded the amount of the purchase price; and (2) the account had a balance at the time of withdrawal no greater than the amount of tainted funds that were put into the house.

The court determined that “the lowest intermediate balance rule” should be applied to determine the amount of the equitable lien, which would be held in the constructive trust.⁴⁰³ The court stated as follows:

“[T]he lowest intermediate balance rule” is an acceptable method for treating trust proceeds that have been commingled with other funds: where trust funds are commingled in an account they are considered as undiminished so long as the total account balance is at least equal to the amount of the trust fund deposits. If the aggregate amount of trust deposits exceeds the lowest intermediate balance in the account, they are considered lost. Thus, “the lowest intermediate balance” in a commingled account represents trust funds that have never been dissipated and which are reasonably identifiable.⁴⁰⁴

The court reasoned that since tracing only requires “that [the] tainted funds be identified and followed from the point of origin (i.e. the fraudulent act),”⁴⁰⁵ there was no need for a “‘dollar-for dollar’ accounting.”⁴⁰⁶

When a court applies the lowest intermediate balance test, it uses what is known as a legal fiction. A legal fiction is a “presumption of fact assumed by a court for convenience, consistency, or to achieve justice.”⁴⁰⁷ In cases involving tainted and untainted funds, when applying the lowest intermediate balance rule, courts use the fiction that the debtor will spend his or her own money first to preserve the fraudulently obtained money – presumably to pay back defrauded creditors. Whether or not that is actually the case does not matter to the courts when they apply the test. Thus, the rule is that a debtor’s own money will be spent first, and then the tainted, commingled funds will be spent.

Below are three examples of how the application of this rule may work:

Example 1: A debtor has \$100,000 of “untainted funds” in an account. The debtor then deposits \$250,000 of tainted funds into that same account. If the debtor spends \$200,000 on his or her homestead, the court will presume that the debtor used \$100,000 of the untainted funds first, exhausting the untainted amount in the account, and used \$100,000 of tainted funds to purchase the home. The remaining \$150,000 in the account will be considered tainted funds, and \$100,000 of tainted funds used to secure the house will be subject to equitable lien.

⁴⁰³ *Wiand v. Lee*, No.: 8:15-bk-01038-KR, slip op. at 11 (Bankr. M.D. Fla. June 22, 2017).

⁴⁰⁴ *Id.*

⁴⁰⁵ *Id.* at 12.

⁴⁰⁶ *Id.*

⁴⁰⁷ Nolo’s Plain English Legal Dictionary, <https://www.nolo.com/dictionary/legal-fiction-term.html>.

Example 2: If the numbers are the same as in the above example, except the house purchased is only \$95,000 instead of \$200,000, then the test would find that \$95,000 of untainted funds were used to purchase the house. \$5,000 of untainted funds remained in the account along with \$250,000 of tainted funds. If the debtor then bought a \$50,000 car, the court will consider the debtor to have paid \$5,000 in untainted funds and \$45,000 of tainted funds. As such, the creditor may have a \$45,000 “equitable lien” on the automobile. Assuming no further contributions of untainted funds to the account, and that subsequent withdrawals are used to improve or repair the car or the house, they will be from the tainted funds remaining in the account and will be subject to lien as well.

Example 3: A debtor who puts \$900,000 of “untainted funds” and \$100,000 of tainted funds into an account, and spends \$901,000 on legitimate expenses and then \$99,000 paying down a homestead mortgage will be found to have contributed \$99,000 of tainted funds into the homestead, and will thus be subject to an equitable lien of \$99,000, and constructive trust treatment may also apply. See also the United States First Circuit Court of Appeals case of *Connecticut General Life Insurance Company v. Universal Insurance Company*, 838 F.2d 612, 619 (1st Cir. 1988).⁴⁰⁸

A DEBTOR CAN LOSE ALL OF HIS OR HER HOUSE IN BANKRUPTCY (EXCEEDING \$170,350) AS THE RESULT OF A FRAUDULENT TRANSFER WITHIN ONE YEAR BEFORE FILING.

DON'T DO THIS WITHIN A YEAR OF FILING BANKRUPTCY, OR EVERYTHING MIGHT BE LOST! Paying one's mortgage down with non-exempt monies less than one year before filing bankruptcy can be catastrophic where the payment causes the debtor to lose his or her bankruptcy discharge. In *In re Chauncey*, the Eleventh Circuit Court of Appeals determined that the debtor's actions in not filing for bankruptcy until just a few days after she used her non-exempt personal injury action settlement proceeds to pay down the mortgage on her homestead (to protect those funds from creditors) did not warrant the imposition of an equitable lien on her homestead based on the principles set forth in *Havoco*.⁴⁰⁹ However, the court affirmed the bankruptcy court's decision to deny a discharge of her debt, stating that “[i]ts finding of fact in determining that [the debtor] transferred her property within one year before filing her petition with intent to defraud creditors and in failing to keep financial records without justification are not clearly erroneous.”

WHAT ELSE CAN YOU HAVE ON YOUR HOMESTEAD BESIDES YOUR HOME?

The Florida Constitution is not clearly written with reference to the question as to whether a debtor can use homestead property for functions other than the residence of the debtor and the debtor's family. Specifically, Article X, Section 4 of the Florida Constitution reads as follows:

- (a) There shall be exempt from forced sale under process of any court, and no judgment, decree or execution shall be a lien thereon, except for the payment of taxes and assessments thereon,

⁴⁰⁸ See, *In re Columbia Gas Sys. Inc.*, 997 F.2d 1039, 1063 (3rd Cir. 1993); *In re Dameron*, 155 F.3d 718, 724 (4th Cir. 1998); *First Fed. of Mich. v. Barrow*, 878 F.2d 912, 916 (6th Cir. 1989).

⁴⁰⁹ *In re Chauncey*, 454 F.3d 1292 (11th Cir. 2006).

obligations contracted for the purchase, improvement or repair thereof, or obligations contracted for house, field or other labor performed on the realty, the following property owned by a natural person:

(1) a homestead, if located outside a municipality, to the extent of 160 acres of contiguous land and improvements thereon, which shall not be reduced without the owner's consent by reason of subsequent inclusion in a municipality; or if located within a municipality, to the extent of one-half acre of contiguous land, upon which the exemption shall be limited to the residence of the owner or the owner's family.

The above underlined language may apply only to property within city limits, or might apply to property outside of city limits. The case law associated with this issue is summarized as follows:

OUTSIDE CITY LIMITS

Property located outside of the city limits can qualify for homestead exemption even when the property (up to 160 acres) is also used for substantial and independent business activities. This was confirmed by the First District Court of Appeals in *Davis v. Davis*, where the homestead property included the home and an independently operated mobile home park.⁴¹⁰

Further, in *In re Oullette*,⁴¹¹ the Middle District of Florida held that property located outside a municipality with two mobile homes located on it was exempt homestead property even though the debtors rented one of the mobile homes to a third party. However, in *Radtko*, a Bankruptcy Court Judge in the Southern District of Florida declined to follow the *Davis* case referred to above, and held that a debtor's 2.23-acre property located in an unincorporated area of Highlands County could only be considered homestead for the residential portion, and would not allow the mobile home park commercial space to be included in homestead property.⁴¹²

Noting the difference in, and even "declin[ing] to follow" the outcome in *Davis*, the *Radtko* court held that "when a debtor utilizes a portion of his or her land for commercial purposes, the debtor is not entitled to claim that portion as exempt by virtue of the Florida homestead exemption."

The *Radtko* court distinguished the two cases by noting that the debtor leased portions of his homestead property to third parties with mobile homes and RVs, who in turn would sublease those mobile homes and RVs for their own business enterprise.

In acknowledging the difference in *Davis*, *Radtko* noted that while "a decision of a court from an alternate state district is persuasive, this Court finds that the language contained in the Florida Constitution was not intended to extend homestead protection to those portions of property which its owner utilizes for commercial enterprise."

⁴¹⁰ 864 So.2d 458 (Fla. 1st DCA 2003).

⁴¹¹ 2009 WL 1936896 (Bankr. M.D. Fla. 2009).

⁴¹² *In re Radtko*, 344 B.R. 690 (S.D. Fla. 2006).

INSIDE CITY LIMITS

Recent cases in Florida have held that a “separate structure” on contiguous homestead property where the debtor’s daughter lived did not qualify as the debtor’s homestead, because the homestead exemption is limited to the “residence” of the debtor.

The law is flexible for debtors with dual purpose homestead properties within city limits, but there are limitations.

In the bankruptcy case of *In re Bornstein*,⁴¹³ a debtor who lived on one side of a duplex and rented out the other side was unable to claim the portion of the duplex occupied by the tenant as being exempt from creditors because it was within city limits on property smaller than one-half an acre. The court found that the debtor could claim exemption of the sales proceeds attributable to the portion of the duplex that she resided in, and that the amount attributable to the rental portion would be distributed to her creditors. The court divided the net equity available after satisfaction of the mortgage on the property between the debtor and the creditor.

The court distinguished this case from *In re Ballato*,⁴¹⁴ where the court allowed a full exemption, despite evidence that unrelated third persons were living in the home and paying rent. In *Ballato*, the home was a single-family residence with no “severable portions,” and the debtor/owner had unlimited use of the entire home, presumably including the bedroom or bedrooms that the renter slept in. In *In re Makarewicz*,⁴¹⁵ the debtor, whose homestead was located **“within a municipality,”** was entitled to a full homestead exemption, notwithstanding the fact that a portion of the two-story garage attached to the home was rented to third parties, based upon the rationale that rented portions were not severable and that the property could not be partitioned and sold.

In *In re Ensenat*, a Southern District Bankruptcy Court judge found that two buildings located on a one-half acre parcel of land in incorporated Miami qualified as exempt homestead property, even though only one building was occupied by the debtors and the other building was a second dwelling consisting of two bedrooms and a bathroom that was connected to the “main house” by a covered patio and occupied by a half-niece and her family.⁴¹⁶ The second building had an independent living room, kitchen and separately gated entrance with separate electrical metering and its own water supply. The debtors never rented the second building, but allowed family members emigrating from Cuba to live there. At the time of the case, the building was occupied by the wife’s half-niece, the half-niece’s young son, and the half-niece’s boyfriend. They did not pay rent, but the boyfriend paid the electric, phone and water bills.

The Trustee argued that the debtors were not entitled to exempt the second building because it was not part of the debtor’s residence, and the half-niece was not a member of the debtor’s family. The court found that a separate structure on what is otherwise homestead property is not disqualified from the same protection as the residential structure merely because it is separate from the primary residential structure. In

⁴¹³ 335 B.R. 462 (Bankr. M.D. Fla. 2005).

⁴¹⁴ 318 B.R. 205 (Bankr. M.D. Fla. 2004).

⁴¹⁵ 130 B.R. 620 (Bankr. S.D. Fla. 1991).

⁴¹⁶ *In re Ensenat*, 2007 WL 2029332 (Bankr. S.D. Fla. 2007).

support of this proposition, the court cited *Armour & Co., v. Hulvey*,⁴¹⁷ where the Florida Supreme Court noted in 1917 that outhouses, barns, wagon houses, garage, sheds, chicken houses and fences could all be appurtenant and subsidiary to and used in connection with a protected homestead resident.

Further, the court noted that abandonment or waiver of the exemption in a separate structure within city limits can occur when it is used to generate income. Here, the Trustee argued that because the property could be rented (even though it was not currently being rented and had not previously been rented), that homestead protection should not be given to the structure; however, the court rejected this argument. The court stated that the “potential of a separate building for use for a business purposes, like a prior use of such building for a business purpose, is not adequate to compromise the debtors’ homestead rights.”

THE HOMEOWNER DOES NOT HAVE TO RESIDE IN A PROTECTED HOMESTEAD IF “FAMILY” LIVES THERE AND OTHER REQUIREMENTS ARE MET

While the Constitution protects the homestead, courts have limited that protection to the “residence of the owner or his family.”⁴¹⁸ Therefore, the homeowner need not live in the homestead as long as a family member does. The test for what constitutes a family member has been extended beyond marital and blood relationships, and instead requires “either singly or in combination (1) a legal duty to maintain arising out of the relationship; and (2) a continuing communal living by at least two individuals under circumstances where one is regarded as the person in charge.”⁴¹⁹

The 1977 First District Court of Appeals decision in *In re Ensenat* found that a debtor’s “half-niece” did not fit within the definition of “his family” because the debtor who owned the home that the niece lived in had no legal obligation to support either the niece or her family. Nonetheless, the court held that the debtors were entitled to claim the homestead exemption for the entire residence, including the second building, because the structure in which the half-niece’s family resided was part of the property that fell within the protection of the constitutional homestead guidelines and was not used for a business purpose.

A relevant case discussing the extension of the homestead exemption protection to family members when the owner no longer lives in the house is *Beltran v. Kalb*.⁴²⁰ In this case, the homeowner, Evaristo Beltran, owned a homesteaded property with his wife, Carmen. They divorced in 1990. Carmen and their daughter remained in the house. Evaristo was later sued and a final judgment was rendered against him. In 2007, Carmen passed away and Evaristo quit-claimed his interest in the property to his daughter. The judgment against Evaristo remained and in 2007 was re-recorded. In March 2007, a sheriff’s levy was recorded on the property and a sheriff’s sale was conducted in May of 2007. Evaristo filed a motion to vacate the sale that was denied by the trial court, but reversed on appeal.

The appellate court found that “the homestead exemption is ‘limited to the residence of the owner or the owner's family.’ Accordingly, ‘the Florida Constitution does not require that the owner claiming

⁴¹⁷ 74 So. 212 (Fla. 1917).

⁴¹⁸ *In re Wierschem*, 152 B.R. 345, 347 (Bankr. M.D. Fla. 1993).

⁴¹⁹ *In re Ensenat*, 2007 WL 2029332 at *3 (citing *Heard v. Mathis*, 344 So.2d 651, 654 (Fla. 1st DCA 1977)).

⁴²⁰ *Beltran v. Kalb*, 63 So. 3d 783 (Fla. Dist. Ct. App. 2011).

homestead exemption reside on the property; it is sufficient that the owner's family reside on the property.'" *Nationwide*, 400 So. 2d at 561.⁴²¹ A concurring opinion found the following:

Grisel, Evaristo's daughter, is a member of his family. *See Cain v. Cain*, 549 So. 2d 1161, 1163 (Fla. 4th DCA 1989). So long as Evaristo owned any interest in the former marital home and Grisel resided in it, the interest he owned was exempt from execution and levy (forced sale) to satisfy the judgment obtained.⁴²²

Evaristo left the house pursuant to the terms of a final judgment to his wife, and after the divorce, Carmen and Grisel continued to live on the property. Meanwhile, Evaristo continued to support his daughter financially as she aged into adulthood and by the time of this case, Grisel lived in the home with her son. Despite this, the court found that the daughter was an eligible family dependent residing in the home even though she was no longer a minor. It therefore appears that a "moral obligation" to support a family member as a "dependent" should be sufficient.

The court goes on to note that homestead status continues until the homestead is abandoned or alienated in the manner provided by law. In order to show abandonment, "it must be shown that both the owner and the owner's family abandoned the property."⁴²³ Thus, because Carmen and Grisel continued to live on the property and there was no showing of abandonment, the property maintained its homestead character.

In *Nationwide*, referenced above, the court found that the extension of the homestead protection rested on a two part test. "First the property must be the residence of either the owner or the owner's family. Second, the owner of the property must be the 'head of a family'."⁴²⁴ "We cannot assume . . . the 'head of the family.'" It is a factual question."⁴²⁵ The court goes on to describe why the "head of family" test is somewhat less important today as it writes:

Since the homestead exemption for the "head of a family" has been a part of the constitution, however, separate living arrangements, dissolutions and single parentage have become a much more frequent occurrence. It is common for more than one member of the family to provide family income. When the "family" is not a cohesive unit or when only one parent provides the income, it is no easy task to determine who is the "head" of the family, and the courts have been reluctant to adhere to any hard and fast rule in making that determination.⁴²⁶

Courts can be expected to apply homestead law "liberally" in order to protect homestead property owners and their family. Footnote 3 of the decision provides as follows:

⁴²¹ *Nationwide*, 400 So. 2d at 559.

⁴²² *Beltran v. Kalb*, 63 So. 3d 788 (Fla. Dist. Ct. App. 2011).

⁴²³ *Nationwide*, 400 So.2d at 561.

⁴²⁴ *Nationwide*, 400 So. 2d at 559.

⁴²⁵ *Id.* at 561.

⁴²⁶ *Id.*

[T]he trial judge faced with making a finding on who is the family head may take some solace in the knowledge that a common thread can be found running through each case: the homestead law should be construed liberally for the benefit of those whom it was designed to protect. See *Vandiver v. Vincent*, 139 So.2d 704, 707-708 (Fla. 2d DCA 1962).⁴²⁷

HOW MUCH OF THE HOMESTEAD IS REALLY HOMESTEAD?

The courts have repeatedly held that a homestead will not be exempted from creditor claims if it is within the city limits and used for business purposes, except for the portion of the property that functions solely as a residence.⁴²⁸

In 2009, the Bankruptcy Court addressed this issue in *In re Wilson*. In *Wilson*, the debtor attempted to claim homestead on a nightclub that he alleged that he lived in, but was not currently living in because he had moved out to have carpet installed. The Court found that the debtor's residence was the apartment above the nightclub, but refused to say that the entire property constituted as his homestead since it was undisputed that the debtor's living area constituted only a small portion of the building. In arguing that the portion of the building that his son lived in should be considered homestead, the debtor admitted that his son was an adult who was not physically or mentally disabled. The Court held that because the debtor had no legal duty to support his son for purposes of the debtor's homestead, his son could not be considered to be a family member and the room he lived in did not constitute as part of the debtor's homestead.⁴²⁹

Similarly, in *In re Fowler*, decided in 2016, the Bankruptcy Court stated:

Just as Bankruptcy Judge Isicoff held in *Wilson* that an adult son living in a building also housing a nightclub and the debtor's apartment did not justify homestead status for the son's room, the residence of the debtor's adult daughter in a separate home with a separate address and driveway creates no homestead exemption to the Second Parcel for the debtor.⁴³⁰

In both of these cases, it seems like the courts would have extended homestead, to at least the portion of the property the child lived on, if the child of the debtor was actually dependent on the debtor. In each case, the court could not because both "children" were above the age of maturity (18) and possessed no disability.

Perhaps the more important theme to gather from these cases, however, is that the homestead exemption does not extend to exempt property used for business purposes.

Additionally, an adjoining vacant lot may not be considered homestead where it has not been used or considered by logistics and fencing to be part of the homestead estate. This was the result in *In re Estate*

⁴²⁷ *Id.* at Footnote 3.

⁴²⁸ *In re Wilson*, 393 B.R. 778, 783 (Bankr. S.D. Fla. 2008).

⁴²⁹ *Id.* at 781.

⁴³⁰ *In re Wilson*, 393 B.R. 778, 783 (Bankr. S.D. Fla. 2008).

of *Ritter*,⁴³¹ where the property in question was not jointly fenced with the residence and was “merely a separate, empty lot which served, at best, as an excess side yard to the residence.”

Floridians owning adjoining houses will be well advised to make sure that there are no fences between the homes, and to build pathways, integrate uses, and coordinate appearance from the road and otherwise to promote the concept that the two separate houses are a single homestead. The second house may be referred to as a storage/exercise/guest house. If possible, the homeowner should request the Property Appraiser to merge both parcels under one parcel ID number.

Because homestead can be owned under a revocable trust, and a land trust is a revocable trust which may own multiple properties and even properties as defined in the trust agreement as portions of parcels in different manners, the authors believe that it is possible to place more than one-half acre of property in the name of a land trust, and to have the land trust agreement provide that a defined one-half acre portion of the property will be considered as owned directly by the individual beneficiary of the land trust, while the acreage surrounding the most valuable one-half acre is considered as owned by a limited liability company or other entity that may provide it with better creditor protection.

For example, the land trust agreement could define a parcel of real estate as being the “homesteaded one-half acre” and “excess property,” and the grantor of the land trust would be able to assign all beneficial interests in the “excess property” to a separate family LLC.

If all of this is done in advance of a judgment being filed, then it would seem that the judgment against the debtor would not attach to the one-half acre homestead part of the property, and that the debtor would not own the excess acreage held under the family LLC.

This could occur without notification to third parties such as neighbors, homeowner’s associations, or municipalities that the property was divided for beneficial ownership purposes.

IS A HOMESTEAD SAFE IF IT IS TITLED UNDER A REVOCABLE TRUST?

The 2001 case of *In re Bosonetto*,⁴³² surprised a great many Florida advisors when a well-respected bankruptcy judge in Jacksonville concluded that an 89-year-old widow’s homestead was not protected when found by the court to be owned by her revocable trust. The widow’s home was titled by deed in her own personal name, but the revocable trust had a provision stating that the trust owned all real estate registered in her individual name.

Since the *Bosonetto* decision, however, there have been a number of cases holding that homestead is perfectly safe under a revocable trust, and the judge that presided over *Bosonetto* passed away in 2007.

In 2006, in *In re Edwards*,⁴³³ the Bankruptcy Court for the Middle District of Florida explicitly rejected *Bosonetto*, and held that debtors can claim the homestead exemption for residences held under revocable trusts. The court stated that “[t]he great weight of the relevant case law holds to the contrary. Fee

⁴³¹ 407 So.2d. 386 (Fla. 3rd DCA 1981).

⁴³² 271 B.R. 403 (Bankr. M.D. Fla. 2001).

⁴³³ 356 B.R. 807 (Bankr. M.D. Fla. 2006).

simple title of the property is not required, and an equitable or legal interest should afford protection pursuant to the provision.”

Notably, Judge Michael G. Williamson of the Tampa Bankruptcy Court has held that debtors can claim residences as exempt under the Florida homestead exemption, even though title to the subject property is held by a revocable trust at the time that a petition is filed.⁴³⁴ In 2003, a similar result was reached by the Third District Court of Appeals in *Callava v. Feinberg*,⁴³⁵ and, in 2006, the Fourth District Court of Appeals came to the same conclusion in *Engelke v. Estate of Engelke*.⁴³⁶

In *Callava v. Feinberg*, the Third District Court of Appeals held that the debtor’s homestead held under a trust was protected from an attorney who was a creditor. The court held that the Florida Constitution “does not designate how title to the property is to be held, and it does not limit the estate that must be owned . . .”⁴³⁷ The beneficial interest the client owned in the home from the trust was enough to enjoy homestead protection.

Also, Florida’s Third District Court of Appeals confirmed that property held in a revocable trust qualifies for the homestead creditor protection.⁴³⁸ In this case, a husband placed his homestead in a revocable trust, and the court found that it was protected, specifically stating that “it is undisputable the Key Biscayne condominium was the decedent’s homestead.” In footnote two, the court clarified that “the estate owned need not be fee simple, but may be any type of interest in the property, legal or equitable, so long as the interest is a possessory interest.”

In the 2009 Bankruptcy Court case of *Steffen v. United States*, the court held that even though the debtor was the sole beneficiary of a revocable trust, she did not have a legal or equitable interest in the property to support her homestead claim. Therefore, “even though she resided on the property, she failed to show that she had a legal right to use and possess it as of her bankruptcy filing date.”

The court distinguished other cases in which the trustee and beneficiary of a revocable trust claimed property titled in the name of the trust as exempt homestead property. However, In *Steffen*, several more layers of ownership were involved that the court was not willing to extend homestead protection towards. Here, she was sole beneficiary of a trust that was a limited partner of a limited partnership; she also owned 100% of the stock in the limited partnership’s general partner holding corporation. The limited partnership, however, was the entity that the supposed homestead property was titled in.

The court reasoned that when property is held by a revocable trust, the debtor could revoke the trust thereby causing the property to revert back to the debtor. Here, even if she revoked the trust she would not have had a beneficial ownership interest in the property.

INHERITANCE OF HOMESTEAD – IS IT PROTECTED WHEN IT ENDS UP IN AN ESTATE OR TRUST?

⁴³⁴ *In re Alexander*, 346 B.R. 546 (Bankr. M.D. Fla. 2006).

⁴³⁵ 864 So.2d 429 (Fla. 3rd DCA 2003).

⁴³⁶ 921 So.2d 693 (Fla. 4th DCA 2006).

⁴³⁷ *Id.* at 431 (citing *Southern Walls, Inc. v. Stilwell Corp.*, 810 So.2d 566, 569 (Fla. 5th DCA 2002)).

⁴³⁸ 81 So.3d 515 (Fla. 3rd DCA 2012).

One trap for the unwary is that the former homestead of the decedent that is left by Will, trust or intestacy to the “heirs” of a decedent will not be subject to the decedent’s creditor claims, but there is authority for the proposition that if the Will or trust requires that the homestead be sold, or that it pass in trust instead of outright to one or more “heirs,” then it may lose its homestead creditor protection status.⁴³⁹

The 2010 4th District Court of Appeals decision of *Pajares v. Donahue* involved language under a Will which was read by the Court to require the sale of the deceased debtor’s homestead, and distribution of the proceeds to the heirs of the debtor.

The Appellate Court concluded that where a decedent has no surviving spouse or minor children, and specifies under his or her Will that the homestead will be sold and the proceeds will be divided, then the homestead will no longer be protected from creditors of the deceased debtor. The Court did not accept the appellant’s argument that the Will “should be strictly construed in favor of retaining the homestead exemption,” and reiterated that the intent of the testator is polestar to Will interpretation.⁴⁴⁰

The Court in *Pajares* relied on the 2010 Florida Supreme Court case of *McKean v. Warburton* which held that “where a decedent is not survived by a spouse or minor children, the decedent’s homestead property passes to the residuary devisees, not the general devisees, unless there is a specific testamentary disposition ordering the property to be sold and the proceeds made a part of the general estate.”⁴⁴¹

In *Pajares*, there was a specific clause in the Will requiring that Mrs. Pajares’s homestead be sold, with the proceeds to be paid equally to the beneficiaries listed after all estate taxes and debts were satisfied. Therefore, her homestead was no longer protected from creditors because her Will explicitly indicated a testamentary intent to dispose of the property by sale and to distribute the proceeds.

Homestead creditor protection has also been found to inure to the beneficiary of a spendthrift trust who would otherwise be entitled to claim homestead protection if title passed directly to him or her by devise or intestacy. Florida’s 1991 Third District Court of Appeal’s decision in *HGA Gulf Coast Hospital v. Estate of Phyllis Downing* indicated that the homestead of the decedent, which was left to a spendthrift trust for her daughter, continued to be homestead property after the death of the homeowner, and was therefore exempt from the hospital creditor of the decedent.⁴⁴²

Homestead protection can also transfer from a trust to a person intact. In *Cutler v. Cutler*, a woman created a land trust for estate planning purposes, naming herself and her two children as trustees.⁴⁴³ The grantor was the sole beneficiary during her life, but the trust provided that upon her death, the remainder interest in the trust property was to be distributed to her estate. In her Will, however, she specifically devised the homestead property to her daughter. The court held that the property was constitutionally protected

⁴³⁹ See *Elmowitz v. Estate of Zimmerman* where Mr. Zimmerman provided for his homestead to go to a trust for the benefit of his sister, in lieu of outright, when he had no spouse or minor child. A contrary determination was made in the case of *HCA Gulf Coast Hospital v. Estate of Downing* by the First District Court of Appeals in 1991.

⁴⁴⁰ *Pajares v. Donahue*, 33 So. 3d 700, 702 (Fla. 4th Dist. App. 2010).

⁴⁴¹ *McKean v. Warburton*, 919 So. 2d 341, 347 (Fla. 2005).

⁴⁴² 594 So.2d 774 (Fla. 1st DCA 1991).

⁴⁴³ 994 So.2d 341 (Fla. 3rd DCA 2008).

homestead, stating that “property held in trust may be impressed, legally speaking, with the character of the homestead.” The homestead protection required that the decedent’s debts be paid from the estate. The court held that the homestead was part of the estate.

LEASEHOLD INTERESTS, REMAINDER INTERESTS, LIFE ESTATES, LADY BIRD DEEDS, AND CO-OPs.

If a client wants to avoid probate and still retain homestead creditor protection, he or she may consider transferring the remainder interest in the homestead to a revocable trust by use of a “life estate deed” or a “lady bird deed.” Under the classic life estate deed, the grantor gives away the remainder interest in a property, but keeps the lifetime right to use, enjoyment, and control of the property. The grantor also retains the right to any rental profits, as well as the right to sell, lease, mortgage or otherwise dispose of the property. The transfer of the remainder interest in an established homestead should not be considered a fraudulent transfer if the entire property was protected at the time of the transfer and there was no intent to defraud. The retained life estate should also qualify for homestead creditor protection and tax advantages under the Florida Constitution and Florida Statutes Section 196.031.

The operative language for a typical lady bird deed is as follows:

WITNESSETH, that the Grantor, for and in consideration of the sum of ten dollars (\$10.00) and other good and valuable consideration, receipt whereof is hereby acknowledged, hereby grants, bargains, sells, aliens, remises, releases and conveys and confirms unto the Grantee all that certain land situate in _____ County, State of Florida, and more fully described as follows:

[INSERT LEGAL DESCRIPTION HERE]

Grantor reserves unto Grantor for and during Grantor’s lifetime, the exclusive possession and enjoyment of the rents and profits of the property described herein. Grantor further reserves unto Grantor, for and during Grantor’s lifetime, the right to sell, lease, encumber by mortgage, pledge, lien, or otherwise manage and dispose, in whole or in part, or grant any interest therein, of the aforesaid premises, by gift, sale, or otherwise so as to terminate the interests of the Grantee, as Grantor in Grantor’s sole discretion shall decide, except to dispose of said property, if any, by devise upon Grantor’s death. Grantor further reserves unto Grantor the right to cancel this deed by further conveyance which may destroy any and all rights which the Grantee may possess under this deed. Grantee shall hold a remainder interest in the property described herein and upon the death of the Grantor, if the property described herein has not been previously disposed of prior to Grantor’s death, all right and title to the property remaining shall fully vest in Grantee subject to such liens and encumbrances existing at that time.

The Grantor hereby represents and warrants that the above-referenced property **IS NOT** the homestead property of the Grantor.

This deed was prepared without the benefit of a title search of the subject property and the preparer of this conveyance does not guarantee merchantability or marketability of title.

Together, with all the tenements, hereditaments, and appurtenances thereto belonging or in anywise appertaining.

AND the Grantor hereby covenants with said Grantee that the Grantor is lawfully seized of said land in fee simple; that the Grantor has good right and lawful authority to sell and convey said land, and hereby warrants the title to said land and will defend the same against the lawful claims of all persons whomsoever; and that said land is free of all encumbrances, except covenants, conditions, easements and restrictions of record; and subject to taxes for the year _____ and subsequent years.

TO HAVE AND TO HOLD, the same in fee simple forever.

A remainder interest holder living in a homestead has protection. In the 2010 Bankruptcy case of *In re Williams*, a son lived in a home with his wife and mother. The mother had transferred her ownership to hold a life estate, with the remainder interest owned by her son. The court determined that the property was held by a debtor who constituted a natural person and that the homestead exemption applied. A second case, *In re Hildebrandt*, came to the same conclusion.

MOVING OUT OF THE HOMESTEAD FOR A FEW MONTHS AT A TIME SO THAT IT CAN BE A SEASONAL RENTAL TO PRODUCE INCOME FOR THE HOMESTEAD OWNER.

The case law is clear that homestead status continues to apply if the owner of the homestead is not physically present there, but intends to continue to make it his or her homestead and to return there.⁴⁴⁴ It should be safe for the homestead owner to rent out his or her house occasionally for a few weeks at a time during the prime season while maintaining homestead exemption status for both property tax and creditor exemption purposes. An individual can maintain their homestead status even when they are “temporarily removed from the homestead but the homestead remains the permanent abode to which the family unit intends to return.”⁴⁴⁵

WILL A LEASEHOLD INTEREST QUALIFY FOR HOMESTEAD CREDITOR PROTECTION?

Can a debtor prepay a lease and then live rent-free on a leased property for a period of time without the Florida Fraudulent Transfer Statute to apply? In the 2012 Second District Court of Appeals case of *Geraci v. Sunstar EMS*, it was determined that a long-term lease constituted “property owned by a natural person” under the Florida Constitution, Article X, Section 4, and thus qualified for homestead creditor protection.⁴⁴⁶ The court also specifically found that fee simple ownership is not necessarily to claim this type of homestead protection.

⁴⁴⁴ See *Novoa v. Amerisource Corp.*, 860 So. 2d 506, 507 (Fla. Dist. Ct. App. 2003) (noting that “continuous uninterrupted physical presence is not required to create a homestead.”)

⁴⁴⁵ *Id.*

⁴⁴⁶ 93 So.3d 384, 385 (Fla. 2nd DCA 2012).

In *Geraci*, the court considered whether a long-term lease of a condominium qualified for homestead creditor protection under Article X, Section 4 of the Florida Constitution. The property at issue was a Pinellas County condominium that was the subject of a 100-year lease agreement from 1976. The decedent, Mary J. Geraci, owned the leasehold interest, which had approximately 64 years remaining, and upon her death, creditors filed claims against her estate. Lawrence Geraci, Jr., as personal representative of Mary Geraci's estate, filed a petition with the court to determine whether the condominium qualified as homestead and thus was exempt from creditor's claims.

Judge Lauren C. Laughlin of the Circuit Court for Pinellas County concluded that the condominium did not qualify for homestead creditor protection because it was subject to a lease agreement rather than being owned in fee simple. The Second District reversed, finding that fee simple ownership is not necessary to claim homestead creditor protection.

Applying Article X, Section 4(a) of the Florida Constitution, which grants homestead creditor protection, the 2nd DCA found that the condominium qualified as a homestead, despite the fact that it was not owned in fee simple. Specifically, the court stated that "Article X, section 4(a) does not distinguish between the different kinds of ownership interests that are entitled to the homestead exemption against forced sale."⁴⁴⁷ And the Florida Supreme Court has long held a fee simple estate is not necessary to this exemption.

The court also noted that "'any beneficial interest in land' may entitle its owner to the exemption." Significantly, the court stated that the proper inquiry in determining whether a property qualifies for homestead creditor protection is whether: 1) the debtor intended to make the property his or her homestead; and 2) whether the debtor used the property as his or her principal and primary residence.

CO-OPS QUALIFY.

Similarly, in *Southern Walls, Inc. v. Stilwell Corp.*, the Fifth District Court of Appeals held that a co-operative interest qualified for homestead creditor protection.⁴⁴⁸ Specifically, the court stated that "a co-op must be a dwelling that an individual has an ownership interest in that gives him or her the right to use and occupy it as his or her place of abode." The Fifth District further noted that the Florida Constitution does not define the term "owned" and that it "does not designate how title to the property must be held and it does not limit the estate that must be owned."

In *Phillips v. Hirshon*, the Third District Court of Appeals discussed the divergence in court opinions regarding whether ownership is required to claim homestead creditor protection and specifically stated, "[W]e respectfully submit that the courts may not diverge when interpreting the same subsection of the Florida Constitution, even if it seems to make good policy."⁴⁴⁹ The court attempted to resolve the confusion among courts by certifying a question to the Florida Supreme Court, but the Court declined jurisdiction, leaving this issue unresolved.

⁴⁴⁷ *Id.* at 385; (citing *In re Alexander*, 346 B.R. 546, 549-50 (Bankr. M.D. Fla. 2006); *Cutler v. Cutler*, 994 So. 2d 341, 344 (Fla. 3d DCA 2008); *S. Walls, Inc. v. Stilwell Corp.*, 810 So. 2d 566, 571 (Fla. 5th DCA 2002)).

⁴⁴⁸ 810 So.2d 566 (Fla. 5th DCA 2002).

⁴⁴⁹ 958 So.2d 425 (Fla. 3rd DCA 2007).

Although the Second District in *Geraci* is not the first court to hold that a long-term leasehold interest may qualify for homestead creditor protection, this decision is significant because it strengthens the body of case law allowing homestead creditor protection absent an ownership interest. However, other Florida decisions have declined to extend this form of homestead protection to interests other than fee simple ownership.

It is also important to note that extending constitutional creditor protection to long-term leasehold interests may result in these interests being subject to the constitutional restrictions on descent and devise. It is also noteworthy that New York Law was modified in 1996 to permit married couples to directly own Co-Op's as Tenants by the Entireties where certain requirements are met.⁴⁵⁰

[ALAN TO POTENTIALLY MOVE CHART TO ITS OWN SECTION. THIS WOULD MAKE A GREAT THURSDAY REPORT ARTICLE WITH AN INTRODUCTION.]

	Constitutional Homestead Creditor Protection	Tenancy by the Entireties
1	Florida Constitution.	Florida Common Law.
2	Immune from Florida Statute 726 Fraudulent Transfer Set Asides.	Non-immune from Florida Statute 726.
3	Transfers can qualify for four years plus one year lookback?	Transfers can qualify for four years plus one year lookback?
4	Ten year rule applies under bankruptcy code.	Four year Fraudulent Transfer Statute will apply in bankruptcy – within one year lookback.
5	White collar crime exception in bankruptcy.	No white collar crime exception in bankruptcy.
6	Cannot reinvest proceeds – must borrow and reinvest borrowings and sell later.	Can reinvest in other exempt assets, including a homestead.

PROCEEDS FROM SALE.

Proceeds from the sale of an exempt homestead can be used to purchase an exempt replacement homestead, and will be protected during the transition if the following four requirements are met: The owner (1) has a good faith intent to reinvest the proceeds in a new homestead, (2) does not commingle the proceeds, (3) the proceeds are both identifiable and kept separate from other monies, and (4) reinvests the proceeds in a new homestead within a reasonable time. However, Florida courts have held that the proceeds from the sale of a homestead cannot be used by a debtor to reinvest in other exempt assets if the transfer would otherwise be set aside under the Florida Fraudulent Transfer Act. This section will first look at the three restrictions on using homestead sale proceeds to purchase a new homestead, and will then turn to the limitations on using homestead funds in other exempt asset scenarios.

USING HOMESTEAD PROCEEDS TO PURCHASE A NEW HOMESTEAD.

⁴⁵⁰ N.Y. Est. Powers & Trusts Law § 6-2.2 (McKinney).

Florida law will allow the proceeds of a sale of homestead to be reinvested in a new homestead within a reasonable period of time with continued protection. To qualify for this protection, the Florida Supreme Court, in *Orange Brevard Plumbing & Heating Co. v. La Croix*, held that the homeowner must show a good faith intention at the time of sale of the homestead to reinvest the proceeds within a reasonable period of time.⁴⁵¹

The Florida Supreme Court declined to define a reasonable period of time and stated that “whether funds received from the sale of a homestead are invested in another homestead within a reasonable time must be determined from the facts and circumstances of each case.”

Subsequently, court cases have found that the monies held to purchase a homestead would be protected for a short period of time. For example, in *Rossano v. Britesmile, Inc.*,⁴⁵² the court found that a fourth month period was reasonable, but in *In re Delson*⁴⁵³ and *Sun First National Bank of Orlando v. Gieger*,⁴⁵⁴ the court found that four years and ten years, respectively, were not reasonable.

The 2016 Florida Supreme Court decision of *JBK Assocs. v. Sill Bros.* approved a four month holding period, and affirmed the decision in *Orange Brevard Plumbing & Heating Co. v. LaCroix* without discussion of how long the proceeds can be held in an account.

There are two bankruptcy cases which state that 13 months and two years were reasonable timeframes for proceeds to stay in a bank account (while still making a good faith effort to purchase a new homestead property). Those cases are (1) *In re Fling*, decided in 2011 in the United States Bankruptcy Court for the Northern District of Florida, Tallahassee Division, which approved 13 months; and (2) *In re Castro*, decided in 2006 in the United States Bankruptcy Court for the Southern District of Florida, Miami Division, which approved two years.

As long as the individual has a “good faith intention” to reinvest the proceeds from the sale of one homestead into another within a year, a court will likely rule in that individual’s favor. The shorter the timeframe, though, the safer.

INVESTING HOMESTEAD SALE PROCEEDS INTO OTHER EXEMPT ASSETS – THIS DOESN’T WORK!

Because the funds from a homestead can be reinvested in a new homestead, one would assume that monies received from the sale of a protected homestead could be reinvested in another creditor exempt asset, given the general rule that one exempt asset can be converted to another exempt asset.⁴⁵⁵ In *Sneed*, the Florida Supreme Court in 1938 cited the original Corpus Juris legal encyclopedia (which is now C.J.S.) for this general rule of law:

⁴⁵¹ 137 So.2d 201 (Fla. 1962).

⁴⁵² 919 So.2d 551 (Fla. 3rd DCA 2005).

⁴⁵³ 247 B.R. 873 (Bankr. S.D. Fla. 2000).

⁴⁵⁴ 402 So.2d 428 (Fla. 5th DCA 1981).

⁴⁵⁵ *In re Kimmel*, 131 B.R. 223 (Bankr. S.D. Fla. 1991) (holding that transfer of funds from one form of exempt assets to another was not a fraudulent conveyance).

According to the weight of authority a debtor in disposing of property can only commit fraud on creditors only by disposing of such property as the creditor has a legal right to look to for satisfaction of his claim, and hence a sale, gift or other disposition of property which is by law absolutely exempt from the payment of the owner's debts cannot be impeached by creditors as in fraud of their rights. Creditors have no right to complain of dealings with property which the law does not allow them to apply on their claims, even though such dealings are with a purpose to hinder, delay or defraud them.⁴⁵⁶

Unfortunately, in 1962, the Florida Supreme Court did not agree with this general rule as it relates to homestead proceeds in *Orange Brevard Plumbing & Heating Co. v. La Croix*.⁴⁵⁷ In this case, the Florida Supreme Court stated the following:

[W]e hold the proceeds of a voluntary sale of a homestead to be exempt from the claims of creditors just as the homestead itself is exempt if, and only if, the vendor shows, by a preponderance of the evidence an abiding good faith intention prior to and at the time of the sale of the homestead to reinvest the proceeds thereof in another homestead within a reasonable time. Moreover, only so much of the proceeds of the sale as are intended to be reinvested in another homestead may be exempt under this holding. Any surplus over and above that amount should be treated as general assets of the debtor. We further hold that in order to satisfy the requirements of the exemption the funds must not be commingled with other monies of the vendor but must be kept separate and apart and held for the sole purpose of acquiring another home. The proceeds of the sale are not exempt if they are not reinvested in another homestead in a reasonable time or if they are held for the general purposes of the vendor.⁴⁵⁸

This issue arose again in the 2000 Bankruptcy Court case of *In re Simms*,⁴⁵⁹ where the homestead owners took the check from the sale of their house and endorsed it directly to purchase an annuity. The Court followed the decision of the Florida Supreme Court in *Orange Brevard Plumbing & Heating Co. v. La Croix*, and found that homestead proceeds only retain their exempt status when rolled over into another homestead, and therefore the proceeds were non-exempt when they were rolled into the annuity. Specifically, the court stated:

The voluntary liquidation of an exempt asset and subsequent reinvestment in another exempt asset should be considered permissible per se because such a maneuver neither harms creditors nor changes their position vis-a-vis the debtor. However, as directed by the Eleventh Circuit Court of Appeals, “[T]he bankruptcy court must interpret and apply the Florida exemption law in the same manner as a Florida state court.”

⁴⁵⁶ 184 So. 865 (Fla. 1938).

⁴⁵⁷ 137 So.2d 201 (Fla. 1962).

⁴⁵⁸ *Id.*

⁴⁵⁹ 243 B.R. 156 (S.D. Fla. 2000).

In dicta, the court cited two non-Florida cases for the general proposition that exempt assets may be rolled over into another exempt asset, and noted that these cases were persuasive.⁴⁶⁰ Thus, it seems that the court was convinced that the proceeds should be exempt, but was required to follow the Florida Supreme Court's ruling in *La Croix*.

A separate question is whether money borrowed on a homestead can be directly transferred into an exempt asset, such as a variable annuity, a life insurance policy, or tenancy by the entirety.

In *In re Goldberg*, the debtor refinanced his house and transferred \$80,000 directly to his fiancée from the loan proceeds.⁴⁶¹ He then took out a second mortgage and transferred another \$50,000 directly to his fiancée. The Court distinguished this case from *La Croix*, and held the following:

[T]he Debtor retained no interest in the funds generated by the loans against his homestead and never had possession of the funds since they were delivered directly to [his fiancée]. Moreover, the Debtor did not sell his homestead. The Debtor merely mortgaged and refinanced his homestead, encumbering the Real Property with liens that must be satisfied upon its sale. Mortgage and refinance proceeds are not the functional equivalent of sale proceeds. Thus, the fact that the Debtor did not reinvest the proceeds or have the requisite intent to reinvest the proceeds into another homestead within a reasonable period of time is irrelevant. The Court finds that no creditor could have forced the Debtor to mortgage his homestead to satisfy its claims. Thus, the Debtor's creditors were not harmed and there was not, nor could there be, any fraudulent intent on the part of the Debtor.

The court did not specifically address what would happen if the debtor had transferred the refinance and second mortgage proceeds into an exempt annuity; however, because he was able to transfer these proceeds to his fiancée without triggering a fraudulent transfer, it could be argued that a debtor should also be able to borrow against his homestead and purchase an exempt annuity.

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	DESCRIPTION	HOLDING/REASON
1	<i>Orange Brevard Plumbing & Heating Co. v. La Croix</i> , 137 so. 2d 201 (Fla. 1962).	The debtor voluntarily sold his homestead and was currently living in a rental home, with no evidence on when he intended on buying a new homestead.	Established the rule that proceeds from the sale of homestead can be reinvested in another homestead. IF there is a good faith intention prior to and at the time of the sale of the homestead to reinvest the proceeds thereof in another homestead within a reasonable time. Did not provide a definition of reasonable time, but noted that the facts and circumstances of each case should be considered.

⁴⁶⁰ *Love v. Menick*, 341 F.2d 680 (9th Cir. 1965) (subsequently overruled).

⁴⁶¹ 229 B.R. 877 (Bankr. S.D. Fla. 1998).

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	DESCRIPTION	HOLDING/REASON
2	<i>In re Simms</i> , 243 B.R.156 S.D. Fla. 2000).	Debtors sold homestead and transferred proceeds directly into an annuity by endorsing check in favor of annuity company.	The court considered non-Florida cases and found it persuasive that the voluntary liquidation of an exempt homestead and subsequent reinvestment in another exempt asset should be permissive. BUT the court was required to follow the Florida Supreme Court's decision in <i>La Croix</i>. Pursuant to <i>La Croix</i> the \$65,467.57 net sale proceeds of the homestead constituted a non-exempt asset because the Debtors had no intention of reinvesting the proceeds in another homestead. However, the transaction was not considered a fraudulent transfer because there was not enough evidence to establish that the debtors intended to hinder, delay or defraud creditors.
3	<i>In re Delson</i> , 247 B.R. 873 (Bankr. S.D. Fla 2000).	Husband has \$4 million in debt. Husband & wife sold homestead and proceeds were transferred to bank account owned solely by wife. Wife then transfers proceeds into mutual fund investment accounts.	Homestead sale did not retain homestead exemption status. The proceeds were used by the debtor's wife to purchase collateral for a business loan; and, nearly four years after the homestead sale, neither the debtor nor his wife has purchased a new homestead. This subsequent action and inaction belies any purported intent at the time of the sale to reinvest in another homestead within a reasonable time.
4	<i>In re Vick</i> , 2008 WL 2444526 (Bankr. S.D. Fla. 2008).	Debtor filed a bankruptcy petition. On the petition date, the debtor occupied the home and held title to the homestead, but sold the homestead after filing. Trustee argued that Debtor was required to reinvest the proceeds of the post-petition sale of her homestead into another homestead within a period of time or suffer the loss of the exemption.	The debtor retained the homestead protection for the proceeds. The court held that the sales contract did not constitute an abandonment of the property. The Trustee's attempt to reach into the future, to recover post-petition assets for the payment of pre-petition debts or administrative expenses, is unauthorized and against the policies upon which the Bankruptcy Code is premised.

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	DESCRIPTION	HOLDING/REASON
5	<i>In re Goldberg</i> , 299 B.R. 877 (Bankr. D. Fla. 1998).	Debtor refinanced his house and transferred \$80,000 directly to his fiancée from the loan proceeds. He then took out a second mortgage and transferred another \$50,000 directly to his fiancée. The Trustee cited <i>La Croix</i> for the proposition that once homestead property is converted into another form, it loses its exempt status unless reinvested into another homestead within a reasonable period of time.	The Court held that this is distinguishable from <i>Orange Brevard</i> because the debtor did not sell his home and he retained no interest in the funds since. Thus, the fact that debtor did not reinvest the proceeds or have the requisite intent to reinvest the proceeds into another homestead within a reasonable period of time was irrelevant. Not a fraudulent transfer.
6	<i>In re Dozon</i> , 347 B.R. 920 (Bankr. M.D. Fla. 2006).	Debtor's homestead was sold in a foreclosure sale. There were surplus proceeds from the sale. The surplus funds were being held in a trust account pending the Court's decision.	Debtor was entitled to Florida homestead exemption in surplus proceeds, notwithstanding that he did not know, prior to mortgage foreclosure sale, that there would be any surplus proceeds.
7	<i>In re Cottrill</i> , 118 B.R. 535 (Bankr. S.D. Ohio 1990). Exempt to Exempt Case.	Debtor husband withdrew money from his deferred compensation program, deposited \$9,700 into a joint account with his wife, and shortly thereafter transferred \$8,287.36 into the Public Employee's Retirement System.	"Because Mr. Cottrill essentially 'rolled-over' money from one exempt retirement fund into another, the transfer cannot be considered fraudulent." To the extent that transfer of funds to purchase pension plan benefitted not only debtor, but debtor's wife, transfer was not voidable as fraudulent. Death of debtor husband after commencement of bankruptcy case, leaving benefits from debtor's husband's pension plan payable to debtor's wife, did not render transfer of assets to pension plan fraudulent. Temporary placement of money in debtor husband's personal checking account for specific purpose of transferring funds from one exempt fund into another exempt fund did not cause asset to lose its exempt status, nor render transfer fraudulent.

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	DESCRIPTION	HOLDING/REASON
8	<i>In re Kimmel</i> , 131 B.R. 223 (Bankr. M.D. Fla. 1991). Exempt to Exempt Case.	Debtor made 4 transfers: 1) IRA to IRA 2) Pension to Pension 3) Two Life Insurance Policies 4) Proceeds from Automobile to Annuity.	1) Exempt to Exempt transfer, not a fraudulent conveyance. 2) Exempt to Exempt transfer, not a fraudulent conveyance. 3) Not a fraudulent conveyance, life insurance policies were not purchase with intent to defraud creditors. 4) Not a fraudulent conveyance, because transfer was not done with intent to defraud creditors.
9	<i>Sneed v. Davis</i> , 184 So. 865 (Fla. 1938).	Debtor owned stock in a corporation, then transferred it back to the company, which re-issued the stock to the debtor's family. At the time of the transfer, the debtor was the head of a family residing within the state, and the stock, together with all other personalty owned at such time by debtor, was worth less than \$1,000.	The stock was exempt under the personal property exemptions, thus, transferring the exempt stock did not result in a fraudulent transfer.

ONE ADVANTAGE OF BEING MARRIED AND LIVING SEPARATELY.

In *In re Colwall*, the Eleventh Circuit Court of Appeals held that married couples legitimately living apart can occupy two protected homesteads.⁴⁶² It is noteworthy, however, that under Florida law, the local County Property Appraiser has discretion to deny a homestead tax exemption to married individuals who live separately, based upon criteria, including whether they actually have separate finances, file separate income tax returns, and constitute true independent separate households. This process, as well as the process to appeal a homestead tax exemption denial, are enumerated in Florida Statute Section 194.011.

For property tax purposes, however, the law is clear that a married couple cannot claim two separate homesteads unless they truly live separately, and file separate federal income tax returns. Fortunately, the property tax status of separately owned and occupied houses will not be determinative as to creditor protection, but is often persuasive.

SOMETIMES THE BEST STRATEGY IS TO BUY ANOTHER HOUSE.

When spouses own a home as tenants by the entireties and only one spouse is liable to a creditor, it may make sense to have the debtor spouse purchase a new home and use the old home as an income property. This is the best available strategy if the debtor spouse will not be forced into bankruptcy.

OCCUPANCY MUST BE LEGAL.

⁴⁶² 196 F. 3d 1225 (11th Cir. 1999).

The Florida Supreme Court has stated that “[a] piece of land, never occupied as a dwelling place or home, and incapable of such occupancy, is not a homestead within the meaning of the Constitution and laws of this State.”⁴⁶³ Thus, if an individual owns a commercial property or a vacant property where county or city law prevents residential use, the individual will not qualify for creditor protection on the property. Also, to qualify for a homestead, the individual must be a Florida resident or a U.S. resident alien with a permanent visa or “green card.”⁴⁶⁴

WHAT IF SOMEONE BESIDES THE DEBTOR OWNS PART OF THE HOMESTEAD AND RESIDES THERE?

In the 2007 Bankruptcy Court decision of *In re Gatto*,⁴⁶⁵ Judge Williamson observed that the homestead ownership interest of a married debtor, where the debtor does not claim or qualify for homestead exemption, may not be partitioned or sold by the bankruptcy trustee by reason of Florida law protecting the homestead rights of the non-debtor spouse. The Court noted that one spouse cannot destroy the other’s homestead rights. Footnote 4 of such decision reads as follows:

While a bankruptcy trustee, pursuant to Bankruptcy Code Section 363(h) may attempt to partition and sell the debtor’s interest in the home where the debtor does not claim the homestead as exempt under Section 4, Article X of the Florida Constitution, it is questionable whether such an attempt to utilize Section 363 (h) in this fashion would be successful. In Florida, homesteads are regarded as sacred cows and cannot be alienated so as to harm the interests of those meant to be protected by its very character as homestead. As such, the rights of each spouse pertain to the entire home. To this end, homestead status of a home may not be destroyed unless both spouses join in the conveyance of the homestead to a third party, even where the homestead is owned by only one spouse. Moreover, one spouse cannot destroy the other’s homestead rights by apparent abandonment, mere express or implied intent, or indication of his choice. That is, one spouse acting alone cannot abandon the homestead rights of the other spouse. In bankruptcy, property comprising the bankruptcy estate, as broadly defined by Section 541(a), includes all legal or equitable interest of the debtor in property as exist under state law as of the commencement of the case. However, in *In re Bryant Manor, LLC*, the court held that there are two exceptions to the general rule. If Congress modifies state law through legislation enacted under its authority to establish uniform bankruptcy laws under the U.S. Constitution or if federal interest requires a different result, property rights of a bankruptcy will not be determined by state law. As importantly, the bankruptcy trustee has no greater rights to the estate property than the debtor and is subject to all claims, liens, and equities that the debtor is subject to with respect to such property. It would appear to follow, therefore, that because a debtor cannot act on behalf of his spouse to alienate or abandon his spouse’s interest in their homestead, a debtor’s failure to claim homestead rights does not create a right in the trustee that the debtor does not have to partition that homestead property.⁴⁶⁶

⁴⁶³ *Drucker v. Rosenstein*, 19 Fla. 191 (Fla. 1882).

⁴⁶⁴ *In re Boone*, 134 B.R. 979, 981 (Bankr. M.D. Fla. 1991) (See also *Raheb v. DiBatisto*, 513 So. 2d 717 (Fla. App. 3 Dist. 1987) (holding that Iranian nationals did not have the requisite permanent alien status to qualify for a Florida homestead).

⁴⁶⁵ 380 B.R. 88 (Bankr. M.D. Fla. 2007).

⁴⁶⁶ *Id.* at 96 n.4.

The *Gatto* court further held that the debtor spouse cannot claim the special personal property exemption of \$4,000 in bankruptcy (which applies when the debtor does not claim homestead) if the debtor is still receiving the protection of the homestead exemption through the non-debtor spouse.

In *Tullis v. Tullis*, the Florida Supreme Court allowed a partition of homestead property when one of the co-owners brought suit for partition of the property.⁴⁶⁷ In that case, marital property owned as tenants by the entirety became owned as tenants in common pursuant to Florida Statutes Section 689.15 when the spouses divorced, thereby losing tenancy by the entirety status and subsequently owned the home as tenants in common. The husband lived in the home with the daughter, and the wife brought suit for partition. Both parties agreed that the property was not divisible, and the Court stated that “forced sale is the only method through which the wife can obtain beneficial enjoyment of her one-half undivided interest in the property.” The Court also noted that “[h]omestead interests should be protected from forced sale whenever possible, but not at the expense of others owning interests in the property.”

In the important case of *In re Lezdey*,⁴⁶⁸ a creditor obtained a judgment against two brothers. The two brothers each owned an undivided one-half interest in property in Pinellas County, Florida. One brother lived on the property and claimed that it was his protected homestead.

The Middle District of Florida Bankruptcy Court found that the creditor had a valid lien on the property but that the lien did not exist to the one-half beneficial interest of the brother who had a homestead interest in the property. The Bankruptcy Court held that the creditor could not enforce the lien or partition the property as long as the property remained the homestead property of the brother who lived there.

The debtor was represented by Michael Markham, which is part of the reason that we say that it is important above.

Unfortunately, not all Florida decisions support the position that a debtor can claim constitutional homestead creditor protection absent an ownership interest. For example, in *In re Lisowski*,⁴⁶⁹ the United States Bankruptcy Court for the Middle District of Florida sought to determine whether a debtor was entitled to claim homestead creditor protection under Article X, Section 4 of the Florida Constitution, which would disqualify him from claiming the greater personal property exemption under Florida Statutes Section 222.25. The court held that the debtor’s interest in a mobile home on a leased land did not constitute an “interest in realty” for purposes of homestead creditor protection, thus he could not claim homestead protection under the Florida Constitution. However, he could claim Florida’s statutory modular home exemption under Section 222.05, which allows owners who live in modular homes on land not owned by the debtor to protect these homes from creditors.

The *Lisowski* court held that homestead creditor protection only applies to “improved land or real property owned by a debtor, provided [that] the debtor’s residence is situated on the land,” seemingly interpreting Article X, Section 4 of the Florida Constitution to require ownership in order to qualify for homestead creditor protection.

⁴⁶⁷ 360 So.2d 375 (Fla.1978).

⁴⁶⁸ *In re Lezdey*, 373 B.R. 164 (Bankr. M.D. Fla. 2007).

⁴⁶⁹ 395 B.R. 771 (Bankr. M.D. Fla. 2008).

When an owner rents out a portion of the property, a two-part analysis has been used in determining whether the homestead exemption extends to the entire property. The court must determine whether the residence is a fraction of the entire property and whether the property can be severed. *Anderson v. Letosky*, 2020 Fla. App. LEXIS 7307. In duplex cases, homestead has been limited to the portion of the duplex in which the owner resided with their family. *Id.* When renters and owners alike have access to the same common areas, homestead may apply to the whole. *Id.*

A homeowner doesn't abandon their homestead protection merely by renting a portion of the property. *Id.* Loss of protection is dependent upon whether the property is "susceptible to division by perpendicular and/or horizontal lines" and "Lawfully conveyable as an independent parcel under existing law." *Id.*

WHAT ABOUT RECREATIONAL VEHICLES, MOBILE HOMES AND HOUSEBOATS AS HOMESTEAD?

Florida Statutes Section 222.05 extends homestead protection to unconventional homes stating:

Any person owning and occupying any dwelling house, including a mobile home used as a residence, or modular home, on land not his or her own which he or she may lawfully possess by lease or otherwise, and claiming such house, mobile home, or modular home as his or her homestead, shall be entitled to the exemption of such house, mobile home, or modular home from levy and sale as aforesaid.⁴⁷⁰

In *Matter of Leroy George Yettaw*, Judge Baynes of the Bankruptcy Court for the Middle District of Florida held that a motor home was a "dwelling house" for purposes of Section 222.05 and was thus entitled to homestead creditor protection where the debtor intended to make it his homestead.⁴⁷¹ Mr. Yettaw's motor home was parked in a motor home park. The motor home was equipped with water, sewage and electrical service, and was maintained for long-term habitation.

Although mobile and modular homes are specifically protected under Section 222.05, courts have found that more non-traditional types of housing, such as houseboats, are also protected under this statute. In *Miami Country Day School v. Bakst*, the court found that a 3,000 square foot houseboat, fully equipped with four bedrooms, three bathrooms, and a garden, qualified for homestead protection under Section 222.05.⁴⁷² The houseboat had never been equipped with a motor and was towed to its location.

On the other hand, in *In re Major*, the court held that an 80-ft. boat with a broken engine did not qualify for the homestead exemption.⁴⁷³ In this case, the boat was only inoperable because the debtors did not have the funds to repair the motor, but would be operable if the motor were fixed.

⁴⁷⁰ Fla. Stat. § 222.05 (2015).

⁴⁷¹ 316 B.R. 560 (Bankr. M.D. Fla. 2004).

⁴⁷² 641 So.2d 467 (Fla. 4th DCA 1994).

⁴⁷³ 166 B.R. 457 (Bankr. M.D. Fla. 1994).

EFFECT OF BEING ANNEXED.

Where the owner of homestead property, which exceeds one-half acre outside of city limits becomes annexed, that owner becomes “grandfathered” for homestead creditor protection so long as he or she continues to own the homestead property.

It is better to only have the half acre with the most valuable building and/or waterfront included in the name of the debtor, and to have the surrounding property that would not be protected in a separate entity in order to avoid a division based upon acreage, which could be very unfair to the debtor.

An irrevocable trust formed by the debtor for the benefit of the debtor may facilitate maintaining the homestead tax exemption and 3% cap while making this distinct and separate from the one-half acre that would be creditor protected.

THE IRS CAN TAKE YOUR HOME!

The Middle District Bankruptcy Court case *In re McFadyen* confirmed that the Commissioner of the Internal Revenue Service has the ability to seize a homestead from a Florida resident for payment of unpaid taxes.⁴⁷⁴ The court quoted Internal Revenue Code Section 6321, which provides that:

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

Nevertheless, a judge or magistrate of a United States District Court must approve the levy in writing under Internal Revenue Code Section 6334, the Taxpayer Bill of Rights.

IRC 6334(13) Residences Exempt In Small Deficiency Cases And Principal Residences And Certain Business Assets Exempt In Absence of Certain Approval Or Jeopardy.

A. Residences in small deficiency cases. If the amount of the levy does not exceed \$5,000;

(i) any real property used as a residence by the taxpayer; or

(ii) any real property of the taxpayer (other than real property which is rented) used by any other individual as a residence.

B. Principal residences and certain business assets. Except to the extent provided in subsection (e);

(i) the principal residence of the taxpayer (within the meaning of section 121); and

⁴⁷⁴ 216 N.R. 1006 (Bankr. M.D. Fla. 1998).

- (ii) tangible personal property or real property (other than real property which is rented) used in the trade or business of an individual taxpayer.

However, Internal Revenue Code Section 6334(a)(13) provides an exception for residences in small deficiency cases. Under this Section, real property used as a residence by the taxpayer or any other property, except rental property, owned by the taxpayer that serves as the residence of another is exempt in small deficiency cases if the amount of the levy does not exceed \$5,000.

HOMESTEAD TAX PROTECTION AND PLANNING.

Like most states, Florida law provides for lower ad valorem tax assessments on property that is used as a homestead. Article VII, Section 6 provides the following taxation exemption:

Every person who has the legal or equitable title to real estate and maintains thereon the permanent residence of the owner, or another legally or naturally dependent upon the owner, shall be exempt from taxation thereon, except assessments for special benefits, up to the assessed valuation of twenty-five thousand dollars and, for all levies other than school district levies, on the assessed valuation greater than fifty thousand dollars and up to seventy-five thousand dollars, upon establishment of right thereto in the manner prescribed by law. The real estate may be held by legal or equitable title, by the entireties, jointly, in common, as a condominium, or indirectly by stock ownership or membership representing the owner's or member's proprietary interest in a corporation owning a fee or a leasehold initially in excess of ninety-eight years.

Under this provision, every Florida homeowner can receive a homestead exemption up to \$50,000. The first \$25,000 in property value is exempt from all property taxes, including school district taxes. The additional \$25,000 exemption is available for non-school taxes and applies only to the assessed value between \$50,000 and \$75,000.

The recession of 2008 caused most real estate in Florida to be reset to a lower tax assessed value, while being limited to increases of 3% per year thereafter, where the economy had recovered.

SHOULD THE CLIENT FILE A NOTICE OF HOMESTEAD?

Under Florida Statutes Section 222.01, a Notice of Homestead can be filed on public record to put the public on notice that property is homesteaded. There is no substantive legal effect of filing an affidavit under this statute, but clients may be well advised to file such an affidavit if there is any question as to whether some or all of the subject property is a homestead because it demonstrates intent. This may particularly be the case where a client owns homestead property and expands by purchasing one or more adjoining lots. Florida Statutes Section 222.01 (1) reads as follows:

Whenever any natural person residing in this state desires to avail himself or herself of the benefit of the provisions of the constitution and laws exempting property as a homestead from forced sale under any process of law, he or she may make a statement, in writing, containing a description of the real property, mobile home, or modular home claimed to be exempt and declaring that the real property, mobile home, or modular home is the homestead of the party in whose behalf such claim is being made. Such statement shall be signed by the person making it and shall be recorded in the circuit court.

Section 222.01(2) provides a suggested form for the notice, which is provided below:

NOTICE OF HOMESTEAD

To: (Name and address of judgment creditor as shown on recorded judgment and name and address of any other person in the recorded judgment to receive a copy of the Notice of Homestead).

You are notified that the undersigned claims as homestead exempt from levy and execution under Section 4, Article X of the State Constitution, the following described property:

(Legal description)

The undersigned certifies, under oath, that he or she has applied for and received the homestead tax exemption as to the above-described property, that _____ is the tax identification parcel number of this property, and that the undersigned has resided on this property continuously and uninterrupted from _____ (date) to the date of this Notice of Homestead. Further, the undersigned will either convey or mortgage the above-described property pursuant to the following:

(Describe the contract of sale or loan commitment by date, names of parties, date of anticipated closing, and amount. The name, address, and telephone number of the person conducting the anticipated closing must be set forth).

The undersigned also certifies, under oath, that the judgment lien filed by you on _____ (date) and recorded in Official Records Book ____, Page ____, of the Public Records of _____ County, Florida, does not constitute a valid lien on the described property.

YOU ARE FURTHER NOTIFIED, PURSUANT TO SECTION 222.01 ET SEQ., FLORIDA STATUTES, THAT WITHIN 45 DAYS AFTER THE MAILING OF THIS NOTICE YOU MUST FILE AN ACTION IN THE CIRCUIT COURT OF _____ COUNTY, FLORIDA, FOR A DECLARATORY JUDGMENT TO DETERMINE THE CONSTITUTIONAL HOMESTEAD STATUS OF THE SUBJECT PROPERTY OR TO FORECLOSE YOUR JUDGMENT LIEN ON THE PROPERTY AND RECORD A LIS PENDENS IN THE PUBLIC RECORDS OF THE COUNTY WHERE THE

HOMESTEAD IS LOCATED. YOUR FAILURE TO SO ACT WILL RESULT IN ANY BUYER OR LENDER, OR HIS OR HER SUCCESSORS AND ASSIGNS, UNDER THE ABOVE-DESCRIBED CONTRACT OF SALE OR LOAN COMMITMENT TO TAKE FREE AND CLEAR OF ANY JUDGMENT LIEN YOU MAY HAVE ON THE PROPERTY.

This ____ day of _____, 20 ____.

(Signature of Owner)

(Printed Name of Owner)

(Owner's Address)

Sworn to and subscribed before me by _____, who is personally known to me or produced _____ as identification, this ____ day of _____, 20 ____.

(Notary Public)

BANKRUPTCY AND OTHER IMPLICATIONS OF HOMESTEAD PROTECTION – IS THE PARTY OVER?

The “mansion loophole closing” provisions of the 2005 revisions to the Bankruptcy Code can reduce the protected homestead equity value to as low as \$146,450, and the entire value of the home will not be protected if the ten-year fraudulent set aside provision applies.

When a homestead has been purchased within 1,215 days of filing bankruptcy with the proceeds from a previously protected homestead, the exemption will be the sum of \$170,350 and the amount that has come from the previously protected homestead.⁴⁷⁵

The Bankruptcy Code's prohibition upon the protection of homestead for a debtor in bankruptcy applies under the supremacy clause of the U.S. Constitution.⁴⁷⁶

Notwithstanding that the creditor will have the right to receive such “ill-gotten gains” upon the sale of the homestead, the case law has indicated that the homestead will not be sold until the debtor voluntarily does so, or is required to do so by a lender having a mortgage on the property. The debtor may therefore continue to make use of the homestead as long as he or she can afford to do so.

The \$4,000 wildcard exemption that applies if there is no homestead protection elected by the debtor will apply for a married couple where both spouses file bankruptcy together and they elect for only tenancy by the entireties protection to apply, such as where each spouse has separate creditors, so that there is no

⁴⁷⁵ Nelson, Barry, *Estate Planning and Asset Protection in Florida*, Juris Publishing, Inc., 2019.

⁴⁷⁶ *Id.*

common creditor that would be able to pursue tenancy by the entirety property, including a jointly owned homestead.

A bankruptcy court may deny the debtor's discharge when the debtor pays a mortgage on a homestead with non-exempt funds in a fraudulent transfer that occurs within one year before the filing of bankruptcy. As further described in Section 4(F), in the case of *In re Chauncey*,⁴⁷⁷ the Eleventh Circuit affirmed the bankruptcy court's decision to deny a discharge when the debtor used her non-exempt personal injury settlement proceeds to pay down the mortgage on her homestead just a few days before filing before bankruptcy.

TEN YEAR FRAUDULENT TRANSFER SET ASIDE.

The entire value of homestead property will not be protected to the extent that its net value has been increased by a disposition of non-exempt property made by the debtor during the ten years prior to filing bankruptcy with the intent of hindering, delaying or defrauding creditors. Specifically, Section 522(o) states the following:

For purposes of subsection (b)(3)(A), and notwithstanding subsection (a), the value of an interest in—

- 1) real or personal property that the debtor or a dependent of the debtor uses as a residence;
- 2) a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;
- 3) a burial plot for the debtor or a dependent of the debtor; or
- 4) real or personal property that the debtor or a dependent of the debtor claims as a homestead; shall be reduced to the extent that such value is attributable to any portion of any property that the debtor disposed of in the 10-year period ending on the date of the filing of the petition with the intent to hinder, delay or defraud a creditor, and that the debtor could not exempt, or that portion that the debtor could not exempt, under subsection (b) if on such date the debtor had held the property so disposed of.

The reduction is based upon the value of the homestead resulting from such “fraudulent transfers.” The courts must determine how to apportion appreciation in the value of a homestead that occurs after the “fraudulent conversion” has occurred.

In *In re Cook*, the bankruptcy court found that a couple's conversion of \$175,000 in proceeds from a non-exempt tax refund into an exempt homestead was not done with fraudulent intent, and therefore, the ten-year “look back” provision under Bankruptcy Code Section 522(o) did not apply.⁴⁷⁸ In determining that the investment was not a fraudulent transfer, Judge Killian of the United States Bankruptcy Court for the Northern District of Florida stated that “[t]he Debtors’ explanation that the purchase of the homestead using the non-exempt tax refund was to ensure that they had a permanent place to live is credible and realistic” and “receiving the tax refund finally give the Debtors the opportunity to procure a stable and permanent residence.”⁴⁷⁹

⁴⁷⁷ 454 F.3d 1292 (11th Cir. 2006).

⁴⁷⁸ 460 B.R. 911 (Bankr. N.D. Fla. 2011).

⁴⁷⁹ *Id.* at 914.

The court also determined that the couple's equity in the home did not exceed the cap under the Bankruptcy Code Section 522(p)(1). In 2011, the applicable caps and homestead exemption was \$146,450 for property acquired within the 1,215 days preceding the filing of a bankruptcy; however, because the cap applies separately to each individual debtor, the couple's cap was \$292,900, thus allowing the entire amount of equity in the home to remain exempt.⁴⁸⁰

In this case, the Cooks obtained a \$3 million loan to begin a car dealership. With the economic downturn in 2008, the car dealership suffered substantial losses, causing the Cooks to default on the loan and file for bankruptcy. The Cooks sold their home, once valued at \$5 million, for \$2.3 million to pay the remainder of the mortgage and to pay down part of the loan. The couple was then forced to move into a mobile home afterwards as they were unable to afford a down payment or receive credit to purchase a new home.

In 2010, the Cooks received a tax refund of \$184,769, which they used to make a down payment on a waterfront home on January 3, 2011, with a purchase price of \$800,000. The Cooks made a \$155,000 cash down payment, and the seller gave them a mortgage for the remaining amount owed. In addition to the down payment, the Cooks spent \$20,000 making improvements to the home.

In mid-January 2011, the bank initiated a lawsuit against the Cooks as a result of their default on the loan, and a judgment was entered against the couple in March of 2011. Unable to pay the judgment, the Cooks filed for bankruptcy on May 23, 2011, and claimed the property as homestead, even though it was acquired less than five months before filing the petition.

In the bankruptcy hearing, the creditor objected to the homestead exemption under Section 522(o)(4) of the Bankruptcy Code, which provides that "a debtor's homestead exemption shall be reduced to the extent that the debtor, with an intent to hinder, delay or defraud a creditor, converted non-exempt assets into exempt assets within ten years of the bankruptcy filing."

In arguing that the Cooks acted with fraudulent intent, the creditors relied on a "badges of fraud approach," claiming that purchasing an \$800,000 waterfront home immediately preceding collection efforts and shortly after defaulting on a \$3 million loan established fraud. The court rejected this notion, explaining that the Bank failed to establish fraud by a preponderance of the evidence. The court found that it was reasonable for the Cooks to use the tax refund to buy another home, noting that "receiving the tax refund finally gave the Debtors the opportunity to procure a stable and permanent residence."

Further, the court noted, "[w]hile it may seem unreasonable to purchase an \$800,000 waterfront property after living in a mobile home, the Debtors actually went from living in a \$5 million home to a home worth substantially less."

Although the court ruled in the Cooks' favor, transferring non-exempt assets shortly before filing bankruptcy was a gutsy move on the part of the Cooks. If the court had determined that they committed a

⁴⁸⁰ Dollar amounts shall be adjusted "at each 3-year interval ending on April 1." 11 U.S.C. § 104 (2017).

fraudulent transfer by using the tax refund to purchase the home, not only would the Cooks have lost their home, but they also would have been eternally unable to discharge the judgment owed to the bank.

From the above-described cases, it seems that if there is a good reason for the transaction, separate and apart from incidental creditor protection benefits, a debtor may be able to transfer assets before filing for bankruptcy without this being considered to be a fraudulent transfer; but such actions are not without risk.

A debtor cannot exempt any amount of homestead property worth in excess of the current cap (\$170,350 for 2017) that is acquired during the 1,215 days (three years and four months) before the bankruptcy filing.⁴⁸¹

Also, remember that the “730 Day Rule will apply,” which requires the Debtor to have maintained a domicile within Florida for the 730 days (2 years) prior to filing a bankruptcy petition in order for the Florida exemption laws to apply in the bankruptcy.

Section 522(p) reads as follows:

- A. Except as provided in paragraph (2) of this subsection and sections 544 and 548, as a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition that exceeds in the aggregate \$125,000 in value in –
 - a. Real or personal property that the debtor or a dependent of the debtor uses as a residence;
 - b. A cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;
 - c. A burial plot for the debtor or a dependent of the debtor; or
 - d. Real or personal property that the debtor or dependent of the debtor claims as a homestead.
- B.
 - a. The limitation under paragraph (1) shall not apply to an exemption claimed under subsection (b)(3)(A) by a family farmer for the principal residence of such farmer.
 - b. For purposes of paragraph (1), any amount of such interest does not include any interest transferred from a debtor’s current principal residence, if the debtor’s previous and current residences are located in the same state.

This is not an intent-based provision, but applies automatically when a person does not have the requisite time period to qualify for protection.

An exception to this \$146,450 cap applies when money derived from the sale of a prior residence is applied to facilitate the purchase of a replacement property. Where the new homestead costs significantly

⁴⁸¹ 11 U.S.C. § 522(p) (2017).

more than the prior homestead, the amount of homestead protection is limited to \$146,450, plus the proceeds from the sale of the prior residence used to purchase the new residence.

The transfer of an ownership interest from one spouse to another should not constitute a fraudulent transfer under the Florida law, but may implicate the 1,215-day requirement under the Bankruptcy Code.

In the Bankruptcy Court case of *In re Leung*,⁴⁸² the Eastern District of Massachusetts Bankruptcy Judge held that the transfer of homestead property by the debtor's spouse to the two of them as tenants by the entireties constituted a transfer to the debtor under the 1,215-day period. The debtor argued that the property should not be subject to the then statutory \$136,875 cap because he had been living there as his primary residence since before the 1,215-day period started, and because he had contributed to the home's upkeep and had an equitable interest under marital law. However, the court rejected this argument and found that there was no basis under Massachusetts law for holding that the debtor had an equitable interest in the property.

Further, courts have allowed spouses to enjoy the benefit of two caps if they can separately claim a homestead exemption. In *In re Rasmussen*, the Bankruptcy Court in the Middle District of Florida ruled that two spouses could stack their "caps," creating \$250,000 of coverage for their home when they both filed bankruptcy in 2006.⁴⁸³ The court noted that Section 522(p) "clearly says 'a' debtor is subject to the cap." The court also analogized to state law exemptions and stated that "in this respect, it is clear under Florida law that each debtor gets to claim exemptions separately. For example, each spouse is entitled to the constitutional exemption for \$1,000 of personal property even though the personal property is jointly owned, resulting in an aggregate exemption of \$2,000."

ARE MORTGAGE PAYMENTS CONSIDERED ACQUISITION OF EQUITY?

Again, "any equity acquired" in a homestead asset during the 1,215 days prior to *filing is subject to the reach of creditors pursuant to Bankruptcy Code Section 522(p)*. This raises the issue of whether regular mortgage payments constitute "any equity acquired" that would trigger the provisions of this cap. The literal interpretation of the statute and a handful of earlier cases suggest that the increase in equity would trigger the cap.

However, more recent cases have found that the language of Section 522(p) does not apply to mortgage payments. Congress' obvious intent was to cap the homestead exemption for debtors who choose to flee to debtor-friendly homestead exemption states, the most notable being Florida and Texas, unless the debtor resides in the homestead protection state for at least 1,215 days before filing.

Notably, the Bankruptcy Court for the Middle District of Florida in *In re Burns*⁴⁸⁴ held that making regular mortgage payments relative to a mortgage note encumbering homestead property, which is otherwise exempt during the 1,215 days immediately preceding the filing of a bankruptcy case, will not be treated as the acquisition of an interest in real property for purposes of calculating the then \$136,875 limitation contained in Section 522(p)(1). While the decision is promising, the court did not address whether the

⁴⁸² 356 B.R. 317 (Bankr. D. Mass. E.D. 2006).

⁴⁸³ 349 B.R. 747 (Bankr. M.D. Fla. 2006).

⁴⁸⁴ 395 B.R. 756 (Bankr M.D. Fla. 2008).

prepayment of all or a portion of the mortgage note (i.e., not a regularly scheduled payment) will also not be treated as an acquisition in real property if the homestead has been owned by the debtors for a period in excess of 1,215 days.

Further, *In re Chouinard* held that the equity passively resulting from market appreciation is not to be counted toward the homestead exemption cap imposed by Section 522(p) on an interest in property “acquired” during the 1,215 prepetition period.⁴⁸⁵

In another post-BAPCPA case decided in October of 2005, *In re Wayrynen*, the debtor had not owned property in Florida long enough to meet the 1,215-day requirement.⁴⁸⁶ However, the court found that the debtor was not subject to the cap, despite the fact that he purchased his home within 1,215 days prior to filing. The debtor argued that he was entitled to exempt the full value of his home because he made no “election” pursuant to Section 522(p)(1) to invoke the exemption provisions of either state or federal law. The court strictly construed the statute and stated that “since a Florida resident is not entitled to claim federal exemptions, it could be construed that, at least as to Florida residents filing for bankruptcy relief, the limitations provided in Section 522(p)(1) do not apply.” However, this reasoning has not been routinely followed by Florida courts.

LIMITATION ON HOMESTEAD PROTECTION FOR “BAD ACTIONS.”

Section 522(q) provides another limitation on the homestead exemption for “bad actions” and provides the following:

- (1) As a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of an interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) which exceeds in the aggregate \$125,000 if-
 - (a) the court determines, after notice and a hearing, that the debtor has been convicted of a felony (as defined in section 3156 of title 18), which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of this title; or
 - (b) the debtor owes a debt arising from-
 - i. any violation of the Federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws;
 - ii. fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 or under section 6 of the Securities Act of 1933;
 - iii. any civil remedy under section 1964 of title 18; or
 - iv. any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years.

⁴⁸⁵ 385 B.R. 814 (Bankr. M.D. Fla. 2006).

⁴⁸⁶ 332 B.R. 479 (Bankr. S.D. Fla. 2005).

(2) Paragraph (1) shall not apply to the extent the amount of interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) is reasonably necessary for the support of the debtor and any dependent of the debtor.

Based on this provision, the homestead exemption can be limited to an absolute cap of \$146,450 where the debtor is convicted of a felony, which evidences that the filing of the bankruptcy was abusive (perhaps the rationale here is that the debtor won't need a house if he is going to jail).

Thus, homestead protection is limited to \$146,450 where the debt involved arises from the violation of federal or state securities laws, fiduciary fraud violations of RICO, intentional torts, or willful or reckless conduct resulting in serious physical injury or death in the preceding five years. Undoubtedly, there will be more suits filed against doctors alleging willful and reckless conduct in malpractice actions as a result of this provision.

However, the Section 522(q)(1) reduction to \$146,450 will not apply to the extent that the homestead property is reasonably necessary for the support of the debtor and any dependent of the debtor.

A DOG OF A CASE: *In Re Burns*

The definition of willful or reckless misconduct was discussed in the August 8, 2008 Bankruptcy Court decision of *In re Burns*.⁴⁸⁷

In this “ruff” case, the court noted that an act can result from reckless misconduct if the act was intended by the actor, even if the actor did not intend to cause the harm that results from it. The court stated that “[i]t is enough that he realizes or, from facts which he knows, should realize that there is a strong probability that harm may result, even though he hopes or even expects that his conduct will prove harmless.”

In *Burns*, the debtors' chow-mix dog “Teddy” lunged at an unfortunate motorcyclist, causing him to lose control of the bike. Sadly, Teddy died in the accident (and was thus unable to testify), and the motorcyclist was seriously injured. A canine behavior expert testified that the dog's owners acted with reckless misconduct in allowing the four-year-old chow-mix to be unrestrained when they lived on the road, their house was partially unfenced, and the dog was typically chained, got insufficient exercise, and had aggressive tendencies. The court rejected the expert's opinion, noting that he was an expert on animal temperament and not on human behavior. While the dog acted wrongly in lunging at the motorcycle, the court found that the plaintiff did not satisfy the burden of showing “highly unreasonable conduct involving an extreme departure from ordinary care in a situation where a high degree of danger is apparent.” In fact, the debtors did not even know how the dog had gotten out.

HOMESTEAD DISPOSITION LIMITATIONS.

⁴⁸⁷ 395 B.R. 756 (Bankr. M.D. Fla. 2008).

The Florida Constitutional and statutory limitations on the ability of a homestead owner to transfer or mortgage the property without permission of a spouse, or to leave the property by Will or other testamentary devise in a manner not permitted by Florida law merit the discussion below.

Notwithstanding common sense and how the law works in other states, the Florida Constitution imposes limitations on how a homestead can be devised upon the owner's death to protect the surviving spouse and minor children. Specifically, the Constitution prohibits the devise of the property if the owner is survived by a spouse or minor child, except the homestead may be devised to the owner's spouse if no minor child exists. Thus, both spouses must sign on a mortgage even if only one spouse is the borrower.

The Constitution also prevents a married homeowner from transferring or mortgaging the homestead property without the consent of the owner's spouse or an appropriate waiver. This is why a spouse will have to sign on a mortgage if the homeowner spouse wants to borrow money, even though the non-owner spouse is not actually a borrower and is not guaranteeing the note. The Florida Constitution Article X, Section 4 restricts the devise of the homestead. Subsection (c) reads as follows:

The homestead shall not be subject to devise if the owner is survived by spouse or minor child, except the homestead may be devised to the owner's spouse if there be no minor child.

However, the Florida Constitution does not address how homestead property descends upon the death of the owner of the homestead. The descent of homestead property is controlled by Florida Statutes Section 732.401. Under the prior law, if the devise violated the Florida Constitution, the spouse was given a life estate and the children were given the remainder interest.

Effective October 1, 2010, Florida Statutes Section 732.401 was amended to provide the surviving spouse with a choice. If the homeowner is married and has one or more children, then upon the homeowner's death, a home in his or her sole name will become owned as a "life estate" held by the surviving spouse and a "remainder interest" held by the child or children of the deceased homeowner. The surviving spouse can then choose to keep the life estate or to convert this to a fifty percent ownership, whereby the other fifty percent interest will be owned by the deceased homeowner's descendants. This fifty percent ownership conversion option became effective for homesteads owned by decedents who have died on or after October 1, 2010. The surviving spouse must make the election to take a tenant in common interest within six months of the decedent's death. The statute provides that the election is irrevocable.

These changes will not change the fact that a full estate tax marital deduction will be allowable where the spouse receives a life estate. If the spouse elects the one-half tenant in common interest, then the one-half interest received by the spouse will also qualify for the federal estate tax marital deduction.

Expenses for a life tenant differ from that of a tenant in common. The following chart taken from the Legislative white paper explains the differences:

	Life Tenant Obligations	Obligation as 50% Tenant in Common
Mortgage Principal	None	50%

Mortgage Interest	100%	50%
Property Taxes	100%	50%
Ordinary Maintenance	100%	50%
Long-Term Maintenance	None	50%

If the spouse instead remains with a life estate, then he or she will have the exclusive right to use and ownership of the home during his or her lifetime, which includes the right to rent it out to third parties or to otherwise make use of it in any reasonable way. The children or grandchildren, as “remaindermen,” have no right to occupy the property during the time that the owner of the life estate is still alive, and become the sole owners of the property on the death of the life tenant.

The life tenant, however, has a duty to make and pay for ordinary and reasonable repairs to the house in order to prevent “waste.” The life tenant is also responsible for paying property taxes and insurance. This can be problematic because some spouses cannot afford the obligations of the life estate, or the children cannot or will not make the principal payments on the mortgage or make extraordinary repairs. Remaindermen are responsible for paying for extraordinary repairs and costs assessed to the property, as evidenced by the Fourth District Court of Appeals case, *Schneberger v. Schneberger*, which held that the remaindermen had to pay for hurricane repair costs from the proceeds of the insurance as well as a special hurricane assessment from the homeowners’ association.⁴⁸⁸

Before making such a transfer, the client should consider whether segregated ownership is permitted under deed restrictions, condominium associations, or related rules, whether it is worth the risk of violating those rules even if they do not permit the segregated ownership, whether insurance or insurability will be affected by such a transfer, and whether a spouse will consent, as required by applicable law.⁴⁸⁹

The transfer of the remainder interest to the irrevocable trust MAY be an “incomplete gift” (not considered to be a gift for gift tax purposes) if the grantor retains the power to direct how the trust assets will pass on death. This was a well-accepted practice until February 2012, when the IRS shocked the estate planning community in IRS CCA 2012208026⁴⁹⁰ by concluding that a taxpayer made a taxable gift to an irrevocable trust, despite retaining a power to appoint trust assets upon death. Now more extensive powers may need to be retained to be sure an arrangement will not be considered a complete gift by the IRS.

When the parties cannot agree, selling the homestead property may be an option. However, the children must agree to sell the house; the spouse who is the life tenant cannot force the remaindermen children to sell the house. Furthermore, selling the house could create federal gift tax consequences.

If the surviving spouse instead elects to be a one-half owner, every joint owner in a Florida tenancy in common property has equal rights of occupancy, but any owner also has the right to require that the property be sold to the highest bidder “on the courthouse steps” in a partition action.

⁴⁸⁸ 979 So.2d 981 (Fla. 4th DCA 2008).

⁴⁸⁹ Thanks to attorney A. Stephen Kotler of Naples, Florida for providing the above planning idea. His email address is skotler@kotlerpl.com.

⁴⁹⁰ For more information on this decision see Alan S. Gassman, Leslie A. Share, Ken Crotty & Kacie Hohnadell, *Planning After IRS Memo 201208026: How Foreign Can Creditor Protection Trust Laws Get?*, Leimberg Information Services Newsletter No. 207 (Sept. 11, 2012).

The amendment to the statute also provides the surviving spouse with the option of partition whereby the surviving spouse may sell the house, with half of the proceeds payable to the spouse, and the rest to the decedent's descendants in equal shares. Partition is not an option for a life tenant.

Please note that these rules do not apply if the house is being treated as owned jointly with right of survivorship or tenants by the entireties between a husband and wife. In that event, the home will be completely owned by the surviving spouse. This will apply whether or not the married co-owners have children.

Florida Statutes Section 732.401 provides a sample form for the election of a surviving spouse to take a tenant in common interest instead of a life estate interest:

**ELECTION OF SURVIVING SPOUSE TO TAKE A ONE-HALF INTEREST OF DECEDENT'S
INTEREST IN HOMESTEAD PROPERTY**

STATE OF _____
COUNTY OF _____

- 1 The decedent, _____, died on _____. On the date of the decedent's death, the decedent was married to _____, who survive the decedent.
- 2 At the time of the decedent's death, the decedent owned an interest in real property that the affiant believes to be homestead property described in s. 4, Article X of the State Constitution, that real property being in _____ County, Florida, and described as: (description of homestead property).
- 3 Affiant elects to take one-half of decedent's interest in the homestead as a tenant in common in lieu of a life estate.
- 4 If affiant is not the surviving spouse, affiant is the surviving spouse's attorney in fact or guardian of the property and an order has been rendered by a court having jurisdiction of the real property authorizing the undersigned to make this election.

(Affiant)

Sworn to (or affirmed and subscribed before me this ____ day of (month), (year), by (affiant)

(Signature of Notary Public – State of Florida)
(Print, Type, or Stamp Commissioned Name of Notary Public)
Personally Known OR Produced Identification
(Type of Identification Produced)

Previously, practitioners have used disclaimers to attempt to cure invalid homestead devises. Effective October 1, 2010, Florida Statutes Section 732.4015 was amended to add section (3) to clarify that disclaimers may not be used to cure invalid homestead devises.

Florida Statutes Section 732.4015(3) states that if an interest in homestead property has been properly devised to the surviving spouse, and the surviving spouse disclaims the property, the disclaimed property interest transfers according to the disclaimer statutes in Florida Statutes, Chapter 739. Then the decedent's Will or trust determines how the surviving spouse's interest passes, but not the remaindermen's interest. Therefore, if the devise was a valid devise, a disclaimer of the devise affects only the surviving spouse's interest. The disclaimer does not cut off any vested rights of the decedents descendants under the constitution. For example, if the property went life estate to the wife and remainder to the children, and the wife disclaimed, her life estate would pass pursuant to her husband's Will or trust, but the disclaimer would not affect the children's remainder interest.

TIME TO BUY HOMES FOR THE CHILDREN?

A parent's creditors should not be able to obtain title to his or her child's homestead if it is gifted or purchased for the child before the parent has creditor issues. Clients are often purchasing homes for children. There are many reasons, however, not to place a homestead in the child's individual name, including divorce planning, creditor planning, and the possibility that the client's spouse or other children may need monies derived from the home equity at a later date. The following is a letter written to a client, and describes various alternatives:

Dear Client:

1. The first alternative is that you loan money to the child and the child buys the home.

Upon later sale, the child can take the \$250,000 capital gains exclusion. The child can take the Florida \$50,000 homestead exemption and will have the advantage of the 3% per year cap on homestead tax valuation.

On divorce, you would get the first monies out of the house in repayment of the loan owed to you, and any equity might need to be shared with a present or future spouse.

The equity that would otherwise be shared with a present or future spouse might be handled by having a Prenuptial Agreement.

2. You could own the house and let the child and their family live there.

You would not qualify for the \$250,000 capital gains exclusion on the later sale of the house.

You would not have the benefit of the homestead exemption or the 3% homestead cap, unless the child signs a 99-year lease, which may be feasible. A 99-year lease might provide that it is terminable upon certain events and might pass muster with the county as far as homestead exemption and 3% cap purposes.

On divorce, the home should be protected as well as possible. You would have continuing absolute control over the house.

3. We discussed an Irrevocable Homestead Bypass Trust.

There are two different types of Irrevocable Homestead Bypass Trusts that you can form and fund. Each would be held by Mama Bear as Trustee, and could be used not only for the purchase of a home, but also for the health, education and maintenance of Mama Bear and one or more descendants as Mama Bear deems appropriate.

One variety of this trust is a “Via Child Funded Homestead By-Pass Trust.” Under this type of trust, you are treated as if you gifted the money for the home to the child, and the child then made an immediate gift to the Trust by putting the money in the Trust. Your transfer of monies or the house to the Trust is considered for income tax and state law purposes to be a transfer of assets via your daughter.

As a consequence of this, her \$250,000 exemption from capital gains tax can apply upon sale of the house. The downside of this Trust is that if your daughter is considered to have been the contributor, then her creditors would be able to reach into the Trust if they know to do so, although, if she had a creditor who might reach into the Trust, Florida law would probably allow Mama Bear, in her capacity as Trustee, to transfer the home into your daughter’s direct name, and then in it would in all likelihood be protected from your daughter’s creditors under the Florida Homestead Law.

The second variety of Homestead Bypass Trust is a “Direct Client Funded Homestead Bypass Trust.” Under this type of trust, you would gift the money from the home directly to the trust. This Trust would not be considered to have been funded by your daughter, so her creditors could not reach into it. However, this Trust would not qualify for the \$250,000 exclusion for the sale of a primary residence upon eventual sale of the house.

Both varieties of Trusts should be fairly well protected from potential divorce claims against the house, and should allow for homestead exemption and 3% cap application while your daughter lives there.

If you utilize the Direct Client Funded Homestead Bypass Trust, the Trust would be treated for income tax purposes, as if it is owned by you, so all of the items of income and deduction associated with the house would be included on your personal tax return. This would include the real estate taxes and any deductions or income associated with an eventual sale of the property.

If you utilize the Via Child Funded Homestead Bypass Trust, the child is considered the owner for income tax purposes and would receive the tax deductions associated with the property and would be responsible for income tax upon the sale of the home, even though the child would have no control over the disposition of the home. At the time of funding the Trust, you would file a gift tax return reporting the amount of the contribution, whether directly to the Trust or via your child. No gift tax would be payable as a result of the contribution. However, the contribution would utilize some of your lifetime gift allowance.

If you utilize the Via Child Funded Homestead Bypass Trust, your child would also need to file a gift tax return reporting the amount of the contribution. No gift tax would be payable as a result of the contribution. However, the contribution would utilize some of your child's lifetime gift allowance.

If you decide to use one of the Trust techniques for multiple children, we will prepare a separate Trust for each child.

Best personal regards,

[ATTORNEY]

COMPARISON OF METHODS TO PURCHASE HOMES FOR THE CHILDREN					
	\$250,000 Exemption on Sale of Home	\$50,000 Homestead Exemption and 3% Per Year Cap on Valuation	Divorce	Control	Notes
Father and Mother loan money to child. Child purchases and owns home.	Child gets income tax exemption.	Child gets homestead exemption and cap.	Loan will be repaid to parents. Equity may be subject to claim by spouse if this is not waived by Prenuptial Agreement.	Child controls the house. However, we may be able to call the Note to force a sale.	Note: Child gets equity above Note.
Father and Mother own the home and child lives in the house.	No.	Generally, no. However, it may be possible to obtain these with a 99-year lease.	Better protected.	Father and Mother control.	
Via Child Funded Homestead Bypass Trust.	Child gets income tax exemption.	Child gets homestead exemption and cap.	Better protected.	Mother would be Trustee of the Trust and would retain control.	Note: Creditors may be able to get into the Trust. It may be possible for Mother to transfer the house to the child's individual name in the event of a Creditor issue.
Direct Client Funded Homestead Bypass Trust.	No.	Child gets homestead exemption and cap.	Better protected.	Mother would be Trustee of the Trust and would retain control.	Note: The \$250,000 exemption is lost, but no Creditor of the child should be able to get the asset.
One-half purchased by child and one-half owned by Father and Mother.	One-half.	Child gets homestead exemption up to value of child's interest in property (can receive entire exemption if interest value is \$50,000 or greater). Only receives half of 3% valuation cap.	One-half, better protected.	Each controls one-half.	

NEGATIVE PLEDGE AGREEMENTS.

Under a Negative Pledge Agreement, a debtor agrees not to mortgage a particular property or properties so that a lender would have the ability to obtain a judgment that could presumably be recorded in the public records to become a lien upon the property. One question that comes up quite often is whether a bank with a Negative Pledge Agreement has the equivalent of a mortgage.

In the 2007 bankruptcy case of *In re Gosman*, the Bankruptcy Court refused to allow an equitable lien to be placed on property for a breach of contract where the debtor had entered into a "Negative Pledge Agreement" which provided that the debtor could not sell, convey or encumber any of his assets without the consent of the lender. The Bankruptcy Court noted that the monies that were used to purchase the homestead were not obtained fraudulently or through egregious conduct.

CHAPTER 6

WAGES AND WAGE ACCOUNTS

BASIC RULES.

In many states wages earned by the head of household are not subject to creditor claims and may be invested in other exempt assets without constituting a fraudulent transfer. Florida Statutes Section 222.11 protects earnings, including compensation paid or payable, in money of a sum certain, for personal services or labor whether denominated as wages, salary, commission, or bonus of a head of family.⁴⁹¹

According to the statute, a head of family is any natural person providing more than one-half of the support for a child or other dependent.⁴⁹² In these types of claims, the dependent is typically a child, but can also be a spouse, grandparent, or other family member. “A person qualifies as a dependent under § 222.11 if that person's income is insufficient to sustain him or her without the support of the person claiming him or her as a dependent.”⁴⁹³

However, the courts have been somewhat limited in their protection of wages that could have been re-characterized as profits when related to professional practice entities and closely held businesses owned or controlled by them, and there is some confusion in the case law caused by the tendency of judges to refer to independent business holders as “independent contractors”, while independent contractors who do not have their own separate business and simply earn monies for services rendered can have been able to protect their wages under the statute.

Florida Statutes Section 222.11 “head of family” exemption was amended in October of 2010, which changed the amount of disposable earnings that are automatically exempt (garnishment exemption) from \$500 to \$750 per week,⁴⁹⁴ and created supplemental requirements for creditors who wish to obtain an enforceable waiver of the garnishment exemption.⁴⁹⁵ Pursuant to Florida Statutes Section 222.11(b), the waiver of the judgment debtor is now required to be stated on a separate document, and therefore can no longer be discreetly placed within an agreement or contract.⁴⁹⁶ The effectiveness of wage garnishment from

⁴⁹¹ Fla. Stat. § 222.11.

⁴⁹² Fla. Stat. § 222.11(c).

⁴⁹³ *In re Beckmann*, 98-10325-6B7, 2000 WL 33722204, at *3 (Bankr. M.D. Fla. June 30, 2000).

⁴⁹⁴ Fla. Stat. § 222.11(2)(a).

⁴⁹⁵ Fla. Stat. § 222.11(2)(b).

⁴⁹⁶ The waiver must also be in at least 14-point font and “substantially” in the following form: If you provide more than one-half of the support for the child or other dependent, all or part of your income is exempt from garnishment under Florida law. You can waive this protection only by signing this document. By signing below, you agree to waive the protection from garnishment.

an otherwise financially solvent judgment debtor may be substantially limited under the garnishment wage exemption, as it enables debtors to exempt significant amounts of disposable earnings for up to six months.⁴⁹⁷

Section 222.11(3) provides for the protection of monies deposited into a “wage account” for up to six months after the deposit has been made. The account must be held in a “financial institution.” Many advisors encourage physicians to establish wage accounts, deposit their wages into the accounts, and then to move the monies from the wage account into other protected investments within six months of each wage check deposit.

The wage and wage accounts exemption under Florida Statutes Section 222.11 provides that the first \$750 per week of such disposable earnings are exempt from attachment or garnishment, and disposable earnings above that amount will not be subject to attachment or garnishment unless such person has agreed otherwise in writing. Advisors negotiating bank loan documents should be sure to ask the bank to strike any reference to waiver if Florida wage exemption rights apply. Waiver of wage exemption documents have been upheld by multiple courts. For example, in a 2011 case, *USAmeriBank v. Klepal*,⁴⁹⁸ the Second District Court of Appeals upheld a waiver of disposable earnings in a promissory note.

But even if loan documents purport to waive the exemption of wages, such clauses may not be enforceable if the debtor did not have reason to know that they were part of the loan document package. Recently revised Florida Statutes Section 221.11(2)(b) provides the following requirements for a waiver to be valid:

(b) Disposable earnings of a head of a family, which are greater than \$750 a week may not be attached or garnished unless such person has agreed otherwise in writing. The agreement to waive the protection provided by this paragraph must:

1. Be written in the same language as the contract or agreement to which the waiver relates;
2. Be contained in a separate document attached to the contract or agreement; and
3. Be in substantially the following form in at least 14-point type:

IF YOU PROVIDE MORE THAN ONE-HALF OF THE SUPPORT FOR A CHILD OR OTHER DEPENDENT, ALL OR PART OF YOUR INCOME IS EXEMPT FROM GARNISHMENT UNDER FLORIDA LAW. YOU CAN WAIVE THIS PROTECTION ONLY BY SIGNING THIS DOCUMENT. BY SIGNING BELOW, YOU AGREE TO WAIVE THE PROTECTION FROM GARNISHMENT.

⁴⁹⁷ *Id.*

⁴⁹⁸ 100 So.3d 56, 61 (Fla. 2d. Dist. App. 2011).

Under Florida Statutes Section 222.11(3), wages that would qualify as exempt that are deposited into an account at any financial institution are exempt from attachment or garnishment for six months after the earnings are received by the financial institution if the funds can be traced and identified as earnings.⁴⁹⁹ The statute also states that commingling earnings with other funds does not by itself defeat the ability of a head of family to trace earnings.

It is noteworthy that Bankruptcy Code Section 522(f) may prevent the waiver of exemption rights from applying in bankruptcy. The specific language of the statute is as follows:

(f)(1) Notwithstanding any waiver of exemptions but subject to paragraph (3), the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is...

The paragraph (3) referred to above states:

(3) In a case in which state law that is applicable to the debtor—

(A) permits a person to voluntarily waive a right to claim exemptions under subsection (d) or prohibits a debtor from claiming exemptions under subsection (d); and

(B) either permits the debtor to claim exemptions under State law without limitation in amount, except to the extent that the debtor has permitted the fixing of a consensual lien on any property or prohibits avoidance of a consensual lien on property otherwise eligible to be claimed as exempt property; the debtor may not avoid the fixing of a lien on an interest of the debtor or a dependent of the debtor in property if the lien is a nonpossessory, nonpurchase-money security interest in implements, professional books, or tools of the trade of the debtor or a dependent of the debtor or farm animals or crops of the debtor or a dependent of the debtor to the extent the value of such implements, professional books, tools of the trade, animals, and crops exceeds \$6,425.

In *In re Holmes*, a 2009 case from the Bankruptcy Court for the Southern District of Florida, a debtor successfully argued that the “gratuities” that were added to and thus included in his paycheck were exempt from garnishment under Section 222.11.⁵⁰⁰ In this case, the debtor was a bartender who moonlighted as an event photographer. His employer automatically added a “service charge” to all orders. This service charge was then passed along to the debtor in his paychecks under a line item labeled “gratuities.” The decision does not indicate whether the service charge was added to photography, bartending, or both. The Bankruptcy Court stated that commissions are only eligible for the exemption under Section 222.11 when the debtor is an employee, and not when the debtor is an independent contractor.

The court went on to explain that “[i]n order for compensation to be exempt under the statute, a debtor must receive **regular compensation** dictated by the terms of an **arm’s-length employment agreement** to perform services that are much like a job.”⁵⁰¹ In this case, the Bankruptcy Court held that the

⁴⁹⁹ Fla. Stat. § 222.11(3).

⁵⁰⁰ 414 B.R. 868, 870 (Bankr. S.D. Fla. 2009).

⁵⁰¹ *Id.* at 870.

debtor's gratuities were exempt because they were earned under an arm's-length employment agreement and could be properly traced and identified as earnings.

As alluded to earlier in the section, compensation is looked at with more scrutiny in closely-held businesses. In cases such as these the court makes it a point to determine whether the monies paid to the debtor actually qualify as "wages" or are simply profits derived from the company. The more regular the payments look, the more likely they are to be considered as wages.

In *In re Harrison*⁵⁰², a dentist who owned 50% of a dental practice that he worked for entered into an employment agreement which stated his compensation would be set forth in an attached exhibit, which was never completed or attached. The debtor and the other 50% shareholder who both worked full time controlled the timing and amount of their compensation. The debtor argued that his wages were the "regular" \$4,000 he was paid every two weeks. The evidence showed, however, that the debtor was only paid when the business had enough cash on hand. When the business has more than enough cash on hand, his payments were above \$4,000. The court determined that the debtor was not entitled to the exemption because the payments were not regular, and the distributions were more akin to a return on equity investment than earned wages.

A written agreement memorializing the arms-length agreement, however, did not seem to be a requirement in *In re Harrison*, or in future cases. In both *In re Pettit*⁵⁰³ and *In re Cook*⁵⁰⁴, the debtors were able to claim the exemption despite the employment agreement being a verbal one. It is important to note that in both cases the absence of a written employment contract seemed to bring into question whether or not the agreement was entered into at arms-length. In *Pettit*, the debtor had no ownership interest, and in *Cook* the debtor was a 33% owner. Because each compensation plan was paid regularly and not at the full discretion of the debtor, the exemption was allowed.

CAN THE EMPLOYEE WORK OUTSIDE OF FLORIDA? APPARENTLY YES - In the 2015 Fourth District Court of Appeals case of *Ulisano v. Ulisano*, the court found that a debtor qualified for Florida's wage garnishment exemption under Florida Statutes Section 222.11 despite the fact that he resided outside of Florida.⁵⁰⁵ The debtor had lived in South Carolina for the past seven years, worked for a Florida corporation, and used his wages to support his family. The creditor argued that debtor's claim of exemption under Florida Statutes Section 222.11 should not be granted because the head of household garnishment exemption does not apply to non-residents. The court rejected this argument because the words "residing in this state" were removed from the statute by amendment in 1993. The court went on to note that "[b]y removing the phrase 'residing in this state,' the plain language of the statute applies the exemption to both non-resident and resident heads of family."⁵⁰⁶

THE HEAD OF FAMILY MUST HAVE A DEPENDENT TO HAVE PROTECTED WAGES.

⁵⁰² *In re Harrison*, 216 B.R. 451 (Bankr. S.D. Fla. 1997).

⁵⁰³ *In re Pettit*, 224 B.R. 834 (Bankr. M.D. Fla. 1998).

⁵⁰⁴ *In re Cook*, 454 B.R. 204 (Bankr. N.D. Fla. 2011).

⁵⁰⁵ *Ulisano v. Ulisano*, 154 So. 3d 507 (Fla. 4th Dist. App. 2015).

⁵⁰⁶ *Id.* at 509.

Section 222.11 defines “head of family” as “any natural person who is providing more than one-half of the support for a child or other dependent.” Notably, the term “child” is not limited to a specific age in the statutory language, such as the age of majority.⁵⁰⁷ “Even when the child has reached the age of majority, a parent will qualify as head of the family so long as the child looks to the parent for support.”⁵⁰⁸ The child could potentially be a 30 year old receiving more than one-half of support.⁵⁰⁹ Nor is “dependent” defined in the statute. A dependent could be an aunt, uncle, or parent who does not necessarily reside in Florida, but receives financial support from a Floridian. However, there has not been a case to support this!

In cases where debtor is attempting to claim a spouse as a dependent in order to qualify as the “head of household” requirement, courts have explained that “[a] person qualifies as a dependent under § 222.11 if that person's income is insufficient to sustain him or her without the support of the person claiming him or her as a dependent.”⁵¹⁰

In *In re Beckman* the debtor received \$58,000 a year in salary while the debtor’s wife received \$53,000 a year. The court stated that the husband was the functional head of the family, made decisions on which bills to pay and when to pay them, and was the primary financial source for the majority of the marriage. Despite all of this, however, the court determined that because the income of the debtor’s wife precluded her from “becoming a public charge or an object of charity,” she was therefore “not a dependent of the Debtor.”⁵¹¹

In *In re Holland* the court analyzed *Beckman* and previous case law to determine that “the case law demonstrates, that **showing actual dependency** is the more important factor, rather than the mere existence of some financial support.”⁵¹² When the debtor in *Holland* was unable to demonstrate that the Wife would be incapable of supporting herself or would become a charge upon society without her husband’s income, the court held that the “Husband [was] not a head of family under section 222.11 because, even though he brings in marginally more net income, the Wife would not become an object of charity without the Husband.”⁵¹³

Any natural person may be found to be the head of family for purposes of the wage garnishment exemption under Florida Statutes Section 222.11. For example, an unmarried parent may qualify as the head of the household when he or she voluntarily continues to provide more than one-half of the support of a child, even though he or she is not legally required to do so. As noted in *Mazzella*, “child” can mean “any son or daughter, regardless of his or her age.”⁵¹⁴ Thus, an unmarried woman financially supporting her son while he attended college qualifies for the exemption.

⁵⁰⁷ Fla. Stat. § 222.11.

⁵⁰⁸ *Mazzella v. Boinis*, 617 So.2d 1156, 1157 (Fla. App. 4 Dist. 1993).

⁵⁰⁹ *Id.*

⁵¹⁰ *In re Beckmann*, 98-10325-6B7, 2000 WL 33722204, at *1 (Bankr. M.D. Fla. June 30, 2000).

⁵¹¹ *Id.*

⁵¹² *In re Holland*, 3:15-BK-3084-JAF, 2017 WL 6550493, at *3 (Bankr. M.D. Fla. Apr. 11, 2017)

⁵¹³ *Id.* at *5.

⁵¹⁴ *Mazzella v. Boinis*, 617 So.2d 1156, 1157 (Fla. App. 4 Dist. 1993).

But Can Wages of a Non-Head of Household Nevertheless Be Protected Once Deposited into a Wage Account?

In a 2009 case in Bankruptcy Court for the Southern District of Florida, *In re Weinshank*, a debtor successfully argued that he was not required to be a head of family to be entitled to the wage exemption under Section 222.11.⁵¹⁵ In this case, the debtor was a single man earning about \$4,200 a month working at a hospital. The court found that even though the debtor did not have dependents or a “family” to speak of, that the plain language of the statute did not require the debtor to be the “head of household” because Section (2)(c) of Florida Statute 222.11 provides that the earnings of someone other than a head of family cannot be garnished in excess of what is allowed under the Consumer Credit Protection Act.⁵¹⁶ Thus, even though the debtor was not a “head of family,” he was entitled to exemption for funds deposited into his checking account within six months of his bankruptcy filing that could be traced and properly identified as wages.

YOU SUPPORT TOMMY AND I’LL SUPPORT JANE.

Where two working spouses have two or more children, it seems possible that each of them can support a designated child by maintaining proper records and allocating expenses so that each spouse provides most of the support for one or more designated children or other dependents. Can you therefore have two “heads of family” in one house?

Unfortunately, this is not the case according to multiple Florida courts which have held that “there cannot simultaneously be two heads of household in the same family.”

For example, in *Matter of Hersch*,⁵¹⁷ the Bankruptcy Court for the Middle District of Florida held that “[i]t is without any serious dispute that there cannot be two heads of one family unit and in a split household situation the Court must make a determination based on the facts involved in each case who is, in fact, the head of the household.” In this 1982 decision, Judge Alexander L. Paskay noted that the debtor received \$1,000 per month in child support and earned only \$600 per month. The children lived with her. Judge Paskay found that “children of such tender age do not require \$1,000 per month and the bulk of this provision was, in fact, an alimony provision for her, at least in substantial...” The Judge concluded that Mrs. Hersch’s wages could be protected, apparently assuming that her net paycheck could be considered to be what was primarily supporting the children.

INDEPENDENT CONTRACTORS QUALIFY FOR WAGE PROTECTION.

Florida Statutes Section 222.11 does not require that the person earning “wages, salary, commission, or bonus” be an employee, and the case law is consistent therewith. A good example of an independent contractor arrangement that can qualify under the wage exemption statute is the case of *In re Jans*.

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⁵¹⁵ 406 B.R. 413, 417-18 (Bankr. S.D. Fla. 2009).

⁵¹⁶ *Id.* at 417-418.

⁵¹⁷ 23 B.R. 42, 44 (Bankr. M.D. Fla. 1982).

⁵¹⁸ Case No. 9:15-bk-01763-FMD.

In *Jans*, Mrs. Jans was a licensed real estate agent who managed an office owned by a real estate company for the sole purpose of selling pre-construction condominium units for a particular project. She was classified as an independent contractor, and not involved in the administration of the condominium business. She received a monthly draw of \$4,000 as an advance on future commissions, and additionally received \$2,500 per month for serving as the team leader/officer manager of the sales office. She and the other two sales people were required to share the office hours of 10 a.m. to 6 p.m. Monday through Saturday, and 12:00 p.m. to 5:00 p.m. on Sunday. She was also required to attend weekly meetings and to use her own automobile to take prospective purchasers on tours of the property. The Bankruptcy Court for the Middle District of Florida held that her earnings were exempt under the statutes and qualified as a “sum certain”, whether determined before or after payment was received.

In contrast, the Eleventh Circuit Court of Appeal’s decision of *In re Tobkin*⁵¹⁹ found that a lawyer who had his own legal practice that was run as a proprietorship could not protect legal fees that he received under contingency fee arrangements to be considered as protected wages.

In this case, Bankruptcy Judge Laurel M. Isicoff of the Southern District noted that in the 1995 case of *In re Zamora*, a solo practitioner lawyer who also owned a marina business was not able to exempt monies derived from those activities as wages because they were “both in the nature of running a business.” What is important is whether “the debtor had an arm’s-length arrangement to perform services that were much like a job,” and “whether the debtor had control over the amount of his compensation 187 B.R. at 785.”

Footnote 15 of the 2016 *Tobkin* decision reads as follows:

[15] This is not an easy decision for the Court. Debtors that are independent contractors and run their own business also have to worry about providing for their families. This Court recognizes the importance of this decision not only for this Debtor, but other debtors in similar circumstances. Because federal courts dominate the interpretation of Florida’s head of household wage exemption, to the extent this issue reaches the Eleventh Circuit Court of Appeals, this Court respectfully suggests that this matter should be certified to the Florida Supreme Court – a step that this Court is unable to take under applicable law.

What would prevent a lawyer, doctor, or other professional from operating a professional practice from a company, and being compensated under an Employment Agreement that clearly provides that the professional is receiving a fixed or otherwise determined periodic wage for services that are legally required to be rendered?

Time will tell whether that approach will be successful.

Under the statute, earnings are defined as “compensation payable, in money of sum certain, for personal services or labor whether denominated as wages, salary, commission, or bonus.” In various cases, Florida courts have found that proceeds from a debtor’s business, including a law practice, are not earnings,

⁵¹⁹ Case No. 11-34669-BKC-LMI, 2016 WL 5106996 (Bankr. S.D. Fla. Sept. 19, 2016).

and the Eleventh Circuit came to the same conclusion in *Tobkin* because Tobkin was a solo practitioner and his earnings were the result of running a business, not being an employee.

There may also be an issue where compensation is received from an entity taxed as a partnership, since under Internal Revenue Code Section 707(c) Salary Paid to a Partner is considered to be a “guaranteed payment” as opposed to being subject to withholding or payroll tax. It is best to characterize a debtor as an employee and not have him or her be a partner in a partnership that he or she works for if wage exemption is important.

WHAT ABOUT A SHAREHOLDER WHO IS EMPLOYED BY A WHOLLY OR PARTLY OWNED COMPANY?

In *In re Harrison*, a 50% shareholder in a professional association (P.A.) dental practice, in which the two dentists worked full time and each derived equal salaries, was not entitled to wage exemption protection for compensation received.⁵²⁰

In *In re Manning*, the court denied wage protection status for the spouse of a business owner, while seeming to recognize that an owner of a business can benefit from Section 222.11’s wage exemption if the owner/debtor receives regular compensation under the terms of an arm’s-length Employment Agreement.⁵²¹

The court stated that “for the exemption to apply, the debtor must not only perform personal services to the business, he must also receive regular compensation dictated by the terms of an arm’s-length employment agreement.” In this case, however, the debtor’s wife owned all of the stock of a general contracting corporation and the debtor served as President, had no written employment agreement, and determined his own salary, including commissions and bonuses. Thus, the debtor was not entitled to the exemption because he determined the amount and timing of compensation and “essentially constituted discretionary distributions from the family owned business.”

Additionally, the Employment Agreement in place should provide for a schedule of regular compensation that is actually followed. In *In re Harrison*, the court held that the debtor was appropriately characterized as an owner rather than as a wage earning employee based in large part upon the fact that he and his 50/50 partner shared all monies equally notwithstanding their relative productivity, and would only pay themselves when there was sufficient cash flow. Or conversely, would supplement their paychecks when there was excess cash flow.⁵²²

In *Brock v. Westport Recovery Corporation*⁵²³, the Fourth District Court of Appeals determined in 2002 that an individual’s earnings are not exempt wages if they are actually profit distributions in lieu of earnings for services rendered under Section 222.11. The court described the debtor, Mr. Brock’s testimony as follows:

⁵²⁰ 216 B.R. 451, 454 (Bankr. S.D. Fla. 1997).

⁵²¹ 163B.R. 380, 382 (Bankr. S.D. Fla. 1994).

⁵²² *In re Harrison*, at 454.

⁵²³ 832 So. 2d 209 (Fla. 2002).

Brock testified that he received a salary of about \$56,000 per year, being paid once every two weeks on a regular basis. He claimed his salary never fluctuated. Brock and his brother were the principals of All Island. Somewhat confusingly, Brock testified that he owned fifty percent, or forty-nine percent, or zero percent of the company; “technically” his brother was “a hundred percent shareholder,” but they had an agreement that they would be “partners.” Brock was the vice president of operations, overseeing warehouse employees, and his brother took care of sales.

Mr. Brock’s 1999 and 2000 tax returns showed wages of \$108,000 and \$56,000 respectively, and dividend income of \$57,000 and \$94,859 respectively. The court quoted the *Manning* case for the proposition that “a debtor that owns and controls a business cannot exempt the funds that he distributes to himself from the business simply by calling the money ‘wages.’” Thus, the court concluded that “Brock’s earnings did not qualify for the exemption because they were not compensation. Paid or payable, in money or a sum certain for personal services or labor.”

This line of cases has essentially found that where a professional has a degree of control in the management of the company he or she works for, and could manipulate between compensation and dividends, no wages received would be considered as protected under Section 222.11. The authors believe that these cases are incorrect, but recognize the number of cases supporting this position. The Ninth Circuit Court of Appeals has come to an opposite conclusion based upon a California Statute that is almost identical to Florida’s Wage Statute.⁵²⁴ The above makes little or no sense given that Florida’s Exemption Statutes are to be liberally construed and that wage exemption procedures in Florida must be liberally construed in favor of the debtor.⁵²⁵

The July 27, 2016 decision of *Kane v. Stewart Tilghman Fox & Bianchi, P.A.* by the Bankruptcy Court found that two lawyers who owned and operated their own law firm and were the sole shareholders, officers and directors thereof, could not protect salaries that they received from the firm as wages because the monies that they received were “the equivalent of shareholder distributions from their wholly owned law firm.”

The Court noted that the Kanes had Employment Agreements which called for fixed salaries of \$120,000 per annum, which were never paid in full because the law firm had inadequate cash flow.

The Court reiterated much of the previous jurisprudence in this area, but did not specifically rule that wages that a wholly owned professional entity pays to a shareholder employee pursuant to the terms of an Employment Agreement would not be protected from creditors.

It seems possible that contractual obligations with respect to salary, and possible limitations thereon, that might exist with creditors, or between shareholders, that are entered into at arm’s-length, may facilitate having a company owned by its employees be able to pay wages that would be protected under the statute.

The Court’s opinion included the following discussion:

⁵²⁴ See *In re Nell Carter*, 182 F.3d 1027 (9th Cir. 1999).

⁵²⁵ See *Miami Herald Publishing Co. v. Payne*, 258 So.2d 541, 543 (Fla. 1978).

The issue in this case is whether the payments flowing from the firm to the Kanes are exemptible wages or salary, or some other form of compensation. “To decide whether monies from employment qualify for the section 222.11(2)(b) exemption, the relevant inquiry is often whether a person’s employment is a salaried job or is in the nature of running a business.” *Brock v. Westport Recovery Corp.*, 832 So.2d 209, 211 (Fla. 4th DCA 2002).

Courts have looked to a number of factors when determining if payments are salary/wages or actually come from the running of the business, including how the debtor defines the payments. *Id.* at 212 (noting that the debtor “characterized his earnings as disbursements from profits”). However, this self-determination is not dispositive. “A debtor that owns or controls a business cannot exempt the funds he distributes to himself from the business simply by calling the distributions wages”. *In re Harrison*, 216 B.R. 451, 454 (Bankr. S.D. Fla.1997); see also 13 Fla. Jur. 2d Creditors’ Rights § 12.

Establishing that the debtor receives “regular compensation dictated by the terms of an arms-length employment agreement” is a factor favoring a finding that the payments are exemptible wages. *Brock*, 832 So.2d at 212 (quoting *In re Manning*, 163 B.R. 380, 382 (Bankr. S.D. Fla.1994)); see also *Harrison*, 216 B.R. at 454 (same). Courts are more likely to find income to be wages where the debtor has less control “over the amount of his compensation and the terms of his employment,” *Brock*, 832 So.2d at 212, including whether the debtor was able to be fired. *Manning*, 163 B.R. at 382 (finding that income was not exemptible where, “[a]s a practical matter,” the debtor was not subject to firing where his wife was sole owner of corporation and the debtor “sometimes did not take the salary if [the business] was running low on cash”); see also *In re Im*, 495 B.R. 46, 51 (Bankr.M.D.Fla.2013) (“Florida courts have held, in essence, that where the debtor controls the timing and amount of distributions from a family owned business, those distributions do not qualify as ‘earnings’ for purposes of Fla[.] Stat. § 222.11.” (quoting *In re McDermott*, 2011 WL 740727, at *2 (Bankr.M.D.Fla.2011))).

In this case, the Kanes operated under contracts that were negotiated only between themselves. They controlled the firm, were not able to be terminated except by themselves, and were not paid in accordance with their purported contracts, but rather received payment when the firm could afford to do so. One Appellant testified that since the contracts were formed, he had yet to receive the amounts of money the contract promised. These facts lead to the conclusion that the payments flowing from the firm to the Kanes were not salary, in the ordinary sense of the word, but were actually akin to shareholder distributions that were outside the scope of the exemption found in section 222.11. Therefore, we agree with the trial court and hold that these funds were not exempt from garnishment.

Conclusion

For the foregoing reasons, we affirm the trial court's decision allowing the entry of a second writ of garnishment and finding that the monies owed to the Kanes from the firm were not exempt.

Affirmed.

WHAT ABOUT DEFERRED COMPENSATION AS PROTECTED WAGES?

In *Harrison*, discussed above, the Bankruptcy Court for the Southern District of Florida ruled that the deferred compensation rights of a dentist to receive deferred wages, secured by a UCC-1 lien on the assets of the professional association in which he owned 50% of the stock, were not protected as wages under the Florida Statutes.

There, Dr. Harrison was a 50% shareholder, and he and the other 50% shareholder were the only two dentists working in the practice. The two dentists entered into an arm's-length agreement, whereby on termination of employment, \$75,000 would be paid over time to the terminating shareholder as deferred compensation.

The court ruled that "for the exemption to apply, the debtor must not only perform personal services for the business, he must also receive regular compensation dictated by the terms of an arm's-length employment agreement. Although the debtor . . . has indeed executed an employment agreement with the P.A., it is, in substance, an agreement between himself and the only other shareholder and is accordingly enforceable only by themselves."

The court noted that the debtor and his fellow shareholder did not follow a schedule of regular compensation, and basically paid themselves based upon available cash flow. The court noted that the compensation provisions of the employment agreement were left blank, and that the agreement failed to lay out specific terms of employment, specified work hours, or vacation schedules.

Although in the *Harrison* case, the dentist's wage agreement was found not to be protected, one reason was that the set deferral amount of \$75,000 was found by the court to be a return on equity, and not the result of professional services.⁵²⁶ A similar finding occurred in *In re Stroup*, where the court found that a Salary Continuation Agreement was not directly attributable to Dr. Stroup's personal services and was not correlative to the services he performed.⁵²⁷ The court indicated that the Florida Bankruptcy Courts are uniform that severance pay is not "earnings" under Florida Statutes Section 222.11.

Experts believe that a properly drafted and followed Salary Continuation Agreement should withstand judicial scrutiny where it defines the payment based upon the professional employee's "unpaid productivity compensation," which may be defined as 100% or less of the Accounts Receivable collected from professional services rendered by the professional debtor and which are collected after the period of active employment. The authors agree, but are cognizant that the case law in this area has not been as would be expected.

⁵²⁶ 216 B.R. 451, 455 (Bankr. S.D. Fla. 1997).

⁵²⁷ 221 B.R. 537, 539 (Bankr. M.D. Fla. 1997).

It is probable that the Florida Legislature did not intend to discriminate against working professionals who earn their wages the same way that non-shareholder employees and independent contractors (who by definition have their own independent business) earn monies.

Does this mean that a professional who may have creditor problems should practice for someone else's practice or company? Professionals who works for a professional corporation may be better protected by giving ownership and control over their corporation to a third party, and having airtight employment agreements with airtight wage definition provisions. Hopefully an appellate court will eventually set the record straight on what many believe to be a line of incorrect decisions.

THE CONSUMER CREDIT PROTECTION ACT.

Those who are not a head of family may not have their disposable earnings (which are the earnings of any head of family reduced by those amounts required to be withheld by law) garnished above certain limits under the Consumer Credit Protection Act.⁵²⁸ The Act provides that the amount attached or garnished will not exceed the lesser of 25% of the person's disposable income for that week or the amount by which the person's disposable income exceeds thirty times the Federal minimum wage at that time. However, the Consumer Credit Protection Act's limits do not apply where support of any person has been court ordered, in a Chapter 13 or Chapter 11 Bankruptcy, or in any case where any Federal or State taxes are owed.

Where support of any person is court ordered, the maximum disposable income for any workweek that may be garnished will not exceed 50% of those earnings if the person is supporting a spouse or a dependent child. If the person is **not** supporting a dependent child or spouse, the maximum weekly disposable earnings subject to garnishment cannot exceed 60%.

WAGE ACCOUNTS AND THE SIX MONTH RULE.

Some practitioners believe that the transfer of monies from a wage account to another exempt asset may be subject to fraudulent transfer set-aside rules, unlike other "exempt to exempt asset" transfers. The theory is that if the wage account is only protected for six months, then there may be a time limitation on protection of what the money therein is converted into as well, but the authors are not aware of any case or specific support for this position.

Because of the six-month expiration deadline, and the work caused by depositing wage checks into special wage accounts and then having to remember to move the money out of the wage account within six months, many advisors recommend that clients simply deposit their wage checks into otherwise protected vehicles, such as tenancy by the entireties accounts, family limited partnership accounts, annuity investments, or life insurance contracts where protection of the wages will not be a concern.

As noted by commentators, the term "financial institution" is not defined under Florida Statutes Section 222.11. We assume that a brokerage firm will qualify as a "financial institution" to hold a wage account since the Statute was specifically changed to allow "financial institution" accounts within its breadth

⁵²⁸ 15 U.S.C. § 1673.

to overturn a court decision to not allow wage account protection to a Merrill Lynch brokerage account. Florida Statutes Section 710.102(8) defines financial institution to be a “bank, trust company, savings institution, or credit union,” and does not mention brokerage firms. The authors believe that brokerage firm money market and similar accounts will be protected so long as the debtor can prove that the funds in the account are.”

FLORIDA’S PHYSICIANS GUIDE TO PROTECTION OF WAGES AND WAGE ACCOUNTS.

Florida law provides limitations upon the access that creditors may have to “wages” and “wage accounts” earned and funded by Florida residents. As discussed in part A of Chapter 6 (Basic Rules), the statute states that wages earned by a head of household will generally be immune from creditors.

Courts have indicated that where the wage earner is a shareholder in a closely held corporation, and can thus manipulate between what would be received as wages and what would be received as dividends, then no wages may be protected. These unfortunate bankruptcy court decisions have not been appealed, and point out the importance of taking regular paychecks and having arm’s-length employment agreements in place so that wages are paid periodically in a traditional manner to enhance the probability that they will be protected.

If wages are “creditor exempt,” then it is important to maintain the creditor exempt status of the wages by depositing them into an account or other investments that will also be creditor exempt.

Other creditor exempt assets that wages may be “converted to” can include paying down the mortgage on a protected home, investing the paycheck directly into a properly titled annuity contract or life insurance policy, funding a tenancy by the entirety account where the wage earner’s spouse would not be sued by the same creditor as the wage earner, or making deposits into a wage account.

Physicians who have monies or investments that are not creditor exempt might be well advised to spend down the non-creditor exempt savings, while accumulating wages in a wage or other protected account.

The Florida Statutes do not explicitly impose any ownership, titling, naming or other specific requirement for an account to qualify as a wage account. A “wage account” can be owned by the physician earner, or may be held as tenancy by the entirety by the physician earner and the physician’s spouse.

Most, if not all, married physicians whose spouses do not practice with them will be better protected by depositing their wages into a tenancy by the entirety account so that the wages may be safeguarded for two reasons: (1) the wage exemption rules as described above will apply, and (2) to “invade” a tenancy by the entirety bank account, a creditor must have a judgment against both spouses or show that the transfer into the account was a fraudulent transfer. If a wage check is a creditor exempt asset, then the deposit of the wage check directly into a protected tenancy by the entirety account should not be considered a fraudulent transfer.

Many physicians and bankers waste a lot of time opening “wage accounts” where tenancy by the entirety accounts or other vehicles are just as, if not more, protective and would qualify as wage accounts anyways.

The statute simply says that wages are protected for six months in the account so long as they can be traced, and thus are not confused with non-wage or older wage deposits that would not be protected.

It makes sense to have an account funded solely by wages, and to “empty the account” into other exempt investments, at least every six months, so that there would never have to be a tracing and proof analysis as to wage money protection.

DEPOSITING WAGES IN A TENANTS BY THE ENTIRETIES ACCOUNT.

Typically, wages regularly deposited into a tenant by the entirety account will retain protection by reason of being an exempt asset transferred into another exempt asset. But what if the wages would not be exempt for one of the reasons the courts have denied exemption as discussed above? Will the transfer of wages to a tenant by the entirety account be considered a fraudulent transfer that be set aside by a creditor when the debtor has always transferred his or her paychecks into tenancy by the entirety accounts?

In *Ellis Sarasota Bank & Trust Co. v. Nevins*,⁵²⁹ Florida’s Second District Court of Appeals considered whether a husband’s deposit of wages into a tenant by the entirety account constituted a fraudulent transfer. The court held that such a transfer may constitute a fraudulent transfer in some cases, but not in the facts before the court in *Ellis*.⁵³⁰ The court also stated that “[t]he sole fact of a transfer into an entirety account will not always be sufficient evidence of such fraud,” but that certain factors, such as how long the tenancy by the entirety account existed, whether a previous entirety account existed, and whether all of the funds in the account were from one source.⁵³¹ While the case was remanded to the trial court to determine whether there was any fraud in the transfer of wages to the tenants by the entirety account based on the principles enumerated in this case, the rule of law established in *Ellis* is sound.

Chapter 10 of this book provides detail on federal government employee benefits that can be creditor exempt under the federal law.

By analogy, in the case of *In re Cook*,⁵³² the court found that a couple’s conversion of \$175,000 in proceeds from a non-exempt tax refund into an exempt homestead was not done with fraudulent intent, so that the ten-year “look back” provision under Bankruptcy Code Section 522(o) did not apply. The court looked at the circumstances surrounding the transfer and found that it was reasonable for the Cooks to use the tax refund to buy another home, noting that “receiving the tax refund finally gave the Debtors the opportunity to procure a stable and permanent residence.”

⁵²⁹ 409 So.2d 178, 179 (Fla. 2d DCA 1982).

⁵³⁰ *Id.* at 180.

⁵³¹ *Id.*

⁵³² 460 B.R. 911, 915 (Bankr. N.D. Fla. Dec. 7, 2011).

In a December 31, 2012 Forbes online publication, creditor protection authority, Attorney Jay Adkisson of the California firm Riser Adkisson LLP, described a Pennsylvania case regarding the transfer of wages to a tenants by the entireties account. In *In re Cohen*,⁵³³ the Bankruptcy Court for the Western District for Pennsylvania held that wages directly deposited into a tenant by the entireties account following a stable pattern that had been followed for over twenty years did not constitute an actual fraudulent transfer, but did constitute constructive fraud under Pennsylvania law. As to the “actual fraudulent transfer” decision, the court stated the following:

The Trustee failed to prove that the Debtor actually intended to hinder, delay, or defraud Trizec when he transferred his wages into the Entireties Account. As was the Defendants’ custom for at least twenty years before the Trizec Litigation, they continued to deposit their paychecks directly into the Entireties Account after Trizec sued them. While Mrs. Cohen retired subsequent to the commencement of the Trizec Litigation, she deposited her monthly pension payments into the Entireties Account. Thus, the Trustee has not provided evidence sufficient to establish that the Debtor, after Trizec sued him, made any change in the way he handled his paychecks, or otherwise proven that the Debtor acted with any actual fraudulent intent.

However, the court found that the debtor was liable for constructive fraud. To show constructive fraud in Pennsylvania, the Trustee must prove that the “[d]ebtor made the transfer without receiving reasonably equivalent value in exchange, and was insolvent at the time of the transfer or was rendered insolvent by the transfer.” This decision was overturned in the case of *Cohen v. Sikirica*, where the U.S. District Court concluded that the Trustee (Sikirica), “failed to satisfy his burden that Mr. Cohen’s funds alone were used to pay the unexplained expenditures.”⁵³⁴

Attorney and author Jay Adkisson has stated that, “the Court found that the transfers of the Debtor’s wages to the entireties account constituted fraudulent transfers because no consideration [was given] for the transfers (although the Court allowed the Debtor to try to prove that a portion of the moneys were spent on necessities, which would have been consideration), and the transfers rendered the Debtor insolvent or he was insolvent when they were made.”

Florida Statutes Section 726.105 recognizes the concept of “constructive fraud” and reads as follows:

- A. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor’s claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
 - (1) With actual intent to hinder, delay, or defraud any creditor of the debtor; **or**
 - (2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
 - (a) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

⁵³³ 2012 WL 5360956 *2 (Bankr. W.D. Pa. Oct. 31, 2012).

⁵³⁴ 487 B.R. 615, 628 (W.D. Pa. 2013).

- (b) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

However, the court in *Ellis*, discussed above, found that depositing wages into tenants by the entireties account will only constitute a fraudulent transfer when “clothed with fraud.”⁵³⁵

⁵³⁵ 409 So.2d 178, 180 (Fla. 2d DCA 1982).

CHAPTER 7

DISABILITY INSURANCE AND PROCEEDS

Florida Statutes Section 222.18 exempts disability payments from creditors. The statute specifically provides:

Disability income benefits under any policy or contract of life, health, accident, or other insurance, shall not in any case be liable to attachment, garnishment, or legal process in the state, in favor of any creditor or creditors of the recipient of such disability income benefits, unless such policy or contract of insurance was effected for the benefit of such creditor or creditors.

In order for a debtor to claim funds as exempt under Florida law as “disability benefits”, it must be established that (1) the funds are disability income benefits, and (2) that the benefits are under a policy.⁵³⁶

In 1997, the Supreme Court of Florida held that any benefits due or payable under workers compensation law continue to be exempt even after they are received and put into a bank account.⁵³⁷ The Court found that wages placed into a bank account will continue to be exempt from creditor claims so long as the funds being claimed as exempt are traceable to the benefits.⁵³⁸ The Court indicated that the legislature must have intended for residents of Florida to be able to protect their disability benefits, even after they were deposited into a bank account.⁵³⁹

Even lump sum proceeds resulting from settlement of a claim against a disability carrier will be exempt according to the Florida Supreme Court. In *Zuckerman v. Hofrichter & Quiat, P.A.*,⁵⁴⁰ the Florida Supreme Court held that debtor’s settlement proceeds of \$75,000 were exempt under Section 222.18. Specifically, the court stated:

Section 222.18 expressly reads that disability income benefits “of whatever form” paid pursuant to an insurance contract or policy shall not be subject to garnishment, unless such insurance was affected for a creditor’s benefit. The words “of whatever form” are dispositive. The clarity of these words leads us to conclude that the Section 222.18 exemption is not contingent upon the form of payment, i.e., lump sum versus monthly payments, nor does it discriminate between monies paid pursuant to settlement or otherwise.

Thus, when a Floridian receives disability insurance proceeds, whether in a lump sum or monthly payments, the proceeds are protected from creditors.

⁵³⁶ *In re Chesley*, 526 B.R. 888 (M.D. Fla. 2014).

⁵³⁷ *Broward v. Jacksonville Med. Ctr.*, 690 So. 2d 589 (Fla. 1997).

⁵³⁸ *Id.*

⁵³⁹ *In re Ryzner*, 208 B.R. 568 (Bankr. M.D. Fla. 1997).

⁵⁴⁰ 646 So.2d 187, 188 (Fla. 1994).

CHAPTER 8

PENSION PLANS, IRAS, AND OTHER QUALIFIED RETIREMENT PLANS

INTRODUCTION.

Pension and IRA accounts enjoy exempt asset status both under the Florida Statutes and the Federal Bankruptcy Code.

Many new businesses and professionals do not have pension plans, or have plans which are not of optimum design for their situation. Fortunately, some pension actuaries will not charge to take a look at an existing plan and employee information in order to advise on optimum plan design, which may include consideration of cross-tested defined benefit or cash balanced plans, which are not well understood. The census that follows can be used to provide the information that an advisor will need to facilitate plan design.

Many advisors are not aware of the Affiliated Service Group rules and Employee Leasing rules under Internal Revenue Code Sections 414(m) and (n) which can cause individuals who work indirectly or in associated companies to be required to be included in a pension plan in order to avoid disqualification under the anti-discrimination rules.

In Bankruptcy, individuals who are not able to use state law to facilitate exemption of IRAs will be subject to loss of exemption for any inherited IRAs they own or receive, because the federal Bankruptcy Code protection does not extend to any inherited IRA, at least if it was not inherited by a surviving spouse. The present cap, which was last updated for inflation on April 1, 2019, totals \$1,362,800. The cap is next set to be adjusted for inflation in April of 2022.

Florida's exemption status applies to the unlimited values of both pension and IRA accounts, and includes rollover IRAs that pass to surviving spouses and other beneficiaries who reside in Florida, but can be somewhat finicky. See, for example, what might happen if the owner of an IRA gives a blanket UCC-1 financing statement to a lender – does this disqualify all IRAs, and cause loss of the applicable exemption, as described in Section H of this chapter?

Previously case law permitted creditors of an IRA beneficiary to reach an inherited IRA, but this was changed when a Florida Statute was amended in 2011.⁵⁴¹ The updated language under Florida Statutes Section 222.21 and Bankruptcy Code Section 522 provides protection for plans that have legal or operational flaws, and for single person pension plans that were not considered to be qualified under ERISA, as further discussed below.

⁵⁴¹ Fla. Stat. § 221.21(c)(2).

For example, pension and IRA accounts will be considered to be in compliance with applicable law “unless it has been ... determined that the plan or governing instrument is not exempt from taxation in a proceeding that has become final and nonappealable.”⁵⁴² Pension plans and IRAs with documentation or operational flaws will still be protected under the Florida statute if the debtor claiming the exemption proves by a preponderance of the evidence that the fund or account would have been in substantial compliance with the applicable requirements for tax exemption but for the negligent or wrongful conduct of a person or persons other than the debtor claiming the exemption.

The Florida statute reads as follows, with forgiveness provisions being underlined for the convenience of the reader:

§ 222.21 Exemption of pension money and certain tax-exempt funds or accounts from legal processes.

(1) Money received by any debtor as pensioner of the United States within 3 months next preceding the issuing of an execution, attachment, or garnishment process may not be applied to the payment of the debts of the pensioner when it is made to appear by the affidavit of the debtor or otherwise that the pension money is necessary for the maintenance of the debtor’s support or a family supported wholly or in part by the pension money. The filing of the affidavit by the debtor, or the making of such proof by the debtor, is prima facie evidence; and it is the duty of the court in which the proceeding is pending to release all pension moneys held by such attachment or garnishment process, immediately, upon the filing of such affidavit or the making of such proof.

(2)(a) Except as provided in paragraph (d), any money or other assets payable to an owner, a participant, or a beneficiary from, or any interest of any owner, participant, or beneficiary in, a fund or account is exempt from all claims of creditors of the owner, beneficiary, or participant if the fund or account is:

1. Maintained in accordance with a master plan, volume submitter plan, prototype plan, or any other plan or governing instrument that has been preapproved by the Internal Revenue Service as exempt from taxation under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended, unless it has been subsequently determined that the plan or governing instrument is not exempt from taxation in a proceeding that has become final and nonappealable;

2. Maintained in accordance with a plan or governing instrument that has been determined by the Internal Revenue Service to be exempt from taxation under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended, unless it has been subsequently determined that the plan or governing instrument is not exempt from taxation in a proceeding that has become final and nonappealable; or

⁵⁴² Fla. Stat. § 222.21(2)(a)(1) 2017.

3. Not maintained in accordance with a plan or governing instrument described in subparagraph 1. or subparagraph 2. if the person claiming exemption under this paragraph proves by a preponderance of the evidence that the fund or account is maintained in accordance with a plan or governing instrument that:

a. Is in substantial compliance with the applicable requirements for tax exemption under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended; or

b. Would have been in substantial compliance with the applicable requirements for tax exemption under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended, but for the negligent or wrongful conduct of a person or persons other than the person who is claiming the exemption under this section.

(b) It is not necessary that a fund or account that is described in paragraph (a) be maintained in accordance with a plan or governing instrument that is covered by any part of the Employee Retirement Income Security Act for money or assets payable from or any interest in that fund or account to be exempt from claims of creditors under that paragraph.

(c) Any money or other assets or any interest in any fund or account that is exempt from claims of creditors of the owner, beneficiary, or participant under paragraph (a) does not cease to be exempt after the owner's death by reason of a direct transfer or eligible rollover that is excluded from gross income under the Internal Revenue Code of 1986, including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in s. 408(d)(3) of the Internal Revenue Code of 1986, as amended. This paragraph is intended to clarify existing law, is remedial in nature, and shall have retroactive application to all inherited individual retirement accounts without regard to the date an account was created.

(d) Any fund or account described in paragraph (a) is not exempt from the claims of an alternate payee under a qualified domestic relations order or from the claims of a surviving spouse pursuant to an order determining the amount of elective share and contribution as provided in part II of chapter 732. However, the interest of any alternate payee under a qualified domestic relations order is exempt from all claims of any creditor, other than the Department of Revenue, of the alternate payee. As used in this paragraph, the terms "alternate payee" and "qualified domestic relations order" have the meanings ascribed to them in s. 414(p) of the Internal Revenue Code of 1986.

(e) This subsection applies to any proceeding that is filed on or after the effective date of this act.

The Bankruptcy Code section on pension and IRA accounts can be relied upon by Floridians, and also individuals whose states do not provide as much protection. The following language is from Bankruptcy Code Section 522(b)(4):

1. If the retirement funds are in a retirement fund that has received a favorable determination under section 7805 of the Internal Revenue Code of 1986, and that determination is in effect as of the date of the filing of the petition in a case under this title, those funds shall be presumed to be exempt from the estate.
2. If the retirement funds are in a retirement fund that has not received a favorable determination under such section 7805, those funds are exempt from the estate if the debtor demonstrates that—
 - (i) no prior determination to the contrary has been made by a court or the Internal Revenue Service; and
 - (ii)
 - (I) the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986; or
 - (II) the retirement fund fails to be in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986 and the debtor is not materially responsible for that failure.
3. A direct transfer of retirement funds from 1 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, under section 401(a)(31) of the Internal Revenue Code of 1986, or otherwise, shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.
 - (D)
 - (i) Any distribution that qualifies as an eligible rollover distribution within the meaning of section 402(c) of the Internal Revenue Code of 1986 or that is described in clause (ii) shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such distribution.
 - (ii) A distribution described in this clause is an amount that—
 - (I) has been distributed from 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; and
 - (II) to the extent allowed by law, is deposited in such a fund or account not later than 60 days after the distribution of such amount.

Neither the Florida Statute nor the Bankruptcy Code makes mention of retirement plans that arise under Internal Revenue Code Sections 412(i) or 419A, so it is possible that these types of retirement plans are not exempt from creditor claims unless they qualify under the Florida and Bankruptcy Code statutes discussed below.

A 412(i) plan is similar to a defined benefit plan, but simplified rules apply, and the plan must be funded only with life insurance and annuity products. Many commissioned insurance agents are not licensed to sell other types of investments, such as mutual funds, stocks and bonds, and encourage 412(i) plans. Such a plan is clearly permitted under the Internal Revenue Code as a retirement plan for employees that can be funded in a tax deductible manner, and may facilitate contributions exceeding what would normally be permitted under 401(k) plans, but clients and advisors are best served by having knowledgeable actuaries or pension lawyers and investment advisors involved to assure that conventional pension planning is considered.

419A plans are often referred to as Welfare Benefit Plans and it is said that the IRS has challenged a high proportion of 419A plans as a matter of routine procedure. As a result of this they are often challenged by the IRS, and normally not recommended by conventional advisors. An excellent summary of 419A plans and their possible effect and risks can be found on the website of tax lawyer Harvey M. Katz who can be reached at (212) 878-7976 or hkatz@foxrothschild.com.

While life insurance and annuities are protected from the creditors of a policy owner who is the insured as to life insurance, or the owner of an annuity, having life insurance or annuities under a 412(i) plan or a 419A plan will not help from a Florida asset protection standpoint, because only life insurance and annuity contracts owned by Florida residents will be protected.⁵⁴³

Florida Statutes Section 222.201 provides that the exemptions under Bankruptcy Code Section 522(d)(10) will apply. Subsection (10)(E) includes the following, which may protect 412(i) plans when provided for “non-insiders”⁵⁴⁴:

(E) a payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor, unless—

⁵⁴³ See *In re Allen*, 203 B.R. 786 (Bankr. M.D. Fla. 1996).

⁵⁴⁴ The term “insider” includes (A) if the debtor is an individual - (i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control; (B) if the debtor is a corporation - (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor; (C) if the debtor is a partnership - (i) general partner in the debtor; (ii) relative of a general partner in, general partner of, or person in control of the debtor; (iii) partnership in which the debtor is a general partner; (iv) general partner of the debtor; or (v) person in control of the debtor; (D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor; (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and (F) managing agent of the debtor.

(i) such plan or contract was established by or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose;

(ii) such payment is on account of age or length of service; and

(iii) such plan or contract does not qualify under section 401(a), 403(a), 403(b), or 408 of the Internal Revenue Code of 1986.

419A plans are much more controversial than 412(i) plans, but may qualify for creditor protection under the same rationale.

BANKRUPTCY PROTECTION FOR IRAS.

Pursuant to Bankruptcy Code Section 522(n),⁵⁴⁵ when the Federal exemptions apply, assets held in traditional and Roth IRA accounts are exempt from creditors and thus not part of the bankruptcy estate in the present amount of up to \$1,362,800.⁵⁴⁶ This limitation does not apply where state law explicitly provides for unlimited protection, as per the 1993 11th Circuit Court of Appeals decision in *In Re Schlein*.⁵⁴⁷ Additionally, assets attributable to amounts properly rolled over from a qualified retirement plan or certain other retirement plan accounts into an IRA plan will not be subject to the Section 522(n) limitation.

However, in the 2014 decision of *In re Clark v. Rameker*, the United States Supreme Court held that inherited IRAs are not classified as "retirement funds" within the Federal bankruptcy law, and can therefore be included in the bankruptcy estate.⁵⁴⁸ Because of this case, and the uncertainty of being able to predict where the beneficiary of an IRA may reside when they inherit an IRA, it is often best to have IRAs made payable to "accumulation trusts" which may be held for the benefit of the intended beneficiary after the death of the IRA owner in a manner that will protect the IRA from creditors of the intended beneficiary. Florida Statutes Section 221.21 does exempt inherited IRAs from the bankruptcy estate, and will probably not apply if the intended beneficiary resides in a state that does not provide similar protection.

PROTECTING THE INTENDED BENEFICIARIES OF IRA AND PENSION PLAN ACCOUNTS.

Make Benefits Payable to Trusts

⁵⁴⁵ Section 522(n) provides: For assets held by debtors in traditional or Roth IRAs, other than a simplified employee pension under section 408(k) or a simple retirement account under section 408(p), the aggregate value of such assets exempted under this section, without regard to amounts attributable to rollover contributions under IRC sections 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8), and earnings thereon, shall not exceed \$1,000,000, except that such amount may be increased if the interests of justice so require.

⁵⁴⁶ This value is adjusted every three years for inflation, with the last increase occurring April 1, 2016.

⁵⁴⁷ *Schlein v. Mills (In re Schlein)*, 8 F.3d 745, 746 (11th Cir. 1993).

⁵⁴⁸ *Clark v. Rameker*, 134 S. Ct. 2242 (U.S. 2014).

Although the beneficiary of an IRA or pension plan who resides in Florida will have protection from a creditor standpoint on the death of the planned participant or IRA holder under Florida Statutes Section 222.21(2)(a), beneficiaries who reside outside of Florida may not have this protection.

Additionally, Florida Statutes Section 222.14 protects the cash value of insurance policies and all annuities from creditor's claims. While a Florida resident is alive, the cash value of any insurance policy that the individual owns for herself or for another Florida resident is exempt from creditor's claims. However, this benefit is only for the owner/insured. The law does not protect the cash value of life insurance when the insured is someone other than the debtor.

The 2019 SECURE Act changed the playing field for many aspects of IRA and pension distribution planning that applies when an IRA owner or pension plan participant dies. The minimum distribution rules can be followed by those who become adept in this complicated area to facilitate having trusts that may protect a beneficiary from his or her creditors receive distributions. These rules are too complicated to summarize in a single paragraph, but the following 2020 Leimberg Newsletter . . . should be helpful.

Feeling InSECURE With Estate Planning For Your Large IRA

Consider the “TEA POT” Trust System, Unless Paying Taxes is Your Cup of Tea

by Alan S. Gassman, Christopher J. Denicolo, and Brandon Ketron

“Yes, that’s it,” said the Hatter with a sigh; “It’s always tea-time and we have no time to wash the things between whiles.”⁵⁴⁹

EXECUTIVE SUMMARY

New tax laws create new opportunities for estate and tax planners to optimize the economic results for their clients, using both time tested and newly adapted structures.

The SECURE Act provides us with less complexity in the long run, but also has increased and accelerated the potential income taxes that are associated with required distributions from IRA and other qualified required plans⁵⁵⁰ after the death of the IRA owner or retirement plan participant⁵⁵¹. Specifically, “stretch” payouts over the life expectancies of non-spouse adult beneficiaries who are not disabled, chronically ill, or

⁵⁴⁹ Alice’s Adventures in Wonderland. The authors are curious as to what kind of tea Louis Carroll was drinking when he wrote this incredible book, notably including Chapter 7 – A Mad Tea-Party.

⁵⁵⁰ For the purposes of this Article, the authors are referring to the term “IRA/Plan” to signify IRAs and other qualified retirement plans, including IRAs, SIMPLE IRAs, Simplified Employee Pensions (SEP), Employer sponsored retirement plans (such as 401(k) plans, defined benefit plans, defined contribution plans, and profit sharing plans), 403(b) Plans, 457(b) Plans, Roth 401(k) Plans, and Roth IRAs (however, Roth IRAs are not subject to the Required Minimum Distribution rules until the owner of the Roth IRA (or the spouse of the deceased owner who rolled over into his or her own Roth IRA) dies), Canadian Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Plans (RRIFs) (to the extent that such retirement plans are treated as USA IRA equivalents).

⁵⁵¹ For the purposes of this Article, the term “Plan Participant” means the person who is the IRA owner or qualified retirement plan participant, while alive, or after death.

less than 10 years younger than the deceased Plan Participant have been eliminated. Instead, all assets must be distributed from the IRA/Plan within a usually appreciably shorter timeframe (generally no longer than approximately 10 years after the death of the Plan Participant), and such distributions typically are treated as ordinary income subject to income tax. This can result in a significant departure from the income tax deferral afforded by the “stretch” that was available under prior law.

While qualified advisors can take an educated guess as to how to allocate IRAs/Plans among multiple trusts for multiple adult children and their descendants in a tax efficient manner, it is almost certain that such an estimate will miss the mark by a significant degree, given the changes in circumstances, tax law and family objectives, that can change considerably over the course of a decade.

In light of these potential cumbersome challenges, an alternative is for the Plan Participant to leave an IRA/Plan to a single pot trust and to give the trustee thereof the discretionary authority to sprinkle income among the Plan Participant’s children and other descendants, while allowing the trustee to conduct an annual strategic review of beneficiaries and their tax situations to determine if and when to make distributions that will carry taxable income out so that the net tax result is optimized. The trust will be drafted as an “Accumulation Trust,” meaning that all assets must be distributed from the IRA/Plan no later than December 31st of the 10th year following the year of the Plan Participant’s death, although the trustee is not required to distribute any assets from the trust to the trust beneficiaries.

The pot trust structure allows for tax efficient allocation of IRA/Plan assets between the trust beneficiaries; hence its name- the “Twin Tax Efficient Accumulation POT TrustSM,” or the “TEA POT Trust.”

FACTS (“Take some more tea”, the March Hare said to Alice, very earnestly.)

The SECURE Act became law on December 20, 2019, and has drastically changed planning for qualified retirement plans. Effective January 1, 2020, the SECURE Act requires the vast majority of IRAs/Plans that are inherited by individuals or trusts, other than by a surviving spouse or certain other qualifying beneficiaries in limited circumstances (or in a special type of trust for the benefit of any such beneficiaries), to be paid out by no later than December 31st of the 10th year following the calendar year of the Plan Participant’s death. This rule is referred to as the “10-Year Rule.”

Under the previous law, IRAs/Plans that were inherited by individuals or properly drafted “See-Through Trusts” for individuals could be paid out over the life expectancy of the individual (in the case of an individual being the direct beneficiary of the IRA/Plan), or over the life expectancy of the oldest beneficiary of the trust who could receive benefits from IRA/Plan (in the case where the trust is a beneficiary). An IRA/Plan that can be paid out over the life expectancy of a beneficiary is known as a “Stretch IRA.” However, for most beneficiaries, the Stretch IRA has been eliminated. The effects of this change are drastic.

For example, as discussed in the authors’ LSI Employee Benefits and Retirement Planning Newsletter #715 (January 6, 2020), if a 50-year-old non-spouse beneficiary who is the Designated Beneficiary of a \$1,000,000 IRA with assets that grow at a 6% annual rate of return, and if the beneficiary is in the 37% income tax bracket, and will reinvest amounts distributed at a 5% after-tax rate of return, then the loss of life expectancy deferral will result in a \$470,492 difference in the amount of total assets remaining after taxes 10 years after the death of the Plan Participant, assuming that the 10-Year Rule applies. The difference

is \$594,905 after 20 years and \$470,810 after 30 years.

This is a very large difference.

The growth in value inside an IRA/Plan over a number of years will cause a significant advantage for a lifetime payout beneficiary that simply is not available under the SECURE Act.

There are exceptions under the SECURE Act for IRAs/Plans that are left directly to, or to a special type of trust for the Plan Participant's surviving spouse, the Plan Participant's minor children, beneficiaries who are chronically ill or disabled, and beneficiaries who are no more than ten years younger than the deceased Plan Participant (these beneficiaries are known as "Eligible Designated Beneficiaries"), but these exceptions will not help the vast majority of individuals who will inherit IRAs left by their parents, aunts, uncles or others.⁵⁵² However, under the SECURE Act, the Stretch IRA treatment expires upon the death of an Eligible Designated Beneficiary, or upon a minor child reaching the age of majority, and all assets must be distributed out of the IRA/Plan by December 31st of the year that is 10 years after the event causing expiration of the Stretch IRA treatment. This can lead to undesired results, despite the initial attractiveness of the availability of the Stretch IRA treatment.

What's more, the Stretch IRA treatment generally applies only where an IRA/Plan is left directly to an Eligible Designated Beneficiary or to a "Conduit Trust" for an Eligible Designated Beneficiary (which must require that all distributions from the IRA/Plan be paid directly to the Eligible Designated Beneficiary). Therefore, leaving an IRA/Plan to or for the benefit of an Eligible Designated Beneficiary in a manner that will qualify for Stretch IRA treatment comes at the cost of severely compromising the asset preservation and creditor protection benefits that result from leaving an IRA/Plan to a protective trust structure for the Plan Participant's desired beneficiaries.

COMMENT

For most married clients, a common approach is for the Plan Participant to leave IRA/Plans to his or her surviving spouse. This will enable the surviving spouse to roll over all or any portion of the inherited IRA/Plan into the spouse's own IRA. The surviving spouse then will be treated as if he or she were the original Plan Participant of the rolled over IRA, which allows the surviving spouse to delay required distributions from the IRA until after he or she has reached the age of 72, and to take required minimum distributions over the more favorable "Uniform Life" distribution table. It also allows the surviving spouse to select the beneficiary who will inherit the IRA upon his or her later death.

In a second marriage situation or other circumstances where the Plan Participant wants the surviving spouse to have the lifetime benefit of an IRA/Plan, but not the ability to choose the beneficiary thereof after the spouse's death, a Conduit Trust for the lifetime benefit of the surviving spouse might be the (relatively) optimal recipient of the Plan Participant's IRA/Plan upon his or her death. The Conduit Trust can be drafted to provide for the IRA/Plan to be held in the Trust for the Plan Participant's desired secondary beneficiaries after the spouse's death, but the 10-Year Rule will apply after the surviving spouse's death to require that all assets be distributed from the IRA/Plan.

⁵⁵² For a great summary of the changes to qualified retirement plans brought about by the SECURE Act, see Leimberg Employee Benefits and Retirement Planning Newsletter #713 written by Natalie Choate.

When an unmarried Plan Participant dies and has multiple descendants, or the Plan Participant's surviving spouse dies and the IRA/Plan had been held under a Conduit Trust for the spouse's lifetime benefit, the typical distribution and division will be for equal shares set aside for each child, or for separate equal trusts to be funded for each child. Normally, these trusts are drafted so that the child can be the trustee or a co-trustee, and the child and his or her descendants can receive distributions as reasonably needed for their health, education, maintenance, or support, although no distributions are required to be made from the trusts. Such trusts should be drafted to qualify as Accumulation Trusts to avoid the having the otherwise default "5-Year Rule" (whereby all assets must be distributed from IRA/Plan by December 31st of the 5th calendar year following the Plan Participant's death) from applying. While the Treasury Regulations will need to clarify this issue, it appears to the authors that the At Least As Rapidly Rule will continue to be available to beneficiaries of an IRA/Plan where the Plan Participant has died after reaching his or her required beginning date⁵⁵³.

⁵⁵³ Under prior law, if a Plan Participant died after reaching his or her required beginning date, then the beneficiaries would be entitled to choose whether the "At Least As Rapidly Rule" applied to cause required minimum distributions to be payable over the deceased Plan Participant's life expectancy, based upon the single life table, without annual recalculation. There is some question as to whether this "At Least As Rapidly Rule" continues to apply where an IRA/Plan is left to an individual designated beneficiary or to a trust that qualifies as a See-Through Trust (i.e. a Conduit Trust or an Accumulation Trust).

Treasury Regulation §1.401(a)(9)-5, Q&A-5 references the longer of: (i) the life expectancy of the designated beneficiary (which no longer applies under the SECURE Act unless the beneficiary is an eligible designated beneficiary); or (ii) the deceased Plan Participant's remaining life expectancy, regarding the determination of the distribution period if the Plan Participant dies on or after his or her required beginning date.

Nevertheless, it seems that a beneficiary of an IRA/Plan still has the ability to use the At Least As Rapidly Rule if the Plan Participant dies on or after his or her required beginning date because IRC Section 401(a)(9)(B)(i)(II) was not modified by the SECURE Act to modify or remove the "At Least As Rapidly Rule," and nothing in the revised statute indicates that the 10-Year Rule was intended to eliminate the "At Least As Rapidly Rule" or change the default distribution period applicable where the Plan Participant dies on or after his or her required beginning date.

While IRC Section 401(a)(9)(H)(i)(II) indicates that the 10-Year Rule applies in lieu of the 5-Year Rule where there is a designated beneficiary, regardless of whether the Plan Participant died on or after his or her required beginning date, if Congress intended to remove the at least as rapidly rule, then Section 401(a)(9)(B)(i)(II) would have been modified accordingly. The objective of IRC Section 401(a)(9)(H)(i)(II) appears to be to replace the 5-Year Rule with the 10-Year Rule where a Plan Participant dies and leaves a (non-eligible) designated beneficiary, even if the Plan Participant dies on or after his or her required beginning date.

Under the SECURE Act, IRAs/Plans that are left to such Accumulation Trusts will be subject to the 10-Year Rule whereby all assets must be distributed from IRA/Plan by December 31st of the 10th calendar year following the Plan Participant's death (or from the surviving spouse's death if the IRA/Plan was payable to a Conduit Trust for his or her benefit upon the original Plan Participant's death). Nevertheless, income tax planning opportunities exist to mitigate the effect of the 10-Year Rule.

"The best way to explain it is to do it."

Most affluent families who have large IRAs also have children who are well-educated and are in the upper income tax brackets, but this is not always the case. For example, an individual with a \$900,000 traditional IRA and \$3,000,000 of other assets may have one adult child who is in the 40% combined federal and state tax brackets ("Chrys Chamomile"), another adult child in the 25% combined federal and state tax brackets ("Earl Grey"), and a third adult child in the 10% combined federal and state tax brackets ("Chai Green").

If trusts for the three adult children each receive \$300,000 in IRA benefits that have to be paid out within 10 years of the death of the surviving parent, then the taxes that might have to be paid by each respective trust would be \$120,000 by Chrys Chamomile ($\$300,000 \times 40\%$), \$75,000 by Earl Grey ($\$300,000 \times 25\%$), and \$30,000 by Chai Green ($\$300,000 \times 10\%$).

It would make sense to leave the IRA to the trust for Chai Green, and other assets to the trusts for the other children in larger proportions to counterbalance the negative effect of income taxes on the IRA/Plan assets as the required distributions are made, in order to cause greater tax efficiency. However, it will be hard to

Further, if this Section is read in conjunction with the post-SECURE Act IRC Section 401(a)(9), it seems that the "longer of" the deceased Plan Participant's remaining life expectancy, or the distribution period applicable to the designated beneficiary (whether it be the life expectancy rule if the designated beneficiary is an eligible designated beneficiary, or the 10-Year Rule otherwise) will apply if Plan Participant died on or after his or her required beginning date.

The solution is easier if a trust is the beneficiary of the Plan, as the choice can be made by intentionally failing to comply with the requirement that certain documentation be provided to the plan administrator by October 31st of the year after the Plan Participant's death.

It also does not seem that Congress wanted to provide less flexibility for individual designated beneficiaries, rather than for situations where the designated beneficiary is determined under a See-Through Trust or if there is no designated beneficiary, as it is clear that the At Least As Rapidly Rule will apply if there is no designated beneficiary. Additionally, the At Least As Rapidly Rule would not change the distribution period that would apply if the Plan Participant were still living, so the distribution period would not be extended by reason of the Plan Participant's death, which leads to conclusion that it was intended to remain in effect where there is a designated beneficiary of the IRA/Plan.

estimate how much in extra assets to give to the other two children to take into account that Chai Green may have to pay significant income taxes on \$900,000, plus growth, coming out of an IRA over 10 years. Additionally, circumstances might change. Chrys Chamomile may become disabled for one or two years and have deductible nursing expenses that would enable him or her to receive \$100,000 a year from an IRA tax-free.

Twinkle twinkle little bat!

How I wonder where you're at!

Up above the world you fly

Like a tea tray in the sky.

(- the Mad Hatter)

For these reasons, and for this situation, the Twin TEA POT Trust SystemSM makes good sense. In the above example, all \$900,000 of the IRAs can be made payable to one Accumulation Trust, which can be the beneficiary of one or more IRAs/Plans until the tax year after date on which the 10-Year Rule mandates full distribution of all assets from the IRA/Plan. Such time period is referred to as the "Allocation Period" for the purposes of this Article. During the approximately 10-Year Period, the trustee of that trust can sprinkle the distributions received among the children and their respective family members as the trustee deems appropriate, taking need and tax brackets into account.

This is why we believe that a "TEA POT Trust" serving solely as the "Stretch Trust" beneficiary of IRAs/Plans can provide advantageous income tax results, and that having a non-IRA, non-pension "Equalization Trust" set aside will enable the Trustees to make distributions to or for the benefit of one or more of the descendants or trusts for their benefit to "even things up" during or after the Allocation Period.

Obviously, the distributions received by this trust will be expended on some descendants to a greater extent than others. For example, annual payments can be made to Chai Green to make use of the lower brackets each year, as opposed to waiting to give him, or a trust for his benefit, all \$900,000 worth, plus growth, in the 10th year.

Further, Chrys Chamomile might have a child of her own, Mushroom Brew, who is disabled and has significant deductible medical and personal care expenses. It can make good tax sense for the monies to be spent for low income grandchildren to the extent that they may not be subject to the Kiddie Tax⁵⁵⁴.

In order to keep things fair and equitable, a separate "Equalization Trust" can be established as part of the TEA POT Trust System, which can be held until the expiration of the Allocation Period to provide benefits to the family members who do not receive a "fair share" of the benefit from the TEA POT Trust due to IRA/Plan assets having been allocated to other family members.

⁵⁵⁴ The Kiddie Tax was also changed by the SECURE Act to cause any investment or unearned income of a child under the age of 19 (or a full-time student between the ages of 19 and 23) to be subject to income tax at the tax brackets of the child's parents, instead of at the tax brackets applicable to complex trusts which applied after the Tax Cuts and Jobs Act of 2017.

In our example, the TEA POT Trust would receive all rights to the \$900,000 in IRA accounts, and the Equalization Trust would receive \$1,500,000 worth of other assets. This would leave \$1,500,000 worth of assets that would be divided into three under the surviving parent's revocable trust shortly after such parent's death, so that the trust for each separate child would receive \$500,000 in assets. Over the course of the approximately 10-year Allocation Period following the surviving parent's death (but no later than the expiration of the Allocation Period), each child's trust will receive the child's one-third share of the total \$2,400,000, which can equate to at least \$800,000 plus growth (net of taxes).

A competent CPA who understands income taxes for individuals and trusts can be retained by the trustee of the TEA POT Trust, and can advise each year on whether to take a distribution, and how to distribute the distribution to most effectively reduce income tax and enhance the inheritance of all beneficiaries.

The TEA POT Trust and the Equalization Trust can be managed by all of the children, along with a professional or corporate trustee, if desired, and someone from outside of the family, like a long-term lawyer, CPA, or other advisor or close friend can serve to act as the "tie-breaker" in order to help determine how the Equalization Trust is distributed. Alternatively, a CPA firm could be named and given the task to determine what the after-tax impact of the TEA POT Trust has been, and to calculate how much of the Equalization Trust should be distributed to the trusts for the separate children in order to facilitate after-tax sharing in the most equitable manner.

Most tax and estate planners are well aware that a separately taxed "complex trust" measures its taxable income in a manner very similar to what applies to individuals, but that distributions made during a tax year, as well as distributions made within 65 days of the end of the tax year that the trustee elects to have considered as having been distributed in the previous year.

As discussed in the authors' LISI Employee Benefits and Retirement Planning Newsletter #715 (January 6, 2020), there is a question of whether the IRS will consider the TEA POT Trust and the Equalization Trust to be considered as one trust for federal income tax purposes.

Because of this, it will be safest to not make distributions from the Equalization Trust in the same calendar year that distributions are made from the TEA POT Trust, so that the IRS does not treat the income as coming pro rata from each trust to the recipient beneficiaries. Some families will distribute from the TEA POT only for the first ten years, and then from the Equalization Trust, while others may alternate years – year 1 from the TEA POT Trust, year 2 from the Equalization Trust, etc.

With reference to if and when two or more trusts will be considered to be a single trust, under IRC Section 643(f) and Treasury Regulation Section 1.643(f), two or more trusts will be treated as one trust if they have all three of the following:

- (1) substantially the same grantor, with married couples being considered as one grantor, even if they each separately establish a separate trust;
- (2) substantially the same primary beneficiaries, and

- (3) a principal purpose of such trust is the avoidance of income tax.

Under the prior law, “shadow trusts” have been commonly used for the purpose of being the beneficiary of IRAs/Plans after the death of the Plan Participant, so that the rules and limitations required to qualify the trust as a “See Through Trust”, are complied with. This may provide sufficient justification to establish a multiple trust arrangement for reasons other than to avoid income tax. Further, it may be sufficient if each trust has different provisions regarding the distribution of income or principal, and one trust provides for the possibility of distributions being made to beneficiaries who are not beneficiaries of the other trust. For example, the Equalization Trust could permit the trustee thereof to make distributions of non-IRA Plan assets to charitable organizations.

A separate TEA CUP Trust could be established from the IRA accounts otherwise intended for the TEA POT Trust if there is a chronically ill or disabled beneficiary who is intended to receive IRA/Plan assets. The TEA CUP Trust can be structured as an Accumulation Trust for the benefit of such chronically ill or disabled beneficiary, and the TEA CUP Trust should be entitled to Stretch IRA treatment with respect to required minimum distributions payable over the lifetime of the chronically ill or disabled beneficiary. This is because a chronically ill or disabled beneficiary is an eligible designated beneficiary to which the Stretch IRA treatment applies, and a special exception unique to chronically ill or disabled beneficiaries allows for Stretch IRA treatment to apply even if the IRA/Plan is made payable to an Accumulation Trust for the benefit of the chronically ill or disabled beneficiary and such separate Accumulation Trust is divided from a larger trust after the death of the Plan Participant.

It is noteworthy that an Accumulation Trust established for a minor must be directly funded to qualify for the use of the minor’s life expectancy through the age of majority, so it does not appear that a TEA POT Trust can share its assets to fund a TEA CUP Trust under the new law.

In addition, the family may have charitable intentions, and the TEA POT Trust can allow the trustee to make distributions from the IRAs/Plans accounts directly to charity provided that no such distributions may be made to any charity or other non-individual after September 30 of the of the calendar year following the year of the death of the Plan Participant. The September 30 deadline serves to help assure that the Trust will qualify as an Accumulation Trust, as only individuals can be beneficiaries of an Accumulation Trust after such September 30. This means that the family may huddle shortly after the Plan Participant’s death to determine how much or what to give to charity, and which beneficiaries will have their inheritance trusts reduced to take this into consideration.

While we recommend that neither of the TEA POT Trusts have any disposition to charity after the September 30 of the year following death date, it seems that the tax law will permit the Equalization Trust to invest its assets in an entity taxed as a partnership, and to receive ownership in the partnership in exchange for such investment. The partnership can make charitable contributions, and can receive an income tax charitable deduction that is passed through to its partners (including the Equalization Trust) on Forms K-1. It might be possible for the TEA POT Trust to be a partner in the partnership as well, but the IRS may argue that the charitable recipients of the partnership’s charitable contributions are considered to be beneficiaries of the Trust, which would cause detrimental effects to the TEA POT Trust’s ability to qualify as an Accumulation Trust.

The TEA POT Trust has other advantages besides tax savings and flexibility, namely:

1. The TEA POT Trust will relieve the children and their respective trustees from having to work with smaller (\$300,000 each in our example) IRA stretch trusts that will need to be separate and apart from their other lifetime benefit trusts in order to have the 10-Year distribution deferral period apply, and to avoid the expenses and possible mistakes associated with the administration and maintenance thereof.
2. The TEA POT Trust keeps the children together with respect to the management and distribution thereof, as opposed to each child going their own separate way from an investment decision-making, management and interpersonal standpoint. Further, the Trust can require that each child attend an annual meeting, and that competent advisors be hired and used.

The most adept and conscientious child or children will hopefully set a good example and “rub off” on the less adept and less attentive child or children, which may influence everyone to do a better job in being a trustee or co-trustee for their own trusts. Additionally, an advantage to not having separate trusts is that one child may have little or no appreciation for the need of staying in touch and requesting assistance from competent tax and legal advisors.

3. As stated above, the TEA POT Trust can provide the creditor protection and asset preservation benefits afforded by a spendthrift trust that does not require compulsory distributions therefrom. This is perhaps the most significant advantage of the TEA POT Trust relative to the IRA/Plan being left directly to a child or to a Conduit Trust for the child.
4. Having the children receive additional distributions after the Allocation Period can help assure that the trusts for the children and subsequent generations are not inadvertently exhausted.
5. The TEA POT Trust will be more flexible, if there are law changes in the future, because of the special language that can be provided in the trust agreement to facilitate this.

CONCLUSION

Try a Little TEA POT, short and stout,

To pay less tax from distributions, so that the beneficiaries don’t pout.

Explain that it is a tax savings vehicle of choice.

And that interaction with tax advisors

To give tax advisors and good management a solid voice.

Let us know whether you agree

That for many clients this will be the right cup of tea.

The Twin TEA POT Trust SystemSM will be discussed in greater detail on the authors' upcoming LISI Webinar on Thursday, January 9, 2020, entitled "Practical Estate and Trust Planning After the Secure Act- Including Sample Provisions, Checklists and Client Explanation Letters."

"But what happens when you come to the beginning again?" Alice ventured to ask.

"Suppose we change the subject", the March Hare interrupted, yawning.

WHY INHERITED IRAS ARE NOW PROTECTED IN FLORIDA.

Despite the apparent intent of the legislature, court decisions issued in 2001 and 2010 came to the conclusion that IRAs that were inherited by beneficiaries were not protected from their creditors under Florida Statutes Section 222.21.⁵⁵⁵ However, as mentioned in the Introduction, the statute was amended in 2011 to clarify that inherited IRAs are protected. The following language became effective on May 31, 2011 and applies retroactively to all inherited individual retirement accounts:

Any money or other assets or any interest in any fund or account that is exempt from claims of creditors of the owner, beneficiary, or participant under paragraph (a) does not cease to be exempt after the owner's death by reason of a direct transfer or eligible rollover that is excluded from gross income under the Internal Revenue Code of 1986, including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in s. 408(d)(3) of the Internal Revenue Code of 1986, as amended. This paragraph is intended to clarify existing law, is remedial in nature, and shall have retroactive application to all inherited individual retirement accounts without regard to the date an account was created.

While it is commonly believed that IRAs that are rolled over and thus delayed as to distributions for a surviving spouse will yield substantially more for the family than IRAs that must immediately begin making payments over the life expectancy of a trust beneficiary, the numbers do not all bear this out.

WILL MONEY OR ASSETS DISTRIBUTED FROM IRAS OR PROTECTED QUALIFIED RETIREMENT PLANS BE EXEMPT? HOPEFULLY SO.

⁵⁵⁵ In *Robertson v. Deeb*, 16 So.3d 936, 939 (Fla. 2d DCA 2001), Florida's Second District Court of Appeals found that an inherited IRA was not exempt under Section 222.21. In this case, Mr. Robertson was named as the beneficiary of his father's IRA, and upon his father's death, he chose to transfer the IRA into another IRA. The court denied the exemption, noting that the "fund or account" language in Section 222.21 does not apply when the original fund or account passes to a beneficiary upon the death of the participant. The Middle District of Florida reached a similar conclusion in the 2010 case of *In re Ard*, 435 B.R. 719, 722 (Bankr. M.D. Fla. 2010).

The 2001 Florida Northern District Bankruptcy Court decision in *In re Ladd* held that distributions from a 401(k) plan were exempt even after being placed into a checking account because the funds were traceable to the distribution.⁵⁵⁶ In *Ladd*, the debtor was terminated from his place of employment and his qualified 401(k) plan required that his account be distributed within 60 days after his employment ended.⁵⁵⁷ The court in *Ladd* stated that:

While prematurely distributed benefits that do not roll over into another qualified plan may be subject to income taxes, there is no provision in the IRS Code, the Bankruptcy Code, or Florida Statute that strips the exempt status of the plan proceeds with regard to creditors other than the IRS and other exception creditors.

If the Debtor's plan was qualified, the proceeds were received by the Debtor as a mandatory distribution. Regardless of the tax status of those proceeds, they would be exempt from creditors under F.S. § 222.21(2)(a), and would be exempt from the bankruptcy estate under 11 U.S.C. § 522(d)(10)(E). The Trustee did not attack the qualification status of the 401(k) plan. Instead, she offered the legal argument that the plans proceeds lost their exempt status when they left the confines of the 401(k) plan, and were deposited into a checking account.

If the retirement plan bearing the distribution was qualified under the IRS Code, then the monies paid from the plan are exempt, despite their deposit into a checking account.⁵⁵⁸

Two 2016 Middle District Bankruptcy Court decisions have distinguished *In re Ladd*, by ruling that exempt status is removed if the retirement benefit is voluntarily withdrawn. In *In re Ladd*, the withdrawal was involuntary because the debtor was terminated from employment, and had no choice but to make the withdrawal.

On the other hand, in *In re Jones*, the debtor withdrew all of the funds from his pension account and deposited the proceeds into his personal checking account.⁵⁵⁹ Within two months after the liquidation of the pension account, Mr. Jones filed bankruptcy. The court held that:

The transferred property originated with Mr. Jones' pension fund, and may have been entitled to an exemption from the claims of Mr. Jones' creditors if it had remained in the account at Fidelity Investments.

Under the circumstances of this case, however, the Court finds that the property transferred by Mr. Jones was not an asset that was exempt from the claims of his creditors.

⁵⁵⁶ 258 B.R. 824 (N.D. Fla. 2001); West's Bankr. Newsl. 9 (Mar. 28, 2001) (West's Bankruptcy Newsletter describes *In re Ladd* and states, "Funds distributed from a Chapter 7 debtor's 401(k) plan were exempt under Florida law, even though the proceeds had been placed into the debtor's checking account)."

⁵⁵⁷ *Id.* at 824.

⁵⁵⁸ *Id.* at 827, Brown, Ahearn & McLean, *Bankruptcy Exemption Manual*, § 5.11 at 11 (2011 ed.) (The 2011 Bankruptcy Exemption Manual states that *In re Ladd* "concluded that funds from an otherwise exempt 401(k) plan did not lose their exempt status when they were placed into a segregated checking account.")

⁵⁵⁹ *In re Jones*, 2016 WL 492439 (Bankr. M.D. Fla. 2016).

Specifically, the funds that originated from the pension account did not retain their exempt status for a number of reasons . . .⁵⁶⁰

The *Ladd* court provided four reasons as to why it concluded that the funds did not retain creditor exempt status:

- A. The withdrawals were voluntary;⁵⁶¹
- B. The funds were not rolled over into another investment vehicle;⁵⁶²
- C. The funds were not exempt under Florida Statutes Section 222.21;⁵⁶³ and
- D. The withdrawn funds were not claimed as an exemption on bankruptcy schedules.⁵⁶⁴

As a result, the court found that Mr. Jones was not eligible for the exemptions under the Florida Statutes because his voluntary liquidation of the account was actually different from the situation in *Ladd*; therefore, his pension proceeds were subject to creditors.⁵⁶⁵

Presumably, the *Ladd* decision will apply, even if the *Jones* decision is accurate, where individuals who have reached age 70 ½ are required to make minimum distributions to avoid the 50% federal excise tax

⁵⁶⁰ *Id.* at *3-4.

⁵⁶¹ “The “cash out” of the account was a voluntary withdrawal by Mr. Jones of the entire amount of the fund. His voluntary liquidation of the account, therefore, is unlike the situation in *In re Ladd*, 258 B.R. 824 (Bankr. M.D. Fla. 2001) and *In re Hickox*, 215 B.R. 257 (Bankr. M.D. Fla. 1997). In each of those cases, the debtor’s employment was terminated, and the debtors received the proceeds of their pension accounts as mandatory distributions under the terms of the accounts as a result of such termination.” *Id.* at *4.

⁵⁶² “Mr. Jones deposited the proceeds of the fund into his general checking account. The checking account was not opened or specially designated to receive the proceeds of the pension fund. Instead, the checking account was an existing bank account that was overdrawn at the time that Mr. Jones deposited the pension proceeds. After the deposit, Mr. Jones continuously drew down and replenished the account to accommodate his transfers, and the pension funds were never placed in any other investment vehicle.” *Id.* at *4.

⁵⁶³ “Section 222.21(2) provides an exemption for ‘money or other assets payable to an owner, a participant, or a beneficiary’ from an account that is maintained in accordance with certain requirements of the Internal Revenue Code Fla. Stat. § 222.21(2) . . . therefore, it appears that the exemption under § 222.21(2) is provided only to those funds that are payable or owing to the beneficiary of such a plan, but not to funds that have already been distributed to or received by the beneficiary.” *Id.* at *5.

⁵⁶⁴ “On their bankruptcy schedules. The Debtors claimed the petition-date balance in Mr. Jones’ checking account as exempt only pursuant to the *personal property* exemptions provided by Fla. Stat. § 222.25(4) and the Florida constitution...Despite filing an amended SOFA, however, the Debtors never claimed an exemption for any of Mr. Jones’ pension funds pursuant to § 222.21(2) of the Florida Statutes.” *Id.* at *5. Note that in *In re Jorge Rivera-Cintrón* mentioned below, the debtor did not list the IRA account on the exemption schedules, but notified the Trustee in the first hearing and was permitted to have them exempted.

⁵⁶⁵ Prior to the decisions in *Jones* and *McMillan*, a District of Columbia Bankruptcy case, *In re Kemp*, was illustrative. *In re Kemp*, 2011 WL 4434996 (Bankr. D.C. Sept. 22, 2011). In *Kemp*, the debtor sought to exempt funds held in a checking account because the funds were proceeds of a pension. The court rejected this argument and noted that *In re Ladd* interpreted a Florida Statute differing from the relevant District of Columbia statute, which only provides for “a right to receive” such benefits, where Florida’s statute specifically protects payments.

that would otherwise apply. Such minimum distributions should be creditor exempt, along with anything that they are used to purchase.

The 2015 Middle District Bankruptcy Court case of *In re McMillan*⁵⁶⁶ addressed this issue. Mr. McMillan used withdrawals from his IRA to purchase an auto repair shop and claimed that the auto repair shop was an exempt asset under Florida Statutes Section 222.21. Mr. McMillan, however, failed to disclose his interest in the auto repair shop on his bankruptcy schedules, so the Court found that the shop would not be an exempt asset, regardless of whether it would have otherwise been exempt. The decision includes the following observation:

The instant case is clearly distinguishable from *Ladd* for the obvious reason that while Mr. McMillan used funds from his exempt IRA to invest in the LLC, Mr. McMillan, unlike the debtor in *Ladd*, did not claim his interest in the business as exempt on his bankruptcy schedules. The proceeds from the sale of Mr. McMillan's interest in the LLC are not exempt.⁵⁶⁷

MONIES RECEIVED FROM PENSION AND IRA ACCOUNTS AND PLACED INTO PERSONAL ACCOUNTS FOR 60 DAYS BEFORE A SUBSEQUENT ROLLOVER TO AN IRA WILL BE PROTECTED.

Another related question is whether monies withdrawn from an IRA or qualified plan will remain protected if they are reinvested in a rollover IRA within the time parameters permitted under the income tax rules.

In two Florida decisions, debtors received monies from protected retirement accounts and placed these into individual non-IRA accounts for a period of time before eventually transferring the funds to IRAs within sixty days of initial receipt.

In the 1997 case of *In re Hickox*,⁵⁶⁸ the debtor received a 401(k) distribution that was deposited into her checking account and transferred the funds to her mother, who then gave some of the money back to Ms. Hickox, who used it to fund an IRA within the time limits provided under the Internal Revenue Code. The Court found that the IRA was protected, even though the bankruptcy was filed shortly thereafter.

The same result occurred in the 2016 Middle District Bankruptcy Court Case of *In re Jorge Rivera-Cintron*.⁵⁶⁹ The debtor did not list the IRA account on the exemption schedules, the Court noted that failure

⁵⁶⁶ 3:11-BK-5348-JAF, 2015 WL 2147044 (Bankr. M.D. Fla. May 4, 2015).

⁵⁶⁷ *Id.* at *2; Further, although Florida Statute 222.21 provides that that “any money or other assets payable to an owner . . . in a fund or account is exempt from all claims of creditors,” this language does not explicitly state that distributions will remain exempt. In a 2005 Florida State University Business Review Article, attorneys Richard Jacobs and Tye Klooster concluded “that distributions from retirement vehicles enumerated in [Florida Statute] Section 222.21 are also provided creditor protection by the statute.” See Richard O. Jacobs & Tye J. Klooster, *Asset Protection Tools for Florida Business Professionals: Strategies to Pursue and Strategies to Avoid*, 4 Fla. St. U. Bus. Rev. 1, 67 (2005).

⁵⁶⁸ 215 B.R. 257 (Bankr. M.D. Fla. 1997).

⁵⁶⁹ *In re Jorge Rivera-Cintron*, 2015 WL 4749217, at *1 (Bankr. M.D. Fla. Aug. 12, 2015).

to disclose assets on schedules does not cause loss of exemption where the debtor made the Trustee in bankruptcy aware of the IRA at the first hearing with respect to the bankruptcy.

The Court noted that the 2014 U.S. Supreme Court decision of *Law v. Siegel* “struck down any notion of a Bankruptcy Court’s ‘general equitable power . . . to deny exemptions based on a debtor’s bad faith conduct,’” and concluded that “federal law provides no authority for Bankruptcy Courts to deny an exemption on a ground not specified in the Code.”

DANGER LURKS FOR SELF-DIRECTED IRAS THAT ARE NOT HANDLED “EXACTLY RIGHT.”

As indicated in Section A of this Chapter, IRA mismanagement can result in loss of both the tax deferred status and creditor protection. A case on point is *Willis v. Menotte*, where the Eleventh Circuit Court of Appeals decided that the signing of an indemnity agreement with Merrill Lynch that exposed an IRA to creditors of the IRA owner almost caused the IRA to be accessible to creditors.⁵⁷⁰

The 2019 case of *In re Yerian* is discussed in depth below.

Also, the Fourth Circuit Court of Appeals 2013 opinion in *Daley v. Mostoller* determined that an agreement that would have allowed Merrill Lynch to seize IRA assets if there was a loan to the IRA owner in default did not disqualify the IRA when there was no loan taken.

The court described the law in this area as follows:

Willis v. Menotte does not help the trustee either.⁵⁷¹ Willis did much more than sign a lien provision; he “transferred \$700,000.00 from his Merrill Lynch account to a non-IRA account held with his wife, and then transferred the money to a third party in order to fund a real property mortgage.”⁵⁷² Even though Willis had a favorable-determination letter from the IRS, the court said, Willis’s transfer of funds from his IRA went beyond the approved form of the account.⁵⁷³ In marked contrast, other than signing the papers to open the retirement account, Daley authorized no remotely comparable transactions. The Bankruptcy Code explains how to treat a Chapter 7 debtor’s assets-what goes to creditors and what remains exempt. The bankruptcy trustee obtains control of the debtor’s non-exempt property and distributes it to creditors.⁵⁷⁴ A debtor may exempt “retirement funds” if they are in an “account that is exempt from taxation under section” 408 of the tax code.⁵⁷⁵ Section 408 designates certain trusts as “individual retirement

⁵⁷⁰ *Willis v. Menotte*, 06 Apr 2010 United States District Court, S.D. Florida, Miami Division. *Willis v. Menotte*, docket no. 09-82303-CIV (S.D. Fla., aff’d, 11th Cir. (4/21/2011)).

⁵⁷¹ No. 09-82303, 2010 WL 1408343 (S.D. Fla. April 6, 2010).

⁵⁷² *Id.* at *1.

⁵⁷³ *Id.* at *5.

⁵⁷⁴ 11 U.S.C. § 541(a) (2017).

⁵⁷⁵ *Id.* § 522(b)(3)(C) (2017).

account[s],”⁵⁷⁶ and says that “[a]ny individual retirement account is exempt from taxation.”⁵⁷⁷ An IRA loses its tax-exempt status if the owner “engages in any transaction prohibited by section 4975” of the Tax Code.⁵⁷⁸ There are six such transactions, including the one bedeviling Daley: “any direct or indirect” “lending of money or other extension of credit” between the IRA and its owner.⁵⁷⁹ The question is whether Daley used his IRA to obtain credit from Merrill Lynch, resulting in an indirect extension of credit between Daley and the IRA. We think not for several reasons.

To start, there is a statutory presumption that his account is exempt. If a retirement fund “has received a favorable determination” from the IRS, “those funds shall be presumed to be exempt from the estate.”⁵⁸⁰

In the second place, the exemption does not apply in this setting. Yes, the phrase “any direct or indirect . . . lending of money or other extension of credit” is broad.⁵⁸¹ “Any” and “direct or indirect” are roomy terms; so too are “extension[s]” of “credit,” as other provisions in the United States Code confirm.⁵⁸² (“The term ‘credit’ means the right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment.”)⁵⁸³; (“[T]he term ‘loans and extensions of credit’ shall include . . . all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person . . .”).⁵⁸⁴ But this breadth of phrasing still demands the “lending of money or other extension of credit between a plan [the IRA] and a disqualified person [Daley],”⁵⁸⁵ and nothing of the sort happened here.

On June 26, 2019, the case *In re Yerian* was decided by the U.S. Court of Appeals, Eleventh Circuit, and provides an excellent explanation and interpretation of Florida Statute § 222.21 (2), which reads as follows:

§ 222.21 (2)

(a) Except as provided in paragraph (d), any money or other assets payable to an owner, a participant, or a beneficiary from, or any interest of any owner, participant, or beneficiary in, a fund or account is exempt from all claims of creditors of the owner, beneficiary, or participant if the fund or account is:

⁵⁷⁶ 26 U.S.C. § 408(a) (2017).

⁵⁷⁷ Id. § 408(e) (2017).

⁵⁷⁸ Id. § 408(e)(2)(A).

⁵⁷⁹ Id. § 4975(c)(1)(B).

⁵⁸⁰ 11 U.S.C. § 522(b)(4)(A).

⁵⁸¹ 26 U.S.C. § 4975(c).

⁵⁸² See 18 U.S.C. § 891(1) (“To extend credit means to make or renew any loan, or to enter into any agreement . . . whereby the repayment or satisfaction of any debt or claim . . . may or will be deferred.”)

⁵⁸³ 15 U.S.C. § 1602(f).

⁵⁸⁴ 12 U.S.C. § 84(b)(1).

⁵⁸⁵ 26 U.S.C. § 4975(c)(1)(B).

[...]

(2). Maintained in accordance with a plan or governing instrument that has been determined by the Internal Revenue Service to be exempt from taxation under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended, unless it has been subsequently determined that the plan or governing instrument is not exempt from taxation in a proceeding that has become final and nonappealable⁶

The court found that the debtor “forfeited his exemption when he engaged in self-dealing transactions prohibited by the IRA’s governing instruments.”¹

In the beginning of his opinion, Judge Grant put it mildly by stating that Mr. Yerian “made some interesting choices with respect to the management of his individual retirement account.”² These choices, the court noted, included “titling IRA-owned cars in his own name and his wife’s name, as well as purchasing a condo in Puerto Rico with IRA funds and then using the condo for his personal travel needs.”³

Yerian did not dispute that these were prohibited transactions and conceded that his IRA had lost its tax exempt status. However, Yerian maintained that “his IRA [was] still creditor exempt under Section 222.21(2)(a)(2). In his view, the Florida exemption statute shields even an IRA operated in violation of the federal tax code, so long as the form of the IRA’s governing instrument satisfies the requirements of Section 408(a) on paper.”⁴

Mr. Yerian attempted to evoke the statutory exemption set forth in Florida Statutes Section 222.21(2)(a)(2). There are three prongs to protection of an IRA under this section of the statute.

The first prong is that the IRA’s plan or governing instrument was initially determined by the IRS to be exempt from tax. Even though that may not have happened in this case, the creditor did not challenge whether that happened, so this was not fully addressed by the court in its decision.

The second prong is what the court found Mr. Yerian failed: whether the IRA had been maintained in accordance with the plan or governing instrument. There is no mention in this prong that there has to be compliance with tax law, only with the plan or governing instrument. However, the plan or governing instrument will have to be compliant with tax law in order for the IRA to be compliant.

The judge noted that when this man “titled an IRA-owned car into his own name and his wife’s name and bought a condo in Puerto Rico with IRA funds and used the condo for personal travel needs,”⁵ he did not follow the governing instrument and did not satisfy the second prong.

⁶ Fla. Stat. Ann. § 222.21(2)(a)(2).

¹ *Yerian v. Webber (In re Yerian)*, 27 Fla. L. Weekly Fed. C 2093 (U.S. 11th Cir. 2019).

² *Id.* at 1.

³ *Id.*

⁴ *Id.* at 9.

⁵ *Id.* at 1.

The judge noted that given the statutory language of Florida Statute Section 222.21(2)(a)(2) whereby conformance to the IRA's governing instruments is necessary to satisfy prong number two, there are two important things to consider:

1 An IRA that conforms to its governing instruments, but not necessarily to a shift in the tax code, may experience somewhat of a safe harbor in Florida in terms of creditor protection because the statute emphasizes conformity to the governing instrument directly.

2 An IRA's governing instrument may have requirements that go *beyond* the tax law. In this way, an IRA could theoretically satisfy the tax law, but not live up to the restrictions set forth in the governing instrument. Thus, an IRA could lose creditor protection in Florida by virtue of violating the governing instrument, even in the absence of a tax code violation.

The third prong was that no final and non-appealable proceeding has been subsequently determined that the plan or governing instrument is no longer exempt. It did not matter that this prong was not satisfied because the second prong was not satisfied.

It therefore appears that Floridians who choose to have self-directed IRA accounts are putting themselves at risk for the loss of both tax advantages and of creditor protection if they do not follow the governing instrument of the IRA. As highlighted in this case, examples of self-dealing and prohibited transactions are scrutinized if they do not conform to the governing instrument (which they likely will not). At the very least, it is likely that titling cars in your own name, if you are deemed a "disqualified person" by the governing instrument of the IRA, will trigger the loss of exemption status for your IRA in bankruptcy.

Below is an excerpt of Florida Statutes Section 222.21 containing the provisions relevant to the opinion summarized by the court in *In re Yerian*.

The above statutory language and the judicial interpretation of the three prong test outlined in *In re Yerian* is summarized in the chart below:

Summary of the Statutory Prongs and the Judicial Analysis of Each in <i>In re Yerian</i>	
Fla. Stat. Ann. § 222.21(2)(a)(2)	Judicial Interpretation in <i>In re Yerian</i>
(1) The IRA's plan or governing instrument was initially "determined by the [IRS] to be exempt from taxation" under § 408.	"It is the Trustee who must demonstrate that an exemption is inapplicable, and the Trustee has not challenged the exemption on that ground." "Because the parties here agree that Yerian properly invoked section 222.21(2)(a)(2), we examine the matter no further."
(2) Over time, the IRA has been "maintained in accordance with" that plan or governing instrument.	"Florida statute says that to be exempt, an IRA must be "maintained in accordance with a plan or governing instrument that has been determined by the [IRS] to be exempt from taxation under . . . s. 408." Fla. Stat. § 222.21(2)(a)(2) (emphasis added)." "The Florida exemption thus turns on whether the IRA has been maintained in accordance with its own governing instrument, not on whether the IRA has been maintained in compliance with § 408 in the first instance." "This will often be a distinction without a difference where (as we will see is the case here) the IRA owner engages in behavior that turns out to be prohibited by both the governing instrument and the tax code." <u>However, this could theoretically have two important impacts:</u> 1. If/when federal laws governing retirement accounts change, the tax code may require changes to IRAs for them to conform to the tax code. If that doesn't occur, the fund may not comply with the tax code, but may still allow the pensioner to have his IRA protected from creditors through the Florida exemption statute as long as the IRA complies with its governing instrument. The court noted that "The Florida exemption thus contains somewhat of a safe harbor, allowing IRAs to maintain creditor-exempt status for a period of time after the law changes." 2. "Conversely, because an IRA's plan or governing instrument may contain requirements that go beyond the law, an IRA could be operated in a way that satisfies the tax code, yet violates additional restrictions set out in its own governing instruments." So an IRA could impose requirements that go beyond the tax code, and those requirements would have to be satisfied to maintain the exemption.
(3) No final and nonappealable proceeding has "subsequently determined" that the plan or governing instrument is no longer exempt from taxation under § 408.	"The third requirement—that no final and nonappealable proceeding has declared that Yerian's IRA is no longer tax-exempt—is satisfied as well. It is settled law that a "claim of exemption is to be determined as of the petition date." <i>In re Fodor</i>, 339 B.R. 519, 521 (Bankr. M.D. Fla. 2006). And it is clear from the record before us that, prior to Yerian's bankruptcy petition date, no final and nonappealable proceeding—before the IRS or any court—had determined that his IRA's governing instrument was no longer exempt under the tax code."

The following article discusses the “Rollover as Business Start Up Plan” (“ROBS”) arrangements whereby taxpayers may be able to use their IRAs to own business companies and other investments. These arrangements should be approached very carefully if the IRA participant will be working in the business, because of the need to be paid no more or no less than the fair market value for services actually rendered.

CAN I USE MY IRA TO START A BUSINESS? MAYBE, BUT WITH GREAT POWER, COMES GREAT RESPONSIBILITY

By: Brandon Ketron & Alan Gassman, Reprinted with permission from Leimberg Information Services 07-Feb-17 Steve Leimberg’s Asset Protection Planning Email Newsletter – Archive Message #668

EXECUTIVE SUMMARY:

One potential way for an entrepreneur to fund a new business is with his or her retirement plan assets. This is known as a Rollover as Business Start Up Plan (ROBS).

A typical ROBS plan involves forming a new C corporation and adopting a simple 401(k) plan. The entrepreneur can then roll over his or her IRA account into the new 401(k) plan. The 401(k) plan then purchases stock in the new corporation. This results in the funding of a new corporation with the entrepreneur’s former IRA account. [i] While ROBS Plans do not violate the prohibited transaction rules per se, the IRS heavily scrutinizes these plans to ensure their compliance with these complex rules. If a Plan Participant engages in a prohibited transaction, the plan will be disqualified and result in a deemed taxable distribution of the entire account balance, which will also be subject to the 10% excise tax if the Plan Participant is under the age of 59 ½.

It is important to note that while a ROBS plan may satisfy the retirement plan rules initially, any failure to comply with the rules during the life of the plan will also result in a deemed distribution of the entire retirement plan.

COMMENT:

The authors do not advocate or recommend that clients use their retirement plan or IRA assets to establish a ROBS, but it should be known that this is a possible way for entrepreneur clients to find capital to start a business. No-one should even think about starting a ROBS without specific written guidance from a qualified tax and ERISA lawyer. The C corporation owned by the 401(k) plan will be taxed as a corporation and will be burdened by the compliance described herein, and possible future restrictive legislation.

The following are some potential traps for the unwary involved with establishment and maintenance of a ROBS Plan.

1. Personal Guarantees of Corporate Loans

In *James E. Theissen et ux. v. Comm’r* and *Peek v. Comm’r*, the Tax Court held that a personal guarantee of a corporate loan when the Plan Owner’s IRA owned stock in the corporation was a prohibited transaction.[i] As a result, the taxpayers’ IRAs ceased to be IRAs as of the first day of

the taxable year in which the guarantee occurred, and were deemed to have received distributions on that first day of the entire fair market value of their IRA assets.[ii]

These cases involved IRAs and not 401(k)s or ESOPs. It is unclear whether the same reasoning would apply to a ROBS Plan, but account owners and parties related thereto should strictly avoid personal guarantees of loans to be safe. Unrelated parties may be paid reasonable guarantee fees, but only from the business entity. Traditional lenders will be reluctant to lend to ROBS for concern of the tax impact of disqualification.

2. Payment of reasonable compensation to Entrepreneur

Unlike a self-directed IRA, a 401(k) or ESOP may pay compensation to the owner of the Plan and related parties, provided that the compensation is reasonable.

In *Ellis, et ux. v. Comm'r*, the IRA owner purchased a used-car dealership inside of his IRA, and ran the day-to-day operations of the business. The dealership paid the IRA owner reasonable compensation for his role as the manager of the business. The Tax Court held that the payment of compensation to the IRA owner was a prohibited transaction and resulted in the indirect use of plan assets for the benefit of the individual. Accordingly, the IRA was deemed distributed to the owner and the owner was immediately liable for taxes on the entire value plus the 10% excise tax and other applicable penalties and interest. [iii]

Natalie Choate points out that this is particularly problematic for IRA-owned businesses. She states that “if your IRA-owned business cannot pay you compensation, you really cannot run a small business inside your IRA”. If you work with no compensation, there is a risk of an “assignment of income problem.”[iv]

Had Mr. Ellis rolled over his IRA into a 401(k) using a ROBS Plan, Mr. Ellis may have been able to avoid the prohibited transaction rules. The ERISA rules do not prevent an employee from taking a reasonable salary from a 401(k) owned business; however, the IRS may argue that the immediate payment of compensation to the Entrepreneur results in the indirect use of plan assets for the benefit of the individual. Entrepreneurs may consider only taking a salary from the profits of the company in order to avoid this characterization.

Additionally, any compensation paid to the Entrepreneur should be W-2 compensation, and not classified as 1099 independent contractor compensation. [v] In order for the Entrepreneur to participate in the 401(k) plan, he or she must be a legitimate employee of the Corporation. If the Entrepreneur fails to qualify as a qualified employee the Plan may be disqualified.

3. Providing Direct or Indirect Services to an IRA

Leimberg and Jones caution that providing any kind of service to an IRA-owned business may constitute furnishing of services to the IRA by a disqualified person. [vi] This rule does not apply to a 401(k) or ESOP, and it is therefore vitally important to roll the funds over into an employer sponsored plan prior to providing any services to the company.

4. Lack of Notification of Plan Existence

If current or future employees are not notified of the existence of an ESOP or 401(k) plan, then it would cause a violation of the rule that a retirement plan must “be a definite, written program communicated to employees.”[vii]

If employees are not notified the Plan will be disqualified resulting in a taxable distribution of the entire Plan.

The IRS has cautioned against Entrepreneurs using independent contractors to avoid offering stock ownership to employees. [viii] If an independent contractor is reclassified as an employee this could disqualify the entire Plan in addition to the other problems caused by this reclassification.

5. Plan Assets Used for Personal Expenses

A plan was disqualified when a corporation bought an RV for the business owner using some of the money it received in exchange for the stock of the corporation in a ROBS plan. [ix] The use of corporate money or assets for personal expenses or purposes also presents other problems, so appropriate corporate formalities must be followed.

6. Stock Sale Must Be a Transaction for Adequate Consideration

ERISA exempts a plan’s acquisition of employer stock from the prohibited transaction rules only if the purchase was for adequate consideration. [x] Therefore, a valuation of the business may need to be completed to have proof that the stock sale as part of the ROBS plan was for adequate consideration. [xi]

7. Improper Use of Funds to Pay Promoter Fees

The IRS has stated that when a corporation uses part of the cash it raises from the stock sale to pay the fee of a promoter it may result in the indirect use of plan assets in a prohibited transaction. [xii]

8. Discrimination in Favor of Highly Compensated Employees

Natalie Choate states that this is the IRS’s best argument to disarm a ROBS, but that it is only useful against ROBS plans that have employees other than the plan owner and that do not in fact offer employer stock to rank and file employees. [xiii]

9. Failure to Issue a Form 1099-R when the Assets Are Rolled Over into the ROBS Plan.

A reputable CPA should be retained to assure that all proper tax returns and forms are filed, including the Form 1099-R.

10. Failure to file 5500’s

A reputable actuary or qualified pension plan lawyer should be retained to assure that appropriate plan rules and formalities are followed, including the filing of a timely and accurately prepared Form 5500.

CONCLUSION:

In conclusion, the IRS heavily scrutinizes these types of arrangements, and has issued literature as to the technical reasons why they might be seen as problematic. The IRS has not issued any specific adverse rulings related to ROBS plans, but will target ROBS plans for other violations of retirement account rules. Entrepreneurs should consult with the appropriate advisors in order to comply with the complex rules involved with a ROBS Plan. If a ROBS plan is undertaken it will be important to make sure that all your I's are dotted and your T's are crossed due to the fact that one mistake will result in a termination and taxable distribution of the entire retirement account.

CITATIONS:

- [i] *James E. Theissen et ux. v. Comm'r*, 146 T.C. 7 (2016); *Peek v. Comm'r*, 140 T.C. 216 (2013).
- [ii] For further discussion see Leimberg and Jones, Employee Benefits and Retirement Planning Newsletter #654, (April 4, 2016).
- [iii] *Id.*
- [iv] See Choate, *What Goes in Your IRA? None of Your Small Business!* (September 11, 2015).
- [v] Curry & Esposito, *You Invested 401(k) Money Into Your Company: Common Myths and Important Compliance Reminders* (Presented January 24th, 2017, a copy of the slides can be obtained by emailing Jewell.Esposito@jacksonlewis.com).
- [vi] Leimberg and Jones, Employee Benefits and Retirement Planning Newsletter #654, (April 4, 2016).
- [vii] See Choate, Employee Benefits and Retirement Planning Newsletter # 471.
- [viii] Michael D. Julianelle, *Guidelines Regarding Rollovers as Business Start-ups*.
- [ix] *Id.*
- [x] IRC § 4975(d)(13).
- [xi] Michael D. Julianelle, *Guidelines Regarding Rollovers as Business Start-ups*.
- [xii] *Id.*
- [xiii] *Id.*
- [xi] Michael D. Julianelle, *Guidelines Regarding Rollovers as Business Start-ups*, (October 1, 2008).
- [xii] *Id.*
- [xiii] *Id.*

MORE UNPLEASANT SURPRISES AND A RECENT EXAMPLE - A BLANKET UCC-1 FILING CAN OBLITERATE PROTECTION OF IRAS

Bankruptcy is a mode of litigation, and therefore somewhat unpredictable. Unpleasant surprises can certainly occur.

An example on point is the 2019 11th Circuit Case of *Kearney Construction Company, LLC, v.*

Travelers Casualty and Surety Company of America. Before filing bankruptcy, Mr. Kearney had executed one or more promissory notes and a security agreement to enable an LLC owned by his son to place a lien against all of his tangible and intangible assets that could be secured by the lien under Florida law. The court did not cite the fact that the LLC was owned by Mr. Kearney's son as determinative so its holding likely would have been the same if the lender were a completely unrelated third party.

The court found that this lien attached to Mr. Kearney's IRA accounts at the time that it was executed and that this constituted a Prohibited Transaction under Internal Revenue Code Sections 408 and 4975, which penalizes taxpayers who make personal use of their IRA accounts by pledging them as security for a personal loan. Florida Statute Section 222.21(2) generally requires that an IRA must be properly qualified under Code Section 408, to be exempt from creditors. Code Section 408 states that "[a]ny individual retirement account is exempt from taxation," but this status can be lost if the owner "engages in any transaction prohibited by section 4975."⁵⁸⁶

Mr. Kearney argued that there was no intent to pledge the IRAs as collateral, but the "boilerplate language" of the Security Agreement and the Form UCC-1 Financing Statement that was filed nevertheless attached, according to the Eleventh Circuit Court of Appeals, and this caused loss of the creditor-proof nature of the IRA, even though the creditor that had the lien did not attempt to garnish the IRA, and was apparently paid in full.

The court in *Kearney* held that the plain language of the UCC-1 agreement signed was sufficient to implement a lien on six of Mr. Kearney's accounts including his IRA. The plain language of the UCC-1 agreement was as follows:

Grant of Security Interest. As security for any and all Indebtedness (as defined below), the Pledgor hereby irrevocably and unconditionally grants a security interest in the collateral described in the following properties[:] all assets and rights of the Pledgor, wherever located, whether now owned or hereafter acquired or arising, and all proceeds and products thereof, all goods (including inventory, equipment and any accessories thereto), instruments (including promissory notes)[,] documents, accounts, chattel paper, deposit accounts, letters of credit, rights, securities and all other investment property, supporting obligation[s], any contract or contract rights or rights to the payment of money, insurance claims, and proceeds, and general intangibles (the "Collateral")

The court stated that "the above language constitutes an unambiguous pledge of 'all assets and rights of the Pledgor,' including his IRA Account."⁵⁸⁷

This case can be distinguished from the 2013 bankruptcy decision in *In re Daley*, where Mr. Daley executed loan documentation with Merrill Lynch that reported to place a lien upon all of his individual accounts, including one or more IRAs that he had with Merrill Lynch. Mr. Daley signed a "blanket" Client

⁵⁸⁶ 26 U.S.C. § 408(e)

⁵⁸⁷ *Kearney Construction Company v. Travelers Casualty and Surety Company of America*, 795 Fed.Appx. 671, 674 (2019)

Relationship Agreement (not a UCC-1) with Merrill Lynch was as follows:

All of your securities and other property in any account—margin or cash—in which you have an interest, or which at any time are in your possession or under your control, shall be subject to a lien for the discharge of any and all indebtedness or any other obligations you may have to Merrill Lynch.⁵⁸⁸

Fortunately for Mr. Daley, he never actually borrowed any money from Merrill Lynch, so the court in *Daly* concluded that there was never a Prohibited Transaction because he did not directly or indirectly borrow against the IRA.⁵⁸⁹

The court's opinion stated that "[t]he mere existence of a 'cross-collateralization agreement,' as the IRS calls it, does not by itself disqualify an IRA from exempt status."⁵⁹⁰ The appellant in *In re. Daley* did not engage in any disqualified transactions under section 4975 with his IRA account, and therefore the IRA was exempt from creditors because of Florida Statute 222.21. The "blanket" agreement was not enforceable.

The court also discussed that the IRS had issued IRS Announcement 2011-81 in 2011 which indicated that pledging an IRA as collateral under loan documents will not constitute a Prohibited Transaction unless or until a loan is actually taken.

This is an example of one of the many cases where new law gets made at the expense of a surprised and unfortunate debtor, along with the debtor's legal counsel.

Courts have traditionally liberally construed exemptions in favor of debtors. The Supreme Court of Florida noted in the 2007 case of *Chames v. DeMayo*, that a "blanket" statement is unenforceable unless the statement is "knowing, intelligent, and voluntary."⁵⁹¹

The Supreme Court of Florida compared the informality of these "blanket" statements to those that a client is required to sign from their attorney, in which they initial each paragraph to note their understanding of the agreement.

Nevertheless, the *Kearney* decision has caught many by surprise, as the prevailing thought is that the creditor protection afforded by Florida Statute Section 222.21 was not considered to be waived as a result of boilerplate language and a Pledge Agreement, which is often found in substantially all consumer loan and mortgage documents. The decision therefore has wide reaching effects in that it could cause many unsuspecting individuals to be considered to have received a deemed distribution of the assets in his or her pension plans, IRAs or qualified retirement plans, which could subject the individual to taxes, interest and penalties, and also could subject such assets to creditor claims of Florida residents.

As of publication of this Book, the Tax Section of the Florida Bar is proposing legislation to provide an exception which would not cause loss of creditor exemption provisions for pension plans, IRAs and other

⁵⁸⁸ *In re Daley*, 717 F.3d 506, 509 (6th Cir. 2013).

⁵⁸⁹ *In re Daley*, 717 F.3d 506, 509 (6th Cir. 2013).

⁵⁹⁰ *Id.*

⁵⁹¹ *Chames v. DeMayo*, 972 So.2d 850, 861 (Fla. 2007)

retirement plans, and surely this issue will be one to monitor.

I.

Example: Many financial planners evaluate the pros and cons of a non-deductible IRA and often advise clients that from a financial perspective. In some cases, it is not determined to be a worthwhile step. However, in many states a non-deductible IRA contribution can create an asset protected “pot” even if it is small. While small additions to IRAs will not safeguard significant wealth, they can constitute useful sources of creditor proof capital, and clients who have judgments against them, and protected IRAs may have a protected IRA start and own a business that the client can work in using the ROBS technique.⁵⁹²

ROBS stands for Roll Over Business Start Up, and refers to an arrangement whereby an IRA owner converts his or her IRA into a 401(k) plan, which can attach to and start a business that the IRA/401(k) owner can operate, but these are not without technical or practical challenges. In fact, the IRS website at: <https://www.irs.gov/retirement-plans/rollovers-as-business-start-ups-compliance-project> has the following discussion of ROBS, which is well written:

What is a ROBS? ROBS is an arrangement in which prospective business owners use their retirement funds to pay for new business start-up costs. ROBS plans, while not considered an abusive tax avoidance transaction, are questionable because they may solely benefit one individual – the individual who rolls over his or her existing retirement funds to the ROBS plan in a tax-free transaction. The ROBS plan then uses the rollover assets to purchase the stock of the new business.

Promoters aggressively market ROBS arrangements to prospective business owners. In many cases, the company will apply to IRS for a favorable determination letter (DL) as a way to assure their clients that IRS approves the ROBS arrangement. The IRS issues a DL based on the plan’s terms meeting Internal Revenue Code requirements. DLs do not give plan sponsors protection from incorrectly applying the plan’s terms or from

⁵⁹² Leimberg LISI Newsletter #668, 07-Feb-17

operating the plan in a discriminatory manner. When a plan sponsor administers a plan in a way that results in prohibited discrimination or engages in prohibited transactions, it can result in plan disqualification and adverse tax consequences to the plan's sponsor and its participants.

Employee Plans ROBS Project

EP initiated a ROBS project in 2009 to:

- Define traits of compliant versus noncompliant ROBS plans;
- Identify ROBS plans that are noncompliant and take action to correct them; and
- Use results to design compliance strategies focusing on identified issues and trends (for example, Employee Plans Compliance Resolution System, Fix-It Guides, Web-based information, newsletters, and speeches).

Using compliance checks, we initially focused on companies that sponsored a plan and received a DL but didn't file a Form 5500, Annual Return/Report of Employee Benefit Plan, or Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan (PDF), and/or Form 1120, U.S. Corporation Income Tax Return.

Our contact letter to plan sponsors asked questions about the ROBS plan's recordkeeping and information reporting requirements, including:

- the plan's current status
- plan contribution history
- information on the rollover or direct transfer of the assets into the ROBS plan
- participant information
- stock valuation and stock purchases
- general information about the business itself
- why no Form 5500 or 5500-EZ and/or Form 1120 were filed

We always invite a plan sponsor to furnish any other documents or materials that they believe will be helpful for us to review as part of the compliance check.

ROBS Project Findings

New Business Failures

Preliminary results from the ROBS Project indicate that, although there were a few success stories, most ROBS businesses either failed or were on the road to failure with high rates of bankruptcy (business and personal), liens (business and personal), and corporate dissolutions by individual Secretaries of State. Some of the individuals who started ROBS plans lost not only the retirement assets they accumulated over many years, but also their dream of owning a business. As a result, much of the retirement savings invested in their unsuccessful ROBS plan was depleted or 'lost,' in many cases even before they had begun to offer their product or service to the public.

Not Filing Form 5500 or Form 1120

Many ROBS sponsors did not understand that a qualified plan is a separate entity with its own set of requirements. Promoters incorrectly advised some sponsors they did not have an annual filing requirement because of a special exception in the Form 5500-EZ instructions. The exception applies when plan assets are less than a specified dollar amount and the plan covers only an individual, or an individual and his or her spouse, who wholly own a trade or business, whether incorporated or unincorporated. In a ROBS arrangement, however, the plan, through its company stock investments, rather than the individual, owns the trade or business. Therefore, this filing exception does not apply to a ROBS plan and the annual Form 5500 or 5500-EZ (5500-SF for filing electronically) is still required.

Specific Problems with ROBS

Some other areas the ROBS plan could run into trouble:

- After the ROBS plan sponsor purchases the new company's employer stock with the rollover funds, the sponsor amends the plan to prevent other participants from purchasing stock.
- If the sponsor amends the plan to prevent other employees from participating after the DL is issued, this may violate the Code qualification requirements. These types of amendments tend to result in problems with coverage, discrimination and potentially result in violations of benefits, rights and features requirements.
- Promoter fees
- Valuation of assets

- Failure to issue a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., when the assets are rolled over into the ROBS plan

Additional resources

- Guidelines regarding rollovers as business start-ups, Memorandum from Michael Julianelle, Director, Employee Plans Rulings & Agreements (October 1, 2008)

CHAPTER 9

MISCELLANEOUS FLORIDA EXEMPTIONS

ALIMONY.

The Fourth District Court of Appeals in *Waters v. Albanese*, held that garnishment of alimony payments would be contrary to public policy, but this decision did not discuss whether the alimony being received by the debtor was necessary for her support and maintenance.⁵⁹³ We discuss below that the Bankruptcy Code provision to protect alimony, support, or separate maintenance requires that it be “reasonably necessary for the support of the debtor and any dependent of the debtor.”

We have reproduced the entire (very short) Waters opinion:

STONE, Judge.

A former husband appeals from an order holding him in contempt for failure to pay alimony. The appellant defended on the theory that he was obligated to withhold the alimony payments pending the outcome of garnishment proceedings that had been instituted against him as a garnishee. The garnishment involved a judgment against both provides that a garnishee is liable to the creditor for all “debts” due to the debtor defendant. The appellant contends that alimony is a debt.

The trial court determined that the alimony obligation was not subject to garnishment because Section 222.11, Florida Statutes, exempts wages due for personal labor or services. The court also found alimony to be exempt from garnishment under the Federal Wage Garnishment Act, 15 U.S.C. Section 1673. That statute limits the percentage of wages subject to garnishment and gives priority to orders of support.

We note that the same public policy behind Section 222.11 and the Federal Act, which prevents the debtor, and his or her family, from being a charge on the public, applies equally to the debtor who is dependent, in whole or in part, on alimony for support.

Cf. *Killian v. Lawson*, 387 So.2d 960 (Fla. 1980); *Holmes v. Blazer Financial Services, Inc.*, 369 So.2d 987 (Fla. 4th DCA 1979). The policy considerations favoring the protection of support and alimony payments from the garnishment of creditors are readily apparent. See *198 *Joel Bailey Davis Inc. v. Poole*, 194 Ga. 824, 22 S.E.2d 795 (1942); *Columbus Personnel Service v. Gachette*, 158 Ga.App. 298, 279 S.E.2d 746 (1981); *Siver v. Shebetka*, 245 Iowa 965, 65 N.W.2d 173 (1954); *Wright v. Wright*, 93 Conn. 296, 105 A. 684 (1919); *Shanahan V. Klyn*, 268 Mich. 120, 255 N.W. 733 (1934).

⁵⁹³ 547 So.2d 197 (Fla. 4th DCA 1989), rev. den., 560 So.2d 235 (Fla. 1990).

The order holding the appellant in contempt is affirmed.

Multiple secondary sources cite to this case to support the proposition that alimony payments are not subject to garnishment from creditors. For example, a legal encyclopedia, American Jurisprudence, states that “public policy considerations favor the protection of support and alimony payments from the garnishment of creditors.”⁵⁹⁴

For bankruptcy purposes, Florida Statutes Section 222.201 provides that the federal bankruptcy exemption for “alimony, support or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor” will apply, by coordination with Bankruptcy Code Section 522(d)(10).

In applying this provision, bankruptcy courts in Florida have considered the debtor’s need for the alimony payments. For example, in *In re Brackett*, the Bankruptcy Court for the Middle District of Florida, the court stated:

[a]lthough Debtor undoubtedly needs spousal support to some degree, whether an additional \$200 per month is necessary for her support is questionable. “If the obligations under consideration relate to the preservation of an asset, which is necessary to preserve the lifestyle of a spouse, particularly to keep a roof over her head, [it] would clearly be an obligation in the nature of support. . .”⁵⁹⁵

In *Brackett*, the court ultimately determined that the \$200 payments were not reasonably necessary for the spouse’s support. Thus, at least for bankruptcy purposes, the entire amount of alimony will not be exempt; only the amount reasonably needed for support will be exempt. However, it is unclear under Florida law whether the entire amount of the alimony will be exempt from garnishment.

UNEMPLOYMENT COMPENSATION BENEFIT RIGHTS.

Unemployment compensation benefits as defined in Florida Statutes Section 443.051(2) are exempt from all claims of creditors outside of Florida, at least according to the Florida Statutes.

FLORIDA PREPAID TUITION FUNDS AND 529 PLANS.

Tax advantaged college savings plans are creditor protected even if the sponsor is outside of Florida.⁵⁹⁶ Clients with children or grandchildren likely to attend college should strongly consider having one or more 529 plans. In addition, there is no language in the Internal Revenue Code that prohibits the owner of a 529 plan from setting up a 529 and naming himself as a beneficiary if he is going to be attending college. No income tax is payable on plan earnings so long as all monies are spent on college tuition and

⁵⁹⁴ 24A Am. Jur. 2d Divorce and Separation § 574, n.5 (current through Feb. 2017) (citing *Walters v. Albanese*, 547 So.2d 197 (Fla. 4th Dist. Ct. App. 1989).

⁵⁹⁵ 259 B.R. 768, 775 (Bankr. M.D. Fla. 2001).

⁵⁹⁶ 11 U.S.C. § 541(b)(6)(c) (2017).

living expenses for the initial or subsequent beneficiary. Nevertheless, the “plan” is owned by the person designated in the documents, which may be the contributing individual.

Under state law, the contributor has the right to withdraw any or all of the plan assets for his or her own use, provided that income tax and a 10% of income excise tax will apply to the withdrawal of plan earnings.

Monies paid into or out of, the assets of, and the income of any validly existing qualified tuition program (including the Florida Pre-Paid Post-Secondary Education Expense Trust Fund) are not subject to attachment, garnishment or legal process pursuant to Florida Statutes Section 222.22. This protection is against the creditors of any program participant, purchaser, owner contributor or beneficiary.

Further, monies paid into or out of, and the income held under a health savings account or medical savings account authorized under Internal Revenue Code Sections 220 and 223 respectively, are creditor proof, as are educational IRAs.

Some planners have speculated that 529 plans sponsored by states other than Florida may not be creditor protected because the legislature does not have the power to require that out of state intangibles would qualify for tenancy by the entireties protection. Most planners believe otherwise. The legislature clearly intended to protect all 529 plans owned by Florida residents, as evidenced by the fact that the requirement that a plan be in Florida was explicitly removed from the Statute in 2005, and apparently concluded that it has the power to do so. One author signed up to take Conflicts of Law in law school, but found it to be very confusing on the first day, and therefore switched to Agricultural Law, which was much more “meat and potatoes.”

529 plans are favored for gifting purposes, in that taxpayers can place assets in a 529 plan and consider the transfer to have been made one-fifth over five consecutive taxable years, beginning in the year of the transfer, if the gift tax return is filed with a special election being made. Notwithstanding that the 529 plan can be excluded from the person’s estate for estate tax purposes, the donor can be the plan holder and have complete control thereof, including the right to stem the plan monies for personal purposes, or to simply make a withdrawal to keep the money.

For non-Floridians, the 2005 revisions to the Bankruptcy Code exempt up to \$6,425 contributed no earlier than two years and no later than one year before the date of filing bankruptcy. However, the 2005 version of the Bankruptcy Code is unclear on whether the provisions that invalidate 529 plan contributions made within one year of filing will apply when state law exempts 529 plans. It is therefore unknown whether Florida’s 529 Plan exemptions will apply to residents who file bankruptcy.

Contributions to a 529 plan made by a debtor are not included in the bankruptcy estate to the extent that such contributions (a) were made no later than 365 days before the date of filing for bankruptcy and (b) the designated beneficiary of the 529 plan was a child, stepchild, grandchild, or step-grandchild of the debtor for the taxable year in which the funds were contributed. Contributions that are made within the 730 to 365-day window before the date of filing bankruptcy are only excluded from the estate to the extent of \$6,425.

The exemptions that exclude 529 plan contributions from the bankruptcy estate only apply to the extent that the 529 plan provides adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for qualified higher education expenses.

HURRICANE SAVINGS ACCOUNTS.

This protection will not be effective until there are federal law changes to provide tax exempt or tax-deferred status to “hurricane savings accounts,” and these are not expected to exist anytime in the near future.

The hurricane savings account legislation in Florida Statutes Section 222.22(4)(a) permits an insurance policyholder for residential property to fund an account equal to twice the deductible sum of any insurance to cover an insurance deductible or other uninsured portion of the risks of loss from a hurricane, rising flood waters, or other catastrophic windstorm events.

The residential real estate must meet the requirements of the Homestead Exemption at Section 4 Article X of the State Constitution (1/2 of an acre of contiguous land upon which the exemption is limited to the owners’ residence).

The account must specify that its purpose is to cover the amount of the insurance deductible and other insured portions of risks of loss.

PHYSICAL ASSETS EXEMPTIONS – “CAN THEY TAKE MY CAR, FURNITURE, AND ELECTRIC WHEELCHAIR?”

Florida Statutes Section 222.25 also affords a debtor the following exemptions:

- A. Up to a \$1,000 interest in a motor vehicle to be exempted from creditors.
- B. Any interest in professionally prescribed health aids for the debtor or a dependent of the debtor. Aggressive planners may encourage debtors to have expensive health items that might be resold in the same way that homesteads can be adorned with gold and silver doorknobs and other finishing’s that could have an independent value upon later being severed.
- C. Florida Statutes Section 222.25(4) provides for up to \$4,000 for tangible personal property if the client is not claiming the homestead creditor exemption in bankruptcy. This is in addition to the \$1,000 exemption in personal property under the homestead provision of the Florida Constitution, for a total of \$5,000.

In *In re Bezares*, the court held that an individual may claim as exempt \$5,000 in personal property provided the person does not own a homestead property or claim a homestead exemption.⁵⁹⁷ In this case,

⁵⁹⁷ 377 B.R. 413, 414 (Bankr. M.D. Fla. 2007).

the debtor claimed a \$5,000 personal property exemption. The Trustee argued that because of Florida Statutes Section 222.25, the maximum allowable personal property exemption was \$4,000. The debtor's counsel relied on the well-established principle that the legislature has no power to abrogate, alter or amend any provision in the Constitution. A cursory reading of the statute would warrant the conclusion that the amount stated is a cap that indirectly includes the \$1,000 exemption provided in the Constitution. However, the court was compelled by the debtor's argument that the legislature does not have the power to amend or alter a constitutional provision. The court concluded that Florida Statute added \$4,000 to the previous \$1,000 personal property exemption, making a total of \$5,000 as the allowable amount for a person who does not own homestead property or claim a homestead exemption.

If the debtor does claim the homestead exemption, the exemption will remain at \$1,000 as provided for in the Florida Constitution. The \$1,000 or \$5,000 per person exemption can be aggregated when spouses jointly file bankruptcy to protect up to \$2,000 or \$10,000 worth of assets.⁵⁹⁸

Where a debtor's homestead interest is protected by reason of tenancy by the entirety and the debtor files bankruptcy without explicitly using his or her homestead exemption, the courts are divided on whether the debtor receives a \$1,000 or \$5,000 exemption.

In *In re Ellis*,⁵⁹⁹ an August 8, 2008 decision from the Bankruptcy Court Middle District of Florida, Judge Funk determined that a debtor who owns a homestead as tenants by the entirety with his non-debtor spouse receives the benefits of the constitutional homestead exemption because of the spouse's ability to assert the constitutional exemption; thus, the debtor can only receive the \$1,000 personal property exemption.

In *In re Gatto*, however, the court allowed the debtors to use the \$4,000 personal property exemption, stating that because "the debtors did not claim their homes exempt pursuant to the Florida Constitution and stated their intention to surrender their home, they did not receive the benefits of the Constitutional homestead exemption and therefore were entitled to the enhanced personal."⁶⁰⁰

The relevant question is whether a debtor protecting a homestead as tenancy by the entirety is "directly or indirectly receiving the benefits of the constitutional homestead exemption" under Florida Statutes Section 222.25.

⁵⁹⁸ *In re Rasmussen*, 349 B.R. 747 (Bankr. M.D. Fla. 2006).

⁵⁹⁹ 395 B.R. 751 (Bankr. M.D. Fla. 2008).

⁶⁰⁰ 380 B.R. 88, 90 (Bankr. M.D. Fla. 2007).

CHAPTER 10

FEDERAL NON-BANKRUPTCY EXEMPTIONS

The following items are exempt from creditor claims in all states, including Florida, by reason of federal law. Please note that Chapter 1, Section D reviews federal bankruptcy exceptions.

Some states allow debtors to choose between the federal bankruptcy exemptions and the exemptions of their individual state; however, in Florida debtors are required to use the state exemptions, but may also protect pension, IRA, and tenancy by the entirety assets under the Bankruptcy Code, and also the following non-bankruptcy exempt assets.

RETIREMENT BENEFITS.

Civil Service Employees. 5 U.S.C. § 8346. Under this provision, federal employees' retirement or disability benefits are exempt from garnishment, attachment, levy, execution, or similar legal process.

Foreign Service Employees. 22 U.S.C. § 4060. Members of the Foreign Service with annuities and benefits for retirement or disability qualify for exemption of such assets from execution.

Railroad Workers. 45 U.S.C. § 231m. Retirement annuities paid pursuant to the Railroad Retirement Act of 1974 are exempt. 45 U.S.C. § 352(e). Railroad Workers' unemployment benefits are also exempt.

Military Service Employees. 10 U.S.C. §§ 407 and 1383. Benefits provided pursuant to the Social Security Act are exempt from execution. Such benefits include retirement and survivors' benefits, supplemental security income benefits, disability insurance benefits and child support payments that are processed pursuant to Part D of Title IV of the Social Security Act. These benefits are exempt from garnishment, execution, levy, attachment, or any other legal process including bankruptcy and cannot be assigned. Even if the payments are commingled with other funds they are still protected.⁶⁰¹ Payments are not, however, exempt from child support or alimony obligations.

The Federal Social Security Act provides a specific exemption for Social Security benefits, which is applicable for both bankruptcy and garnishment purposes. Title 42 U.S.C. § 407(a) provides the following:

The right of any person to any future payment under this subchapter shall not be transferable or assignable, at law or in equity, and none of the moneys paid or payable or rights existing under this subchapter shall be subject to execution levy attachment,

⁶⁰¹ *S & S Diversified Services, L.L.C. v. Taylor*, 897 F. Supp. 549 (D. Wyo. 1995).

garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law.

However, the United States Court of Appeals for the Eleventh Circuit has placed a limitation on the protection provided under § 407. In *Citronelle Mobile-Gathering, Inc. v. Watkins*,⁶⁰² the court found that the exemption available under § 407(a) will not apply when the “reaching of Social Security benefits is not going to impair the ability of the recipient to satisfy his or her basic needs.”⁶⁰³

Multiple secondary sources have recognized this limitation. For example, Federal Procedure, Lawyer’s Edition, states that “in the eleventh Circuit, there is an implied exemption to 42 U.S.C.A. § 407 that permits the garnishment of Social Security payments if garnishment does not impair the ability of social security recipient to satisfy basic needs.”⁶⁰⁴

Multiple cases have also held that Social Security proceeds do not lose their exempt status when deposited into a bank account; however, these proceeds are still subject to garnishment if “reaching Social Security benefits is not going to impair the ability of the recipient to satisfy his or her basic needs.”⁶⁰⁵

Unfortunately, judicial activism has limited the protection of accumulated social security proceeds, well beyond what the statute appears to indicate.

In the case of *In re Lazin*, Judge Paskay of the Bankruptcy Court for the Middle District of Florida considered whether accumulated Social Security proceeds deposited into a bank account would be exempt under Section 407.⁶⁰⁶ Judge Paskay held that Social Security proceeds did not lose their exempt status simply because they were paid and deposited into a bank account. However, summary judgment was precluded as to the issue of whether the accumulated Social Security proceeds were exempt because an evidentiary hearing was needed to determine “whether the Debtor has the necessary resources for continuing basic care and maintenance without the accumulated Social Security benefits.”⁶⁰⁷

In the case of *In re Crandell*, the Bankruptcy Court for the Middle District of Florida applied Section 407 in determining that a portion of the debtor’s accumulated Social Security proceeds held in a bank account would be exempt.⁶⁰⁸ The court applied the Eleventh Circuit’s limitation and determined that “the Debtor’s ability to satisfy her basic needs may be impaired should unforeseen expenses occur” because the

⁶⁰² 934 F.2d 1180 (11th Cir. 1991).

⁶⁰³ The holding of *Citronelle Mobile-Gathering, Inc. v. Watkins* has been abrogated by *In re Franklin*, 506 B.R. 765, 768 (Bankr. C.D. Ill. 2014), finding that equitable exceptions to § 407 of The Social Security Act’s Exemption for social security benefits are not permitted. The court held that § 407 allowed a debtor to exempt the entire balance of a savings account where social security payments were placed, established before he declared Chapter 7 Bankruptcy, from the creditors’ claims. Further, the U.S. Supreme Court’s decision in *Law v. Siegel*, 134 S. Ct. 1188, 1196 (2014) precluded the court’s power from requiring the debtor to turn over the social security payments received in his savings account, despite not having any present need to use the funds for living expenses.

⁶⁰⁴ 11 Fed. Proc., L. Ed. § 31:25 (updated Dec. 2016).

⁶⁰⁵ *Citronelle*, at 1192.

⁶⁰⁶ 217 B.R. 332, 336 (Bankr. M.D. Fla. 1998).

⁶⁰⁷ *Id.* at 335.

⁶⁰⁸ 200 B.R. 243, 245 (Bankr. M.D. Fla. 1995).

debtor barely had enough income to cover her monthly expenses (income of \$789/month and expenses of \$766/month).⁶⁰⁹ Thus, the court allowed \$5,000 of accumulated Social Security proceeds in a bank account to be exempt, with the remaining \$5,000 of accumulated Social Security proceeds in the account becoming property of the estate.

Veteran's Benefits. 38 U.S.C. § 5301. Veteran's Benefits paid from the Veteran's Administration are exempt from garnishment, levy, and other legal process including bankruptcy, except for the payment of child and spousal support obligations, federal taxes, and federal student loans. Comingling the assets will not subject them to garnishment. Florida Statutes Section 222.201 provides that property listed in Bankruptcy Code Section 522(d)(10) will apply for any Florida bankruptcy action.

CIA Employees. 50 U.S.C. § 2001. Retirement benefits are exempt for member of the CIA.

Military Medal of Honor Roll Pensions. 38 U.S.C. § 1562(c). In addition to any other pensions they might receive, recipients of the Medal of Honor are paid a pension that is exempt from garnishment, levy, attachment, tax lien, execution or detention under any process. Florida Statutes Section 222.201 provides that property listed in Bankruptcy Code Section 522(d)(10) will be exempt in bankruptcy for Floridians. This includes "a veteran's benefit" under Section 522(d)(10)(B).

Fraudulent Transfers. The authors do not know of any Florida case law finding that transferring exempt federal retirement benefits into a Florida exempt asset (such as a tenants by the entireties account) would constitute a fraudulent transfer.

Although not exactly on point, the case of *In re Short*⁶¹⁰ from the Bankruptcy Court for the Middle District of Florida references the fact that the transfer of a creditor exempt asset to an account owned by a person other than the debtor is not considered to be a "fraudulent transfer" under Florida law because the creditor had no claim to the property whether it was transferred or not.

Thus, it appears possible to transfer a federal exempt asset, such as federal retirement benefits, into a Florida exempt asset, although the courts may not agree with this observation. This is reflected by *In re Lazin*, where a trustee contended that the social security benefits and annuity payments received and deposited by a debtor pre-petition were accumulated funds, and lost their exemption status once received and deposited in a bank account.⁶¹¹ However, the court determined that, under Florida law, a debtor does not lose exemption in proceeds of annuity contracts to which the debtor was entitled under non-bankruptcy federal law merely by depositing proceeds into a bank account.⁶¹²

The *Lazin* court cites to *Treadwell*,⁶¹³ an 11th Circuit case regarding the transfer of funds accumulated from social security benefits to family members by a debtor, within one year of filing for petition in bankruptcy. In *Treadwell*, the debtor claimed exemptions pursuant to 11 U.S.C. § 407, not 11 U.S.C. §

⁶⁰⁹ *Id.*

⁶¹⁰ 188 B.R. 857 (Bankr. M.D. Fla. 1995).

⁶¹¹ 217 B.R. 332 (Bankr. M.D. Fla. 1998).

⁶¹² *Id.* at 336.

⁶¹³ 699 F.2d 1050 (11th Cir. 1983).

522(d), and therefore relinquished the right to immunize the funds.⁶¹⁴ The *Treadwell* court found the transfers to be fraudulent because the transfer was not for value, the debtor was insolvent at the time of transfer, and the exemption granted to social security income did not apply since the income was fraudulently conveyed and was not being used for living expenses.⁶¹⁵

Because the debtor represented that the exemption claimed was based on non-bankruptcy federal law, the *Lazin* court found that “[t]here is nothing in *Treadwell* to mean that once the funds have been received by the Social Security recipient and deposited into the bank that the funds lost their immunity from creditor claims. On the contrary, it expressly recognized that one could claim an exemption under 42 U.S.C. § 407 as long as one did not also claim the exemption under § 522(d).”⁶¹⁶

SURVIVOR’S BENEFITS.

Military Service. 10 U.S.C. § 1450. Benefits paid to the surviving spouse, child, or other natural person designated as a beneficiary under an annuity are protected from creditors.

Members of the Judiciary. 28 U.S.C. § 376. Annuities paid to survivors of members of the judiciary, U.S. court directors, judicial center directors, and U.S. Supreme Court Justice’s administrative assistants are exempt.

Lighthouse Workers. 33 U.S.C. § 775. Payments are exempt from execution, levy, lien, attachment, garnishment, or other legal process.

DEATH AND DISABILITY BENEFITS.

5 U.S.C. § 8130. Compensation for injuries of government employees are exempt from creditor claims.

33 U.S.C. § 916. Compensation or benefits due or payable to long-shore and harbor workers are exempt from all claims of creditors, and from levy, execution, and attachment or other collection of debt, which exemption may not be waived.

42 U.S.C. § 1717. Compensation for injury, death, or detention of employees of contractors with the United States outside the United States is exempt from execution, levy, attachment, garnishment, or to the operation of any bankruptcy or insolvency law.

MISCELLANEOUS FEDERAL EXEMPTIONS.

Military Deposits and Life Insurance. 10 U.S.C. § 1035(d). Military deposits to savings accounts are exempt while the service member is on active duty outside the U.S. 38 U.S.C. § 1970(g). Benefits from Group Life Insurance for military members and veterans are exempt.

⁶¹⁴ *Id.* at 1052.

⁶¹⁵ *Id.* at 1053.

⁶¹⁶ 217 B.R. 332, 334 (Bankr. M.D. Fla. 1998).

Wages. 15 U.S.C. § 1673. Those who are not a head of family may not have their disposable earnings garnished above certain limits under the Consumer Credit Protection Act. The Act provides that the amount attached or garnished will not exceed the lesser of 25% of the person's disposable income for that week or the amount by which the person's disposable income exceeds 30 times the Federal minimum wage at that time. However, the Consumer Credit Protection Act's limits do not apply where support of any person has been court ordered, in a Chapter 13 or Chapter 11 Bankruptcy, or in any case where any Federal or State taxes are owed. This is further discussed in Section II.

Student Loans. 20 U.S.C. § 1095a. Federal student loan payments are exempt from execution.

Merchant Seamen. 46 U.S.C. § 11109. Wages due or accruing to merchant seamen are exempt from execution except in the case of child or spousal support obligations.

46 U.S.C. § 11110. A seaman's clothing is exempt while on voyage.

46 U.S.C. § 11111. The debts of a seaman incurred while on voyage are exempt.

Indian Tribal Lands. 26 U.S.C. § 7871. Certain Indian tribal lands are also exempted under federal law.

CHAPTER 11

ASSET PROTECTION TRUSTS

INTRODUCTION AND REVOCABLE TRUSTS.

Oftentimes, debtor/creditor lawyers' eyes glaze over when it is time to review trust arrangements and how they impact creditor protection planning. Yet, the importance of carefully considering each provision and overall structure of a trust cannot be understated. A number of decisions discussed below show that judges who want to allow creditors to reach a trust held for the benefit of an unpopular debtor may find ways to make this happen without strictly following the law in this area. Attorneys need to therefore use both belts and suspenders when drafting trusts.

While non-Florida "Asset Protection Trusts" receive most of the attention in the creditor protection community, a great many Florida trusts that should protect beneficiaries from creditors do not do so based upon drafting flaws and misconceptions.

As a general overview with respect to revocable trusts, almost all advisors are aware that assets placed under a trust that can be revoked by its grantor/contributor are accessible to the grantor's creditors, and this may include assets that would otherwise be exempt from creditor claims if owned individually by the grantor, although the law is not clear on this. Chapter 222 of the Florida Statutes generally allows for certain individually owned assets to be exempt from the reach of individual's creditors.

When the grantor of a revocable trust dies, the assets that were held under the trust the moment before death will be subject to the claims of the grantor's creditors to the extent that they would not otherwise be exempt if owned directly by the grantor.⁶¹⁷ A revocable trust may be drafted to facilitate having the Trustee receive assets by beneficiary designation, remainder interest ownership or pay-on-death arrangements, which may allow for avoidance of creditors of the grantor depending upon the circumstances.

While the Florida Trust Code provides that assets under a revocable trust are subject to the claims of the grantor's creditors, and the Florida Probate Code provides that assets owned by a probate estate are generally subject to the claims of creditors, there is no statute or known common law decision that would require a pay-on-death account or similar arrangement to be subject to the creditor claims of a deceased account owner, although the law will probably gravitate towards or be legislated in favor of creditors eventually.

Irrespective of the above, a revocable trust can still be an effective planning tool to avoid probate, and to be the beneficiary of exempt assets that may be payable to the trust upon the death of the grantor while being immune to creditor claims against the grantor and the grantor's estate.

The remainder of this chapter will discuss Irrevocable Spendthrift Trusts, Third-Party Settled Trusts, Domestic Asset Protection Trusts ("DAPTs") and Foreign/Offshore Asset Protection Trusts.

⁶¹⁷ Fla. Stat. § 736.0505.

IRREVOCABLE FLORIDA SELF-SETTLED TRUSTS.

A self-settled trust exists when the grantor who funds the trust is also a beneficiary. Florida follows the common law rule that a creditor can reach whatever trust assets or payments that a trustee would have the power to give to its grantor or a contributor. For example, if the grantor has the right to receive income, the creditor would have the right to reach into the trust to obtain the income before the grantor receives it.

Specifically, Florida Statutes Section 736.0505(1)(b) provides that “[w]ith respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount *that can be distributed to or for the settlor’s benefit*. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor’s interest in the portion of the trust attributable to that settlor’s contribution.” (Emphasis added.)

For example, if John Smith forms an irrevocable trust and appoints a trust company with the discretion to give John Smith up to \$10,000 a year for five years, and up to all of the remaining trust assets after 15 years, then a trustee would be able to attach the right to receive all of the above payments, but would not be able to break into the trust to receive all assets before the sixteenth year, assuming that funding was not a “fraudulent transfer.” It is unknown whether the creditor would be able to reach amounts payable in the future if there is no condition for precedent other than time with respect to the payment. For example, if the payment is to be \$10,000 a year for each year that John Smith is living, then John Smith’s continued survival will cause creditors to not be able to reach the payments in advance. This might be different if the payment is to be made regardless of whether John Smith survived, if his estate was to be the continued recipient of payments.

Most of the law on the protection of creditors under a Florida trust can be found in Florida Statutes Sections 736.0501 through 736.0507, which are reproduced below for the convenience of the reader and should be reviewed periodically by any Florida lawyer who works extensively in this area.

736.0501 Rights of beneficiary’s creditor or assignee.—Except as provided in s. 736.0504, 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 by other means. The court may limit the award to such relief as is appropriate under the circumstances.

History.—s. 5, ch. 2006-217; s. 11, ch. 2007-153.

736.0502 Spendthrift provision.—

(1) A spendthrift provision is valid only if the provision restrains both voluntary and involuntary transfer of a beneficiary’s interest. This subsection does not apply to any trust the terms of which are included in an instrument executed before the effective date of this code.

(2) 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.

(3) A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this part, a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before receipt of the interest or distribution by the beneficiary.

(4) A valid spendthrift provision does not prevent the appointment of interests through the exercise of a power of appointment.

History.—s. 5, ch. 2006-217; s. 12, ch. 2007-153.

736.0503 Exceptions to spendthrift provision.—

(1) As used in this section, the term “child” includes any person for whom an order or judgment for child support has been entered in this or any other state.

(2) To the extent provided in subsection (3), a spendthrift provision is unenforceable against:

(a) A beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance.

(b) A judgment creditor who has provided services for the protection of a beneficiary's interest in the trust.

(c) A claim of this state or the United States to the extent a law of this state or a federal law so provides.

(3) Except as otherwise provided in this subsection and in s. 736.0504, a claimant against which a spendthrift provision may not be enforced may obtain from a court, or pursuant to the Uniform Interstate Family Support Act, an order attaching present or future distributions to or for the benefit of the beneficiary. The court may limit the award to such relief as is appropriate under the circumstances. Notwithstanding this subsection, the remedies provided in this subsection apply to a claim by a beneficiary's child, spouse, former spouse, or a judgment creditor described in paragraph (2)(a) or paragraph (2)(b) only as a last resort upon an initial showing that traditional methods of enforcing the claim are insufficient.

History.—s. 5, ch. 2006-217; s. 13, ch. 2007-153.

736.0504 Discretionary trusts; effect of standard.—

(1) As used in this section, the term “discretionary distribution” means a distribution that is subject to the trustee’s discretion whether or not the discretion is expressed in the form of a standard of distribution and whether or not the trustee has abused the discretion.

(2) Whether or not a trust contains a spendthrift provision, if a trustee may make discretionary distributions to or for the benefit of a beneficiary, a creditor of the beneficiary, including a creditor as described in s. 736.0503(2), may not:

(a) Compel a distribution that is subject to the trustee’s discretion; or

(b) Attach or otherwise reach the interest, if any, which the beneficiary might have as a result of the trustee’s authority to make discretionary distributions to or for the benefit of the beneficiary.

(3) If the trustee’s discretion to make distributions for the trustee’s own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor’s claim were the beneficiary not acting as trustee.

(4) 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.

History.—s. 5, ch. 2006-217; s. 14, ch. 2007-153.

736.0505 Creditors’ claims against settlor.—

(1) Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

(a) The property of a revocable trust is subject to the claims of the settlor’s creditors during the settlor’s lifetime to the extent the property would not otherwise be exempt by law if owned directly by the settlor.

(b) With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor’s benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor’s interest in the portion of the trust attributable to that settlor’s contribution.

(c) Notwithstanding the provisions of paragraph (b), the assets of an irrevocable trust may not be subject to the claims of an existing or subsequent creditor or assignee of the settlor, in whole or in part, solely because of the existence of a discretionary power granted to the trustee by the terms of the trust, or any other provision of law, to pay directly to the taxing authorities or to reimburse the settlor for any tax on trust income or principal which is payable by the settlor under the law imposing such tax.

(2) For purposes of this section:

(a) During the period the power may be exercised, the holder of a 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.

(b) 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 greater of the amount specified in:

1. Section 2041(b)(2) or s. 2514(e); or

2. Section 2503(b) and, if the donor was married at the time of the transfer to which the power of withdrawal applies, twice the amount specified in s. 2503(b), of the Internal Revenue Code of 1986, as amended.

(3) Subject to the provisions of s. 726.105, for purposes of this section, the assets in:

(a) A trust described in s. 2523(e) of the Internal Revenue Code of 1986, as amended, or a trust for which the election described in s. 2523(f) of the Internal Revenue Code of 1986, as amended, has been made; and

(b) Another trust, to the extent that the assets in the other trust are attributable to a trust described in paragraph (a), shall, after the death of the settlor's spouse, be deemed to have been contributed by the settlor's spouse and not by the settlor.

History.—s. 5, ch. 2006-217; s. 5, ch. 2010-122.

736.05053 Trustee's duty to pay expenses and obligations of settlor's estate.—

(1) A trustee of a trust described in s. 733.707(3) shall pay to the personal representative of a settlor's estate any amounts that the personal representative certifies in writing to the trustee are required to pay the expenses of the administration and obligations of the settlor's estate. Payments made by a trustee, unless otherwise provided in the trust instrument, must be charged as expenses of the trust without a contribution from anyone. The interests of all beneficiaries of such a trust are subject to the provisions of this subsection; however, the payments must be made from assets, property, or the proceeds of the assets or property that are included in the settlor's gross estate for federal estate tax purposes and may not be made from assets proscribed in s. 733.707(3) or death benefits described in s. 733.808(4) unless the trust instrument expressly refers to s. 733.808(4) and directs that it does not apply.

(2) Unless a settlor provides by will, or designates in a trust described in s. 733.707(3) funds or property passing under the trust to be used as designated, the expenses of the administration and obligations of the settlor's estate must be paid from the trust in the following order:

(a) Property of the residue of the trust remaining after all distributions that are to be satisfied by reference to a specific property or type of property, fund, or sum.

(b) Property that is not to be distributed from specified or identified property or a specified or identified item of property.

(c) Property that is to be distributed from specified or identified property or a specified or identified item of property.

(3) Trust distributions that are to be satisfied from specified or identified property must be classed as distributions to be satisfied from the general assets of the trust and not otherwise disposed of in the trust instrument on the failure or insufficiency of funds or property from which payment should be made, to the extent of the insufficiency. Trust distributions given for valuable consideration abate with other distributions of the same class only to the extent of the excess over the value of the consideration until all others of the same class are exhausted. Except as provided in this section, trust distributions abate equally and ratably and without preference or priority between real and personal property. When a specified or identified item of property that has been designated for distribution in the trust instrument or that is charged with a distribution is sold or taken by the trustee, other beneficiaries shall contribute according to their respective interests to the beneficiary whose property has been sold or taken. Before distribution, the trustee shall determine the amounts of the respective contributions and such amounts must be paid or withheld before distribution is made.

(4) The trustee shall pay the expenses of trust administration, including compensation of trustees and attorneys of the trustees, before and in preference to the expenses of the administration and obligations of the settlor's estate.

(5) Nonresiduary trust dispositions shall abate pro rata with nonresiduary devises pursuant to the priorities specified in this section and s. 733.805, determined as if the beneficiaries of the will and trust, other than the estate or trust itself, were taking under a common instrument.

History.—s. 5, ch. 2006-217; s. 6, ch. 2010-122; s. 9, ch. 2014-127.

736.05055 Notice of trust.—

(1) Upon the death of a settlor of a trust described in s. 733.707(3), the trustee must file a notice of trust with the court of the county of the settlor's domicile and the court having jurisdiction of the settlor's estate.

(2) The notice of trust must contain the name of the settlor, the settlor's date of death, the title of the trust, if any, the date of the trust, and the name and address of the trustee.

(3) If the settlor's probate proceeding has been commenced, the clerk shall notify the trustee in writing of the date of the commencement of the probate proceeding and the file number.

(4) The clerk shall file and index the notice of trust in the same manner as a caveat unless there exists a probate proceeding for the settlor's estate, in which case the notice of trust must be filed in the probate proceeding and the clerk shall send a copy to the personal representative.

(5) The clerk shall send a copy of any caveat filed regarding the settlor to the trustee, and the notice of trust to any caveator, unless there is a probate proceeding pending and the personal representative and the trustee are the same.

(6) Any proceeding affecting the expenses of the administration or obligations of the settlor's estate prior to the trustee filing a notice of trust are binding on the trustee.

(7) The trustee's failure to file the notice of trust does not affect the trustee's obligation to pay expenses of administration and obligations of the settlor's estate as provided in s. 733.607(2).

History.—s. 5, ch. 2006-217.

736.0506 Overdue distribution.—

(1) As used in this section, the term “mandatory distribution” means a distribution of income or principal the trustee is required to make to a beneficiary under the terms of the trust, including a distribution on termination of the trust. The term does not include a distribution subject to the exercise of the trustee's discretion, even if:

(a) The discretion is expressed in the form of a standard of distribution; or

(b) The terms of the trust authorizing a distribution couple language of discretion with language of direction.

(2) 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, whether or not a trust contains a spendthrift provision.

History.—s. 5, ch. 2006-217.

736.0507 Personal obligations of trustee.—Except to the extent of the trustee's interest in the trust other than as a trustee, trust property is not subject to personal obligations of the trustee, even if the trustee becomes insolvent or bankrupt.

History.—s. 5, ch. 2006-217.

FLORIDA THIRD PARTY SETTLED TRUSTS.

When a third party, such as a parent or spouse, funds a trust from his or her own assets for the benefit of another party, such as a child or spouse, the ability of creditors of the beneficiary to seize trust assets will be dependent upon the factual and legal arrangements, which basically fall into the following categories:

- A. If the beneficiary can freely reach or compel the Trustee to distribute the assets held under the trust, then her creditors can also.
- B. If the beneficiary is not a grantor but is a trustee, and her ability to receive benefits is limited to what is needed for health, education, maintenance and support, then under Florida Statutes Section 736.0504(3), neither “exception creditors” nor “general creditors” of the beneficiary may reach the trust assets, “except to the extent the interest would be subject to the creditor’s claim were the beneficiary not acting as Trustee.”

As stated above, this limitation on the ability of all creditors to reach amounts that can be used for the health, education and maintenance of a beneficiary will apply even where the debtor is the beneficiary and sole Trustee of the Third Party Settled Trust.

One factual question that can arise is whether the debtor could be considered to have been an indirect contributor to the trust, in which event the self-settled trust rules would apply to enable the creditors to reach the maximum amounts and assets that the Trustee would have the discretion or obligation to distribute.

- C. Under Florida Statutes Section 736.0506(2), a beneficiary’s creditor may reach mandatory distributions if the trustee has not made the distribution to the beneficiary within a reasonable time after the designated distribution date, regardless of whether the trust contains a spendthrift provision. Mandatory distributions are distributions that a trustee is required to make, and would not have the discretion or an obligation to withhold under the terms of the Trust Agreement. It is therefore wise to provide that payments for health, education and maintenance may be curtailed in the discretion of the Trustee, so that failure to make payments because the beneficiary does not need or want them does not give a creditor a right to later seize the amounts that would have been payable.
- D. Under Florida Statutes Section 736.0504(1), if the beneficiary is not the trustee or the grantor, and a trustee can withhold distributions in the Trustee’s discretion, then a creditor of the beneficiary may not compel a distribution that is subject to the trustee’s discretion. This protection even prohibits “exception creditors” from being able to receive trust assets.

As further discussed below, Florida Statutes Section 736.0503 provides that certain “exception creditors of a beneficiary” can invade a trust to the extent that a Trustee would be required to make distributions, as opposed to having the discretion to withhold them. These exception creditors consist of (1) a beneficiary’s child, spouse, or former spouse who has a judgment or court order against the beneficiary

for support or maintenance; (2) someone who has provided services for protection of a beneficiary's interest in the trust; (3) a claim of the United States; and (4) claims as permitted by federal law.

The statutory language that provides for the above result is set forth below in its entirety, with "last resort" language underlined in subsection (3) below to show that no other sources of payment are available if the exception creditor is a child, spouse or former spouse suing for support or maintenance, or a lawyer or other creditor who has provided services for the beneficiary relating to the trust. Section 736.0503 reads as follows:

1. As used in this section, the term "child" includes any person for whom an order or judgment for child support has been entered in this or any other state.
2. To the extent provided in subsection (3), a spendthrift provision is unenforceable against:
 - (1) A beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance.
 - (2) A judgment creditor who has provided services for the protection of a beneficiary's interest in the trust.
 - (3) A claim of this state or the United States to the extent a law of this state or a federal law so provides.
3. Except as otherwise provided in this subsection and in s. 736.0504, a claimant against which a spendthrift provision may not be enforced may obtain from a court, or pursuant to the Uniform Interstate Family Support Act, an order attaching present or future distributions to or for the benefit of the beneficiary. The court may limit the award to such relief as is appropriate under the circumstances. Notwithstanding this subsection, the remedies provided in this subsection apply to a claim by a beneficiary's child, spouse, former spouse, or a judgment creditor described in paragraph (2)(a) or paragraph (2)(b) only as a last resort upon an initial showing that traditional methods of enforcing the claim are insufficient.

Fla. Stat. § 736.0503 (2017) (emphasis added).

Notwithstanding the above, even an exception creditor who has tried any and all other avenues for recovery will not be able to reach into a Third Party Settled Discretionary Trust if a Trustee other than the debtor is able to withhold any and all distributions, and the debtor would not have the right under Florida law to force a distribution, notwithstanding the fiduciary duty of the Trustee.

As mentioned earlier in this chapter, courts may stretch the interpretation of law to come to the conclusion that a Trustee is required to make distributions so that a disadvantaged exception creditor may receive monies from a trust that was intended to be "discretionary" by the grantor.

Medicaid planning for the beneficiary of a third party settled trust is a topic with rules that are separate and apart from what is discussed in this book. Advisors should seek competent Medicaid eligibility lawyer advice in drafting with respect thereto. Trust drafters should also be aware of the “stretch IRA” rules under Treasury Regulation 1.409(a)(9)-4, Q&A-5. For a copy of the book entitled *Planning for Ownership and Inheritance of Pension and IRA Accounts and Benefits In Trust or Otherwise – The Estate Planners IRA/Pension Planning Guide*, please contact agassman@gassmanpa.com, if you are willing to be a BETA reader.

Below is a brief discussion on two cases in California and Arizona that involved situations where creditors were able to reach into “discretionary” trusts, despite the obvious intention to the contrary found in the trust documents.

Both *United States v. Taylor*⁶¹⁸ and *Duckett v. Enomoto*⁶¹⁹ involve situations where discretionary language enables the Trustee to make distributions for beneficiaries who owed money to creditors.

The resultant ability to compel payments by the Trustees to the creditors were found to be based upon the existence of mandatory distribution language (i.e., “shall” pay) or discretionary support (i.e., “shall” pay for the health, education, and support). However, there is a stark difference in the level of discretion the trustees had in *Taylor* and *Enomoto*, and the degree of discretion that the trustees should have under the more protective pure discretionary trusts.

In *Taylor*, the trust provided that: “The trustees shall pay to or apply for the benefit of [the beneficiary] . . . so much of the net income of said trust, up to the whole thereof, as the Trustees may from time to time deem necessary or advisable for his proper care, maintenance and support.”⁶²⁰

The *Taylor* court held that “the taxpayer has a lifetime, enforceable, equitable right to support from the income of the trust. The discretionary feature is limited to the trustees’ determining the amounts they deem ‘necessary’ for the taxpayer’s proper care, maintenance and support. The provision that the ‘trustees shall pay’ is mandatory and conveys the intent of the testator that his son is to receive support payments from the net income of the trust if he needs support.”⁶²¹ The language in *Taylor* clearly provides that the trustee must pay out the income, but that the amount of that distribution is left to the trustee’s discretion and must be based on some need of the beneficiary for support.

Similarly, in the 2016 U.S. District Court case of *Duckett v. Enomoto*, the court found that the language in the trust stated that “the trustees ‘shall pay’ the beneficiary and gave the trustees discretion only as to the amount of payment necessary under the trust standard.”⁶²²

The language in the *Enomoto* trust was as follows:

⁶¹⁸ *United States v. Taylor*, 254 F. Supp. 752 (N.D. Cal., June 9, 1966).

⁶¹⁹ *Duckett v. Enomoto*, No. CV-14-01771-PHX-NVW, 2016 U.S. Dist. LEXIS 51502, 117 A.F.T.R.2d (RIA) 1358 (D. Ariz. Apr. 18, 2016).

⁶²⁰ *Taylor*, at 755.

⁶²¹ *Id.*

⁶²² *Enomoto*, at 23.

The Trustee shall pay to [the Beneficiary] so much or all of the net income and principal of the trust as in the sole discretion of the Trustee may be required for support in the beneficiary's accustomed manner of living, for medical, dental, hospital, and nursing expenses, or for reasonable expenses of education, including study at college and graduate levels. . . In the Trustee's sole discretion and to the extent the Trustee deems advisable, the Trustee may consider or disregard the funds available to the beneficiary from other sources or the duty of anyone to support the beneficiary.

Exceptions for Annual Exclusion Gifting and Payment of Income Taxes on Behalf of a Grantor.

Notwithstanding the general rule that creditors of an individual who directly or indirectly contributes to a trust may reach the maximum amount attributable to contributed assets that the individual could receive, the Florida Statutes provide that an individual will not be considered to have contributed to a trust if he or she simply did not make a withdrawal of a gift intended to qualify for the federal gift tax exclusion under a "crummy withdrawal power", and that the grantor of a trust that will reimburse her for income tax liability incurred by reason of its existence will not be considered to be a beneficiary.

Specifically, under Florida Statutes Section 736.0505, the lapse, release, or waiver of a withdrawal power that does not exceed the greater of \$15,000 for the tax year 2020 and thereafter,⁶²³ or 5% of the value of the trust assets, whichever is more, will not be considered to be a contribution to the trust by the power holder. Such withdrawal powers are called "crummey powers", and enable a contributor to a trust to consider the contribution to qualify for the gift tax exclusion that otherwise applies only for direct transfers to individuals. A \$30,000 amount will apply in lieu of \$15,000 if the grantor is married, and the grantor's spouse's gift tax exclusion can be used to expand the withdrawal power to \$30,000 for each withdrawal power holder.

Further, under Florida Statutes Section 736.0505(1)(c), the grantor's right to require the trustee to pay income taxes imposed upon the grantor that are attributable to the income of the trust under the "grantor trust" rules will not be considered to be a contribution to the trust by the grantor.

Drafting Advice.

It is wise to counsel clients to leave any inheritance to a trust that can provide benefits for the health, education and maintenance of the beneficiary, with language that provides that any distributions will be strictly discretionary if an exception creditor exists.

Clients will nevertheless commonly (and naively) request outright dispositions. The drafter can provide for an outright disposition that would become a third party protected trust if either (a) the beneficiary makes a valid disclaimer under Florida Statutes Section 689.21(6) while the beneficiary is solvent; or (b) the beneficiary is insolvent.

⁶²³ Until this amount increases under the gift tax law, based upon the Consumer Price Index in increments of \$1,000.

The Will or applicable revocable trust providing this language must also provide the language for the protective trust, or for the assets to go into a separate protective trust for the benefit of the beneficiary.

Parents and grandparents should know that an inheritance could otherwise be lost, even if the death or gift occurs within 180 days after the filing of a bankruptcy by a beneficiary, and that the beneficiary can be the Trustee of the trust with the right to receive amounts as needed for health, education, maintenance and support without having the trust be subject to federal estate tax upon the beneficiary's death, if the trust is properly drafted. If the beneficiary has not made a disclaimer causing the assets to pass to the trust, then she may also have the power to direct how the assets will pass upon death, as long as this power is "limited" by not being exercisable in favor of herself individually, her estate, her creditors or creditors of her estate.

In the case of *Safanda v. Castellano*, a trust provided that assets would be devised to the Testatrix's daughter, or would be held in a protective trust if her daughter was insolvent. The daughter's lawyer instead sent a letter to the Trustee requesting establishment of the protective trust because of the daughter's insolvency. The creditor claimed that the trust was therefore considered to be self-settled, because it was funded as the result of the daughter's request, and the trial court agreed. The Appellate Court properly concluded that the trust was funded because of the daughter's insolvency, and not because of her request or any implied transfer.

The daughter would have been much better off if her mother had simply had the trust assets payable to the protective trust, in lieu of having a disclaimer mechanism as described above. Clients still resistant to a protective trust in lieu of a disclaimer mechanism may choose the trust if they are informed that an independent Trustee or Trust Protector can be given the discretionary power to transfer all of the trust assets to the beneficiary.

While the beneficiary can be the sole Trustee of such a trust, it is commonly recommended that there be an independent Trustee or Co-Trustee to have a lesser chance of having a trust be set aside as being an alter ego of the debtor or elusory.

When a debtor is the Trustee, it is doubly important to make sure that all appropriate trust formalities and arm's-length arrangements are strictly followed. Decisions in other states have found that trusts can be invaded by creditors when they constitute an alter ego of the debtor.

What About Spendthrift Clauses?

Spendthrift clauses will assure that a beneficiary cannot sell or assign his or her beneficial interest, but do not provide for the ascertainable standard (health, education, maintenance and support) or discretionary trust language features that are required to prevent a creditor from reaching into a trust. When a spendthrift provision is used, creditors cannot reach the interest of a beneficiary until the beneficiary receives the interest or distribution.⁶²⁴

Florida Statutes Section 736.0502 provides that a spendthrift clause drafted after July 1, 2007, the effective date of the Florida Trust Code, "is valid only if the provision restrains both voluntary and

⁶²⁴ Fla. Stat. § 736.0502(3).

involuntary transfer of a beneficiary's interest", and that a valid spendthrift provision does not prevent the exercise of a power of appointment that may be given to a beneficiary.

If a spendthrift clause is not included, then the beneficiary has the ability to voluntarily and involuntarily alienate, assign or otherwise transfer his or her equitable interest in a trust. Florida Statutes Section 736.0502(3) provides that a "beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this part, a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before receipt of the interest or distribution by the beneficiary."

The statute also provides that the language of a trust which generally indicates 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.⁶²⁵ Having a spendthrift provision protects the trust assets from levy by creditors, as well as dissipation by the beneficiary.

A creditor's (other than "exception creditors") ability to access a trust is dependent on the type of trust and the power given to the Trustee. For example, when a trust is established for one's own benefit, also referred to as a self-settled trust (further explained below), the trust will be accessible to creditor's claims. On the other hand, creditors will only be allowed to access trust property where the trustee is required to make distributions beyond what is needed for the health, education and maintenance of the beneficiary. This applies even if the beneficiary is the trustee of the trust or has requested that no distributions be made to avoid creditor exposure.⁶²⁶ Here, the question is whether the trustee would have a fiduciary duty to make a distribution, in which event the minimum amount that must be paid would go to the creditor, or whether the trustee has full discretion to withhold distributions and fails to do so.

QUALIFYING A CREDIT SHELTER TRUST FOR MEDICAID – MEDICAID QUALIFYING TRUSTS

Medicaid planning is beyond the purview of this book, but it should be pointed out that a third-party trust established for the health, education, maintenance, and support of an individual may disqualify that individual from qualifying for Medicaid unless the trust is spent down or the trust assets are distributed to one or more other beneficiaries. Many experts do not realize that only an irrevocable trust established under the last will and testament of a spouse can be held for the benefit of the surviving spouse without being considered to be a disqualifying asset. Using a revocable trust for this can be catastrophic

⁶²⁵ The statute, in its entirety, reads as follows: 736.0502 Spendthrift provision. (1) A spendthrift provision is valid only if the provision restrains both voluntary and involuntary transfer of a beneficiary's interest. This subsection does not apply to any trust the terms of which are included in an instrument executed before the effective date of this Code. (2) 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. (3) A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this part, a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before receipt of the interest or distribution by the beneficiary. (4) A valid spendthrift provision does not prevent the appointment of interests through the exercise of a power of appointment.

⁶²⁶ See Fla. Stat. § 736.0506.

HOW DO YOU MAKE SURE THAT A FLORIDA TRUST WILL BE PURELY DISCRETIONARY?

Even trusts with unenforceable spendthrift provisions avoid compelled distributions and liens if their terms call only for “discretionary distributions.” When a distribution is wholly within the trustee’s discretion, the beneficiary does not have an “interest” in trust to which a creditor can reach, until the trustee exercises such discretion and distributes income or principal to the beneficiary.

Unfortunately, many estate planners will unknowingly use form trust provisions with a mix of discretionary and mandatory language regarding Trustee distributions, thereby subjecting the Trust property to the reach of creditors.

Florida Statutes Section 736.0504 defines a “discretionary distribution” as a “distribution that is subject to the trustee’s discretion whether or not the discretion is expressed in the form of a standard of distribution”, and whether or not the Trustee has abused the discretion.

Section 736.0504(2) further indicates that if “a trustee may make discretionary distributions to or for the benefit of a beneficiary” then “a creditor of the beneficiary, including an [exception creditor], . . . may not . . . (a) compel a distribution . . . ; or (b) . . . reach the interest . . . the beneficiary might have” should the trustee choose to exercise their discretionary distribution authority.”⁶²⁷

Even though the beneficiary does not have any ability to compel distributions, Florida Statute § 736.0504(4) allows a beneficiary to “maintain a judicial proceeding against [the] trustee for an abuse of discretion or failure to comply with a standard for distribution.” Stated differently, this means that the trustee should not abuse the trustee’s discretion and must decide whether or not he will make a distribution to the beneficiary.

Courts have found, however, that a trustee’s discretion to approve or deny distributions is not limited by provisions that request the trustee to consider the beneficiary’s general means of support or accustomed standard of living. In *Mason v. Mason*,⁶²⁸ the court held that a provision, which provided the Trustee with sole discretion in providing for the beneficiary’s “support, maintenance, education, and medical needs,” while “taking into consideration any other means of support,” was a valid spendthrift provision to prevent creditor access.

Courts have directed that such provisions are merely guidance and should not be construed to force trustees to make distributions inconsistent with the terms of the trust. In *Ziino v. Baker*,⁶²⁹ the court

⁶²⁷ The exact language states: “(2) Whether or not a trust contains a spendthrift provision, if a trustee may make discretionary distributions to or for the benefit of a beneficiary, a creditor of the beneficiary, including a creditor as described in s. 736.0503(2) [exception creditors], may not: (a) Compel a distribution that is subject to the trustee’s discretion; or (2) Attach or otherwise reach the interest, if any, which the beneficiary might have as a result of the trustee’s authority to make discretionary distributions to or for the benefit of the beneficiary.”

⁶²⁸ *Mason v. Mason*, 798 So. 2d 895 (Fla. Dist. Ct. App. 2001).

⁶²⁹ *Ziino v. Baker*, No. 5:07-CV-217-OC-10GRJ, 2009 WL 10670723 (M.D. Fla. June 16, 2009).

concluded that a provisio, which encouraged the Trustees to consider the standard of living that the Beneficiary had been accustomed to, “did not limit the co-trustees’ unbridled authority to make disbursements within their discretion,” and therefore declined to issue a writ of garnishment.

In interpreting such clauses as giving the trustee sole discretionary authority, courts have made note of common trust terminology. In *Mason*, “sole authority” was vested in the Trustee, while in *Ziino*, multiple Trustees retained “broad discretion in the management and distribution of trust income and principal and, to the extent allowed under Florida law.”

The 1994 Minnesota Supreme Court decision of *U.S. v. O’Shaughnessy* held that there was no attachable interest and that the settlor intended the trustee to have unlimited discretion⁶³⁰ under the following language: “The Trustees in their discretion may pay to [the Beneficiary], or for his benefit, all or such part of the principal or the annual net income of the trust estate as they shall see fit during his lifetime.”

A Florida Bar Journal article by Peter B. Tiernan entitled *A Trustee’s Duties and Responsibilities Under Discretionary Invasion Provisions*⁶³¹ makes it clear that trusts should be drafted so that no payments can be forced out by the beneficiary: “Notwithstanding a trustee’s duty to act reasonably and in good faith under Florida law, . . . Florida courts would still decide that all a beneficiary of a discretionary trust has under Florida law is a mere expectancy (as opposed to a proper interest). Therefore, such beneficiary would have no right to demand any distributions from the trustee. Conversely, the trustee would have no duty to make distributions for a beneficiary’s basic needs. . . . Consequently, as long as the trustee gives due and proper consideration to the beneficiary’s request, (i.e., the trustee uses his judgment), and he does not act in bad faith, dishonestly or from an improper motive, no distribution should be required.”⁶³²

FLORIDA’S EXCEPTION FOR LIFETIME QTIP TRUSTS.

While Florida has not adopted asset protection trust legislation which permits grantors to benefit from trusts that they fund without being accessible to creditors, Florida Statute 736.0505(3) provides that one spouse can establish a lifetime income trust for the other spouse, with the donor spouse not being considered as having contributed to the trust, so that the donor spouse’s creditors cannot reach the trust, even when the donor will benefit from the trust after the death of the lifetime beneficiary spouse, assuming that the trust is drafted like a third party spendthrift creditor protection trust for the benefit of the donor after the donor’s spouse’s death.

The key language of the Statute (which is also provided in its entirety at Footnote 574)⁶³³, is as follows:

⁶³⁰ *U.S. v. O’Shaughnessy*, 517 N.W. 2d 574, 577 (Minn. 1994).

⁶³¹ The Florida Bar Journal, *A Trustee’s Duties and Responsibilities Under Discretionary Invasion Provisions* by Peter B. Tiernan, October 2005, Volume 79, No. 9.

⁶³² 79 Fla. Bar J. 50, 53.

⁶³³ (1) Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

(a) The property of a revocable trust is subject to the claims of the settlor’s creditors during the settlor’s lifetime to the extent the property would not otherwise be exempt by law if owned directly by the settlor.

(3) Subject to the provisions of s. 726.105, for purposes of this section, the assets in:

(A) A trust described in s. 2523(e) of the Internal Revenue Code of 1986, as amended, or a trust for which the election described in s. 2523(f) of the Internal Revenue Code of 1986, as amended, has been made; and

(B) Another trust, to the extent that the assets in the other trust are attributable to a trust described in paragraph (a), shall, after the death of the settlor's spouse, be deemed to have been contributed by the settlor's spouse and not by the settlor.

As the result of this statute, Spouse 1 could contribute \$2,000,000 of assets to a trust to pay income to Spouse 2 for Spouse 2's lifetime. Spouse 2 may also have the right to receive amounts as reasonably needed for Spouse 2's health, education and maintenance.

On the death of Spouse 2, the trust may be held for the health, education and maintenance of Spouse 1, and Spouse 1 will not be considered to have been the grantor or a contributor to the trust.

The following is an excerpt from LISI Estate Planning Newsletter Archive Message #2813 entitled *The Biden 2-Step for Wealthy Families: Why Affluent Families Should Immediately Sell Assets to Irrevocable Trusts for Promissory Notes Before Year –End and Forgive the Notes If Joe Biden Is Elected, A/K/A What You May Not Know About Valuing Promissory Notes and Using Lifetime Q-TIP Trusts* by Alan S. Gassman, Jerome B. Hesch and Martin B. Shenkman:

Wealthy individuals who postpone taking appropriate action to eliminate estate taxes may not be able to

(b) With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution.

(c) Notwithstanding the provisions of paragraph (b), the assets of an irrevocable trust may not be subject to the claims of an existing or subsequent creditor or assignee of the settlor, in whole or in part, solely because of the existence of a discretionary power granted to the trustee by the terms of the trust, or any other provision of law, to pay directly to the taxing authorities or to reimburse the settlor for any tax on trust income or principal which is payable by the settlor under the law imposing such tax.

(2) For purposes of this section:

(a) During the period the power may be exercised, the holder of a 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.

(b) 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 greater of the amount specified in:

1. Section 2041(b)(2) or s. 2514(e); or

2. Section 2503(b) and, if the donor was married at the time of the transfer to which the power of withdrawal applies, twice the amount specified in s. 2503(b), of the Internal Revenue Code of 1986, as amended.

(3) Subject to the provisions of s. 726.105, for purposes of this section, the assets in:

(a) A trust described in s. 2523(e) of the Internal Revenue Code of 1986, as amended, or a trust for which the election described in s. 2523(f) of the Internal Revenue Code of 1986, as amended, has been made; and

(b) Another trust, to the extent that the assets in the other trust are attributable to a trust described in paragraph (a), shall, after the death of the settlor's spouse, be deemed to have been contributed by the settlor's spouse and not by the settlor.

use the \$11,580,000 gift tax exemption after 2020. A political change in November 2020 could lead to lower estate and gift tax exemptions effective as early as January 1, 2021. In *Quarty v. U.S.*, the Ninth Circuit Court of Appeals ruled that a retroactive tax increase does not violate the Constitution. The court held that the increase in the estate and gift tax rates was a rational means to raise revenue, noting that an increase in tax rate was merely an increase of an existing tax, not a wholly new tax, citing other court decisions as precedent. Reducing the exemption is *not* a new tax. 170 F.3d 961, 969 (ninth Cir. 1999). The time to act is now!

Implementation of the planning process can take several months. Consideration of the step-transaction doctrine and the reciprocal trust doctrine might suggest planning for time between various components of a plan. Using valuation discounts often requires time for an appraisal.

Changing the ownership of assets, may require getting approval from co-owners or lenders with due on change in ownership provisions, complying with terms of governing documents for the entities to be transferred, and more. Determining planning decisions, which can take time. Additionally, valuation discounts, note sale transactions, and other techniques, may be subject to gift tax return audits and possible IRS challenges. What is not always addressed is that the stress, costs, and risks of discount planning can be reduced significantly by using the “2-Step Process” described below.

This newsletter is designed to explain the fundamental legal and financial principles underlying the concepts we will discuss and why those concepts should be implemented over two calendar years (2020 and 2021), or better in 2020, to best position clients for a possible reduction in the estate tax exemption. Moreover, the techniques we discuss can position families to reduce estate and gift tax exposure even if a reduction in the exemption does not occur until 2026.

IRREVOCABLE TRUSTS THAT ALLOW FOR THE PAYMENT OR REIMBURSEMENT FOR INCOME TAXES OWED BY THE GRANTOR ON TRUST INCOME.

Under a trust which has assets that would not be subject to the creditor claims of the grantor does not become accessible to such creditors just because the Trustee has the authority to reimburse the grantor for income taxes that are paid as the result of trust income.

For example, a parent may establish an irrevocable trust for the benefit of her children, and retain the right to replace the trust assets with assets of equal value, while also providing the trustee with discretion to reimburse the parent for income taxes that she pays as the result of the income of the trust being included in her personal income tax return under the “Defective Grantor Trust” income tax rules. Even though the parent is not a beneficiary of the trust under income tax law, all income and deductions from the trust will be considered to be income and deductions of the grantor, with consequent income tax liability if the net income is positive.

This applies even where the determination as to whether to reimburse the taxes is purely discretionary in a trustee other than the grantor.

For example, Mary may own an S corporation which generates \$100,000 a year of income tax from operations. Mary may donate 90% of the ownership of this company to trusts for her children and remain at arm's length with the company and the trust.

The trust may generate \$90,000 a year of income, and Mary may therefore pay \$33,000 a year of federal income tax for 10 years, totaling \$333,000.

The Trustee has the discretion to reimburse Mary for the income taxes, and the law and the trust document does not provide a limit on the amount of time that can pass between the taxes being paid and the amount being reimbursed.

It is therefore possible that the Trustee can reimburse Mary for up to \$333,000 of taxes after the 10th year, and that Mary's creditors would not be able to reach into the trust, even though Mary has the power to replace the trustee with any individual other than a relative or employee of Mary. The authors thank Jonathan Gopman for his analysis and writing with respect to this statute.

A DISCUSSION OF DOMESTIC ASSET PROTECTION TRUSTS.

Whether and when to use self-settled Asset Protection Trusts for non-estate tax planning purposes is a widely deliberated and not always agreed upon question. Many members of the Asset Protection Trust community have indicated that these trusts have been very effective in protecting assets from creditors, but not all of the case law or war stories have been kind to those who use these trusts. In several cases, there have been negative results for the debtor because of last minute asset transfers and dishonesty, although the vast majority of Asset Protection Trusts have been respected, or at least not seriously challenged. One well-known creditor protection trust lawyer has indicated that he prepared more than 2,000 of these trusts over the decades, and that no client has ever had to give up even a majority of trust assets in creditor claim situations. The vast majority of his clients established trusts on the Cook Islands. He has since passed away.⁶³⁴

Whether an advisor is “for” or “against” Asset Protection Trusts, it is important to understand them. The underlying theory for Asset Protection Trusts is that a creditor cannot reach assets not owned by a debtor, except under fraudulent transfer theories.

In 2009, the IRS released Private Letter Ruling 200944002, which confirmed that a grantor was able to form and fund an irrevocable trust in an asset protection jurisdiction that allows the grantor to be a discretionary beneficiary while having trust assets not be included in the grantor's estate for federal estate tax purposes. A great many individuals formed Asset Protection Trusts in 2012 to make use of their \$5,120,000 gift exemption when the law was positioned to step back to a \$1,000,000 gift exemption January 1, 2013 (which thankfully did not occur). As of 2018, the per person estate tax exemption is \$11,700,000, and is scheduled to increase annually with the Consumer Price Index. In the past, most Asset Protection Trusts were drafted to be “incomplete gifts” for federal estate and gift tax purposes, but now a high percentage Asset Protection Trusts will be drafted strictly for estate tax planning purposes.

⁶³⁴ We can all be thankful that Barry Engel advanced the science and industry of asset protection trusts in the late 1980's. Barry passed away in 2017, and is sorely missed by many debtors and very few creditors.

For example, an individual with a \$9,000,000 net worth, who has never used her \$11,700,000 estate tax exemption, could place up to \$11,700,000 worth of assets into an irrevocable trust in an asset protection jurisdiction that allows for her to become a discretionary beneficiary upon the occurrence of certain events. If that trust is worth \$20,000,000 when the grantor dies, it can escape federal estate tax, and in the meantime be considered a non-marital asset to possibly be protected from divorce if the grantor is not married when then trust was funded or uses pre-marital assets to fund the trust. Also, the trust may enable the grantor to avoid the Florida elective share inheritance rights of his or her spouse, and to provide creditor protection and other advantages.

It is therefore important that estate and tax planners be familiar with the uses of Asset Protection Trusts.

Good Reasons to Use Florida as the Jurisdiction of an Irrevocable Trust:

- No income taxes on trust income.
- No Florida estate, inheritance or gift taxes.
- A well-developed trust law and experienced probate court judiciary.
- A 360-year Rule Against Perpetuities.
- Ability to appoint a Designated Representative, who can waive the right to receive accountings and disclosures on behalf of some or all of the beneficiaries.
- A flexible decanting statute to facilitate transferring trust assets to another irrevocable trust for the same beneficiaries.
- A great place to live or visit!

Good Reasons Not to Use Florida as the Jurisdiction of an Irrevocable Trust:

- An ex-spouse or child's power to invade for child support and alimony.
- Obligations of a trustee to make extensive disclosures to beneficiaries who the settlor may not want to have such information.
- Annual reports and extensive expenses relating thereto.
- Possibility that clauses in trusts requiring beneficiaries to have certain religious orientation, sexual orientation, or to be married may be viewed as unenforceable as against Florida public policy.
- Creditor access to non-lapsed withdrawal powers.
- Concern as to "court of equity" interpretations.
- Potential concern that federal legislation could cause domestic trusts to be subject to governmental agency liability under future law, which would not apply to international trusts or trusts that may exist in less conservative jurisdictions.

SELF-SETTLED SPENDTHRIFT TRUSTS IN ASSET PROTECTION STATES.

Some states have enacted legislation allowing creditor protection for self-settled trusts. These statutes typically refer to the trusts as "Domestic Asset Protection Trusts" and are thus called DAPT statutes.

The statutes vary from state to state, with Alaska, Delaware, Nevada and South Dakota being the most popular and publicized jurisdictions.

For example, in 1997, Alaska enacted the first United States self-settled trust protection legislation. A number of states followed Alaska's lead, most notably including Delaware in 1997 and Nevada in 1999.

Alaska state law provides creditors with a four-year "look back" period, during which assets transferred to an irrevocable self-settled trust may be accessible. Alaska's "look back" statute Section 34.40.110(d) provides as follows:

- (4) A cause of action or claim for relief with respect to a fraudulent transfer of a settlor's assets under (b)(1) of this section is extinguished unless the action under (b)(1) of this section is brought by a creditor of the settlor who
 - is a creditor of the settlor before the settlor's assets are transferred to the trust, and the action under (b)(1) of this section is brought within the later of
 - (1) four years after the transfer is made; or
 - (2) one year after the transfer is or reasonably could have been discovered by the creditor if the creditor
 - (A) can demonstrate, by a preponderance of the evidence, that the creditor asserted a specific claim against the settlor before the transfer; or
 - (ii) files another action, other than an action under (b)(1) of this section, against the settlor that asserts a claim based on an act or omission of the settlor that occurred before the transfer, and the action described in this sub-paragraph is filed within four years after the transfer; or
 - becomes a creditor subsequent to the transfer into trust, and the action under (b)(1) of this section is brought within four years after the transfer is made.

Alaska Stat. § 34.40.110(d) (2016) (emphasis added).

Delaware imposes a four-year look-back period, and other states' look-back periods range from one and a half to five years. Nevada is one of the best asset protection jurisdictions because Nevada's look-back period is only two years and its DAPT statute also has the fewest exemptions of all states. For an excellent description of Nevada law, please see Nevada lawyer Steve Oshins' materials below.

Although these states provide protection for self-settled trusts, there is some uncertainty as to which state's law would apply in the event that a creditor sought to reach into the trust: would the court apply the law of the settlor's state of residency or the law of the state in which the settlor created the trust?

Despite this uncertainty, many asset protection attorneys continue to use these trusts and believe that they can be an effective tool for protecting assets, so long as the trust is properly funded before the look-back period and complies with all technical requirements of the jurisdiction in which it established.

CHAPTER 12

OFFSHORE ASSET PROTECTION TRUSTS

INTRODUCTION.

The use of offshore asset protection trusts by U.S. citizens became popular in the 1980s and 1990s after creditor protection trust lawyer Barry Engel and others worked with the Cook Islands to enact a sophisticated and thorough statutory law preventing creditors of self-settled trusts from reaching trust assets. This law has since been improved and has been widely accepted as being “as good as it gets” by a significant number of members of the asset protection planning community.

As further described below, asset protection trusts are viable estate planning tools, so long as they are properly designed, drafted, and implemented.

A number of jurisdictions have followed the Cook Islands’ lead and have well-developed statutes, trust companies, and associated industries to support the use of these trusts, including Nevis, Belize and the Bahamas.

The Cook Islands and other typical “offshore creditor protection trust jurisdictions” allow a trustee located or residing in the jurisdiction to hold assets for the benefit of the settlor and other family members in the trustee’s discretion, which may be limited as described below. As a result of these laws protecting self-settled trusts, thousands of United States residents have established asset protection trusts in foreign jurisdictions.

Commonly, the sole or primary asset conveyed to such a trust will be 100% ownership or majority position in a limited liability company, limited partnership, or similar domestic or foreign entity that can be managed and controlled subject to a fiduciary standard by the grantor or others to help assure that the foreign trust company does not have responsibility for the management of real estate, businesses, and investments that are better handled within the United States.

In forming these trusts, it is crucial to plan in advance. These trusts should be created and funded well before a creditor situation arises in order to avoid statute of limitation and possible contempt of court issues.

These trusts typically share a few common characteristics. First, the trust should be irrevocable and should give the trustee or trustees’ discretion to pay or withhold payment. The grantor should not be a trustee. The trustee is typically a foreign trust company or financial institution, and possibly a trusted friend or advisors serving as co-trustee. Many grantors also name “trust protectors” in the trust document who have power to replace the trustee in order to assure responsiveness. Most offshore creditor trust statutes allow the grantor to retain the power to replace the trustee. The trust will almost always contain a provision stating that the situs of the trust governs the trust provisions.

Clients who utilize these trusts must be careful to disclose, their existence on financial statements, and it is essential that appropriate tax reporting and Treasury Department disclosures be filed on time and annually. Many clients mistakenly assume that offshore trusts offer income tax advantages, however, this is almost never the case. The assets held under an Asset Protection Trust are generally taxed as if they were owned by the grantor, with very few exceptions.

In 2019, *In the Matter of the Cleopatra Cameron Gift Trust*, the South Dakota Supreme Court held that the “Full Faith and Credit” clause of the U.S. Constitution requires a state court judge to ignore judgment enforcement rules in his or her state where an Asset Protection Trust has been properly formed and funded. In *Cleopatra*, a California-based trust established by a decedent for his daughter, Cleopatra, was moved to South Dakota after having been ordered to pay child support by a California court that subsequently ordered the trust to continue making payments after the South Dakota Trustee refused to do so.

The trust agreement provided that Cleopatra’s creditors could not reach into the trust, and that distributions would be made for Cleopatra as deemed appropriate by the trustee. Since Cleopatra did not form the trust or fund it with her own assets, in most states it would normally not be accessible to Cleopatra’s creditors.

Unfortunately for Cleopatra, this trust, which was formed and funded in California, and had a California trustee, was found to be accessible to Cleopatra’s ex-husband in order to pay him court ordered child support and also attorney’s fees in the California family court. This is because California law will allow a court to order a trustee to pay support obligations, where a court finds that the trustee exercised its discretion in bad faith.

Cleopatra’s ex-husband filed suit in South Dakota, and claimed that the full faith and credit clause of the U.S. Constitution required the South Dakota court to follow the determination of the California family court to the effect that California law applied to enable the court to order child support to be paid by the trustee of the “now in” South Dakota trust.

The South Dakota circuit court found that the Full Faith and Credit Clause of the U.S. Constitution did not apply in this situation, because the question of remedies available to satisfy a judgment against a California resident, like the trust, should be based on South Dakota law, and not California law.

The decision of the circuit court was appealed to the South Dakota Supreme Court, which affirmed the decision of the South Dakota circuit court, and found that the trust’s spendthrift provision prevented any creditors of Cleopatra, including exception creditors, to penetrate the trust.

The cases that run contrary to this decision, as to both foreign and domestic asset protection trusts have determined that the law of the residence of the debtor will be controlling, but without discussion of the Full Faith and Credit Clause of the U.S. Constitution. Time will tell whether all states with DAPTs will apply the law of the residence of the debtor or will follow South Dakota’s lead.

It is therefore best to always have belts and suspenders in place, which can include partial ownership of LLCs to help assure charging order protection, flee clauses to permit the transportation of trusts to an offshore jurisdiction, and not having the debtor as a beneficiary of a particular trust, unless or until

circumstances beyond the reasonable control of the debtor exist, so that the trust may be protected from creditors in the state where the debtor resides.

Tax lawyers that set these trusts up must be familiar with the IRS's pronouncement in CCA 201208026 in 2012, which found that a grantor was making a completed gift to a trust even though he retained the right to appoint how the trust assets would pass on his death. This CCA is described in Steve Leimberg's LISI Asset Protection Planning Newsletter #207 entitled "Planning After IRS Memo 201208026: How Foreign Can Creditor Protection Trust Laws Get?", and came as a great surprise to tax professionals who practice in this area, as explained in an article which criticizes this IRS decision. This article is available upon request from the authors, Alan S. Gassman, Leslie A. Share, Ken J. Crotty, or Kacie A. Hohnadell.⁶³⁵

The following article, written by Vibha Vallabh, General Counsel, Southpac Group Limited, provides an interesting viewpoint on recent developments with respect to offshore trusts:

TRADITIONAL FUNDAMENTALS vs ONGOING INVENTIVENESS AND PASSING FASHIONS

BY VIBHA VALLABH, General Counsel, Southpac Group Limited

It is a truth universally acknowledged that the settlor of a trust should not meddle in trust affairs.

The role of being a trustee is somewhat precarious at the best of times, and yet, the fundamentals have never changed since the Crusades. Over the course of time, the adoption of new fashionable industry practices has seen this creature evolve in order to accommodate the client's every whim. But modernity has failed in recent times with two recent legal judgments causing catastrophic consequences. However with a bit of inventiveness, traditional fundamentals and modernity can still work together.

Both cases provide insight into the approach taken by the courts with regard to passive trusts, and perhaps serve as a warning of things to come as more courts adopt the precedents set by these two cases. This is particularly relevant, as law governing the trusts in both cases exist, even though courts in different jurisdictions held sway over their outcomes.

Going Back to the Fundamentals

The first case is *Mezprom Bank vs Pugachev* [2017] EWHC 2426 (Ch).

⁶³⁵Gassman, Share, Crotty & Hohnadell: Planning After IRS Memo 201208026: How Foreign Can Creditor Protection Trust Laws Get? Leimberg Information Services 11-Sep-12 Steve Leimberg's Asset Protection Planning Email Newsletter – Archive Newsletter #207.

Pugachev is a Russian oligarch who lived in London. Pugachev is the settlor, beneficiary, as well as the protector of five New Zealand trusts settled by declaration. The total value of assets held in the trusts was US\$95m at the date of judgment.

Pugachev founded Mezprom Bank in Russia in 1992, which was held by a company. During the GFC, the bank went into liquidation. The bank was declared bankrupt and the Russian Court ruled personally against Pugachev for the sum of US\$1bn. The Russian order was recognised by an English Court pursuant to the Cross Boarder Insolvency Regulations 2006. The Claimants applied for an order in England to bring the trust assets located in England within the scope of a worldwide freezing order. This was initially refused but upon appeal was successful.

The Hon. Mr. Justice Birss did not consider the trusts to be shams, and instead looked at their true effect. He concluded that the settlor never had the intention of creating the trusts because of the extensive powers Pugachev held within them; which could, if used, ensure that the assets were reverted back to him. The trusts were merely dressed up as nominee or agency agreements because Pugachev did not divest his interest in the assets to the trusts, they always remained Pugachev's personal property, leaving the door wide open for the Claimants to enforce their Russian liquidation order.

In coming to this conclusion, the Judge focused on the substance of the trust over form and on the following:

(i) He considered Pugachev to be the ultimate beneficial owner of the trusts, despite his son also settling assets into them. He did not think that Pugachev's son would be in a financial position to contribute such assets and, in fact, concluded that he was acting as nominee for his father.

(ii) Under the trust deed, Pugachev had the power to direct the sale of the residential property.

(iii) The Judge observed that trust deeds often include a protector, which may provide for the power to remove and appoint trustees, and a power of negative consent. However, in this case, he considered the Protector had both and then some more. Such powers are not fiduciary in nature but they can be; this issue was considered irrelevant. Instead, the distinction should be made as to whether the protector, who is also a discretionary beneficiary, could lawfully act in a selfish way in favour of himself and against the interests of other discretionary beneficiaries, compared with a power which could only be exercised properly for furthering the interest of discretionary beneficiaries.

(iv) The Judge thought that the powers given to Pugachev as protector were personal as, in substance, the deeds allowed Pugachev to retain his beneficial ownership of the assets. If the protector's powers were limited and ceded control of

the assets to the trustee without the power to get them back, then he would not be the beneficial owner of the assets.

(v) The fact that the power of removal of trustees was expressed to be “with or without cause” is significant. The Judge was critical of this point, saying that by the deed stating that the removal of a trustee may be without cause seems to negate any idea that the power is subject to a limitation of any kind. Had the protector not been the settlor (nor discretionary beneficiary), then he could see that the words would not have been read the same way.

(vi) In considering substance over form of the trusts, the Judge found that the trusts fulfil Pugachev’s true intention, which was not to lose control of the assets. The Judge found that at all material times he regarded all the assets in the trusts as belonging to him, and intended to retain ultimate control. The point of the trusts was not to cede control of his assets to someone else; it was to hide his control of them.

As a side note, the Judge was critical of the evidence provided by the director of the New Zealand corporate trustee. He pointed out that although the trustee knew of the assets held in the trust, they had no knowledge of what was occurring in relation to them. The trustee sought reliance on the fact that, strictly speaking, the trust assets were just shares in the company, which ultimately held the property. The Judge said that this will not do. It does not reflect the manner in which the trustee actually undertook its duties at the time because the deeds do not include an anti-Bartlett clause to oust the trustee’s duties to inquire into the affairs of trust-owned companies.

Inventiveness Gone Wrong

The second case of note is *Zhang Hong Li and Another v DBS (Hong Kong) Ltd and Others*, CACV 138/2017, which was decided in Hong Kong. The trust was established in Jersey with a Jersey trustee (DBS Trustee). The trust held a British Virgin Islands holding company (Wise Lords), which held a portfolio with DSB Bank. The holding company had a corporate director (DHJ Management) and a nominee director (DBS Corporate). The investment advisor to the holding company was one of the co-settlors (Ji).

The holding company took a high risk approach to investments, namely various foreign exchange products. The portfolio was leveraged with a loan from DBS Bank. To begin with, the portfolio was making a profit; however, by August 2008, the loan was US\$96.37m which was 73% of the total portfolio value of US\$131.8m. In the aftermath of the GFC, there was a net reduction of 70% of the holding company’s net asset value. The settlors brought a claim against the trustee, corporate director, and nominee director of the holding company, for breach of trust. Their claim was successful. The trustee was not permitted to rely on indemnity provisions within the trust deed on grounds that the trustee’s breach of duty had

directly caused the loss of trust assets, which directly led to a diminution in the value of assets held by Wise Lords' portfolio. Where it had been found that there was a breach of trust, the liability was gross negligence and remained personal to the trustee, therefore as such cannot be transferred to the current trustee.

Both the lower court and appeal court found that the trustee was negligent in its duty of care with regard to the trust assets, despite the trust agreement having an anti-Bartlett provision. This would ordinarily mitigate this duty if the assets were managed by someone else, thus not requiring the trustee to conduct business of the trust with the same care as an ordinary, prudent man of business would extend towards its own affairs. However, this did not occur in this case. The court imposed a higher standard of duty: the trustee must exercise a high-level supervisory role.

The Appeal Court, a panel of five judges, held that whilst the trustee had no duty in pre-approving each investment made by the holding company before Ji made it, the trustee and the director of the holding company had high-level supervisory roles to override Ji's investment decision made by the holding company beforehand. This is despite the fact that neither the trust deed nor the law required this.

The Judges explained that the trustee ought to have had overarching supervision; regularly monitoring and being responsible for ensuring that the value represented by the overall trust fund was subject to appropriate control, review, investment expertise, and management. The Judge noted that the trustee never reversed any of the 519 transactions that had been entered into by the holding company.

They also noted that the purpose of the trust deed did not match the investment risk, which the documents reflected was for confidentiality, caring for children, succession planning, and avoidance of estate duty and asset protection.

The Judge held that although the trustee had an anti-Bartlett clause that stated the trustee has no obligation to obtain information regarding the holding company, it still should have done so as a shareholder of it.

The high-level supervisory duty arises when the trustee chooses not to exercise the power to interfere in the business of the company, or to seek information when no reasonable trustee should refrain from doing so. The failure to do so amounts to a breach of trust. Therefore, the trustee should have approved the investments [not approved] with the power to override the investment advisor's (co-settlor) decision and reverse the transaction she advised for the holding company, rather than everyone doing as she had commanded.

The Court found that not only did the trustee fail to discharge a high-level of supervisory duty over the investments made by the holding company, but the nominee director of the holding company failed to discharge its duty as director. They

further found that the trustee was liable for the acts and omissions of the nominee as they considered them their agent, and not an administrative conduit despite the fact that the trustee was not always informed of their actions.

He also said that the trustee's breach of duty had directly caused the loss of the trust assets, in that they directly led to the diminution of the value of assets held by Wise Lords' portfolio. These breaches of duty had directly led to the losses being suffered by Wise Lords' portfolio.

Additionally, the trustee failed to perform the role it had assumed and a high-level of supervision, in order to ensure that the trust asset is subject to appropriate control. The task to be performed by the trustee involved more than rubber-stamping the transactions.

Finally, the Court said that it was a matter of common sense that, to properly discharge the task, the trustee must have at least kept itself informed of the prevailing financial conditions and that the financial crises did not happen overnight. The trustee ought to have exercised more caution before giving approval for the impugned transactions.

The Court considered the function of the corporate manager of the holding company, including its nominee company and its actions, was tantamount to either willful misconduct on their part, or by such acts of omissions, DHJ acted in such a negligent manner that could be described as "serious and flagrant."

The Court held that DBS Corporate, as nominee director of Wise Lords, owed the duties of a director to Wise Lords despite only providing directorship services pursuant to a Services Agreement. It has to discharge its duties as a director, to act bona fide in the best interests of the company, and exercise reasonable care, skill, and diligence in the performance of their functions and management of the company's affairs.

Therefore, the directors of Wise Lords, DHJ, and DBS Corporate were the same person, despite DBS Corporate being its agent, just as he found that DHJ and the trustee also were. DHJ breached their duty of care as a director. A director has fiduciary obligations to act bona fide in the interest of the company. This breach of duty amounts to gross negligence directly caused loss of the assets held in Wise Lords' portfolio.

Despite DHJ and Ji entering into a Services Agreement, the Court held that DHJ could not rely on the indemnity provision therein to exempt it from liability, because their actions constituted gross negligence on the part of DHJ and that of their agent, DBS Corporate.

A director has fiduciary obligations to act bona fide in the interest of the company. This breach of duty directly caused loss of the assets held in Wise Lord's portfolio.

In comparing the structural and management styles of the trust in the DBS case, the approach is very similar to what the settlor and trustees do, namely:

(i) The trust deeds have an anti-Bartlett provision (this is legislatively provided for in certain jurisdictions);

(ii) The assets of a trust are held by a holding company which are administered passively by the trustee, without knowledge of the trustee;

(iii) It provides corporate directors of the holding company, which also acts passively in its role;

(iv) It provides nominee directors, which also acts passively in its role;

(v) The trustee, director of the holding company, or nominee director do not carry out a high level of supervision when all parties choose not to exercise the powers to interfere in the business of the company, or seek information when no reasonable trustee should refrain from doing so.

(vi) The assets held in trust are not subject to appropriate control, and the trustee rubber-stamps transactions.

It is interesting to note if the Court would have decided differently had not all the parties to the structure been in house and part of DBS Bank. Monitoring each other would have been impractical if all parties to the structure were independent of each other. Would they have been equally liable? Who would have been held liable?

The Way Forward

How the trusts were managed and administered in the above cases is not unusual and it is, probably for many, industry practice to take a passive approach to managing trust's assets and having measures in place that allow a trustee to do so. Unfortunately, collectively, the two cases as mentioned above show that the courts are becoming less tolerant of such practices, and any protection the trustee may have had in mitigating their risks in being passive in their roles may no longer hold.

Trustee companies must take a more active role in managing trusts by adopting practices that allow this to occur. This may include, but is not limited to, the following:

(i) The trustee must take a high level supervisory role of a trust where the parties (trustee, corporate director, or nominee director) choose not to exercise their powers to interfere in the business of the holding company.

(ii) The trustee must seek information on the assets from clients and take an active role as a shareholder of the holding company ought to.

(iii) Any corporate director or nominee director provided by the trustee company must take a more active role as a director of a company ought to.

(iv) Transactions must not be rubber-stamped on a no-questions-asked basis.

(v) Trustee company databases must reflect full information on the assets being administered, including those held by holding companies.

(vi) Indemnity agreements must be entered into with the settlor and the beneficiaries of the trust for each transaction.

(vii) Widen the anti-Bartlett provision by excluding trustee liability for (withholding) not withholding approval for investments recommended by the investment advisor.

(viii) State protector's powers being fiduciary so they are not personal.

(ix) Before on boarding of a client, if it appears that the settlor has too much control to an extent that the trust assets could revert to him/her if they exercise their powers, then a warning notice must be sent to the client informing them of this.

(x) Generally, trustee companies should start implementing measures where they, as trustees, take a more active role as opposed to being passive.

If the risk of a case being brought against the trustee, for a breach of trust, will be reduced; and chances that an order of restitution will be made against the trustee, personally, would be slim.

The *Pugachev* and *DBS* cases show that a client cannot have their cake and eat it too. Trustees should look at implementing the above recommendations and adopt a high level supervisory role over assets held by the holding company of the trust.

Fundamentals and Modernity Working Together

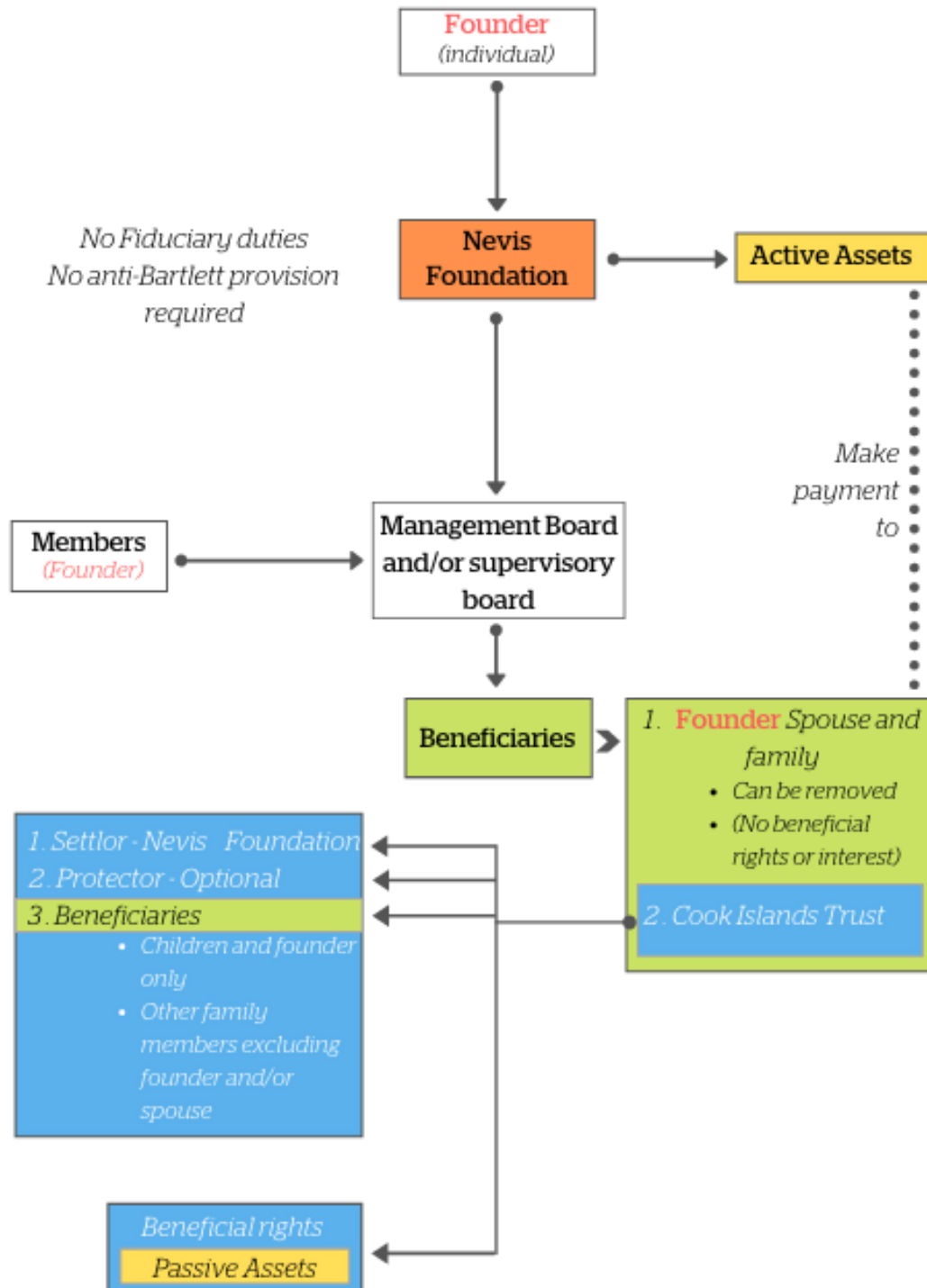
The following structure was devised with the *Pugachev* and *DBS* judgments in mind. It allows a client to have some degree of control, new and modern but at the same time protecting the integrity of the trust.

The Nevis foundation is unique unlike those found in civil law countries where its purpose is limited. It can act as a holding or trading entity for assets which will be directly managed and administered by its board member(s). The Nevis foundation is a hybrid creature of a trust and company. It operates like a company except without shareholders. The foundation must have a purpose and may also have beneficiaries that have no beneficial rights as they would in a trust so can be removed at any time especially in an event of duress.

In this structure the Cook Islands trust will be a beneficiary of the Nevis foundation. The foundation can manage its active high risk assets without having to exercise a high level supervisory role. As the foundation is not a trust, there are no fiduciary duties imposed on the management board so anti- Bartlett provisions are required.

The foundation should periodically make distributions down to its beneficiary, the trust, for safe keeping. In an event of duress at either end, the foundation simply removes the trust as a beneficiary. It can then stand alone with all the assets that were transferred to it. The trust must be administered and managed with the principles discussed in mind but the assets will be at less risk as all the activity takes place in the foundation.

The truth universally acknowledged that the settlor of a trust should not meddle in trust affairs remains unchanged, it has just been achieved by a different method.



SETTLOR'S CONTROL.

In the 1996 case of *In re Portnoy*,⁶³⁶ the Bankruptcy Court for the Southern District of New York found that the debtor was dishonestly trying to avoid paying bank debt, and that upholding his foreign trust arrangement would be repugnant to New York's public policy. Thus, the court applied New York law, rather than the law of the Jersey Channel Islands, which was where the trust was located. In this case, the debtor told the creditor bank that he was paying for expensive cancer treatment in Europe, when, in actuality, he was secreting the funds into an offshore Asset Protection Trust.

In determining that New York law applied, the court *In re Portnoy* weighed the interests of both jurisdictions in the litigation, stating that "[o]n the one hand, Portnoy is a United States domiciliary who transferred all of his personal property to an offshore trust at a time when knew that his guarantee to a New York bank of the debts of his New York company would soon be called" while "[o]n the other hand, Jersey has an interest in determining what rights remain in the settlor of a trust under its law." The court determined that New York has the "greatest interest in the litigation" and applied New York law.⁶³⁷

The court further emphasized Portnoy's ability to control the disposition of trust assets, particularly noting that he had the power to advise the trustee.⁶³⁸ In criticizing Portnoy's argument, the court stated that "[the trustee's] fidelity to Portnoy is plainly apparent, for during the course of this very motion, Portnoy successfully directed the trustee to pay from the assets of the trust for a legal analysis of Jersey law for the sole purpose of determining whether Portnoy would be entitled to a bankruptcy discharge under United States law."⁶³⁹

Finally, in denying the defendant's motion for summary judgment, the court stated that "I think it probably goes without saying that it would offend our policies to permit a debtor to shield from creditors all of his assets because ownership is technically held in a self-settled trust, where the settlor/beneficiary nonetheless retains control over the assets and may effectively direct disposition of those assets."⁶⁴⁰

Since the *Portnoy* decision, there have been a number of other decisions known to the authors that have come to the same conclusion, based upon less horrendous facts.

For example, in the case of *In re Lawrence*, the debtor transferred \$7 million to an offshore trust and retained the sole power to change trustees, while apparently lying to the court about what he had done. Two months later, a judgment was issued against him for over \$20 million dollars. The bankruptcy trustee sought an order requiring the turnover of trust assets. The lower court granted the order based upon the conclusion that the debtor "had control over the Trust, through his retained powers to remove and appoint Trustees and to add and exclude beneficiaries" and held him in contempt for failing to turn over the assets. The court further rejected his impossibility defense, finding that the impossibility was self-created because 1) the trust was created in an "obvious attempt to shelter his funds" the judgment; and 2) when the debtor became an

⁶³⁶ 201 B.R. 685, 702 (Bankr. S.D.N.Y. 1996).

⁶³⁷ *Id.* at 696.

⁶³⁸ *Id.* at 700.

⁶³⁹ *Id.*

⁶⁴⁰ *Id.*

excluded person under the duress clause, “he retained the ability to appoint a new trustee, who would have the power to revoke the excluded person status at any time.”

In the 2019 Bankruptcy Court case of *In re Rensin*, the court found that an “old and cold” Belize Trust, which had been moved from the Cook Islands to a different trust company in Belize in 2014 was controlled by the trustee, and not the debtor, and that large annuity contracts purchased by the trustee with “old and cold money” from the trust, and part of a \$350,000 contribution made by the debtor in 2015, were controlled by the trustee, and thus not considered to have been “fraudulent transfers” made by the debtor to himself. The court found that the annuity contracts were therefore protected from the creditors of Mr. Rensin. This case is further discussed in depth at Section E of Chapter 1.

LAWRENCE AND BILZERIAN – SCHOOLS FOR GAOLS.

An April 25, 2002 article on cases in which debtors have been jailed is reproduced below:

LAWRENCE AND BILZERIAN – SCHOOLS FOR GAOLS

By: Alan S. Gassman

Reprinted with permission from Leimberg Information Services 25-Apr-02 Steve Leimberg’s Asset Protection Planning Email Newsletter – Archive Message #17

LISI Commentator Alan Gassman from Clearwater Florida shares with us what he calls “A Pilgrim’s Nightmare: The Return of Debtor’s Prisons: Bad Facts Make Reprehensible Law.” Alan also adds a new term – at least to my vocabulary. The word is CONTEMNER. It’s a person who ... treats the law – or a court – or a court order – with contemptuous disregard.

Keep reading and you’ll also learn how a thug named Queenie, sewing (or is it suing) machines, and the life and hard times of a renegade financier and corporate raider all can teach us some good lessons about asset protection planning.

This case is a warning to both clients AND their attorneys that the courts “are mad as hell and wouldn’t take it anymore!”

EXECUTIVE SUMMARY

Two recent Appellate cases and a Florida bankruptcy prison-related negotiation serve as a reminder that aggressive asset protection planning is not a sport for the fainthearted. These court decisions make it clear that Courts will treat the transfer of assets to an offshore asset protection trust as an intentional act of creating an impossibility. Immunity from a contempt order on the grounds that it is impossible to comply may no longer be possible when the impossibility is self-created.

While the conventional advice for clients with big creditor problems has been to give up the assets that are non-exempt in a bankruptcy setting, overall clients who have employed more daring strategies and have relied upon the advice of aggressive but skillful counsel often have come out much better off. The operative phrase is “skillful counsel”.

One way for debtors to “beat the creditors” has been to go offshore with assets. The results of the offshore asset protection planning have been so good that the U.S. court system has reacted in quite an ardent manner.

While the court cases that have employed contempt orders to place debtors in jail have been based upon particularly intense circumstances that would not apply to 99% or more of the situations where offshore asset protection techniques are used, the appellate decisions which have come down to justify these situations can have a profoundly detrimental effect upon the “honest debtor” who seeks only to put assets aside for the benefit of themselves and their family while leaving sufficient assets and sufficient time to satisfy reasonably expected creditor obligations.

NOT GOOD ENOUGH TO SAY, “I CAN’T!”

In fact, these court decisions explicitly state that the transfer to an offshore asset protection trust will be presumed to constitute an intentional act of creating an impossibility, so that immunity from being subject to a contempt order will not be available.

ANDERSON: WHERE IT ALL STARTED!

The initial Bad Facts – Bad Law case that began this Ninth and Second Circuit Court of Appeals “attitude” was the *Anderson* case, *Federal Trade Commission v. Affordable Media*. It appears from the Bankruptcy and Circuit Court of Appeals opinions that the Andersons were quite dastardly. They committed a number of civil offenses in the process of raising investor money by aggressive television and telephone methods. Then they wired that money to a Cook Islands trust, apparently knowing full well that they would be pursued by both investors and the Federal Trade Commission.

The Andersons further misrepresented their trust situation to the court, and apparently did not receive good legal advice in structuring the trust, having made themselves the trust protectors and failed to have provisions in the trust that would remove them as trust protector when an event of duress occurred.

While the bankruptcy judge and Ninth Circuit Court of Appeals referred to illegal conduct, dishonestly in court, and obvious potential substance over form nature of the trust arrangement, the language of the Ninth Circuit Court of Appeals was to the effect that virtually any offshore asset protection strategy will be presumed to be illicit and reversible by the grantor, with a heavy burden of proof.

If you are not familiar with the *Anderson* case, you may want to review the following quoted language from the Ninth Circuit Court of Appeal’s opinion:

“The Andersons reportedly spent many months in jail on contempt, and then ostensibly capitulated to go to the Cook Islands with the FTC and to ask the court to order that the assets held under trust be transferred to a new trust company opened by the FTC. The Cook Islands court refused to honor that request, so the assets are still safe and sound, and the Andersons are apparently out of jail, at least in part because they may have demonstrated that it was indeed impossible for them to regain the assets.”

Most of my clients would probably not be so happy to have saved their assets at the cost of spending almost a year in jail.

LAWRENCE:

The *Lawrence* case involved a debtor who, according to the bankruptcy judge sitting in Miami and the Second Circuit Court of Appeals, was at least as dastardly as the Andersons.

Mr. Lawrence owed a significant amount of money to Bear Sterns. But his knowledge of this large debt didn't stop him from transferring assets to a Mauritius trust.

Mr. Lawrence then was apparently far less than truthful with the bankruptcy judge as to the transfer, the nature of the trust arrangement, and the powers he held over the trust.

As with the *Anderson* case, Mr. Lawrence apparently received no (or poor, or didn't listen to) legal advice in structuring the trust. There was no coherent trust document that separated Mr. Lawrence from the control of the trust.

As with the *Anderson* case, the Bankruptcy Court awarded Mr. Lawrence three meals a day as well as free room and board in the form of a contempt citation. Mr. Lawrence was sentenced to jail on contempt October 5, 1999 and, as you read this, remains there.

WHY DOESN'T THE JUDGE SAY WHAT HE REALLY FEELS?

Most LISI members have probably not seen the Second District Court of Appeal's opinion, and because it is quite concise and self-explanatory, the following trial court excerpts are appropriate to share with overzealous clients:

"Now, I like to put things in simple terms. Let's talk about what happened here. We had a debtor, big time debts, big time litigation with Bear Stearns, went on for 42 months, ultimately a \$20 million, roughly, judgment in place, 42 months of that. Within a few days of that a bankruptcy filed – excuse me, not a bankruptcy filed, but a transfer to a trust in a place called Mauritius.

For the purposes the debtor wanted to accomplish, Mauritius may as well have been Mars. In fact, Mars would be better, it would be harder to contact, but the object when you make such a transfer is to put assets out of reach of creditors.

Do you think that all of the attorneys, the trustee, the Court, do you think we're fools? This is the most obvious thing possible. This is almost a ludicrous defense.

You could have had a decent one, but you lied about it. The decent one would be tell us the truth. The truth is you tried to immunize yourself from your creditors, nothing wrong with that. You might not succeed, but that's what you tried to do.

Now, it's been obvious from the pleadings and from the file, from the statements of counsel, that it's been extremely difficult to get the cooperation of the debtor, therefore we had the motion under Federal Rule of Civil Procedure 37(2)(a) and then (b) and we've been engaged in that for three days.

There is no doubt in my mind whatsoever, and I think there is an ample record to justify this as well, if we bring the case under 727, clearly this debtor has concealed assets and discharge would be denied. I don't think there is any way he is ever going to get a discharge of his debts.

Under 37(2)(b), however, I think the relief which has been requested doesn't even require a denial of discharge, it simply is better to do what should be done here, really what will hopefully have some prophetic affect against some other debtors, and that is to grant the relief requested by Mr. Singerman, strike the pleadings and grant default and that relief you may have, Mr. Singerman.

Now, after I receive that, I'll work up a written decision, which will include denial of discharge and relief requested under 37(2)(a) and (b).

In addition, I will refer the matter to the attorney, U.S. Attorney and I'm sure from there it will go to the FBI. I think also there will be a proceeding for perjury under which Mr. Lawrence, you will probably go to jail.

If you truly want to improve your situation in life, then you will give up this farce, this folly, this charade of trying to hide behind this legal trust under the law of Mauritius. As far as I'm concerned, it might as well be Mars. I think the whole thing is patently ridiculous.

What you did is you tried to be clever, you went to a London attorney. They go to the Indian Ocean, find an island, they make ridiculous, I've never seen such goofy. Crazy pleadings - - excuse me, provisions as in this trust, where anything they can think of that would threaten you would allow them to take action to further immunize you. It's just a joke, truly, it's a joke.

I think lawyers who participate, by the way, in that type of folly, and I know there's developing case law in this regard, are liable under our laws and that is certainly something that can be pursued, as well. It's a developing area of the case.

I think you probably saw something somewhere by some sharpie saying you can immunize yourself, go ahead and do this. Then you also thought you could get help in Bankruptcy Court and Florida is famous for help in Bankruptcy Court. You have the homestead exemption, which is subject of national notoriety, but you're not going to get away with this and you're never going to get a discharge. You're probably going to go to jail and you're probably going to be watched forever.

Listen to what I'm saying. If you don't, between now and August 24th help them get the money without triggering further action under this farcical trust, then what's going to happen is never a discharge, no dismissal of this case ever, FBI, probably, investigation through the U.S. Attorney, probably go to jail. You've got a choice.

I would also like to say this, you performed very well up there. It was amazing how clever you were and I was just shocked how you would vacillate. At times your reasons seemed to be pretty good in that you would think yes, maybe I should go along and try to help get this money back and then you would, on coaching through objection by counsel, slip right back into yes, a good trust, I'm protecting my assets, they cannot get it.

If you don't, I would say you're asking - - if you think this is bad so far, wait until you get back into District Court on your criminal proceedings for perjury. Wait until you get into jail, see how you feel then. Wait until you eventually maybe get out of jail and they're still after you and you still can't make money."

Excerpts from the Lawrence appellate decision are also instructive:

A Bankruptcy Court has the power to imprison a debtor for contempt of court when the debtor fails to comply with a Turnover Order. Once a proper showing of a violation of the order has been made, "the burden of production then shifts to the alleged contemnor, who may defend his failure on the grounds that he was unable to comply...In order to succeed on the inability defense, the alleged contemnor must go beyond a mere assertion of inability and establish that he has made in good faith all reasonable efforts to meet the terms of the court order he is seeking to avoid." On appeal the district court's finding that the contemnor has not met his burden of proof in presenting his impossibility defense is a factual determination subject to review under the clearly erroneous rule.

The courts determined that Lawrence's testimony was not credible and that the Trust documents did not preclude his exercise of control over the Trust.

Even if we were to find that Lawrence had set forth sufficient evidence of impossibility, we must agree with the trial court that Lawrence's claimed defense is invalid because the asserted impossibility was self-created. We previously have held that, "where the person charged with contempt is responsible for the inability to comply, impossibility is not a defense to the contempt proceedings."

"If the bankruptcy judge determines that, although Lawrence has the ability to turn over the Trust res, he will steadfastly refuse to do so, the judge will be obligated to release Lawrence because the subject incarceration would no longer serve the civil purpose of coercion."

THE SCARY THING IS...

I was disappointed to find that the Second Circuit chose to use the broad language from the Anderson case without attempting to distinguish arrangements where debtors have engaged in legitimate offshore planning arrangements by placing a reasonable portion of their nest egg offshore for the primary purpose of benefitting family members who rely upon their support at a time when the client is not insolvent but faces normal business risks that are inherent in our court and business systems.

BILZERIAN: ROUND AND ROUND IT GOES (WENT) AND WHERE IT STOPPED...

Nobody knows. The final noteworthy case involves the settlement of the SEC's actions against Paul Bilzerian, who owed \$130,650,328.17 of non-dischargeable debt to the SEC and one other creditor, based upon an enforcement action that was commenced in 1989 when Mr. Bilzerian was convicted of securities laws violations and sentenced to four years in prison. In 1991, Mr. Bilzerian filed a bankruptcy in the Middle District of Florida and between 1994 and 1999, according to a Memorandum of Opinion of the Bankruptcy Court "Bilzerian transferred his substantial assets into a complex ownership structure of offshore trusts and family owned companies and partnerships. It is clear that he did this purposefully to insulate his assets from the reach of his creditors." This apparently included a Cook Islands Trust, a Nevada Limited Partnership owned 99% by the Cook Islands Trust and transactions involving a multi-million dollar home in Tampa, Florida.

Ordering Mr. Bilzerian to jail, the court noted the following:

Bilzerian's own words also reflect his perspective and motives for filing this case:

(a) "[I]t shouldn't be a shock to anybody that I . . . have no reason, I mean, to dedicate my life to trying to earn money all of which would go to basically pay a judgment that I don't believe, with all due respect to the Court, should have been entered in the first place."

(b) "So that there will never be a misunderstanding on this point, I wish to make it crystal clear, for so long as I draw a breath, no matter how long it takes, no matter whether I reside in a prison cell or a rat-infested apartment or the largest mansion in the world, I will never, ever rest until the truth of my case is published for all the world to see."

After being incarcerated from January 30, 2001 until February 2002, Mr. Bilzerian and the government came to an agreement where he apparently gave substantial, but less than all, of his assets to the government in exchange for settlement of all claims.

The following are excerpts from an article in The St. Petersburg Times dated February 5, 2002:

"After nearly a year in prison - - including some memorable days sharing a cell with a bullet-scarred guy named 'Queenie' - - Paul Bilzerian is back inside his family's \$5.7 million Tampa mansion. The former corporate raider was freed from a maximum-security lockup in Miami on Jan.16 after his wife, Terri Steffen, agreed to hand over millions of dollars in stock and other property to the federal Securities and Exchange Commission.

'They had no right to use me as a hostage to extort money from her,' said Bilzerian, who maintained the home and other assets are not his. 'They made it clear to me: I'd never get out of prison unless she paid the ransom.'

Bilzerian said his most recent stint in prison was 'horrifying.' It included a short stay in Tampa Bay area jails, several months at a minimum-security 'camp' in Miami and the longest period at a maximum-security lock-up there. Bilzerian said 'People don't

understand just how awful those places are. There were weeks upon weeks that I wasn't about to see the sunlight or brush my teeth.' He indicated the facility was housed with violent criminals.

During one of three periods he spent in special confinement, he shared a cell with 'Queenie,' who Bilzerian said was there for allegedly 'smashing and cracking the skull of another inmate.' Bilzerian said 'Queenie' called himself a thug, then proceeded to demonstrate by showing me his bullet holes and the obituaries of his gang members."

While Mr. Bilzerian's case may not have involved an offshore trust, it points out that clients who may be placed into incarceration on contempt charges could have to face a very unpleasant situation, and could be subject to bodily harm and immunity of governmental officials who might mismanage their incarceration.

HOME FOR SALE!

Where do we go from here?

Buying a big home in Florida (up to 160-acres outside of city limits with the fraudulent transfer statute being trumped by the Homestead Exemption!) is looking better and better!

A number of other cases have analyzed foreign asset protection trusts, and from a practical standpoint the only thing that United States-based judges have been able to do is to place the settlor/debtors into jail on contempt charges, as described in the materials below.

Alaska followed suit in 1997 by having the first U.S. creditor protection trust legislation. Colorado's common law has probably had this feature since the 1800s, but the law there is not entirely clear.

A number of states have followed Alaska's lead, most notably including Delaware in 1997 and Nevada in 1999. Alaska has a four-year statute of limitations.

STEVE OSHINS' DOMESTIC ASSET PROTECTION STATE RANKINGS CHARTS.

[ALAN AND WESLEY TO DISCUSS OSHINS CHARTS.]

The following pages provide attorney Steve Oshins's well respected chart entitled "11th Annual Domestic Asset Protection Trust State Rankings Chart", followed by charts entitled "9th Annual Dynasty Trust State Rankings Chart", "7th Annual Trust Decanting State Rankings Chart" and "6^h Annual Non-Grantor Trust State Income Tax Chart", which can be essential for situs selection for irrevocable trusts. Steve's website at www.oshins.com contains valuable information for estate planners.

11th Annual Domestic Asset Protection Trust State Rankings Chart

Rank	State	Statute (50% weight)	Uniform Voidable Transactions Act (12.5% weight)	Statute of Limitations (Future Creditor) (2.5% weight)	Statute of Limitations (Preexisting Creditor) (2.5% weight)	Spouse/ Child Support Exception Creditors (Spouse 3%, Alimony 1%, Child Support 1% weight)	Preexisting Torts Exception Creditors/Other Exception Creditors (5% weight)	Ease of Use – New Affidavit of Solvency required for every new transfer? (7.5% weight)	Fraudulent Transfer Standard (10% weight)	Decanting State Ranking (5% weight)	Total Score
1	NV	§§166.010 to 166.170	No	2 Yrs.	2 Yrs. or 0.5 Yr. Discovery	No	No	No Affidavit Required	Clear and convincing	Ranked #2	99
2	SD	§§55-16-1 to 16	No	2 Yrs.	2 Yrs. or 0.5 Yr. Discovery	Divorcing Spouse; Alimony; Child Support (only if indebted at time of transfer)	No	No Affidavit Required	Clear and convincing	Ranked #1	98
3	OH	Ch. 5816	No	1.5 Yrs.	1.5 Yrs. or 0.5 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	No	Affidavit Required (with exceptions)	Clear and convincing	Ranked #6	85
4	MO	§456.5-505	No	4 Yrs.	4 Yrs. or 1 Yr. Discovery	Alimony; Child Support	State/U.S. to extent state/federal law provides	No Affidavit Required	Clear and convincing	Ranked #7	84.5
5	CT	Public Act No. 19-137	No	4 Yrs.	4 Yrs. or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support (only if indebted at time of transfer)	Preexisting Torts	No Affidavit Required	Clear and convincing	None	84
6(tie)	DE	Tit. 12, §§370-3576	No	4 Yrs.	4 Yrs. or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	Preexisting Torts	No Affidavit Required	Clear and convincing	Ranked #3	83.5
6(tie)	TN	§§35-16-101 to 112	No	2 Yrs.	2 Yrs. or 0.5 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	No	Affidavit Required	Clear and convincing	Ranked #4	83.5
8	AK	§34.40.110; §13.36.310	No	4 Yrs.	4 Yrs. or 1 Yr. Discovery	Divorcing Spouse	No	Affidavit Required	Clear and convincing	Ranked #8 (tie)	82.5
9	RI	§18-9.2	No	4 Yrs.	4 Yrs. or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	Preexisting Torts	No Affidavit Required	Clear and convincing	Ranked #14	82
10	IN	§30-4-8	No	2 Yrs.	2 Yrs. or 0.5 Yr. Discovery	Divorcing Spouse; Child Support	Property listed on app. to obtain credit – but only as to that lender	Affidavit Required	Clear and convincing	Ranked #10 (tie)	80.5
11	NH	§564-B:5-505A	No	4 Yrs.	4 Yrs. or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	No	No Affidavit Required	Limited clear and convincing standard	Ranked #5	79
12	WY	§§4-10-502, 504, 506(c), 510-523	No	4 Yrs.	4 Yrs. or 1 Yr. Discovery	Child Support	Property listed on app. to obtain credit – but only as to that lender	Affidavit Required	Clear and convincing	Ranked #13	78
13	MI	§§700.1041 to 700.10502	Yes	2 Yrs.	2 Yrs. or 1 Yr. Discovery	Divorcing Spouse	No	Affidavit Required (with exceptions)	Clear and convincing	Ranked #25 (tie)	75
14	MS	§§91-9-701 to 91-9-723	No	2 Yrs.	2 Yrs. or 0.5 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	Preexisting Torts, State/ Criminal Restitution/ Up to \$1.5MM if no \$1MM Umbrella Policy	Affidavit Required	Clear and convincing	None	72.5
15	HI	§554G	No	2 Yrs.	2 Yrs. Pers. Injury; 6 Yrs. Contract	Divorcing Spouse; Alimony; Child Support	Preexisting Torts/ Certain Lenders/ Hawaii Tax	No Affidavit Required	Limited clear and convincing standard	None	72
16	UT	§25-6-502	Yes	None	2 Yrs. or 1 Yr. Discovery (also 120-day mailing/ publication option)	No	No	Affidavit Required	Missing clear and convincing standard	None	60
NR	OK	Tit. 31, §§10 to 18	No	4 Yrs.	4 Yrs. or 1 Yr. Discovery	Child Support	Must be majority Oklahoma assets	No Affidavit Required	Clear and convincing	None	NR
NR	VA	§64.2-745.1; §64.2-745.2	No	None	5 Yrs.	Child Support	Creditor who has provided services to protect trust/ U.S./city, etc.	No Affidavit Required	Clear and convincing	Ranked #16 (tie)	NR
NR	WV	§44D-5-503A; §44D-5-503B	No	None	4 Yrs.	No	No	Affidavit Required	Missing clear and convincing standard	None	NR

*11th Annual Domestic Asset Protection Trust State Rankings Chart created in April 2020. Original State Rankings Chart created in April 2010.

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*The Decanting State Ranking column is based on the 7th Annual Trust Decanting State Rankings Chart (Jan. 2020), at <http://www.oshins.com/state-rankings-charts>.

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9th Annual Dynasty Trust State Rankings Chart

Rank	State	Perpetuities Statute	Rule Against Perpetuities (40% weight)	State Income Tax (2.5% weight)	Third-Party Spendthrift Trust Provision Effective Against Divorcing Spouse/Child Support (Divorcing Spouse – 7.5% weight/Child Support – 2.5% weight)	Discretionary Trust Protected from Divorcing Spouse/Child Support (2.5% weight)	Domestic Asset Protection Trust State Ranking (10% weight)	Trust Decanting State Ranking (10% weight)	Non-Judicial Settlement Agreement Statute (2.5% weight)	Total Score
1	SD	SD Codified L § 43-5-8	Perpetual	No	Protected	Protected	Ranked #2	Ranked #1	Yes	99.5
2	NV	NV Rev Stat § 111.1031	365 years	No	Protected	Protected	Ranked #1	Ranked #2	Yes	98.5
3	TN	TN Code § 66-1-202(f)	360 years	No (except dividends/ interest on residents)	Protected	Protected	Ranked #6 (tie)	Ranked #4	Yes	95
4	AK	AK Stat § 34.27.051	Perpetual/ 1,000 years if exercise power of appointment	No	Protected	Protected	Ranked #8	Ranked #8 (tie)	No	93.5
5 (tie)	RI	RI Gen L § 34-11-38	Perpetual	No (except residents)	Protected	Protected	Ranked #9	Ranked #14	No	88
5 (tie)	WY	WY Stat § 34-1-139	1,000 years	No	Divorcing spouse = Protected Child support = Not Protected (WY Stat § 4-10-503(b))	Protected	Ranked #12	Ranked #13	Yes	88
7 (tie)	DE	25 DE Code § 503	Perpetual for personal property/ 110 years for real estate	No (except residents)	Divorcing spouse = Not Protected Child support = Not Protected (Garretson v. Garretson (1973))	Protected	Ranked #6 (tie)	Ranked #3	Yes	86
7 (tie)	OH	Ohio Rev Code § 2131.09(B) and (C)	Perpetual/ 1,000 years if exercise power of appointment	No (except residents)	Divorcing spouse = Not Protected Child support = Not Protected (Ohio Rev Code § 5805.02(B)(1))	Protected	Ranked #3	Ranked #6	Yes	86
9	MO	MO Rev Stat § 456.025	Perpetual	No (except residents)	Divorcing spouse = Not Protected Child support = Not Protected (Mo. Rev. Stat. § 456.5-503(2))	Protected	Ranked #4	Ranked #7	Yes	85
10	NH	NH Rev Stat § 564:24	Perpetual	No (except dividends, interest on residents)	Divorcing spouse = Not Protected Child support = Not Protected (NH Rev Stat § 564-B:5-502)	Protected	Ranked #11	Ranked #5	Yes	84
11	IL	765 ILCS 305/3	Perpetual	No (except residents)	Divorcing spouse = Protected Child support = Not Protected (735 ILCS 5/2-1403 codifying <i>In re Matt</i> (1985))	Protected	None	Ranked #8 (tie)	Yes	83.5
12	FL	FL Stat § 689.225(2)(f)	360 years	No	Divorcing spouse = Not Protected Child support = Not Protected (FL Stat § 736.0503(2)(a) codifying <i>Bacardi v. White</i> (1985))	Writ of garnishment allowed for spouse, former spouse, child support (FL Stat § 736.0503(3) ; <i>Berlinger v. Casselberry</i> (2013))	None	Ranked #15	Yes	70

*The Domestic Asset Protection Trust State Ranking column is based on the 11th Annual Domestic Asset Protection Trust State Rankings Chart created in April 2020 at http://www.oshins.com/images/DAPT_Rankings.pdf.

*The Trust Decanting State Ranking column is based on the 7th Annual Trust Decanting State Rankings Chart created in January 2020 at http://www.oshins.com/images/Decanting_Rankings.pdf.

*This Dynasty Trust State Rankings Chart created in October 2020. Original Dynasty Trust State Rankings Chart created in October 2012. Copyright © 2012-2020 by Steve Oshins (soshins@oshins.com / www.oshins.com / (702) 341-6000, ext. 2). All rights reserved.

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7th Annual Trust Decanting State Rankings Chart – Page 1 of 2

Rank	State	Has Decanting Statute? (50% weight)	Can Decant Trust with Ascertainable Standard? (7.5% weight)	Notice to Beneficiaries Required? (7.5% weight)	Can Decant Trust with Ascertainable Standard into Discretionary Trust? (7.5% weight)	Can Remove Mandatory Income Interest? (5% weight)	Allow Power of Appointment in Second Trust to Non-Bene? (2.5% weight)	Can Accelerate Remainder Bene's Interest? (5% weight)	Dynasty Trust State Ranking (7.5% weight)	Domestic Asset Protection Trust State Ranking (2.5% weight)	Total Score
1	SD	§55-2-15	Yes	No	Yes	Yes	Yes	Yes	Ranked #1	Ranked #2	99.5
2	NV	§163.556	Yes	No	Yes	Yes	Yes	Yes	Ranked #2	Ranked #1	99
3	DE	12, §3528	Yes	No	No	Yes	Yes	Yes	Ranked #8 (tie)	Ranked #7	88.5
4	TN	§35-15-816(b)(2)	Yes	No	Yes	No	Yes	Silent	Ranked #3	Ranked #5 (tie)	87.5
5	NH	§564-B:4-418	Yes	No, except charitable trusts	Yes	No	Yes	Silent	Ranked #8 (tie)	Ranked #5 (tie)	84.5
6	OH	§5808.18	Yes	Yes	No	Yes	Yes	No	Ranked #7	Ranked #3	77.5
7	MO	§456.4-419	Yes	Yes, only to beneficiaries of second trust	No	Yes	Silent	Yes	Ranked #10 (tie)	Ranked #4	77
8 (tie)	AK	§13.36.157-159, §13.36.215	Yes	Yes	No	No	Yes	No	Ranked #4	Ranked #8	72.5
8 (tie)	IL	760 ILCS 5/16.4	Yes	Yes	No	No	Yes	Silent	Ranked #10 (tie)	Not allowed	72.5
10 (tie)	IN	§30-4-3-36	Yes	Yes	Yes	No	Silent	Silent	Unranked	Not yet ranked	70
10 (tie)	SC	§62-7-816A	Yes	Yes	No	Yes	Yes	No	Unranked	Not allowed	70
10 (tie)	TX	§6112.071 to 112.087	Yes	Yes	No	No	Yes	Yes	Unranked	Not allowed	70
13	WY	§4-10-816(a)(viii)	Yes	No	Yes	Silent	Silent	Silent	Ranked #5	Ranked #10	69
14	RI	§18-4-31	Yes	Yes	Silent	No	Silent	No	Ranked #6	Ranked #9	66.5
15	FL	§736.04117	Yes	Yes	No	No	Silent	Silent	Ranked #12	Not allowed	66

WARNING: THIS 7th ANNUAL TRUST DECANTING STATE RANKINGS CHART IS MERELY A GUIDE. THE USER MUST BE SURE TO ACCESS THE ACTUAL DECANTING STATUTE AND READ THE TRUST PROVISIONS RATHER THAN SIMPLY RELYING ON THIS CHART. FOR EXAMPLE, IN THE MAJORITY OF DECANTING STATES, A TRUST WITH AN ASCERTAINABLE STANDARD MAY ONLY BE DECANTED INTO A TRUST THAT HAS A SIMILAR ASCERTAINABLE STANDARD FOR THE SAME BENEFICIARIES AS THE BENEFICIARIES OF THE CURRENT TRUST. THAT IS ONE EXAMPLE OF A LIMITATION THAT WOULD NOT BE REFLECTED IN THIS STATE RANKINGS CHART.

*The Dynasty Trust State Ranking column is based on the 8th Annual Dynasty Trust State Rankings Chart and the Domestic Asset Protection State Rankings Chart is based on the 10th Annual Domestic Asset Protection State Rankings Chart, both at <http://www.oshins.com/state-rankings-charts>.

*This Trust Decanting State Rankings Chart created in January 2020. Original Trust Decanting State Rankings Chart created in January 2014.

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Steve Oshins is a member of the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada. He was inducted into the NAEPC Estate Planning Hall of Fame® in 2011. He was named one of the 24 "Elite Estate Planning Attorneys" and the "Top Estate Planning Attorney of 2018" by *The Wealth Advisor* and one of the Top 100 Attorneys in Worth. He is listed in *The Best Lawyers in America*® which also named him Las Vegas Trusts and Estates/Tax Law Lawyer of the Year in 2012, 2015, 2016 and 2018. He can be reached at 702-341-6000, ext. 2 or soshins@oshins.com. His law firm's website is www.oshins.com.

7th Annual Trust Decanting State Rankings Chart – Page 2 of 2

Rank	State	Has Decanting Statute? (50% weight)	Can Decant Trust with Ascertainable Standard? (7.5% weight)	Notice to Beneficiaries Required? (7.5% weight)	Can Decant Trust with Ascertainable Standard into Discretionary Trust? (7.5% weight)	Can Remove Mandatory Income Interest? (5% weight)	Allow Power of Appointment in Second Trust to Non-Bene? (2.5% weight)	Can Accelerate Remainder Bene's Interest? (5% weight)	Dynasty Trust State Ranking (7.5% weight)	Domestic Asset Protection Trust State Ranking (2.5% weight)	Total Score
16 (tie)	AL	§19-3D	Yes	Yes	No	No	Yes	No	Unranked	Not Allowed	65
16 (tie)	CA	§19502	Yes	Yes	No	No	Yes	No	Unranked	Not Allowed	65
16 (tie)	CO	§15-16-901-930	Yes	Yes	No	No	Yes	No	Unranked	Not allowed	65
16 (tie)	GA	§53-12-62	Yes	Yes	Yes	Silent	Yes	No	Unranked	Not Allowed	65
16 (tie)	KY	§386.175	Yes	Yes	No	No	Yes	No	Unranked	Not allowed	65
16 (tie)	NM	§46-12-101-129	Yes	Yes	No	No	Yes	No	Unranked	Not allowed	65
16 (tie)	NC	§36C-8B	Yes	Yes	No	No	Yes	No	Unranked	Not allowed	65
16 (tie)	VA	§64.2-779.1-25	Yes	Yes	No	No	Yes	No	Unranked	Ranked #NR	65
16 (tie)	WA	§11.107	Yes	Yes	No	No	Yes	No	Unranked	Not allowed	65
25	MI	§700.7820a / §556.115a	No	Yes	No	No	Yes	Silent	Unranked	Ranked #12	63
26 (tie)	AZ	§14-10819	Yes	No	Yes	No	Silent	Silent	Unranked	Not allowed	62.5
26 (tie)	MN	§502.851	Yes	Yes	No	No	No	No	Unranked	Not allowed	62.5
26 (tie)	NY	§10-6.6	Yes	Yes	No	No	Yes	No	Unranked	Not allowed	62.5
26 (tie)	WI	§701.0418	Yes	Yes	No	No	Silent	No	Unranked	Not allowed	62.5

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IS A FOREIGN TRUST A VIABLE WEALTH PROTECTION STRATEGY?

Attorney Jonathan Gopman, as mentioned above, has been integrally involved in writing and implementing creditor protection trust laws, both in Delaware and Nevis. Jonathan and his team were kind enough to provide us with the following very valuable materials entitled “Is a Foreign Trust a Viable Wealth Protection Strategy – Absolutely!!!”

Is a Foreign Trust a Viable Wealth Protection Strategy – Absolutely!!!
By: Jonathan Gopman, Ryan Beadle, Evan Kaufman, Michael Sneeringer
and Barbara Ruiz-Gonzalez

The following materials were provided to us by Jonathan E. Gopman, Ryan J. Beadle, Evan R. Kaufman, Michael Sneeringer and Barbara Ruiz-Gonzalez from their treatise entitled *Wealth Protection: Domestic & International Planning*, and providing a very in-depth analysis of offshore Asset Protection Trusts.

Although clearly the best and most flexible wealth protection strategy available, the foreign asset protection trust has been one of the most maligned strategies in recent years. Unfortunately, misperception can produce a dominating influence over the legal profession and other professionals who advise clients on estate planning matters. Similar to any area of the law, however, the better lawyers have the ability to separate fact from fiction. For an excellent discussion on this issue, see Bove, “Offshore Asset Protection Trusts, Have the Rumors of Their Death been Greatly Exaggerated?,” * *Trusts & Estates* 67 (Nov. 2010).

The strongest objection to the use of a foreign wealth protection trust seems to be that implementing such a strategy will cause an individual to be incarcerated. This premise is false and without any basis. Proponents of this “**incarceration position**” obtain the basis for this argument from two published cases where individuals who established and funded foreign trusts were incarcerated under the facts of the case. Many opponents to the use of foreign asset protection trusts claim that there are numerous cases where individuals have established offshore trusts and been incarcerated, however, to date, only a limited number of such cases exist and **in none of these cases did the creation or funding of the trust cause the settlor to be incarcerated.**

The following discussion is intended to review these cases and some additional cases involving foreign asset protection trusts and hopefully debunk the myths (that is, separate fact from fiction) regarding the efficacy of implementing this wealth protection strategy. As this discussion illustrates, similar to any other area of the law, practitioners in the asset protection area should exercise caution in assisting clients with implementing any wealth protection strategy. Nonetheless, competent practitioners should continue to recommend clients implement offshore strategies under appropriate circumstances. In exercising caution practitioners should implement some level of know your client (“KYC”) procedures.

Importantly, honest people seek legitimate wealth protection by using foreign trusts that are created and funded under appropriate circumstances. When properly structured and established under appropriate circumstances, foreign trusts can be one of the most effective wealth protection strategies. It is important to recognize that the law permits individuals, businesses and other organizations to plan to protect assets and income from the claims of future unforeseen creditors. It is equally important to recognize that lawyers

have a duty to zealously represent their clients, including lawyers who practice in the estate planning area. Zealous representation mandates that practitioners discuss all available planning wealth protection strategies and convey sufficient accurate information regarding such strategies so clients can make informed decisions.

The following are tips to live by when counseling clients on asset protection strategies:

(i) Counsel clients to establish wealth protection plans as part of the estate planning process. We live in a litigious society because of a justice system that permits the use (if not abuse) of the contingency fee. It is possible that any client who has amassed wealth will become involved in litigation. Will such a client return one day to the office of the client's estate planning attorney inquiring why the client did not receive advice regarding wealth protection strategies. Wealth protection planning should be part of the general estate planning process in the same manner that estate planners counsel clients in legally reducing their estate and gift tax liabilities.

(ii) As a corollary to the foregoing, clients should plan only at appropriate times and under appropriate circumstances and attorneys should only assist clients under such conditions. Many people seek advice about wealth protection strategies because they are involved or concerned that they are about to become involved in serious litigation. This may be the wrong time to plan or valuable opportunities may be foreclosed without raising serious fraudulent transfer issues. As a general rule, if assisting a client with a particular strategy raises an issue as to a fraudulent transfer do not proceed or proceed with a great caution. Bad things can happen to good people if planning is done under inappropriate circumstances. This does not mean that we cannot ethically assist clients who are involved in litigation (or concerned that litigation is imminent). However, it does mean exercise discretion. As a result of the jurisdiction where a client resides or may want to reside, the manner in which a client owns certain property interests (for example, homestead or tenancy by the entirety) or expected inheritance or gifts, it may be possible to achieve significant wealth protection for a client involved in litigation or concerned that litigation is imminent.

(iii) Any client who implements a foreign trust should receive written advice regarding the preparation of and filing of all appropriate tax compliance with the IRS. It should be clear to a client implementing a foreign trust that it is not an income tax savings or tax avoidance device. A US taxpayer who creates and funds a foreign trust is responsible under the grantor trust rules for paying the income tax liability on all of the income generated by the foreign trust and will be required to file certain information returns with the IRS. Failure to comply with these filing requirements can result in significant penalties.

(iv) Following the creation and funding of a foreign trust or any other wealth protection strategy filing bankruptcy should be viewed as an option of last resort notwithstanding that the planning may have been completed under appropriate circumstances. This is not to say that a properly implemented foreign trust structure or other wealth protection strategy cannot survive a challenge in a bankruptcy proceeding. Nonetheless, it is clear from a few bad fact cases that the present environment in the Bankruptcy Court system is hostile toward certain wealth protection strategies. Unfortunately, bankruptcy judges typically have the pleasure of reviewing bad fact cases involving foreign trusts. Additionally, bankruptcy counsel and judges typically possess insufficient knowledge of trust law, property law and conflicts of law rules to reach the proper technical result in most cases. Experience demonstrates that judges in bad fact cases usually reach the proper result; however, the legal analysis is faulty. This faulty analysis has significantly damaged public perception regarding legitimate wealth protection planning.

(v) A foreign trust should not be used as a tool to violate any law. An individual who attempts to use a foreign trust to evade tax or violate any other law should be prepared to pay the ultimate price for such conduct. Reputable offshore service providers would never knowingly assist an individual in violating the law of any sovereign nation. The IRS or any other government agency is never a desired litigant. As important, however, bad people can violate the law using domestic as well as foreign planning vehicles. The foreign aspect may make reporting a bit more exciting though.

(vi) When implementing a foreign trust structure, a client should be strongly counseled not to serve as a co-trustee, protector, advisor or in any other fiduciary capacity. A client should be prepared to relinquish control of the client's assets that will be transferred into the structure. Use only reputable trustees and reputable financial institutions located in an appropriate foreign jurisdiction that maintain nominal or no contact with the US. It may also be prudent not to retain any investment discretion and to custody the assets in such a structure in an appropriate foreign jurisdiction. Importantly, a provincial statement by an individual intimating that a logical person would not relinquish control of millions of dollars to an offshore service provider ignores reality and implies that quality wealth management only exists in the US. Sophisticated investors understand that there is no validity to such a position.

(vii) A client should always be prepared to use a wealth protection structure as a tool to forge a favorable settlement with a creditor. Most bad fact cases prove that even a foreign trust structure with a faulty design can provide significant protection for the assets held in the structure. *Federal Trade Commission v. Affordable Media*, 179 F.2nd 1228 (9th Cir. 1999) is a perfect example. The FTC spent years pursuing a nominal sum held in this foreign structure. It is believed that the corpus of this trust never exceeded \$2,000,000 in value. Arguably, that structure had significant design faults. Furthermore, the trust had the world's worst creditor pursuing its assets (that is, an agency of the US government). In the end, the FTC could not bust the trust. The agency settled with the trustee of the Cook Islands trust. It is believed that following this settlement a substantial portion of the original corpus remains under administration of the trust. While *Affordable Media* involved bad facts, it should serve as an excellent example of how well (and economical) a properly implemented offshore structure works to protect the assets held in the structure. Any creditor represented by qualified counsel should immediately recognize the insurmountable barrier that stands between the creditor satisfying its judgment.

(viii) Know your client and document the reasons your client is establishing an offshore structure. Reputable banks, trust companies and other financial institutions in quality foreign jurisdictions are required to conduct extensive due diligence before accepting a new client relationship. This process is generally far more extensive and impressive than the due diligence required by domestic institutions. A client may be required to prove source of wealth and substantiate that funding the structure will not result in a fraudulent transfer issue.

From a moral and legal perspective it is acceptable to protect wealth using a properly implemented foreign wealth protection structure. When properly structured and implemented under appropriate circumstances, an offshore trust is the most effective and versatile wealth protection strategy available. In a mobile world where professional and business opportunities require clients to move from one jurisdiction to another, such trusts enable a client to protect wealth without relying on arbitrary local law exemptions that differ from one jurisdiction to the next. Additionally, for the sophisticated investor an offshore trust

will be far more attractive as a wealth protection vehicle in comparison to most other strategies such as investment in annuities and insurance contracts (investment vehicles that are potentially exempt in one form or another from the claims of creditors under laws of many states). The cost and limitations of using such vehicles will not be palatable to many sophisticated clients.

Importantly, the bad fact cases must be viewed in proper perspective. The following is intended to provide a summary of some of the more significant cases involving offshore trusts and asset protection:

1. *Riechers v. Riechers*, 178 Misc.2d 170, 679 N.Y.S.2d 233 (1998).

a. Summary: In *Riechers v. Riechers*, 178 Misc.2d 170, 679 N.Y.S.2d 233 (1998), plaintiff (“P”) and defendant (“D”) were seeking to terminate their long standing marriage. D was a practicing physician (a urologist). Several years before the commencement of their divorce proceeding D established a Cook Islands trust for asset protection purposes. The trust was funded with a ninety-nine percent (99%) interest as a limited partner in a Colorado limited partnership. D owned the remaining one percent (1%) of the limited partnership as its sole general partner. The trust’s share of the partnership had a value of approximately \$4,000,000. According to the court, D maintained that he considered establishing the trust “as a result of three (3) separate malpractice lawsuits filed against him between 1984 and 1988.” P confirmed that P and D were concerned about these cases, however, she denied having ever been consulted regarding D’s asset protection planning. P testified that she only became aware of the existence of the trust after she filed for divorce.

D was a beneficiary of the trust as were D’s and P’s children. P was a beneficiary of the trust as the “Spouse of the Settlor,” however, immediately upon the termination of the marriage her interest in the trust terminated. P maintained that she was entitled to a portion of the trust as part of the equitable distribution of the marital assets because the trust was funded with marital property.

In holding in D’s favor by respecting the validity of the trust, the court stated:

It cannot be said with any degree of certainty that the formation of the limited partnership and the Riechers Family Trust [that is, the Cook Islands trust] was an attempt by [D] to avoid the consequences of equitable distribution of marital assets in contemplation of divorce by secreting marital assets or by deliberate dissipation of marital assets. [Citations omitted.] . . . Assuming arguendo that this Court had jurisdiction over the corpus of the Riechers Family Trust, which it does not, a cause of action would not lie to set aside the trust since the trust was established for the legitimate purpose of protecting family assets for the benefit of the Riechers family members.

b. Analysis: The trust was created under appropriate circumstances and at an appropriate time. The court did not find the trust offensive even though asset protection was the primary purpose for the creation and funding of the trust. It is no surprise that when you have these facts, that the validity and governing law of the trust was respected by the court and the settlor was never under any threat of incarceration.

2. *Eulich v. United States*, 2004 WL 1844821 (N.D. Tex. 2004).

In *Eulich*, the tone of the case is set forth in the second paragraph, which provides:

The Internal Revenue Service (“IRS”) is investigating Eulich and his wife, Virginia, (collectively “the Euliches”) for the tax years of 1995, 1996 and 1997. As part of its investigation, the IRS seeks documents relating to a Bahamian trust, the Mona Elizabeth Mallion Settlement Trust No. 16 (“the Trust”), and to various corporations controlled by the Trust. To that end, the IRS issued formal document requests (“FDRs”) and summonses seeking that information.

The most valuable lesson one can learn from this case is that a foreign trust should never be used as a tool to evade tax or violate any other law. In fact, following the creation of a foreign trust by a US taxpayer substantial tax compliance is required to be filed annually with the IRS to report all transfers to and distributions from the trust and all income derived from the assets held in the trust. Following the establishment of a foreign trust structure, a qualified practitioner will work closely with the settlor’s accountant and other financial advisors and the trustee to ensure all tax compliance is prepared and filed in a timely manner.

The issue in *Eulich* was whether the defendant should be held in contempt for failing to comply with the court’s enforcement order. *Eulich* asserted that he had made all reasonable efforts to comply with the court’s order. In particular, *Eulich* was appealing a magistrate’s determination that he:

- (1) failed to add members to the trust’s Advisory Committee (an act the court believed would enhance the likelihood that the defendant could obtain the documentation required by its order);
- (2) failed to file a lawsuit in the Bahamas seeking to obtain this documentation;
- (3) compromised payments due to him from the trust pursuant to an annuity contract and created an impossibility to comply with the court’s order; and
- (4) prevented the trustee from disclosing the documentation required to be produced to the court.

The government also appealed certain aspects of the magistrate’s holdings, most notably requesting the court to increase the amount of the potential fine for Eulich’s failure to comply with the court order and the circumstances under which application of this fine could be tolled. The magistrate held that Eulich’s fine for failing to comply with the court’s enforcement order should be tolled if Eulich files or causes to be filed a lawsuit in the Bahamas to compel disclosure of the documents by the trustee.

The IRS attempted to obtain certain documents related to the Trust from Eulich for over five (5) years prior to the date of this decision.

An individual who establishes a foreign trust under legitimate circumstances should always be able to obtain sufficient information from a trustee (whether a Bahamian trust company or a trust company in another jurisdiction) to comply with applicable tax laws. It is rare that a qualified practitioner who assists a client in creating and funding a legitimate foreign trust encounters any problem obtaining this information. The presence of this issue in any litigation matter should immediately raise a red flag and cause significant concern that the trust was established for an illegitimate purpose.

The court stated that a person seeking a civil contempt order needs to prove by clear and convincing evidence:

“(1) that a court order is in effect; (2) the order required certain conduct by the respondent; and (3) that the respondent failed to comply with the court’s order.” [Citations omitted.]...Once the movant has shown a prima facie case, the respondent can defend it by showing a present inability to comply with the subpoena or order. [Citations omitted.] “While the court is bound by the enforcement order, it will not be blind to evidence that compliance is factually impossible. Where compliance is impossible, neither the moving party nor the court has any reason to proceed with civil contempt action.” [Citation omitted.] “It is settled, however, that in raising this defense, the defendant has a burden of production.”

The court was not persuaded that Eulich made a good faith effort to comply with its order. According to the court, Eulich could have attempted to appoint additional members to the Trust’s “Advisory Committee.” (Apparently this committee may have had the authority to require the trustee to produce the requested documentation.) Furthermore, the court found that Eulich could have filed an action in a Bahamian court to attempt to compel production of the documents requested by the IRS. The court refused to give any credibility Eulich’s defense that filing such an action was expensive and futile.

According to the court:

Although Eulich has requested the documents in question from the parties who likely have physical possession of those documents, he has not exhausted other avenues for obtaining the requested documents, such as adding members to the Advisory Committee of the Trust or filing a lawsuit in the Bahamas to compel the disclosure of the requested documents....The court thus determined that Eulich failed to exhaust all reasonable efforts to comply with the enforcement order.

As previously mentioned, it is the experience of most qualified practitioners in this area that reputable trust companies will assist a settlor with the settlor’s duty to comply with the US tax law. Compliance with US tax law is generally a high priority among such trust companies. It is bizarre that the settlor was not able to obtain the necessary information from the trustee to comply with the court’s order. Nevertheless, it is important to note that Eulich was given two opportunities to use “all reasonable efforts to comply” with the court’s order to avoid further problems related to the contempt order (such as potential incarceration for failing to comply). First, he could attempt to appoint additional members to the Trust’s Advisory Committee – perhaps individuals selected or approved by the court. Second, he could file an action in Bahamian court seeking to compel the trustee to provide him with the necessary documentation. Pursuing this course of action will most likely avoid further problems for Mr. Eulich.

It should be noted the Andersons in *Affordable Media* were given a similar opportunity to comply with the court’s enforcement order. After being incarcerated for several months the Andersons chose to cooperate with the court and Federal Trade Commission (“FTC”) in an effort to comply with the court’s order. Accordingly, the Andersons worked with the FTC in an effort to remove the trustee of their Cook

Islands trust and appoint a private trust company established by the FTC as trustee. Their efforts proved futile and were foreclosed in a Cook Islands court. At that point the Andersons were deemed to have exhausted all reasonable efforts to comply with the court's order. Thus, further incarceration under the court's civil contempt order was no longer permissible, and the Andersons were purged of their contempt and released.

One Troubling Statement from the Eulich Court:

Eulich made a conscious decision to set up the Trust in the Bahamas. He thus created the present dilemma regarding the disclosure or nondisclosure of the documents in question. Therefore, even if Bahamian law would prevent disclosure of the requested documents by new members of the Advisory Committee, which is in dispute, Eulich cannot benefit from a situation that he himself created.

By itself this statement could be troubling to anyone who establishes a foreign trust. Nonetheless, taken in proper context it should not be read to be so broad because doing so would misstate the law in this area. It can be reconciled on the theory that Eulich is impeding the efficient administration of the tax law by failing to cooperate with the production of such documentation. Additionally, referring to the foregoing statement the court itself states:

Accordingly, the court overrules Eulich's objection with regard to the magistrate judge's finding that he failed to exhaust all reasonable efforts to comply with the enforcement order *because he did not add or attempt to add members to the Advisory Committee.* (Emphasis added.)

This is significantly different than stating that "The court made clear it will not allow the impossibility defense where the impossibility has been created by the settlor." Clearly, even in this bad fact case the judge leaves Eulich with an option to avoid incarceration by "exhausting all reasonable efforts" to obtain such documentation by attempting to add members to the Advisory Committee of the Trust and by filing a lawsuit in the Bahamas to compel disclosure. There is nothing in the record of the case that indicates that good faith effort by Eulich pursuing such actions would not be acceptable to the court if such effort later proves futile.

The court sustained the government's objection that Eulich's fine should be tolled if he filed or caused to be filed a lawsuit in the Bahamas seeking disclosure of the required documentation. The court felt it would be unnecessarily burdensome to require the court to monitor the Bahamian lawsuit and that "Tolling the sanctions would thus serve only to reward Eulich's conduct for failing to use all reasonable efforts to comply with the court's enforcement order."

Finally, the court agreed to sustain the government's objection to the amount of the magistrate's fine increasing the fine from \$1,500 to \$5,000 per day recognizing that the Trust had a corpus valued at between \$75,000,000 to \$100,000,000. Further, if Eulich fails to comply with the court's order within thirty (30) days, the fine would be increased to \$10,000 per day.

The court also granted Mr. Eulich forty-five (45) days to comply with its order or it would set a date for a subsequent hearing:

to determine whether Eulich was in compliance and, if he is not, whether the daily fine should be increased or whether Eulich should be incarcerated to obtain compliance with the enforcement order.

Separating Myth from Reality: As many times as one reads the *Eulich* decision (and *Federal Trade Commission v. Affordable Media*, 179 F.2d 1228 (9th Cir. 1999) and *In re Lawrence*, 279 F.3d 1294 (11th Cir. 2002) for that matter), it will not be possible to find a statement that says it is illegal to create and/or fund a foreign trust. This is the case even if asset protection may be the primary motivation for an individual to establish such a trust. Furthermore, no statute exists in any jurisdiction that proscribes such conduct and it is not likely that such a statute will ever exist. In fact, it is the opinion of several prominent practitioners that a properly structured foreign wealth protection trusts are the most effective wealth protection technique available when implemented under appropriate circumstances.

The Problem: *Eulich*, and cases like it, should be carefully examined because such cases teach valuable lessons. It is equally important, however, for lawyers, financial professionals and clients to interpret these cases in a proper perspective. When implemented in an appropriate manner a foreign trust can protect wealth well. Nonetheless, there are certain things a foreign trust was never intended to do – at least when implemented as part of legitimate estate planning. Importantly, it is rare that one reads about a “good fact” cases in the asset protection area, whether the planning involves the implementation of a domestic or international planning technique. Often the facts of the case involve someone transferring property at an inappropriate time (that is, a fraudulent transfer) or retaining significant control over the trust. Furthermore, one should never lose sight of the fact that on one side of the matter you have a creditor who is entitled to collect a debt that is founded on a judgment. On the other side you have a debtor who does not want to satisfy the particular judgment. With rare exception, even if the debtor has engaged in legitimate wealth protection planning, the debtor is never going to win this public relations battle.

Epitaph: In the end Mr. Eulich complied with the court’s order.

3. *Duttie v. Bandler & Kass*, 1992 WL 162636 (1992 SDNY).

In *Duttie*, the wife of the defendant (“D”) settled The Casa Trust, an irrevocable trust, under the laws of Liechtenstein for her and D’s benefit. The court found that D used his wife to transfer to the trust all of his assets, including jewelry and artwork, over several years during pending litigation that resulted in a \$3.8 million judgment against D. A magistrate judge found that the trust was merely a device to hide the true ownership of the assets. Although D claimed that his wife owned various bonds that were transferred to the trust and jewelry that was transferred to a corporation owned by the trust, ***the record showed that D exercised absolute control over the bonds and purchased the jewelry with his own funds***. Since the court treated D as having transferred his assets to the trust during the pending litigation without having received fair consideration, the court found the transfers fraudulent because D did not have enough assets available outside the trust to satisfy the judgment. Therefore, the court held the trust invalid as to the judgment creditor and its assets subject to execution (in a footnote, the court also found the trust invalid as it was “created with the unlawful purpose of evading creditors”). D countered that the court lacked personal jurisdiction over the trustee, ***however, because the trustee had two or three meetings in New York and held most of its assets***

in New York, the court found that through these and other connections, it acquired jurisdiction over the trustee.

4. *In re Portnoy*, 201 B.R. 685 (SDNY 1996).

In *Portnoy*, the bankruptcy court denied the debtor's ("D") motion for summary judgment to be discharged from bankruptcy on the basis of concealment of an irrevocable trust established under Jersey Law with a Jersey trust company as sole trustee. The court posed the possibility that it might not have jurisdiction over the trust, however, it could still determine whether an interest retained in the trust was a concealed property interest. D was the president and sole shareholder of a business and personally guaranteed any business indebtedness to Marine Midland Bank. Approximately two and one-half years later, D began transferring substantially all of his assets to the trust. The last of the transfers was made *before* one year prior to the date of the bankruptcy petition. D was the primary beneficiary of the trust and his children were additional beneficiaries. The trustee had absolute discretion as to the distribution of trust assets although it could consider, but was not bound by, D's written wishes. Additionally, the trustee could exclude any person as a beneficiary of the trust. ***D retained the power to remove and replace trustees and appoint successor trustees.***

During settlement negotiations, D lied about having been financially ruined by expensive experimental cancer treatments, stating that everything except encumbered real property was gone. Further, although D had a \$150,000 salary, he claimed that he only earned \$1,700 per month. These lies did not engender good will from the court despite the validity of the foreign trust. The court held that under both federal law and state law principles, the law of the jurisdiction having the greatest interest in the litigation applied. Although the trust was settled in Jersey, specifically required its interpretation and administration to be under the laws of Jersey, and had a Jersey resident serve as trustee, the court held that New York had the greater interest in determining whether D's rights retained in the trust could be considered a property interest. Even though the court based its decision in part on the fact that the interested creditors were all US domiciliaries and D had the greatest contact with the US when he settled the trust, it added its *belief* that the application of Jersey law would be repugnant to New York and federal policy. The court went further by lauding US policy against self-settled trusts and accusing Jersey of implementing opposing laws to drum up business. The court added a second reason for not recognizing Jersey law, that being that equity would not allow a choice of law provision under an agreement to be given effect to the detriment of a stranger to the agreement, *i.e.*, creditors. Thus, the bankruptcy court determined that D's discretionary interest in the self-settled trust under New York law subjected the entire trust to creditors.

5. *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998).

Brooks ("D") transferred stock in Connecticut corporations to his wife, who then transferred the stock to irrevocable foreign trusts settled in Bermuda and Jersey eight (8) and twelve (12) days later, respectively. Each trust designated the local law of its respective country as controlling. D was named the sole income beneficiary and the trustees had discretion to distribute principal for D's health, comfort, support and his personal and investing needs. The court treated the so-called "**scheme**" as a two-step transaction and determined the trusts to be self-settled as to D. D argued that the applicable foreign law, recognizing self-settled trusts, should control per the trust instruments. The bankruptcy court referred to a rule established by the Connecticut Supreme Court that although public policy supports spendthrift trusts created for the benefit of another, other overriding considerations will not support the same conclusion for the settlor, namely the evasion of debts. Since under Connecticut law creditors can reach a maximum amount a trustee

could pay or apply for the benefit of a settlor-beneficiary, the court held that all of the assets in the trust were property of D's bankruptcy estate.

6. *Federal Trade Commission v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999).

In *Affordable Media*, a husband and wife, the Andersons, had earned \$6.3 million in commissions promoting, via telemarketing, a Ponzi scheme that eventually unraveled. In 1997, the Andersons formed Financial Growth Consultants, LLC to market “**media units**” which allowed purchasers to share in the profits of The Sterling Group, a Las Vegas company that sold unusual gadgets through late-night commercials. Two years prior the Andersons created an irrevocable trust for the benefit of their children under the law of the Cook Islands, *appointing themselves and Asiitrust Limited* (“**Asiitrust**”) *as co-trustees*. Additionally, the Andersons were the protectors of the trust. Six months later, the Andersons were added as beneficiaries of the trust. Subsequently, the Andersons transferred the profits from their commissions to the trust. In April 1998, the Federal Trade Commission (the “**FTC**”) requested and the district court granted a preliminary injunction and temporary restraining order (“**TRO**”) requiring the couple to repatriate any assets held for their benefit outside the US. Specifically, the TRO required the Andersons to “transfer to the territory of the United States all funds, documents and assets in foreign countries held either (1) by them; (2) for their benefit; or (3) under their direct or indirect control, jointly or singly.” Soon thereafter, the couple faxed a letter to Asiitrust requesting the trust assets to be repatriated to the US. Upon receiving the request letter, by reason of an “**event of duress**” as defined under the trust deed, the Andersons were automatically terminated as co-trustees, leaving Asiitrust as the sole trustee. Asiitrust refused to repatriate the assets since it would benefit the FTC as an “**Excluded Person**” (as defined under the trust deed) and breach its duty to act in the best interest of all the beneficiaries of the trust.

In an effort to avoid civil contempt, the Andersons attempted to appoint their children as trustees, but Asiitrust immediately removed them from acting because of the continuation of the event of duress. Upon failure to comply with the TRO by repatriating the trust assets, the district court found the Andersons in civil contempt. The court reasoned that the Andersons, as protectors, could certify whether an event of duress had occurred. The judge ordered the Andersons to be jailed in June 1998. The couple remained in jail until just before Christmas when they promised to replace Asiitrust with a Cook Islands company formed by the FTC (“**CI FTC**”). However, Asiitrust rejected the maneuver as invalid. Finally, the Andersons resigned as protectors and attempted to appoint CI FTC as their successor, but Asiitrust refused to recognize the appointment of CI FTC as protector.

The Ninth Circuit held that the district court did not abuse its discretion in finding the Andersons in contempt. To find a party in civil contempt, the moving party must first prove by clear and convincing evidence that the contemnors violated a specific and definite order of the court, and, if the moving party is successful, the burden shifts to the contemnors to demonstrate they are unable to comply. A party's inability to comply with a contempt order constitutes an absolute defense to civil contempt. The Andersons claimed that compliance with the TRO was impossible because Asiitrust, in accordance with the terms of the trust, could not repatriate the trust assets.

In *dicta*, the Ninth Circuit avoided determining if the terms of a foreign asset protection trust should serve as a defense to a civil contempt charge given that such trusts are designed to frustrate the jurisdiction of domestic courts. Instead, the Circuit Court applied a heightened burden to the impossibility defense in

the context of asset protection trusts and held that the Andersons did not satisfy their elevated burden that compliance was impossible. The court agreed that the Andersons could force the repatriation of the trust assets because, as protectors, they had the power to determine whether an event of duress had occurred. With that power the court resolved that the Andersons could have ordered the trust assets repatriated by certifying that no event of duress had occurred. The court suggested that if the Andersons had succeeded in removing themselves as protectors, they still may have retained sufficient control over the trust, however, the court did not need to resolve whether other facts would support such a conclusion. In affirming the district court's contempt order, the Ninth Circuit identified a court's contempt powers as the only way to coerce settlors of foreign asset protection trusts to repatriate assets.

Soon after the Ninth Circuit's decision, Asiastust brought an action before the High Court of the Cook Islands seeking a declaration as to the administration of the trust, specifically, the effectiveness of (i) its removal as trustee, (ii) excluding the FTC from the definition of Excluded Persons, and (iii) the appointment of the FTC as substitute protector. Determining that the purpose of the three actions was designed to repatriate the trust assets for the benefit of the FTC, an Excluded Person, it held the three documents invalid. Consequently, Asiastust, alone, would have the powers of the protector until the court could appoint a new protector. Ultimately, it is believed that Asiastust entered into a settlement with the FTC of approximately \$1 million to resolve its end of the dispute.

7. *In re Lawrence*, 279 F.3d 1294 (11th Cir. 2002).

The Eleventh Circuit affirmed the bankruptcy court and the district court's finding that Stephen Jay Lawrence ("D") was in civil contempt for failure to repatriate the assets held by a self-settled foreign trust. D filed for bankruptcy in June 1997. Prior to October 19, 1987, D, an MIT graduate, had been a successful options trader, using Bear, Stearns as his clearinghouse. As a result of "Black Monday," D suffered a margin call from Bear, Stearns. Upon the conclusion of an arbitration dispute, Bear, Stearns was awarded \$20.4 million, however, only sixty-six (66) days prior to the arbitration award being entered in favor of Bear Stearns, D settled a trust in Jersey with more than ninety percent (90%) of his liquid assets. A month later, that is, only thirty-six (36) days prior to the award, the trust was amended to make it a spendthrift trust and to change its governing law and administration to Mauritius. (The law of Mauritius imposes criminal penalties on a trustee that discloses information about the trust.) The bankruptcy court rejected D's claim that the arbitration played no role in the creation of the foreign trust.

The trust granted the trustee absolute and uncontrolled power to (i) exclude D as a beneficiary, (ii) name additional beneficiaries, and (iii) disregard any inquiries by a beneficiary. Additionally, the trustee had absolute discretion as to the distribution of trust principal. A second amendment in 1993 added an "anti-duress" provision, restricting D's powers upon an event of duress, and provided that his income interest would terminate upon becoming bankrupt. In March 1995, the trustee of the trust executed a declaration of trust that added D as an "Excluded Person," preventing him from receiving any benefit of the trust. A June 1999 clarification sought to confirm D's exclusion status as irrevocable but was held void in violation of a stay order. Outside an event of duress, D retained the absolute power to remove and replace trustees or add new trustees and to add and exclude beneficiaries.

Citing the public policy rationale of *Portnoy* and *Brooks*, the bankruptcy court held that D's rights and obligations under the trust were governed by Florida and federal law and included the trust property in D's bankruptcy estate. Almost one year after the initial motion to compel, the bankruptcy court issued a

Turn Over Order, directing D to repatriate the trust assets and provide a full accounting, otherwise D would be held in contempt. **The bankruptcy court referred to D's unfettered ability to replace trustees as its primary reason for determining that D was not powerless to repatriate the trust assets.** It also would not accept that anyone would voluntarily transfer \$7 million to a "stranger" in a remote country and give him absolute discretion over the administration of the property.

The bankruptcy court concluded that D had not successfully established the defense of impossibility to complying with its order. More importantly, the court stated that the defense of impossibility is not available when the impossibility was self-created. Consequently, D was held in contempt and ordered incarcerated until he turned over the trust assets and fined \$10,000 per day until he purged the contempt. The district court affirmed the turn over order, the contempt order, and the incarceration order. **In determining whether the trust should be included in the bankruptcy estate, the district court focused on its perception that D had the apparent power to replace or add trustees (despite the anti-duress provision added under the second amendment).** It refused to consider the effect of the anti-duress provision as to D's powers because it "contravene[d] clear public policy against allowing a debtor to shield money . . . from creditors." Furthermore, the district court refused to recognize the exclusion of D as a beneficiary since there was a question as to whether the exclusion was revocable. Thus, according to the district court, D's absolute control over the trustees gave him *de facto* control over the trust. Due to D's record of evasiveness, the district court also was not convinced that it was impossible for D to repatriate the trust assets. Even if it was impossible, the court found that the creation and funding of the trust was done in bad faith to shelter assets from his creditors, and, thus, the "**good faith transfer exception**" to the self-created impossibility bar was not available. D had faxed a letter to the trustee demanding it turn over the trust assets, appointed another individual as the new trustee, and executed an amendment to the trust purporting to appoint the bankruptcy trustee as the sole successor trustee. The district court did not deem the "half-hearted, last-minute" attempts sufficient to purge the contempt. It adopted *Affordable Media's* ruling that settlors of asset protection trusts faced a heightened burden to prove impossibility.

In affirming the lower courts' decisions, the Eleventh Circuit agreed with the Ninth Circuit's holding in *Affordable Media* that it would not respect self-settled spendthrift trusts because such trusts violated public policy. It also found that the district court did not clearly err in determining the anti-duress amendment void under Florida law when included in a self-settled spendthrift trust. Without considering the effect of the anti-duress provision, the Circuit Court decided that D retained the requisite power to control the trustees in a way to repatriate the trust assets as ordered. In reviewing the self-creation exception to the impossibility defense, the Eleventh Circuit took issue with D having created the impossibility just prior to the arbitration award even though the turn over order was issued over eight (8) years later. Despite the affirmation, the Eleventh Circuit added that a contempt order may only be used to coerce compliance; at some point, the order switches from coercive to punitive in violation of the contemnor's due process rights.

After more than six (6) years, D was released from the federal detention center holding him for civil contempt. U.S. District Judge Alan Gold (who had affirmed the contempt order in 2000) entered the order on December 12, 2006, ending the standoff that captured the attention of estate planning practitioners and the media. Despite the bankruptcy trustee's opposition, Judge Gold ruled that the continued indefinite incarceration of D no longer served the civil purpose of coercion.

In August 2006, D filed a motion for Release from Contempt Incarceration. The magistrate to whom the motion had been assigned found that D had failed to meet his burden to show that (1) the contempt order was no longer coercive and (2) there exists no realistic possibility of compliance. The magistrate judge issued its report recommending that D's request for release be denied and that the matter should continue to be revisited by the bankruptcy court at reasonable intervals. After a hearing held on December 8, 2006, Judge Gold rejected the magistrate's recommendation that the court deny D's motion for Release from Contempt Incarceration.

Citing the Eleventh Circuit's opinion in *Commodity Futures Trading Com'n v. Wellington Precious Metals, Inc.*, 950 F.2d 1525 (11th Cir. 1992) (the same case the Eleventh Circuit cited in *Lawrence* for the proposition that a contemnor must establish that he has made in good faith all reasonable efforts to meet the terms of the court order), the bankruptcy trustee insisted that the length of incarceration should not alone be enough to prove that there exists no realistic possibility that one can comply with a court's contempt order. However, the contemnor in *Wellington* had been incarcerated for only three (3) months. Furthermore, D had been incarcerated for less than two (2) years when the Eleventh Circuit issued its opinion. Judge Gold did not base his ruling solely on the period of incarceration. He said that it was a factor in reaching his decision and that, based on the totality of the circumstances, he was obligated to release D from incarceration since there was no realistic possibility that D would comply with the contempt order. Consequently, the incarceration no longer served the civil purpose of coercion. In the court's opinion, D valued his money more than his liberty.

Although Judge Gold directed the Clerk of Court to close the case, he permitted the bankruptcy trustee to file with the bankruptcy court within ten (10) days of his order a request for additional protections as the trustee deems necessary to prevent D from having access to the trust assets. The District Court left open the possibility of further contempt proceedings should D fail to comply with any further order of the bankruptcy court. Moreover, Judge Gold added that his Order did not affect the monetary portion of the contempt sanction (that is, \$130,000) ordered to be paid by Chief Bankruptcy Judge Jay Cristol.

Planning Tips:

(1) Bankruptcy judges must give due consideration to self-settled trusts because of the new fraudulent transfer rule under section 548(e)(1) of the Bankruptcy Code. This provision sets forth the standards by which transfers to self-settled trusts are permissible. Thus, this rule condones the use of self-settled trusts established under appropriate circumstances.

(2) While the authors dispute the accuracy of Judge Cristol's application of Florida trust law in *Lawrence*, even Judge Cristol's argument that such trusts violate public policy under Florida law has been weakened by Florida's new trust code. Although the new Florida trust code adopts § 505(a) of the UTC, it also contains a provision that modifies the application of § 505(a) to certain types of trusts. This provision is found in F.S. § 736.0505(1)(c). This provision provides in relevant part:

the assets of an irrevocable trust may not be subject to the claims of an existing or subsequent creditor or assignee of the settlor, in whole or in part, solely because of the existence of a discretionary power granted to the trustee by the terms of the trust, or any other provision of law, to pay directly to the taxing authorities or to

reimburse the settlor for any tax on trust income or principal which is payable by the settlor under the law imposing such tax.

As a result of this provision (and Florida Statutes § 736.0505(3) discussed below), the Florida Legislature has added Florida to the list of asset protection trust states. This occurs because there is no time limit set on the trustee's ability to reimburse the settlor for such taxes. Thus, in theory a trustee can accrue a reimbursement account for several decades and reimburse the settlor for a tax liability incurred many years in the past.

Furthermore, Florida Statutes § 736.0505(3) now provides:

Subject to the provisions of s. 726.105, for purposes of this section, the assets in: (a) A trust described in s. 2523(e) of the Internal Revenue Code of 1986, as amended, or a trust for which the election described in s. 2523(f) of the Internal Revenue Code of 1986, as amended, has been made; and (b) Another trust, to the extent that the assets in the other trust are attributable to a trust described in paragraph (a), **shall, after the death of the settlor's spouse, be deemed to have been contributed by the settlor's spouse and not by the settlor.**

This provision creates another exception to the self-settled trust doctrine protecting the assets in a self-settled trust from the claims of a creditor of the settlor. The exception relates to any trust for the benefit of the settlor that is established after the death of the settlor's spouse when the settlor created and funded an *inter vivos* general power of appointment or QTIP marital trust for the initial benefit of the settlor's spouse. A settlor can fund an *inter vivos* QTIP trust for the settlor's spouse by gifting assets to such trust. A QTIP election **must** be made with respect to any gift to this QTIP trust. As a result of the QTIP election the trust will be includible in the estate of the settlor's spouse for estate tax purposes. See § 2044. The gift by the settlor to the trust will (must - it would seem) qualify for the unlimited marital deduction. The *inter vivos* QTIP trust may contain provisions that provide for the donor-settlor following the donee-spouse's death. The trust assets should not be subject to the claims of the donor's creditors although the trust is self-settled. According to F.S. § 736.0505(3), the settlor would **not be treated** as the settlor of the trust.

(3) Finally, it worth noting that about four (4) years prior to reaching his decision regarding the self-settled trust in *Lawrence*, where Judge Cristol so vehemently attacked the strategy, even he recognized the possibility that such a trust should be respected by a court when created under appropriate circumstances and designed in an appropriate manner. He stated in *In re Wheat*, "the stated policy against self-settled spendthrift trusts is not as compelling in situations where, as here, the settlor-beneficiary's control is relatively limited." Thus, *Lawrence* was more likely a case of bad facts than a condemnation of all asset protection trusts by Judge Cristol.

8. ***Braswell v. Ryan Investments, Ltd.* (No. 3D06-2827, Fla. App. 3 Dist., July 9, 2008).**

Braswell v. Ryan Investments, Ltd. (No. 3D06-2827, Fla. App. 3 Dist., July 9, 2008), involved litigation originating from a divorce proceeding involving Glenn Braswell ("FH") and his former wife, Renee Braswell ("FW"). FW obtained approximately \$24,000,000 in judgments against FH because FH failed to make payments that were required by a marital settlement agreement entered into in calendar year

2000. (See *Braswell v. Braswell*, 881 So.2d 1193 (Fla. 3d DCA 2004).) At the time this case was issued by the court FH had died. In 1997 during their marriage, FH established a company called Ryan Investments, Ltd. (the “**Company**”). The Company acquired a multi-million dollar residence located in Miami-Dade County, Florida.

In an effort to satisfy a portion of her judgments against FH, FW attempted to execute against the residence owned by the Company claiming that the Company was FH’s alter ego. FW claimed that FH acquired the residence through the Company to defraud her; therefore, the court should permit her to execute on the residence using a legal theory known as “outsider reverse corporate piercing.” This theory has previously been recognized in Florida case law. (See *Estudios, Proyectos e Inversiones de Centro America, S.A. (EPICA) v. Swiss Bank Corp. (Overseas) S.A.*, 507 So.2d 1119 (Fla. 3d DCA 1987), review denied, 518 So.2d 1274 (Fla.1987).) According to the court in *Estudios*:

A corporation’s veil will be pierced where the corporation’s controlling shareholder formed or used the corporation to defraud creditors by evading liability for preexisting obligations. The usual result of piercing the corporate veil is that the controlling shareholder or shareholders become liable for the corporate liabilities. *The remedy is equally available, however, to hold the corporation liable for the debts of controlling shareholders where the shareholders have formed or used the corporation to secrete assets and thereby avoid preexisting personal liability.* (Emphasis added.)

Id. at 1120 (citations omitted); see also *Sweeney, Cohn, Stahl & Vaccaro v. Kane*, 6 A.D.3d 72, 773 N.Y.S.2d 420 (2004), leave to appeal dismissed, 3 N.Y.3d 751, 788 N.Y.S.2d 661, 821 N.E.2d 965 (2004) (applying Florida law); contra *Postal Instant Press, Inc. v. Kaswa Corporation*, 162 Cal.App.4th 1510, 77 Cal.Rptr.3d 96 (2008); see generally 2 A.L.R.6th 195.

The trial court ruled in favor of the Company holding that FW could not execute on the residence (that is, a corporate asset) to satisfy any of her outstanding judgments.

The appellate court affirmed the ruling of the trial court because:

(1) the remedy permitted when outsider reverse corporate piercing is applicable is available only “where the shareholders have formed or used the corporation to secrete assets and thereby avoid *preexisting* personal liability” (emphasis added). *Estudios*, 507 So.2d at 1120; and

(2) the preexisting personal liability condition was not met in this case.

The appellate court recognized that the Company acquired title to the residence well before FW’s claims arose and the obligations upon which her lawsuit was based. The court quoted the trial court with approval:

Even more importantly, [FW] did not, and simply cannot argue that [FH] used [the Company] to “secrete” the La Brisas property [the former marital home] from her “pre-existing debts” (which did not exist) as is required by the *Estudios* case. *It is undisputed that title to the La Brisas property was placed in [the Company] from*

inception in 1997, years before the divorce case was commenced or [FW]’s claims against [FH] arose. Whether or not [FW] knew how her marital home was titled at the time, it is indisputable that [the Company] took title in 1997, years before [FW]’s claims arose. This is not a situation in which [FH] transferred title of Las Brisas to [the Company] after [FW]’s claims arose or even when the winds of divorce were blowing, as required in Estudios for reverse piercing. [Emphasis added.]

Accordingly, it was impossible for FW to establish that the Company was used to avoid execution on a liability because FH’s obligations under the marital settlement (executed in calendar year 2000) did not exist when the residence was acquired by the Company (in calendar year 1997). This fact was fatal to FW’s claim. (See *Mason v. E. Speer & Assocs., Inc.*, 846 So.2d 529, 534 (Fla. 4th DCA 2003), review denied, 857 So.2d 196 (Fla.2003); *Bookworld Trade, Inc. v. Daughters of St. Paul, Inc.*, 532 F.Supp.2d 1350, 1361 (M.D.Fla.2007) (case applied Florida law); see also *Dania Jai-Alai Palace, Inc. v. Sykes*, 450 So.2d 1114, 1118 (Fla.1984); *Barnes v. Liebig*, 146 Fla. 219, 238, 1 So.2d 247, 254 (1941); *Select Creations, Inc. v. Paliqfito Am., Inc.*, 852 F.Supp. 740, 774 (E.D.Wis.1994). See generally 1, (rev. 2006).

The court recognized that the rule that permits outsider reverse corporate piercing is applicable only when it has caused “cognizable damage” to a creditor. See *Gasparini v. Pordomingo*, 972 So.2d 1053, 1055 (Fla. 3d DCA 2008); *Priskie v. Missry*, 958 So.2d 613, 614-15 (Fla. 4th DCA 2007); *Seminole Boatyard, Inc. v. Christoph*, 715 So.2d 987, 990 (Fla. 4th DCA 1998), review denied, 727 So.2d 903 (Fla.1998). In *Braswell* FW suffered no cognizable damages unlike the plaintiff in *Estudios*. In *Estudios*, a guarantor of an existing debt established a corporation and transferred his farm to it to conceal his personal assets and defraud his creditors. For outsider reverse corporate piercing to apply a nexus must exist between a judgment creditor’s loss and the “debtor’s intentional and improper financial maneuvering, which caused [the judgment creditor’s] inability to collect the default judgment.” *Sea-Land Servs., Inc. v. Pepper Source*, 993 F.2d 1309, 1313 (7th Cir.1993). *Litchfield Asset Mgmt. Corp. v. Howell*, 70 Conn.App. 133, 799 A.2d 298, 314-15 (2002), cert. denied, 261 Conn. 911, 806 A.2d 49 (2002); *Olen v. Phelps*, 200 Wis.2d 155, 163-64, 546 N.W.2d 176 (1996), review denied, 201 Wis.2d 436, 549 N.W.2d 732 (1996).

Importantly, the *Braswell* court noted:

Looking at the “piercing the veil” doctrines from a broader perspective which may serve to resolve the narrower problem with which we are now concerned, it seems to us that the rule is, perhaps *sub silentio*, based on the idea that *when one enters into an agreement with another entity, whether individual or corporate, which calls for future performance, it is in presumed reliance on the ability to look to all of that party’s existing assets to satisfy any damage caused by his failure to perform and to require this reliance. The direct and reverse piercing doctrines are respectively designed to prevent a fraudulent breach of that understanding which occurs when a contracting individual later fraudulently transfers his assets to a controlled corporation or a contracting corporation does so to a controlling individual. Obviously the considerations do not exist when the contracting party (in this case [FH]) did not have title to the asset in question ([the Company] did when he made the promises sued upon. (Emphasis added.)*

The facts necessary to support the application of outsider reverse corporate veil piercing did not exist in *Braswell* because:

- (1) The Company owned the home prior to the dissolution of the marriage of FW and FH.
- (2) FW was aware that the Company owned the residence when she entered into the marital settlement agreement.
- (3) In the settlement agreement FW released her interest in the residence regardless of how the residence was titled (although the court did recognize that FW executed this release in part for FH's "promise to pay her large sums, the breach of which gave rise to the judgments she is now attempting to satisfy").

Finally, the court recognized in closing, "Bearing in mind that all corporate piercing is based on equitable principles, it would be highly inequitable now, in effect, to give [FW] the home through other means." See *Barineau v. Barineau*, 662 So.2d 1008, 1009 (Fla. 1st DCA 1995).

If you read the *Braswell* decision one might ask why an attorney specializing in wealth protection planning would be interested in a collection case that involves a corporate law issue, that is, outsider reverse corporate veil piercing. Nonetheless, the most interesting aspects of the *Braswell* case involve the facts that the court failed to include in its written decision. Upon further investigation it appears that a significant portion of the story is missing from the decision published by the appellate court.

Three aspects of the *Braswell* decision are particularly interesting.

- (1) First, the case cites other related reported appellate decisions in this highly contentious matter. Unfortunately, none of these other published decisions provides sufficient information to supply the reader with the necessary facts to obtain the full story regarding the instant case.

- (2) Second, the court failed to provide any supporting information regarding the Company, such as the jurisdiction where the Company was formed and granted its legal existence or the names of the individuals who serve as its officers and directors. In reading the decision one might reach the conclusion that the Company was formed in Florida. This conclusion would seem to be buttressed by the fact that the seminal issue in the case involves Florida corporate law. Nonetheless, a review of the public filings in Florida (available online at www.sunbiz.org) indicates that the Company is neither a Florida entity nor qualified to conduct business in Florida.

- (3) Finally, in reading the decision one might reach the conclusion that FH was the sole owner of the stock of the Company. Of course, if this was the case, the next logical question an attorney should ask is why FW did not attempt to execute on the stock of the Company to satisfy her outstanding judgments. Strangely enough, FW was arguing that the Company was FH's alter ego. By obtaining extraneous facts regarding this case, however, it was revealed that FH did not own any of the stock in the Company.

Perhaps the foregoing is enough to provide the basis for a mystery novel? (Probably not.) Nevertheless, it does lead for some interesting speculation regarding the whole story behind the *Braswell* decision. After all, it seemed strange that the reported decision neglected to include this information. Thus, the author decided to contact counsel for the Company to inquire about the missing information. This

conversation revealed two important details about this case. First, it was revealed that the Company was formed in the Cayman Islands, a foreign jurisdiction, and continues its legal existence under the laws of that jurisdiction. Furthermore, the stock of the Company is held in a trust known as “**The Prince Trust**,” which was settled and continues to be administered in the Cook Islands. (Presumably the law of the Cook Islands governs the trust.) None of these facts gave the court any pause in reaching its decision in favor of the Company, which was implicitly in favor of both of the Cook Islands trust, the legal title holder of the Company, and the settlor of the trust, FH, the actual beneficial owner of the Company.

According to counsel for the Company, the beneficiaries of the trust during its settlor, FH’s life, were FH, FH’s girlfriend and FH’s son. (FH’s girlfriend was probably added as a beneficiary after the dissolution of FH’s marriage to FW. FW was probably removed as a beneficiary of the trust on or before that date.)

One cannot say with any certainty that the trial or appellate courts implicitly recognized the validity FH’s self-settled asset protection trust structure, however, silence on the issue suggests a willingness to respect the validity of the structure or at least consider appropriate arguments concerning its validity.

No information was available concerning any other assets that are held in the foreign trust; however, one can presume that the cost of litigation in this case was paid from other assets in the trust structure.

Also of interest is the fact that the Florida real estate owned by the Company was left and defended intact. It is the author’s understanding that at the time of this case the Company was not able to sell the residence and obtain an acceptable price due to the market conditions for real estate in South Florida. Additionally, no credit line or financing arrangement was sought in an attempt to “strip the equity” from the property. Many asset protection planners would strongly encourage a foreign trustee under these circumstances to take whatever action was necessary to sell such real estate or engage in equity stripping so as to transfer value of the wealth that was otherwise invested in real estate to an appropriate foreign custodian, where it could be held beyond the jurisdiction of a domestic court system. Nonetheless, this recommended course of action should have no relevance to the efficacy of defending a properly implemented trust structure. It is simply a prudent strategy and in many cases could provide additional leverage in settlement negotiations. A maxim of quality wealth protection planning is to recommend a client implement a strategy that provides the greatest degree of certainty the client’s wealth will be protected from future unforeseen creditors.

Although we cannot speculate about the manner in which FH used the residence owned by the Company during his life, a few words of caution are helpful. If domestic real estate is held in a structure in this manner, an asset protection planner should recommend that Company lease the residence to FH. The lease should be structured with terms that reflect an arm’s length transaction with fair market value rent paid for the use of the residence.

The author also had some brief conversations with counsel for FH’s estate that were helpful in understanding some facts in this continuing saga. According to counsel for the estate, no issues related to the offshore trust have been litigated yet. The trust was settled and funded some time in or after calendar year 2000 and before the death of FH in 2003. The estate is currently being administered for the benefit of its creditors with FW being the most significant creditor. Counsel for the estate also sought instructions from the court regarding any action it must take regarding the offshore trust, however, to date the court has refused

to issue any order. Whether action against the trust would be practical, economical or produce any positive financial benefit for the estate is unknown. It was also learned that despite current economic conditions, the residence was sold. The proceeds from the sale, however, have been frozen by court order.

Counsel for the estate also disclosed that FW's divorce counsel is considering pursuing the assets held in the trust, perhaps by attempting to avoid the transfer of those assets to the trust as fraudulent. Such an action would not be successful in the Cook Islands (see Section 13B of the International Trusts Act 1984); however, since the proceeds of the sale of residence are frozen by court order this action can be pursued in a court in Florida at least as to the shares of stock in the Company (see Chapter 726 of the Florida Statutes). If the court bases its decision on the fraudulent transfer rule, it will implicitly recognize the validity of the Cook Islands trust as separate and apart from its settlor, that is, not as a sham arrangement. Thus, regardless of the party ultimately prevailing in this continuing saga, planners should be watching with interest. The analysis the court applies to reach its decision will be the most important part of this case, not the ultimate result. Applying a fraudulent transfer analysis, that is, respecting the validity of the trust, would be consistent with the analysis applied by the court in this case respecting the validity of the Company and the ownership of the residence by the Company.

It should also be noted that FH had a rather checkered past. He served time for mail fraud and perjury following a conviction in 1983 and also obtained a pardon from President Clinton in the final days of his presidency in January of 2001. He received pardon while being investigated for money laundering and tax evasion. (See Moss, Michael, "Officials Say Investigation Will Go On Despite Pardon," *The New York Times*, 2001-02-08.) FH paid about \$200,000 to Hugh Rodham, Hillary Clinton's brother, to assist him in obtaining the pardon. Rodham refunded this money when this arrangement become public. (See Walsh, *Salon.com*, Unpardonable, Feb. 23, 2001. Retrieved Jan. 13, 2008. *CNN*, Rodham says he has repaid fees for clemency cases, February 24, 2001. Retrieved Jan. 13, 2008.)

The lesson to be learned from *Braswell* is that notwithstanding the opposition, offshore asset protection trusts are a viable planning strategy and will produce a positive result for a settlor who implements and funds the trust structure under appropriate circumstances. Most knowledgeable practitioners in the asset protection area uniformly agree with this position. As the old adage states, "it was not raining when Noah built the ark." On the other hand, knowledgeable practitioners in this area also understand the reasons why many of the bad fact cases that involve foreign asset protection trusts produce such results. (See *e.g.*, *Federal Trade Commission v. Affordable Media*, 179 F.2d 1228 (9th Cir. 1999) and *In re Lawrence*, 279 F.3d 1294 (11th Cir. 2002)). It should be understood that *Braswell* is a rare case in the asset protection area. "Good fact" cases normally do make it into case reporters; most creditors are unwilling to litigate cases that appear to be doomed to fail.

On a basic level, a result similar to this phase of the *Braswell* litigation should be available to any client with a properly implemented foreign wealth protection trust structure, regardless of the residence of the settlor and regardless of the forum, that is, state court, federal court or bankruptcy court.

9. *Dahl v. Dahl*, Civil No. 090402989 (2011); 779 Utah Adv. Rep. 13 (Jan. 30, 2015).

In *Dahl v. Dahl*, Civil No. 090402989 (2011), a Utah trial court in Provo, Utah denied a spouse's request to consider the assets of a domestic asset protection trust (the "**Trust**"), established in Nevada and

created by her husband, in the division of marital assets. Note that Utah is a DAPT state. See Article X, above.

Dr. Charles F. Dahl (“**Charles**”) and Kim Dahl (“**Kim**”) married in 1992 and were living in Utah during their marriage. In 2002, Charles created the Trust, naming his brother, C. Robert Dahl, as investment trustee (the “**Trustee**”). The discretionary beneficiaries of the Trust were Charles, Kim, their issue and organizations to be designated by Charles. Shortly after the Trust was created, Charles transferred 97% of a Utah LLC to the Trust, retaining a 1% interest for himself and 1% for each of his two children. The LLC owned brokerage accounts valued at just under \$1 million. In 2003, Charles and Kim transferred their primary residence to the Trust.

Beginning in 2006, Charles and Kim became embroiled in a highly-contested divorce. While the divorce was still pending, Kim brought an action in the Fourth Judicial District Court, Appellate Court in Utah County (the “**Court**”) seeking to attack the Trust on a number of grounds. In her petition, Kim sought the following relief from the Court with regard to the Trust: (i) a determination that the Trust should be null and void, (ii) a determination that Kim had an immediate interest in the Trust and (iii) a determination that the Trust was revocable. The Court granted Charles’ Motion for Summary Judgment on all three issues.

On the first claim, the Court ruled that “null and void” is not a formal cause of action. The Court noted that under the law set out in *Ockey v. Lehmer*, 189 P.3d 51 (Utah 2008), contracts that offend an individual, such as those arising from fraud, misrepresentation, or mistake, are voidable, and only contracts that offend public policy or harm the public are void ab initio. Kim failed to accuse Charles of anything actionable under *Ockey*. Therefore, the Court found no basis on which to find the Trust “null and void.”

With regard to the second claim, the Court noted that Trust distributions could only be made in the absolute discretion of the Trustee and, additionally, were subject to Charles’ veto power. Kim was merely a discretionary beneficiary. Therefore, the Court found that Kim had no immediate interest in the Trust corpus.

Regarding the third claim, the Court ruled that the language used in the Trust reserved a statutory right to amend with the consent of all beneficiaries and did not, as Kim argued, create a general right to amend or alter the terms of the Trust. On the contrary, the Court noted that the Trust clearly reflected Charles’ intention that it be irrevocable. The Court pointed out that the “most compelling” counter-argument was based on the relevant Nevada statute, NRS 163.560, which provided that a trust explicitly declared to be irrevocable is irrevocable for all purposes. The Court noted that under *Innerlight, Inc. v. Matrix Group, LLC*, 2009 UT 31, choice of law and choice of forum provisions in contracts and legal document are enforceable. The Court upheld Charles’ choice of Nevada law and found that it was irrevocable under NRS 163.560.

Kim appealed ruling on August 7, 2012, making the following arguments:

(1) The Trust was revocable under Utah law;

(2) The Court erred in resorting to Nevada law as an alternative basis to find the Trust irrevocable because the application of Nevada law leads to a result that violates Utah’s public policy;

(3) The Court abused its discretion in entering summary judgment on Kim’s alter ego theory without allowing her to conduct discovery; and

(4) The Court erred in issuing a hypothetical ruling that cause of action not before him would have been barred by the state of limitations.

At one point, this case was noteworthy as a post-Huber (see Section N in Article VIII (“Alaska Law”); see also Section E in Article XXIX (“Fraudulent Transfers”)) ruling by a court in a settlor’s home state that the law of a DAPT state will apply to protect the trust assets from the claims of the settlor’s creditors. Kim inexplicably failed to attack the trust on a number of seemingly obvious grounds. For example, the residence was transferred to the trust prior to the passage of Utah’s asset protection statute. Despite the fact that the transfer would likely be avoided under Utah law, Kim failed to raise a conflicts of law issue. For additional background on the case, see the commentary by Steve Oshins and Jeremy Spackman in LISI Asset Protection Planning Newsletter #227 (July 3, 2013) at <http://www.leimbergservices.com>.

Upon Kim’s appeal to the Supreme Court of Utah, the court held that Utah law applies, that the Trust was revocable as a matter of law, and that Kim was entitled to withdraw her share of the marital property she contributed to the Trust as a settlor.

Kim asserted that the district court erred when it declared that she had no enforceable interest in Trust assets, the Court reversed the district court, determining that Utah law applied because of its strong public policy interest in the equitable division of marital assets, and that Utah state law should apply to the trust even though the stated choice of law in the trust was Nevada. The Court’s opinion cited to *Waddoups v. Amalgamated Sugar Co.*, 2002 UT 69, ¶ 14, 54 P.3d 1054, for the authority that Utah choice-of-law rules apply whereby although Utah will generally enforce a choice-of-law provision contained in a trust document, it would not do so if such a reading would undermine a strong public policy of the State of Utah, see UTAH CODE § 75-7-107 & cmt. (“This section does not attempt to specify the strong public policies sufficient to invalidate a settlor’s choice of governing law.”); see also *Jacobsen Constr. Co. v. Teton Builders*, 2005 UT 4, ¶ 19, 106 P.3d 719 (refusing to allow parties to “employ choice of law provisions to force forum states to enforce contractual terms wholly repugnant to local public policy”). Thus, the court refused to enforce a settlor’s choice-of-law since doing so undermined Utah’s strong public policy goals.

Kim argued that the Trust was revocable under Utah law, despite the Trust stating “Trust Irrevocable,” because Charles reserved in the Trust an unrestricted power to amend the Trust as the Trust stated “Settlor reserves *any power whatsoever* to alter or amend *any* of the terms or provisions hereof. Emphasis added).” Charles argued that the stated Trust language did not give him a right to unilaterally amend, alter or terminate the trust without consent from all beneficiaries. Charles did not argue that there may have been a typographical error (i.e., using the term “any” instead of the term “no”); this may have been the better argument of the two. The Supreme Court of Utah was unpersuaded, analyzing secondary sources (Restatement (Second) of Trusts and The Law of Trusts and Trustees) and citing to Utah law (Utah Code Ann. § 75-7-605) for the proposition that an unrestricted power to amend any and all provisions of a trust renders a trust revocable under Utah Law.

After holding that the Trust was revocable under Utah law, the Supreme Court of Utah dismissed Charles' argument that Kim had no enforceable interest in the trust because Utah law prohibited her from withdrawing her assets from an irrevocable trust under Utah Code Ann. § 75-7-605(2). Charles argued that Kim could not revoke the Trust with regards to the portion of Trust property attributable to her separate property or any marital property. The Supreme Court of Utah concluded that Kim was a settlor of the Trust, despite having nothing to do with the preparation of the Trust and not signing the Trust or related documents. A trust under Utah law is created by the transfer of property by the owner to another person acting as trustee. Utah Code Ann. § 75-7-401(1)(a). It was indisputable that Kim contributed property to the Trust. Kim neither knowingly nor intentionally forfeited her status as a settlor. As a settlor of the Trust, Kim could revoke that portion of the Trust funded with either her marital or separate property. See Utah Code Ann. § 75-7-605(2).

This case now falls into the category of cases where domestic asset protection trust cases have not fared well in domestic courts, see *e.g.*, *Battley v. Mortensen, et al.*, (*In re Mortensen*), 2011 WL 5025249 (Bankr. D. Alaska); *Parrott v. Sasaki*, Del. Ch., C.A. No. 7227-VCL (Filed Feb. 7, 2012); and *In re Huber*, 493 B.R. 798 (Bankr. W.D. Wash 2013). For additional background on the Utah Supreme Court case, see the commentary by Steve Oshins and Jeremy Spackman in LISI Asset Protection Planning Newsletter #283 (February 12, 2015) at <http://www.leimbergservices.com>. See also Jay Adkisson in LISI Asset Protection Planning Newsletter #291 (Apr. 16, 2015) at <http://www.leimbergservices.com>.

10. United States v. Grant, 2008 WL 2894826 (May 27, 2008).

In 1983 and 1984, Raymond Grant (“**Raymond**”) established two foreign trusts (the “**Trusts**”) for himself and for his wife, Arline Grant (“**Arline**”) (Raymond and Arline collectively are referred to as the “**Defendants**”). One trust was settled in Bermuda and the other trust was settled in Jersey. Raymond was the settlor of both of the Trusts. In 1991 and 1993, the IRS assessed several million in unpaid tax against the Defendants for the years 1977 through 1982 and 1984 through 1987 based on income generated by the assets held in the Trusts. Initially, the Defendants entered into an installment agreement with the IRS where they were to pay \$3,000 per month until their tax liability was fully paid. This installment agreement was terminated, however, and on March 21, 2003, a final judgment was entered against the Defendants for over \$36 million in unpaid tax.

The terms of both Trusts provide that should the beneficiary die, the surviving spouse would become the beneficiary. Raymond died in January, 2005, therefore, Arline became the beneficiary of both Trusts.

The Bermuda trust provides:

During the lifetime of the Grantor, he (or, following his death, his said spouse, ARLINE GRANT, if she shall survive him) shall have the right, at any time, to discharge an existing or acting Trustee (including the Trustee executing this Agreement) and to appoint such other Trustee in any jurisdiction throughout the world, as he (or his said surviving spouse) may in his (or her) sole and unreviewable discretion determine . . .

The Jersey trust contains a substantially identical provision.

The Bermuda trust further provides:

if in the course of time, a successor or substitute Trustee is appointed pursuant to the foregoing provisions of this Indenture, which is organized and is located and functions under the laws of a jurisdiction other than Bermuda, then and thereafter for so long as such successor or substitute Trustee shall remain in such capacity, the rights and duties of all persons with an interest in the Trust Estate . . . shall for all purposes be interpreted and construed exclusively in accordance with the laws of such other jurisdiction and the courts thereof shall be the sole forum for all purposes requiring judicial determination in the execution, operation or termination of the trusts herein created.

The Jersey trust does not contain a similar provision. The Jersey trust provides that the law governing the trust shall be that of England, unless the Grantor declares it to be different.

In 2005, the United States Department of Justice Tax Division (the “DOJ”) filed a motion for repatriation of assets requesting the court to order Arline to appoint a United States (“US”) trustee of the Trusts, or alternatively to otherwise repatriate the assets held in the Trusts. In response to the DOJ’s motion for repatriation of assets, Arline argued that her power to appoint a new trustee of the Trusts is “limited to such trustees as she in her sole and unreviewable discretion determines.” Arline further argued that a court order mandating her to exercise her removal and replacement power would violate the terms of the Trusts because Arline does not have a wish to appoint a US trustee and such appointment would not be one that is made in Arline’s sole and unreviewable discretion.

The court agreed with the DOJ and reasoned that the Trusts have no limitations on the beneficiary’s power preventing her from acting; therefore, Arline’s powers over the Trusts are extensive and as a result the court’s powers are co-extensive. The court reasoned that if Arline has the power to change trustees or repatriate assets, she cannot avoid the obligation by stating, “I choose not to do so.” The court held that Arline has unreviewable discretion to change the trustees and the present trustee must comply with such a directive.

Similarly, the court also notes that Arline has the virtual power to cause the withdrawal of any or all of the trust principal of at least the Bermuda trust. It is in dispute whether Arline may withdraw all of the principal of the Jersey trust; however, the Jersey trust makes it clear that Arline may withdraw at least ten percent (10%) of the principal annually. The Bermuda trust provides:

In addition to the distribution of the net income made hereunder to Grantor’s spouse, ARLINE GRANT, the Trustee may, in its sole discretion, at any time or from time to time during the lifetime of the said ARLINE GRANT pay to or apply for her sole use or benefit so much of the principal of the Trust Estate as the Trustee shall deem necessary, advisable or appropriate for her health, comfort, maintenance and living expenses (without any duty to take into account other resources of Grantor’s said spouse or of any other person, whether or not legally obligated to support Grantor’s said spouse); provided, however, that in making any determination as to the distribution of any portion of the principal of the Trust

Estate pursuant to paragraph (B), the Trustee shall be entitled to rely absolutely upon any written statement of facts made to it by Grantor's said spouse without necessity for an independent verification thereof by the Trustee.

The Jersey trust provides:

If Grantor's spouse, Arline Grant, shall survive him then upon and following the death of the Grantor the Trustee shall pay to, or apply the benefit of, the said Arline Grant during her lifetime, at least annually, all of the net income of the Trust Estate and in addition thereto, such amounts or proportions of the Trust Estate as the Trustee, in its sole discretion, shall at any time or from time to time deem necessary or appropriate for her health, support, benefit and living expenses. In making its determination as to any distribution out of principal of the Trust Estate to the Grantor's said spouse, Arline Grant, pursuant to this Paragraph (B), the Trustee shall be entitled to rely absolutely upon any written statement of facts made to it by the said Arline Grant without necessity for an independent verification thereof by the Trustee.

The court reasoned that although the Trusts give each trustee the sole discretion to invade the corpus, by giving Arline total unreviewable authority over the discharge and appointment of trustees, Arline actually controls the corpus of the Trusts. The Trusts provide that the trustee may rely on Arline's unsupported statements of her needs without the necessity of independent verification. Additionally, there is no showing that either trustee ever declined Arline's request for a distribution.

On September 2, 2005, the court granted the DOJ's motion for repatriation of assets and ordered Arline to appoint a US trustee of the Trusts, or alternatively, to repatriate the assets held in the Trusts.

In 2008, after Arline failed to comply with the court's order to appoint a US trustee of the Trusts or to otherwise repatriate the assets held in the Trusts, the DOJ filed a motion for Arline to show cause why she should not be held in contempt for failure to comply with the repatriation order issued on September 2, 2005. In response to the DOJ's motion, Arline asserted that she made significant efforts to comply with the repatriation order and that she was unable to comply with such order after those efforts. First, Arline on January 12, 2006, within one month of when the repatriation order was formally issued, sent a letter to the Jersey trustee enclosing the repatriation order and seeking information about the procedure to repatriate funds. The Jersey trustee's lawyers responded:

that any attempted exercise by you of your right to remove our client as trustee of the Trust and to appoint U.S. resident trustee in its place would not be a valid exercise of [Mrs. Grant's power as trust beneficiary] and would therefore be void and of no effect, which means that our client will remain the trustee of the trust, notwithstanding your attempted exercise of your power.

This response was based on the trustee's purported obligation to protect the interests of "other beneficiaries" who will become entitled to the Trust assets following Arline's death. The DOJ, however, argued that this was not a significant effort to comply with the repatriation order because Arline never sent

an actual petition to the trustee to repatriate funds. The court noted that no actual petition was necessary as the Jersey trustee's lawyers made it clear from the initial response that any such petition would be ineffective to repatriate funds.

Second, Arline also contacted the trustee for the Bermuda trust and received a similar response from the trustee. The trustee in Bermuda noted:

The Trustees of the above trust have considered your request to transfer the entire trust fund to you. We wish to advise that at this time we cannot comply with your request.

Finally, Arline sent letters to numerous financial institutions, requesting such institutions to serve as transferee trustees. All of Arline's requests were rejected because of the possibility that the offshore trustees will fight any attempt to repatriate the assets.

On May 27, 2008, the court held that Arline sufficiently established that she is not able to repatriate the funds in the Trusts and that her failure to repatriate such funds was not for a lack of effort. The court denied the DOJ's motion for an order to show cause (the "**Denial Order.**")

Despite the fact that the court found Arline unable to comply with the repatriation order due to her significant efforts to repatriate the funds to the United States (to no avail) the DOJ filed a second motion for an order to show cause on January 13, 2012. The DOJ did so after learning that Arline had received over \$221,000 in principal from the two offshore trusts since the time of the Denial Order. The court granted the DOJ's second motion to show cause as to why Arline should not be held in contempt for her failure to comply with the repatriation order upon receiving over \$221,000 in principal from the trusts. Arline filed a motion to discharge the order to show cause, which the court denied and held Arline in contempt on March 22, 2013.

On April 22, 2013, the court granted the DOJ's Motion for Permanent Injunction, which ordered that: (1) Arline request on a quarterly basis that the trustees of her offshore trusts transfer all available income to accounts held in her name (or in the name of the other beneficiaries) within the United States; (2) Arline and any other person acting in concert with her to provide to the United States all funds that have been transferred in the past directly or indirectly from the income of her offshore trusts to accounts held in her name (or in the name of the other beneficiaries); (3) Arline and any other person acting in concert with her, to provide to the United States all funds transferred directly or indirectly from the offshore trusts to any United States account in the future; (4) neither Arline and anyone acting in concert with her are prohibited from spending, transferring, or otherwise dissipating any assets of the offshore trusts; and (5) Arline and anyone acting in concert with her or anyone seeking to help Arline shield her assets from going toward the payment of her tax liabilities, are prohibited from communicating to the trustees that the distributions being requested are compelled. *U.S. v. Grant*, 2013 WL 1729380 (April 22, 2013).

Epitaph: See Riser & Adkisson, "84-Year Old Widow Held in Contempt for Receiving Money Indirectly Through Her Offshore Trusts," LISI Asset Protection Planning Newsletter #223 (May 7, 2013) at <http://www.leimbergservices.com>.

11. S.E.C. v. Solow, 682 F.Supp.2d 1312 (S.D. Fla. 2010).

Jamie L. Solow (the “**Defendant**”) engaged in a fraudulent trading scheme involving the sale of inverse floating rate collateralized mortgage obligations. The Securities and Exchange Commission (the “**SEC**”) obtained a judgment against the Defendant for seven violations under the Securities Exchange Act. The final judgment issued on January 31, 2008, found the Defendant liable for \$2,646,485.99, together with prejudgment interest of \$778,302.91, for a total of \$3,424,788.90 and a civil penalty of \$2,646,485.99. Furthermore, the Defendant was enjoined from attempting to register as a broker-dealer or investment advisor or being associated with or seeking to be associated with a broker-dealer or an investment advisor.

On February 4, 2008, the Defendant’s wife retained the law firm of Donlevy-Rosen & Rosen, P.A., of Coral Gables, Florida, to assist her establishing a Cook Islands trust known as the Gina P. Solow Trust (the “**Cook Islands Trust**”). South Pac Trust International was appointed as the trustee. Thereafter, the Defendant and his wife proceeded with the transfer of various securities accounts and joint checking accounts held in tenancy by the entirety to accounts in the sole name of the Defendant’s wife. On March 24, 2008, the Defendant’s wife executed a mortgage on a beachfront condominium located in Fort Lauderdale, Florida (the “**Fort Lauderdale Condo**”) for \$1,187,500 and the Defendant and his wife each executed a mortgage on their Hillsboro Beach residence (the “**Hillsboro Beach Residence**”) in the amount of \$5,261,289. The lender for both mortgages was Federation Advances Corp., a Nevis limited liability company. The funds loaned pursuant to each mortgage were assigned to the Cook Islands Trust and held in a certificate of deposit owned by the Cook Islands Trust. On April 21, 2008, the Defendant’s wife traveled to Zurich, Switzerland to deposit cash and jewelry in a safe deposit box established by the Cook Islands Trust.

The Defendant claimed he and his wife purchased the Hillsboro Beach Residence as tenants by the entirety in 2002, prior to any wrongdoing alleged by the SEC. The Defendant argued that the \$5,261,289 mortgage received on the Hillsboro Beach Residence was an “in-kind” transaction that did not result in any cash being conveyed to the Defendant or his wife. The mortgage funds were invested solely in a certificate of deposit held by the Cook Islands Trust. The trust is irrevocable and there is no provision made for the Defendant to exercise any control over the trust property. The Defendant further claimed that the Fort Lauderdale Condo was purchased in June 2003 by JSolow Condo One, Inc., which is a corporation owned entirely by the Defendant’s wife. As a result, the Defendant argued that the Fort Lauderdale Condo was never available to the SEC for satisfaction of its judgment since the judgment was only against the Defendant.

Additionally, from February 7, 2008, to March 7, 2008, a total of \$820,000 was deposited in the Defendant’s and his wife’s checking account from Highland Financial Group, Inc. and from Arlene Zayas, the wife of Highland’s principal officers, James Riggio. The Defendant emphasized that these funds were either those belonging to his wife alone or were owned by the Defendant and his wife as tenants by the entirety and that in either case these assets were beyond the reach of the SEC. The Defendant further argued that these funds were used to pay tax liabilities owed by the Defendant and his wife in the amount of \$556,632 and the payment of the tax liability and legal expenses depleted these funds. In a second series of transactions that occurred on February 29, 2008, March 10, 2008 and April 8, 2008 the Defendant and his wife transferred \$777,000 from their joint checking account to a Bank of America checking account titled in the sole name of the Defendant’s wife. The Defendant claimed that the funds in the joint checking account

were held by the Defendant and his wife as tenants by the entirety and therefore the SEC could not satisfy its judgment by seizing such account.

The Defendant made three partial payments totaling \$2,639.24 toward the judgment from the Defendant's separate property. Upon the Defendant's failure to pay the judgment, the SEC motioned for the Defendant to show cause for failure to pay the judgment. The defendant argued that the assets the SEC sought to satisfy its judgment against him are all property that were held in tenancy by the entirety by the Defendant and his wife and that such property was not reachable by the SEC because the judgment was not against the Defendant's wife. The various transfers made to his wife; therefore, did not constitute fraudulent transfers because the SEC could not otherwise reach these assets. Additionally, the Defendant argued that he had insufficient assets to satisfy the judgment and based on the judgment he could not engage in his profession as a broker-dealer or investment advisor. As a result, the Defendant argued he lacked sufficient assets and/or income to satisfy the judgment.

The SEC responded to the Defendant's argument by arguing that the court possessed equitable powers based on *S.E.C. v. Yun*, 208 F.Supp2d 1279 (M.D. Fla. 2002) to enable it to disregard the protection provided under state law by tenancy by the entirety in the enforcement of a disgorgement order. As a result, the SEC argued that since it could reach the Defendant's interest in such property by disregarding state law regarding tenancy by the entirety the prior transfers to the Defendant's wife were available to satisfy the disgorgement order. The SEC also noted that all the property that constituted the entireties estate was derived exclusively from the earnings of the Defendant and his wife contributed no amount toward any of the tenancy by the entirety property.

The SEC also responded to the Defendant's argument that he lacked the ability to pay the judgment by arguing that the Defendant himself created any inability to pay the final judgment. The SEC noted that from 2003 to 2006, the Defendant's earned income was between \$1 million to \$2 million per year and his earnings were the exclusive source of his wife's investments, savings and securities. Furthermore, the Defendant had trading authority on his wife's financial accounts, however, claimed to lack of knowledge of her financing dealings. Citing both *In re Lawrence*, 279 F.3d 1294 (11th Cir. 2002) and *SEC v. Bilzerian*, 112 F. Supp2d 12 (D.D.C. 2000), the SEC argued that the impossibility the Defendant experienced was self-created and the defense of impossibility was, therefore, unavailable to him. In *Bilzerian*, the defendant, Mr. Bilzerian, claimed to not have the ability to pay a disgorgement order. Mr. Bilzerian's assets were transferred to his wife, a web of corporations and ultimately to a Cook Islands trust. The SEC argued that Mr. Bilzerian attempted to conceal his ability to comply with the disgorgement order by transferring assets he held directly into offshore trusts and other entities in which he continued to maintain an indirect beneficial interest. The court found Mr. Bilzerian's failure to disclose his indirect beneficial interests to be misleading and held that it may consider Mr. Bilzerian's beneficial interest in the Cook Islands trust in determining his ability to comply no matter the origin of the assets in the trust.

The SEC argued that similar to the defendants in *Lawrence* and *Bilzerian*, the Defendant divested control over his assets through the use of an offshore asset protection trust and then represented to the judge that it was impossible for him to make his court-ordered payments. Similar to the defendant in *Lawrence*, the Defendant divested himself of his assets in anticipation of the judgment that was about to be entered against him.

The SEC emphasized that even if it were impossible for the Defendant to comply with the judgment such impossibility was self-created by him and the defense is unavailable to a charge of civil contempt when the impossibility is self-created. The court noted that if the Defendant cannot convince his wife to return his assets to him, that is a problem of the Defendant's own doing and he is consequently in contempt of court. The court held that the mortgage executed by the Defendant on March 24, 2008 established that the Defendant has not made a good faith effort to pay the amounts ordered and his claimed inability to use the Hillsboro Beach Residence to obtain funds to pay the disgorgement order was self-imposed because he executed the mortgage on the Hillsboro Beach Residence. This demonstrated the Defendant's ability to extract \$5.2 million from the Hillsboro Beach Residence.

The court held the Defendant in contempt of court for failure to comply with its order for the Defendant to pay the judgment rendered against him. The Defendant was ordered to be incarcerated until such time as he complies with the court's order to pay the judgment.

12. *Advanced Telecommunication Network, Inc. v. Allen*, 2011 WL 3585827 (Bkrcty. M.D. Fla.).

In *Advanced Telecommunication Network, Inc. v. Allen*, 2011 WL 3585827 (Bkrcty. M.D. Fla.), the court held:

Indeed, the facts of this case are nearly identical to the facts in *Lawrence*. Both involve a self-settled trust created or funded in a remote foreign jurisdiction during pending litigation, funded with over 90% of the settlor's assets for "estate planning" purposes, and administered by a stranger supposedly having total control over the trust *res*. Both also involve settlors who, when pressed by the Bankruptcy Court to turn over trust assets, implausibly claimed their inability to do so under the provisions of the trust documents, including the choice of law provisions designating foreign law as controlling. Finally, both cases involve reviewing courts [*sic*] relying upon the trial court's determination that the settlor's impossibility defense to turnover was itself impossible to believe because the alleged impossibility was self-created. Accordingly, consistent with *Lawrence*, and because Judge Briskman's findings were made after a full evidentiary hearing on adequate notice to the parties, this Court adopts Judge Briskman's previous findings as set forth above and orders Daniel Allen *again* to repatriate any funds held in the Shingle Oak Family Trust.

13. *Tasarruf Mevduati Sigorta Fonu v. Merrill Lynch Bank and Trust Company, et al.*, Privy Council of the Cayman Islands, Appeal No. 0036 of 2010, decided June 21, 2010.

Tasarruf Mevduati Sigorta Fonu v. Merrill Lynch Bank and Trust Company, et al., Privy Council of the Cayman Islands, Appeal No. 0036 of 2010 was decided on June 21, 2010. In *Tasarruf*, the Appellant Tasarruf Mevduati Sigorta Fonu ("TMSF") was a corporation established by Turkey to restructure and administer failed banks. TMSF acquired two banks which respondent Demirel had formerly controlled. TMSF sued Demirel and obtained a personal Turkish judgment in the amount of \$30 million, based on fraudulent loan transactions.

Demirel established two revocable trusts in the Cayman Islands. Merrill Lynch (“ML”) was the Trustee of both trusts, and each trust provided the Trustee with the discretionary power to distribute trust assets to Demirel, his wife, and his issue. At all times relevant in the case Demirel had no issue. Combined, the two trusts held \$24 million in assets. The assets of both trusts were shares of Cayman companies. All trust assets were located in the Cayman Islands. By the terms of the trusts, Demirel retained the power to revest the assets of the trust in himself. All parties agreed that the trusts were validly executed and in force under Cayman law.

After TMSF learned of the existence of the trusts, it sought the appointment of a receiver in the Cayman Islands that would take possession of the “property” in Demirel’s possession to satisfy the judgment. Under Cayman law, a Cayman receiver may only collect “property” in the possession of a judgment debtor.

The court noted that under Cayman law there is no legal principle whereby a court may look through the form of a trust and treat the assets of a revocable trust as if such assets belonged to the settlor individually. The court noted that under the law of all except one jurisdiction in the United States, a court would settle the issue in this case by looking through the formalities of the trust to treat its assets as if such assets were owned by the settlor personally. However, under Cayman law, that legal argument is unavailable.

TMSF’s Argument: TMSF argued that Demirel’s power to revoke the trusts was tantamount to a property interest. Further, Demirel could delegate or appoint the power to revoke the trusts, because it was a personal power and not a fiduciary power. Therefore, TMSF sought an order that would appoint a receiver who would, in essence, take possession of Demirel’s power to revoke the trusts. Thereafter, the receiver could revoke the trusts, collect the assets of the trusts (*i.e.*, the capital share of the Cayman companies and the assets of the companies), and vest the assets of the trusts in TMSF.

Demirel’s Argument: Demirel resisted the appointment of a receiver based on the following chain of legal arguments: (1) a receiver could only be appointed over property; (2) a power of revocation was in the same category as a general power of appointment; (3) it had long been understood that, in the absence of legislative provision to the contrary, a power of appointment was not property; (4) the order could only be effective if the receiver were authorized to revoke the trusts on Demirel’s behalf and/or Demirel were ordered to revoke the trusts; and (5) as a matter of law, the power to revoke was not delegable and the court had no jurisdiction to order the exercise of the power of revocation.

Two lower courts denied TMSF the appointment of a receiver. These courts held that Demirel’s power to revoke the trusts was not “property.” Their reasoning was that a power was distinct from property. Also, they reasoned that, at common law, a power could not be treated as if it were a property interest, out of respect for the formalities of trusts. Cayman legislative law crafted several exceptions to the general rule that a power is not a property interest. However, in the absence of legislative direction, courts would not treat a power as a property interest.

Holding: On appeal, the Privy Council reversed the lower courts, holding in favor of TMSF and ordering the appointment of a receiver to revoke the trust and vest the trust assets in TMSF. The court relied heavily on *Masri v. Consolidated Contractors International (UK) Ltd. (No. 2)*, an English case decided in

2008. In *Masri*, the appointment of a receiver was not limited to actual assets, but also extends to whatever is considered in equity to be assets.

The court decided that Demirel's power was tantamount to a property interest for several reasons: (1) the power to revoke was conferred by Demirel on himself at the time he formed the trusts, Demirel reserved the power to revoke; (2) the power to revoke was a personal power, not a fiduciary power, *i.e.*, Demirel owed no duty of trust or confidence to any other person, and no act personal to Demirel was required to be performed, and therefore the power could be delegated and/or assigned by Demirel to another person; and (3) there is no rule that a person holding personal power cannot be ordered to exercise it. Of these three reasons, the court focused extensively on the second. The court held that the power to revoke, where unfettered, is tantamount to a property right.

14. *Goldberg v. Rosen (In re Niroomand)*, 11th Cir., No. 12-11231, Oct. 17, 2012.

This case is discussed heavily by the Jonathan Gopman article cited on pages ____.

15. *Rush University Medical Center v. Sessions*, 2012 WL 4127261 (Illinois).

In *Rush*, the Illinois Supreme Court held that assets in a decedent's self-settled spendthrift trust were subject to the claims of a decedent's creditor under Illinois law. In 1994, Robert W. Sessions ("D") created the Sessions Family Trust (the "**Trust**") in the Cook Islands. At the time D created the Trust, he funded it with a 99% interest as a limited partnership in a Colorado limited partnership and real property located in Hinsdale, Illinois (the "**Illinois Real Property**"). At the time of D's death, these assets were valued at more than \$16.2 million and \$2.7 million, respectively. D was the settlor and a lifetime beneficiary of the Trust. Also, at the time of D's death, there was a trustee in the Cook Islands and two trustees located in Illinois (the "**Illinois Trustees**"). The trust was irrevocable, and authorized the trustees to make distributions to D of both income and principal for his "maintenance, support, education, comfort and wellbeing, pleasure, desire and happiness." The Trust also named D as the trust protector, giving him the absolute power to appoint or remove trustees and to veto any of their discretionary actions. D also had the power to appoint or change beneficiaries, by will or codicil, under the Trust upon his death. The Trust also contained a spendthrift provision that prohibited any trust assets from being used to pay creditors of D or D's estate.

In the fall of 1995, D made an irrevocable pledge to Rush University Medical Center ("**P**") of \$1.5 million (the "**Pledge**") for the construction of a new president's house on P's campus in Chicago. D then executed successive codicils to his will providing that any amount remaining unpaid on the Pledge as of his death would be distributed to P at his death. On September 30, 1996, D sent P a letter stating that the Pledge was "made in order to induce [P] to construct a [presidential residence]."

In reliance on the Pledge, P constructed the president's house at a cost in excess of \$1.5 million. The house has been used as a residence for P's president and as a center for conferences and other university events. P named the house the "Robert W. Sessions House" and held a public dedication honoring D for his generosity. D did not make any payments to P toward the Pledge during his lifetime.

In February 2005, D was diagnosed with late-stage lung cancer. D blamed P for not diagnosing the cancer sooner. On March 10, 2005, about six weeks before he died, D executed a new will that made no provision for any payment to P toward the Pledge. On April 19, 2005, six days before D died, he created a

new revocable trust and transferred his interest as a general partner in the Colorado limited partnership, valued at \$164,205, to it. D died on April 25, 2005.

After D's death, P filed a claim in the probate court against D's estate for payment of the Pledge. D's estate contained less than \$100,000. Thus, P filed a supplemental complaint against the Illinois Trustees seeking to reach the assets of the Trust to satisfy the Pledge. (The Cook Islands trustee was never made a party to these proceedings). In particular, P sought to reach the Illinois Real Property, the value of which would likely satisfy its claim against D's estate. The circuit court granted summary judgment to P as to the claim against D's estate.

The circuit court also granted summary judgment in P's favor as to P's claim against the Illinois Trustees, finding that the Trust was void as to P's judgment against D's estate. The circuit court's holding was based on the common law rule that a trust created for the settlor's benefit is void with respect to the settlor's creditors, who may satisfy their claims out of the trust's assets (the "**common law rule**").

The Illinois Court of Appeals disagreed with the trial court and reversed its ruling, holding that the common law rule was abrogated in Illinois by the Fraudulent Transfer Act (the "**FTA**"). Under the FTA:

A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(1) with actual intent to hinder, delay, or defraud any creditor of the debtor;
or

(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

(A) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(B) intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they came due.

The Illinois Trustees argued (1) the FTA supplanted the common law rule; and (2) the FTA provided specific mechanisms for proving a fraudulent transfer. The Illinois Trustees argued that the standard of proof under the FTA was not met because the Trust was established and funded without "actual intent to hinder, delay, or defraud any creditor" of D. The Court of Appeals agreed with the Illinois Trustees.

The Illinois Supreme Court held that the FTA did not abrogate the common law rule. Rather, the FTA and the common law rule should be read together. The Court noted that both the common law rule and the FTA had as a general purpose the protection of creditors, but that the common law rule "addresses the specific situation where an interest is retained in a self-settled [spendthrift] trust." The Court cited the Restatement (Second) of Trusts § 156, that the common law rule is "applicable although the transfer is not

a fraudulent conveyance . . . and it is immaterial that the settlor-beneficiary had no intention to defraud his creditors.” The Court held that the common law and the FTA were supplementary, not contradictory. The Court noted, “[b]oth laws have a general purpose of protecting creditors. But the common law [rule] focuses on the additional matter of the interest *retained* by the settlor of a specific kind of trust, and not simply the fraudulent *transfer* of an asset or the fraudulent *incurring* of a debt, as does the statute” (emphasis in original).

The Court also noted policy reasons for the common law rule to apply. The Court stated:

[T]he policy behind the common law rule is not limited solely to deterring fraud, as it prevents the distinct injustice of allowing a person to use a trust as a vehicle to park his assets in a way that preserves his own ability to benefit from those assets, while keeping them outside the reach of his present and future creditors. If the law were otherwise, “it would make it possible for a person free from debt to place his property beyond the reach of creditors, and secure to himself a comfortable support during life, without regard to his subsequent business ventures, contracts, or losses.”

The Illinois Trustees contended that the common law rule operated only to negate the effect of the spendthrift clause and not the entire trust. Further, the Illinois Trustees also argued that the common law rule did not apply in this case because P did not become a judgment creditor before D’s death. They argued that the common law rule only applies to a settlor’s lifetime interest, and that when a settlor dies, creditors may not reach assets that could have been, but were not, distributed during life.

The Court responded that the provisions of the Trust gave the trustees of the Trust authority to distribute unlimited amounts of the assets of the Trust to D. Therefore, D’s interest in the Trust extended to the entire trust. The Court also noted D’s retained power to remove and replace the trustees at will and veto trustee decisions through D’s service as trust protector.

The Court also found that D was a debtor of P during his lifetime. The Court stated that it was beyond question that D incurred an obligation to pay P, even if it was to be paid upon his death as a debt. Also, the facts precipitating P’s claim occurred during D’s lifetime. D clearly incurred the obligation to P during his lifetime. Therefore, the Court held that the common law rule applied despite the fact that P did not obtain a judgment before D’s death.

The Court reversed the Court of Appeals and held that the FTA did not displace or abrogate the common law rule in Illinois and that P was a creditor of D for purposes of the common law rule. The Court remanded the case to the circuit court for further proceedings consistent with the Court’s holding.

Commentary: The trust in this case was faulty in a number of ways. First, the trust had trustees located in Illinois. Second, D retained an excessive degree of control over the trust. Finally, the trust owned sufficient real estate in Illinois to satisfy P’s claim. Even a court in the Cook Islands, let alone an Illinois court, would apply Illinois trust law in regards to a Cook Islands trust owning such real estate. Basic conflicts of law rules in regards to trust law would dictate such a result too. These facts appear to have made it next to impossible for the trustee to adequately present an argument that the court in Illinois should accept

the validity of the trust based on conflicts of law rules. *See* Restatement (Second) of Conflict of Laws § 222–223 and Uniform Trust Code § 107. For Illinois law, *see e.g. Aurora Gasoline Company v. Coyle*, 174 F.Supp. 331, 336 (E.D. Ill. 1959).

16. *U.S. Bank v. Rose*, 4 N.E.3d 601 (Ill. App. 3d 2014).

In *U.S. Bank v. Rose* the Illinois 3rd District Court of Appeals (the “**Court**”) found that the defendant (“**D**”) engaged in fraudulent contracting by failing to inform the plaintiff and creditor (“**C**”) that D had established a trust in the Cook Islands (the “**Trust**”) and concealing the transfer of significant assets to the Trust in violation of an anti-assignment covenant in an existing promissory note (the “**Note**”). The Court also found that D engaged in actual fraud as D’s transfer of significant assets to the Trust would have been material to C’s decision to extend an existing loan.

In September 2002, D borrowed \$500,000 from C (the “**Loan**”) and executed the Note. The Note contained a covenant in which D agreed not to “sell, transfer, mortgage, assign, pledge, lease, grant a security interest in, or encumber any of [D’s] assets” without prior written consent from C (the “**Covenant**”). By 2009, C claimed that D was liable to C on various obligations that were in default amounting to approximately \$37,000,000.

In February 2009, D formed MHR Estate Plan, LLC, a Delaware limited liability company (the “**LLC**”), and initially funded the LLC with \$120,000 cash. Thereafter, D gifted his interest in the LLC to the Trust. The settlement establishing the Trust excluded any Trust assets from being used to satisfy claims or judgments of a court of law outside of the Cook Islands.

In October 2009, D assigned his interests in a mobile home park and two limited liability companies (the “**Interests**”) to the LLC. In exchange, D received two 15-year interest-only notes with a combined face value of \$2,000,000. D did not report this transfer to C (which, as noted, C claimed was in violation of the Covenant). C further claimed that the Interests had a fair market value of at least \$6,850,000, while D claimed a value of just under \$2,000,000.

In April 2010, D and C modified the Loan (the “**Modification**”) by adjusting the principal of the Note to \$529,000 and extending the Note’s maturity date to September 1, 2012. As part of the Modification, D represented to C that he had not previously breached the Covenant.

D later defaulted on other obligations owed to C and C learned of the existence of the Trust and the transfer of the Interests to the LLC. C filed a complaint containing three claims. First, C sought to foreclose on the Note claiming D had defaulted on it. Second, C sought monetary and injunctive relief under the Uniform Fraudulent Transfer Act, claiming D fraudulently transferred the Interests to the LLC. Finally, C sought a monetary judgment based on D’s guaranty of a separate loan that had matured. C also sought prejudgment attachment against all of D’s assets and all of the LLC’s assets. C’s motion argued that attachment was justified by four causes under Illinois Attachment Act (the “**Attachment Act**”):

- (1) D was not a resident of Illinois;
- (2) D had concealed himself from service of process of the underlying complaint;

- (3) D and the LLC were about to fraudulently conceal, assign, or otherwise dispose of property as to hinder C as a creditor from collecting on a valid debt; and
- (4) D had fraudulently contracted for the Loan.

The trial court held that C failed to establish any element of cause. C appealed, and the Court held that prejudgment attachment should have been granted because C established both an element of cause and a probability of success on the merits.

Under the Attachment Act, to qualify for an order for prejudgment attachment, a plaintiff must establish both cause and a probability of success on the merits. Cause is established if at least one element of cause is found. The Court focused on C's argument that D "fraudulently contracted for" the Loan. To establish this element of cause, a claim of actual fraud must be established. A claim of actual fraud contains five elements, that is:

- (1) a false statement of material fact;
- (2) by one who knows or believes it to be false;
- (3) made with the intent to induce action by another in reliance on the statement;
- (4) action by the other in reliance on the truthfulness of the statement; and
- (5) injury to the other resulting from that reliance.

The Court found all five elements of actual fraud to be present in this case. It noted that D made a false statement when he represented in the Modification that he had not breached the Covenant because D did not inform C of the existence of the Trust or the transfer of the Interests to the LLC. D had actively concealed the transfer of the Interests. Further, the Court found that D knew that his statement was false because he personally entered into the Covenant and transferred the Interests to the LLC, and the Court determined that D's false statement was made with the intent to induce C to enter into the Modification. Also, the Court stated that C suffered injury because after transferring the Interests to the LLC D was less likely to pay a potential judgment if he defaulted on the Loan.

The Court also ruled that C had a probability of success as to all three of its claims. First, C provided documentation establishing that D defaulted on the Note, and D did not provide evidence of an affirmative defense to this claim. Second, the Court found a probability of success of C's claim under the Uniform Fraudulent Transfer Act based on the documentation C provided regarding the formation of the Trust by D and transfer of the Interests to the LLC. Third, C also provided documentation establishing that the separate loan had matured and D had guaranteed that loan.

The Court found that C had established both requirements for prejudgment attachment, that is, cause and probability of success. Therefore, the judgment of the trial court was reversed and remanded.

Rose is another example of a desperate individual in financial distress taking inappropriate actions at an inappropriate time and under inappropriate circumstances. It seems highly suspect that a knowledgeable attorney with significant experience in asset protection planning should have assisted the individual with such planning.

Importantly, the underlying planning in the case should not fail because D used a foreign asset protection trust as his vehicle of choice to protect his wealth. Rather, the planning should fail because D's actions were clearly a fraud against the rights of C. Such planning should fail as a fraudulent transfer whether D used a foreign trust, a domestic asset protection trust or any other vehicle as his vehicle of choice to attempt to protect such wealth.

This commentary is based on the facts presented in the reported case in which we recognize that the appellate court reversed the trial court's ruling denying the plaintiff's request for prejudgment attachment. It is our understanding that this case will be appealed to the Illinois Supreme Court as to the issue of prejudgment attachment. Regardless of the outcome of a further appeal, the case does remind planners that we can and should take steps and implement procedures in our practice to avoid assisting individuals similarly situated to D with inappropriate asset protection planning.

The process starts with appropriate collection of due diligence and appropriate analysis under all applicable fraudulent transfer statutes. If your clients fail to pass your due diligence procedures or cannot make a transfer that would be respected by a court without being avoided under an applicable fraudulent transfer statute, do not assist that client with such planning.

Appropriate due diligence procedures include searches using:

1. LexisNexis (Accurint) and Westlaw (CLEAR);
2. Civil and criminal dockets;
3. Search engines such as Google, PIPL, and Wikipedia; and
4. The databases of the Federal Bureau of Prisons and any relevant department of corrections.

Also, such due diligence includes collecting:

1. Copies of state and federal income tax returns that the client filed for the past three years;
2. The name and contact information of the client's:
 - a. Accountant;
 - b. Money manager, financial consultant and/or stock broker;
 - c. Bank;
 - d. Personal attorney; and
 - e. Two individuals who the client has known and who have known the client personally for many years;
3. A personal financial statement;
4. A description of any litigation in which the client is currently involved;
5. A description of any potential legal claims that the client believes could be asserted against the client;
6. A description of the employment history for the client;
7. A copy of a recent utility or phone bill addressed to the client at the client's current home address;

8. Copies of the client's:
 - a. Passport; and
 - b. Driver license;
9. The client's full legal name and any other name or names that the client uses or may have used in the past;
10. Whether the client has ever been convicted of a crime;
11. Whether the client has ever been arrested or the subject of a criminal investigation;
12. Whether the client has ever had a professional license revoked;
13. Whether the client has ever been subject to a proceeding that could have resulted in a professional license being revoked;
14. Whether the client has ever been reprimanded or otherwise punished by a state licensing board; and
15. Whether the client has ever been the subject of an investigation by a local, state, federal or other governmental agency.

Asking for this information and requesting your client to respond to such questions and then confirming the accuracy of your client's responses is extremely important.

In addition to the foregoing, in a case like *Rose*, as part of an attorney's due diligence and fraudulent transfer analysis the attorney should review the loan documents and obtain an affidavit of solvency from the client that indicates that the client is not violating such loan documentation.

17. *Branch Banking & Trust Co. v. Hamilton Greens, LLC*, 2014 WL 1603759 (S.D. Fla. Feb. 26, 2014).

In *Branch Banking & Trust Co. v. Hamilton Greens, LLC*, 2014 WL 1603759 (S.D. Fla. Feb. 26, 2014), the United States District Court for the Southern District of Florida denied a motion to hold defendant Richard Bellinger ("**Bellinger**") in contempt of court for failure to pay a monetary judgment entered against him. Bellinger successfully established that he was unable to pay the judgment because prior to the entry of the judgment, he irrevocably transferred his assets to a Cook Islands trust, and that he had no power to compel distributions from the trust.

On September 5, 2006, Colonial Bank issued a loan to Hamilton Greens, LLC ("**Hamilton Greens**") for \$3,375,000 for the purchase of real property. Bellinger was a personal guarantor on the loan. On February 5, 2011, Hamilton Greens defaulted on the loan. On May 5, 2011, Branch Banking & Trust Co ("**BB&T**"), as successor-in-interest to Colonial Bank, filed a complaint against Bellinger seeking to enforce the guaranty.

On November 30, 2011, Bellinger created a Cook Islands trust (the "**Trust**"), funded with approximately \$1.7 million in assets. BB&T filed an amended motion for final summary judgment on January 3, 2013 which the court granted. Thereafter, the court entered a final judgment against Bellinger for \$4,923,797.57, plus post-judgment interest. Bellinger failed to satisfy any portion of the final judgment, and BB&T subsequently filed a motion to hold Bellinger in contempt of court. In support of its motion, BB&T alleged that Bellinger created the Trust in to shield his assets from the final judgment that was ultimately

entered against him. BB&T also asserted that Bellinger could not argue it was impossible for him to comply with the final judgment because, by creating the Trust, any inability to comply was self-created.

In opposition to the motion, Bellinger argued that the Trust was lawfully created before any final judgment was entered against him. Bellinger also argued that BB&T had not pursued a fraudulent conveyance action and that BB&T improperly sought to have him held in contempt because he could not pay a civil judgment. Additionally, Bellinger argued that, because he lacked the authority to have assets released from the Trust, he could not be held in contempt as he did not have the ability to comply with the final judgment.

The court noted that *S.E.C. v. Solow*, 682 F.Supp.2d 1312 (S.D.Fla.2010), *In re Lawrence*, 279 F.3d 1294, 1300 (11th Cir.2002), and *S.E.C. v. Yun*, 208 F.Supp.2d 1279 (M.D.Fla.2002) were factually distinguishable from the instant case. Although both *Solow* and *Yun* state that inability to comply with an order is not a defense if the alleged contemnor created the inability, those two cases involved disgorgement orders arising from fraudulent conduct. The court in *Hamilton Greens* found that because federal courts have “broad equitable powers to reach assets otherwise protected by state law to satisfy a disgorgement,” such courts have more power to enforce compliance with a disgorgement order than they do with a standard money judgment. *In re Lawrence* involved a turn-over order directing the debtor to relinquish assets from an offshore trust, however, that case was distinguishable because aspects of the trust in *Lawrence* allowed the debtor to exercise control over certain trust mechanisms.

At an evidentiary hearing on the motion, Bellinger testified that (1) when he created the Trust he did not do so with an intent to evade any judgment from BB&T, (2) he transferred assets to the Trust to protect his future financial security, (3) he did not have the financial ability to pay the judgment, (4) he could not exercise control over the Trust, (5) he attempted to direct the Trust to release funds to partially satisfy the judgment, however the trustee refused, (6) he could not compel payment of the judgment from the Trust, (7) he could not replace the trustee, and (8) he could not revoke the Trust.

In accordance with the opinion of *United States v. Grant*, No. 00–08986–CIV, 2008 WL 2894826, 1 (S.D.Fla. May 27, 2008), the court concluded that Bellinger adequately demonstrated an inability to comply with the final judgment and as a result, Bellinger should not be held in contempt of court. *See also* *FDIC v. Lewis*, 2016 WL 589666 (D. Nev. Feb. 10, 2016) (denying creditors’ motion for mandatory injunction requiring defendants to repatriate assets from off-shore trusts settled in St. Vincent and the Grenadines where the creditor failed to exhaust several available avenues of legal recourse).

18. *TrustCo Bank v. Mathews*, C.A. No. 8374-VCP (Del. Ch. Jan. 22, 2015).

In TrustCo Bank v. Mathews, C.A. No. 8374-VCP (Del. Ch. Jan. 22, 2015), the parties disputed which state’s law and which state’s statute of limitations applied in regards to alleged fraudulent transfers to tree purported Delaware asset protection trusts. The plaintiffs asserted that New York’s six-year or two-years-from-discovery statute of limitations governed the plaintiff’s claims. The defendants argued that either Delaware or Florida law controlled, and that most of the plaintiffs’ claims were barred by the identical four-year or one-year-from-notice statutes of limitations adopted by both of those states.

TrustCo Bank (“**TrustCo**”) had its principal place of business in New York. TrustCo provided a construction loan to StoreSmart of North Ft. Pierce, LLC (“**StoreSmart**”), a Florida limited liability company. Plaintiff ORE Property Two, Inc. (“**ORE**,” and together with TrustCo, the “**Plaintiffs**”) was a Florida corporation and the assignee of TrustCo’s rights, title, and interest in the StoreSmart loan and related agreements.

Defendant Susan M. Mathews (“**Mathews**”) was a manager and member of StoreSmart and she personally guaranteed the loan from TrustCo to StoreSmart. Mathews created three Delaware trusts (the “**Trusts**”) on December 21, 2006. Mathews and her children were the discretionary beneficiaries of the Trusts. RBC Trust Company (“**RBC**”), a Delaware corporation was the trustee of the Trusts (RBC, together with Mathews, the “**Defendants**”).

TrustCo loaned \$9,300,000 to StoreSmart in July 2006 for the purpose of constructing a self-storage facility in St. Lucie, Florida (the “**StoreSmart Loan**”). The StoreSmart Loan was secured by StoreSmart’s real estate and other assets. Mathews also executed a personal guaranty of the StoreSmart Loan. StoreSmart defaulted on the loan in April 2011. On April 25, 2011, TrustCo filed a foreclosure action against StoreSmart and Mathews in state court in Florida. That case resulted in a judgment on July 12, 2011, in favor of TrustCo of roughly \$8.2 million plus post-judgment interest (the “**Foreclosure Judgment**”).

TrustCo assigned its rights, title, and interest in the StoreSmart Loan, including the related security agreements, and the Foreclosure Judgment to ORE in August 2012. The Plaintiffs, StoreSmart, and Mathews agreed to entry of a deficiency judgment of about \$2.3 million and submitted a stipulation to that effect to the Florida court in February 2013, which the court approved (the “**Deficiency Judgment**”).

The Plaintiffs alleged that various transfers to the Trusts constituted fraudulent transfers. The Defendants contended that Mathews created the Trusts as part of her estate planning, which was underway before she guaranteed the StoreSmart Loan. For purposes of the pending motion for summary judgment, the court considered only the statute of limitations defense, and the court assumed, without deciding, that the challenged transfers were fraudulent.

The Plaintiffs’ complaint challenged several transfers. The most important of these were the transfers of ITRAX stock. Mathews co-founded a company called Corporate Health Dimensions (“**CHD**”). Mathews retired from CHD in 1999. CHD was purchased by ITRAX in 2004. Walgreens later purchased ITRAX in 2008. In two sets of transfers that occurred on January 9 and 22, 2007, Mathews transferred her ITRAX stock to two of the Trusts (generally, the “**ITRAX Transfers**”).

Mathews also held an interest in Terra Optima Ventures, LLC (“**TOV**”). TOV was an investment vehicle for a business owned by her son. Mathews sold her interest in TOV to one of the Trusts in March 2010 for \$63,000 (generally, the “**TOV Transfer**”). The TOV interest had been valued at \$500,000 only a year earlier, therefore, the Plaintiffs contended that the TOV sale was a fraudulent transfer. The Plaintiffs argued that they did not have legally sufficient notice of the ITRAX transfers such that the statute of limitations would begin to run until July 19, 2011. The Defendants contended that the Plaintiffs had: (1) inquiry notice in March and April of 2008; (2) inquiry notice on May 6, 2008; (3) inquiry notice on June 27, 2008; and (4) both inquiry notice and actual notice of the alleged fraudulent ITRAX Transfers in May 2010.

The Plaintiffs filed their initial complaint on March 1, 2013, along with a motion to expedite and a motion for a preliminary injunction. That complaint specifically alleged violations of Delaware's fraudulent transfer statute. On May 28, 2013, the Plaintiffs amended their complaint to remove all references to substantive Delaware law. In an effort to halt all distributions from the Trusts, the Plaintiffs renewed their motion for a preliminary injunction on July 2, 2013.

The parties framed the dispute as whether the Plaintiffs' claims were subject to the statute of limitations under Delaware law or New York law. The Defendants requested that the court treat its submissions on the preliminary injunction as the equivalent of a motion for partial summary judgment on the statute of limitations issue.

The general rule of following the forum state's relevant statute of limitations arguably may be modified by either Delaware's borrowing statute or Delaware's Qualified Dispositions in Trust Act (the "**QDTA**") (12 Del. C. §§ 3570-3576). The court concluded that the applicable statute of limitations should be determinative as to whether the Plaintiffs delayed unreasonably in filing suit more than six years after the allegedly fraudulent transfers took place.

The Defendants sought partial summary judgment that the Plaintiffs' claims for fraudulent transfer as to the ITRAX Transfers were barred by the relevant statute of limitations and laches. The ITRAX transfers occurred in January 2007. An additional disputed transfer, the TOV Transfer, occurred in March 2010. As such, regardless of which statute of limitations applied, the TOV Transfer was not barred by laches and was not subject to the Defendants' motion for partial summary judgment. The Plaintiffs initially filed suit in March 2013. The Plaintiffs also admitted that they discovered the potentially fraudulent ITRAX Transfers by July 19, 2011. Accordingly, the court relied upon the July 19, 2011 date as the date by which the Plaintiffs had discovered the fraudulent transfers under the various statutes of limitations.

The Plaintiffs argued that New York's statute of limitations applied to their fraudulent transfer claims. Under New York law, an action to avoid a fraudulent transfer must be brought within "the greater of six years from the date the cause of action accrued or two years from the time the plaintiff or the person under whom the plaintiff claims discovered the fraud, or could with reasonable diligence have discovered it." N.Y. C.P.L.R. § 213(8). The Defendants contended that Delaware's statute of limitations governed. Under Delaware law, an action to avoid a fraudulent transfer must be brought "within 4 years after the transfer was made or the obligation was incurred or, if later, within 1 year after the transfer or obligation was or could reasonably have been discovered by the claimant." 6 Del. C. § 1309.

The Plaintiffs filed their initial complaint more than six years after the January 2007 ITRAX Transfers occurred. Even under New York law, therefore, the Plaintiffs were required to file within two years of discovery of the allegedly fraudulent transfer. Assuming the undisputed July 19, 2011 discovery date, the Plaintiffs' filing of their claims to avoid the ITRAX Transfers in March 2013 would be sufficiently timely to survive summary judgment if New York law governed. If the Delaware or Florida statutes of limitations applied, the Plaintiffs' fraudulent transfer claims as to the ITRAX Transfers would be substantially outside the relevant limitations period, which would have run by July 19, 2012.

The Delaware Legislature has altered the usual rule of applying the forum state's statute of limitations through 10 Del. C. § 8121 (the "**Borrowing Statute**"), which provides:

Where a cause of action arises outside of this State, an action cannot be brought in a court of this State to enforce such cause of action after the expiration of whichever is shorter, the time limited by the law of this State, or the time limited by the law of the state or country where the cause of action arose, for bringing an action upon such cause of action. Where the cause of action originally accrued in favor of a person who at the time of such accrual was a resident of this State, the time limited by the law of this State shall apply.

The court concluded that the Borrowing Statute presumptively applied. To determine where the causes of action arose in this case, the court looked to Delaware's conflict of law rules.

According to the court, "Delaware conflict of law rules direct that the Court determine where a plaintiff's claims arose by application of the 'most significant relationship test', as set forth in the Restatement (Second) Conflict of Laws ("**Restatement**")." *TL of Fla.*, 2014 WL 3362367, at *5 (citing *Travelers Indem. Co. v. Lake*, 594 A.2d 38, 47 (Del. 1991)). The Defendants argued that Delaware or, alternatively, Florida had the greatest connection. The Plaintiffs maintained that New York had the most significant relationship. The Restatement factors differ slightly depending on whether the alleged wrong sounds in tort or contract.

The court determined that fraudulent transfers bear some resemblance to both tort and contract claims, so the court addressed both the Restatement's tort and contract factors. The court concluded that the contract factors were either in equipoise between New York and Florida, or only weakly favored New York, and that the tort factors from the Restatement moderately favored Florida. Delaware had the next strongest connection to the case, with New York having the weakest relationship to it. The court found that Florida had the most significant relationship to this case and that Florida's four year statute of limitations should apply.

Alternatively, the court concluded that Delaware had the next most significant relationship and had essentially an identical statute of limitations. Under either of those scenarios, the Borrowing Statute was held to be inapplicable. As a third alternative, even if New York did have the most significant relationship, the court held that its contacts were not sufficient to make this case a "special circumstance" where application of the Borrowing Statute to preclude use of New York's longer statute of limitations would be inequitable. As such, if New York did have the most significant relationship, the Borrowing Statute would be triggered and Delaware's statute of limitations nevertheless would have applied. Regardless of which of these three states had the most significant relationship with this case, the court concluded that the Plaintiffs would be subject to a statute of limitations equivalent to Delaware's of four years from the time the transfer was made or one year from when discovery of the transfer occurred or reasonably should have occurred, whichever was longer. The Plaintiffs did not file this action relating to the ITRAX Transfers until after the expiration of that period. Therefore, the court held that the Plaintiffs' claims regarding the ITRAX Transfers were barred by laches.

The Defendants further argued that Delaware's statute of limitations applied for the independent reason that the **QDTA** controlled the dispute. The QDTA limits a creditor's available remedies when attempting to avoid a "**qualified disposition**." A qualified disposition is a "disposition by or from a

transferor . . . to one or more trustees, at least one of which is a qualified trustee, with or without consideration, by means of a trust instrument.” 12 Del. C. § 3570(7). The Defendants contended that the case involved such qualified dispositions. In that regard, the Defendants argued that (1) Mathews was a “transferor” in that she owned property and disposed of that property, (2) that RBC satisfied the definition of a qualified trustee, and (3) the Trusts each were governed by a “trust instrument.” 12 Del. C. §§ 3570 (8),(10),(11). The QDTA requires that any claim by a creditor, to avoid a qualified disposition, must be brought pursuant to 6 Del. C. §§ 1304 or 1305, Delaware’s fraudulent transfer statutes. The QDTA also specifically provides that a creditor’s claim will be extinguished unless it is brought within the time constraints of 6 Del. C. § 1309, Delaware’s statute of limitations for fraudulent transfers. 12 Del. C. § 3572(b)(2). Finally, the QDTA stated that “The Court of Chancery shall have exclusive jurisdiction over any action brought with respect to a qualified disposition.” 12 Del. C. § 3572(a). The Defendants argued that the QDTA is a statutory command requiring both that the Plaintiffs file their suit in Delaware, specifically in the Court of Chancery, and that the court apply Delaware’s statute of limitations in Section 1309 without regard to any most significant relationship analysis. The Plaintiffs contended, primarily, that the QDTA was substantive law and that, under the most significant relationship test, the court should apply New York law. However, the Court rejected the proposition that New York had the most significant relationship with the case.

The Plaintiffs further argued that the restrictions of the QDTA were inapplicable because Mathews maintained impermissible control over the property transferred to the Trusts. *See* 12 Del. C. § 3571. The court concluded that the Plaintiffs’ claims relating to the ITRAX Transfers were barred because of either the most significant relationship choice of law analysis, which pointed to the use of Florida or, perhaps, Delaware law, or Delaware’s Borrowing Statute, which required the application of Delaware’s statute of limitations even if New York had been found to have the most significant relationship to the instant case. As a result, the court did not resolve the question of whether the QDTA required application of Delaware’s fraudulent transfer statute of limitations without regard to the normal choice of law analysis or the Borrowing Statute. However, the court noted that (1) little case law interpreting the QDTA existed, and some of the issues implicated appeared to be issues of first impression, (2) the Court of Chancery had rejected the argument that the QDTA requires suits to avoid a qualified disposition to be brought exclusively in Delaware, and (3) whether or not Mathews maintained impermissible control over the assets transferred to the Trusts such that the QDTA’s restrictions would not apply presented a material question of disputed fact not appropriate for summary resolution. For the foregoing reasons, the court declined to reach the question of whether the QDTA required the application of 6 Del. C. § 1309 (the Delaware statute of limitations for fraudulent transfers).

Ultimately, the court concluded that the Plaintiffs were on inquiry notice of the ITRAX Transfers by July 2010, and that the statute of limitations began running at that time. The Plaintiffs filed suit in March 2013, and thus, the Plaintiff’s claims relating to the ITRAX Transfers were untimely even under New York’s statute of limitations. The court therefore granted the Defendants’ motion for partial summary judgment, holding that the ITRAX Transfers were brought after the expiration of the applicable statute of limitations and were barred by laches. For an excellent summary of this case, see “Alan Gassman & Travis Arango on TrustCo Bank v. Mathews: Self-Settled, Spendthrift Trust Debtor Victory Involving Delaware Trusts, Allegations of Impermissible Control & Statute of Limitations Analysis,” LISI Asset Protection Planning Newsletter #288 (Mar. 31, 2015) at <http://www.leimbergservices.com>.

19. *In re Rensin* 600 B.R. 870 (Bankr. S.D. Fla. 2019).

In *In re Rensin* 600 B.R. 870 (Bankr. S.D. Fla. 2019), the debtor, Joseph Rensin (“**Rensin**”), established an irrevocable trust in the Cook Islands called the Joren Trust (the “**Trust**”). Rensin was both the settlor and primary beneficiary of the Trust. The Trust designated both a trust protector and a trustee. Under the terms of the Trust, Rensin could not remove or veto the trustee or the trust protector of the Trust. Rensin had the ability to select the Trustee when there is was no trust protector or when the trust protector failed to select a Trustee. The court declared this power to be so remote as to not be material to the case. The trustee was a corporate trustee with complete autonomy under the terms of the trust document. Additionally, the settlement establishing the Trust was a wholly discretionary trust meaning Rensin could request, however, not compel the trustee to make distributions from the Trust and contained a spendthrift provision. Rensin funded the Trust in November of 2001 with a gift of US\$9,000,000 from the sale of his interest in a prior business. Southpac Trust International, Inc., an entity formed under the laws of the Cook Islands, served as trustee of the Trust from its creation until December 2014.

In December 2014, more than thirteen years after the Trust was originally funded, Orion Corporate and Trust Services, an entity formed under the laws of Belize, became the Trustee. The Trust was amended and restated to reflect its situs as Belize and to change the governing law to Belize.

From April 2008 through July 2009 Rensin allegedly defrauded more than 50,000 customers in his role as C.E.O. and sole owner of BlueHippo Funding LLC and BlueHippo Capital LLC (collectively, “**BlueHippo**”). The Federal Trade Commission (“**FTC**”) filed a lawsuit against BlueHippo and, in April 2008, the United States District Court for the Southern District of New York (the “**District Court**”) entered a stipulated final judgment on that suit against BlueHippo. In November 2009, the District Court entered an order to show cause against BlueHippo and Rensin alleging violations of the stipulated final judgment. In April 2016, the District Court entered a new judgment against BlueHippo and Rensin in the amount of \$13,400,000 plus post-judgment interest.

In November 2016, Rensin made a demand on the trustee of the Trust to satisfy the FTC’s much-increased judgment. The trustee sought direction from the Supreme Court of Belize. In August 2017, the Supreme Court of Belize ordered the trustee to not comply with any court order other than an order from its court.

Rensin filed for bankruptcy in February 2017. In his initial schedules, Rensin listed a Regions Bank checking account with a balance of \$79,014, which held only proceeds from the fixed annuity. Rensin stated that he was a “discretionary beneficiary” of the Trust, “which is an irrevocable foreign situs trust that was settled in 2001. The [T]rust’s only assets are two annuities that pay [Rensin] \$15,000/monthly.” In December 2018, the court entered a non-dischargeable judgment against Rensin in the amount of \$13,400,000.

From 2009 to 2015, Rensin received approximately \$8,600,000 in distributions from the Trust. Rensin used these funds to pay legal fees, settlements with certain creditors and to start a new company. The new company ultimately failed. In December 2015, Rensin transferred \$350,000 from proceeds from a sale of a residence in Maryland to the trustee of the Trust. The Trustee used these funds to purchase a deferred annuity and the trustee used the remaining assets in the trust to purchase a fixed annuity. Rensin received distributions from the fixed annuity and held the distributions in a bank account at Regions Bank.

During the bankruptcy proceeding, Rensin claimed the annuities and the proceeds of the fixed annuity held in the bank account were exempt. The bankruptcy trustee sought a declaratory judgment that the payments from the fixed annuity, bank account, and assets held in the Trust were property of the bankruptcy estate under Florida law. The bankruptcy trustee objected Rensin's claim that the bank account was exempt. Finally, the bankruptcy trustee sought an order directing Rensin to turn over funds in the alleged exempt bank account, the payments from the fixed annuity and all other funds and the cash surrender values of the annuities that were held in the Trust.

The court determined that Florida law applied to the matter and therefore, it applied Florida law in its analysis of the issues related to the Trust. (It is arguable that this portion of the court's holding was incorrect under Florida conflicts of law rules.) The court analyzed the spendthrift provision of the Trust and determined that Rensin's creditors could attach to all assets held in the Trust under Florida law. The court noted, however, that the Trust was not a party to the proceedings and therefore it could not grant a declaratory judgment against the trustee regarding any assets held in the Trust. The court held that the annuity payments and bank account were property of the bankruptcy estate subject to exemption, however, it could not issue any ruling that would be binding on the trustee or the assets of the Trust. The court further held that the Rensin's rights under the fixed annuity and the variable annuity, including amounts paid and to be paid to him thereunder, and his Regions Bank account, which held only payments from the fixed annuity, were exempt. The court gave the bankruptcy trustee an opportunity to amend its complaint to join the trustee of the Trust as a defendant in the action. Nonetheless, assuming the Trust was joined in the action, the court noted that the likelihood of actually reaching the assets held in the Trust was quite low.

20. *Campbell v. Com'r.*, T.C. Memo. 2019-4.

In *Campbell v. Com'r.*, T.C. Memo. 2019-4, the court recognized the validity of an offshore Nevis asset protection trust. On April 26, 2004, John F. Campbell ("**Campbell**"), the taxpayer, established the First Aeolian Islands Trust (the "**Trust**") in Nevis. This was an irrevocable trust that Campbell funded with an initial gift of \$5 million. At the time he established and funded the Trust Campbell's net worth was approximately \$25 million. See *Campbell v. Commissioner*, T.C. Memo. 2019-4 at pg. 3. The deed establishing the Trust appointed a corporate trustee located in Nevis, Meridian Trust Company Limited ("**Meridian**"), and appointed an independent person as its trust protector. Campbell did not retain any control over the trustee, including control over decisions relating to distributions or investments, however, he could request, however not force, the trust protector to remove and replace the Trustee. Campbell believed Meridian was overbilling the trust and requested that the trust protector remove Meridian as trustee and appoint Southpac Trust Nevis, Ltd. ("**Southpac**") to serve. The trust protector complied with Campbell's request and Southpac was appointed as trustee of the Trust. *Id.*

In 2001 (prior to the time that Campbell established the Trust), Campbell invested in a customizable rate debt structure ("**CARDS**") transaction, however, he failed to report the transaction on his Federal tax return for that year. This resulted in underreported income in excess of \$13.5 million. *Id.* On May 10, 2004, the Service notified Campbell that his 2001 Federal income tax return was being submitted for examination and issued a statutory notice of deficiency on July 2, 2007. *Id.* Campbell disagreed with this tax assessment. In response, Campbell submitted an Offer in Compromise ("**OIC**") of \$12,603 on the basis of doubt as to collectability. *Id.* at pgs. 4, 7. The Service disagreed with Campbell's OIC and calculated his reasonable

collection potential (“**RPC**”) to be \$1,499,698 including “**net realizable equity**” in the Trust of \$1,493,912. *Id.* The IRS Appeals Officer later calculated the RCP was more than \$19.5 million using the Internal Revenue Manual (“**IRM**”) and based on her view that Campbell had dissipated assets from 2006 to 2010 and the original funding amount and value of the assets in the Trust should be included in the RPC. *Id.* at pg. 10. Upon conclusion of a lengthy procedural repartee, the Appeals Office sustained the proposed levy.

In 2006, Campbell made a \$27 million investment in real estate opportunities pursuant to the Gulf Opportunity Zone Act (“**GO Zone**”). *Id.* at pg. 4. Campbell had a net worth of approximately \$19 million at the time of his investment in the GO Zone properties and approximately \$6.5 million in liquid assets after the investment. *Id.* at pgs. 4, 5. Campbell structured his investments through limited liability companies (“**LLCs**”) which purchased and owned the real estate. He created and was the sole member of Sidell Property Management, LLC (“**Sidell**”) and Clairise Court, LLC (“**Clairise Court**”), both of which were formed to own properties in Louisiana. In 2009, it was discovered that over half of residential properties held in Sidell were uninhabitable due to Chinese drywall issues and the lender foreclosed on the assets in 2011. *Id.*

In December 2013, Campbell formed the Antilles Master Fund Limited Partnership (the “**Antilles Master**”), a Cayman Islands limited partnership, which had two investors, Campbell and Liberty Mountain Corp. (“**Liberty**”). Liberty was a wholly owned corporation held in the Trust. *Id.* at pgs. 5, 6. Campbell made Liberty and the trustee of the Trust aware of his conflicts of interest regarding this transaction. Antilles Master formed Antilles Offshore Investors, Ltd. (“**Antilles Offshore**”), a wholly owned LLC. *Id.* at pg. 6.

In March 2014, Campbell successfully brought a suit against the buyer of the Slidell properties pursuant to a Louisiana law that provided borrowers with litigious rights to repurchase properties that had been sold by a lender if an underlying debt obligation existed when the sale occurred. Campbell repurchased the properties in Sidell. Campbell sold Sidell’s assets to Clairise Court which borrowed funds from Antilles Offshore to fund the purchase. *Id.* at pgs. 5, 6.

Campbell continued to invest in the GO Zone using Clairise Court and he personally guaranteed loans for Clairise Court. *Id.* at pg. 6.

If a taxpayer submits an OIC based on doubt as to collectability the Appeals Officer must follow the IRM guidelines to determine the taxpayer’s RCP. Those guidelines consist of determining: (1) assets, including dissipated assets, (2) future income, (3) amounts collectible from third parties and (4) assets available to the taxpayer however beyond the reach of the government. *Id.* at pg. 14. IRM pt. 5.8.4.3.1 (Apr. 30, 2015). The Service argued that its position to reject Campbell’s OIC was reasonable taking into consideration factors (1), (3) and (4), however, the court rejected this argument. In reaching its decision the court examined whether the argument by the Service that Campbell “dissipated assets” was valid. According to the IRM dissipated assets must be included in calculating the RCP “in situations where it can be shown the taxpayer has sold, transferred, encumbered or otherwise disposed of assets in an attempt to avoid the payment of the tax liability” or otherwise used the assets “for other than the payment of items necessary for the production of income or the health and welfare of the taxpayer or their [*sic*] family, after the tax has been assessed or during a period up to six months prior to or after the tax assessment.” *Id.* at pgs. 14, 15. IRM pt. 5.8.5.18(1) (Mar. 23, 2018). The court held that the Appeals Officer abused her discretion to include the assets held in the Trust and the losses Campbell incurred with his Go Zone investments as dissipated assets.

The court emphasized that Campbell only used part of his wealth to fund the Trust and his investment in the GO Zone as he remained solvent after each transaction. Furthermore, the court determined that Campbell funded the Trust prior to receiving notice that the Service was examining his 2001 Federal tax return and that the original funding of the Trust was beyond the applicable look back period of the OIC. The court also noted that Campbell did not invest in the Go Zone in an attempt to avoid paying his outstanding tax liability. *Id.* at pgs. 17, 18.

The court also addressed whether the argument by the Service that even if the Trust was not considered a dissipated asset the assets held in the Trust should be considered as held by a transferee, nominee, or alter ego of Campbell under the *Drye v. United States* test. *Id.* at pgs. 18, 19. 528 U.S. 49 at 58. The *Drye* two-part analysis considers “State law to determine what rights a taxpayer has in property and then turns to Federal law to determine whether a taxpayer’s rights in that property qualify as property or rights to property under Federal tax law.” *Id.* at pg. 19. 528 U.S. 49 at 58. On this issue the court determined that Campbell’s home state of Connecticut had not adopted the nominee theory and there was no evidence that Supreme Court of Connecticut would adopt Federal principles of nominee theory. *Id.* at pg. 19, 20 *United States v. Snyder*, 233 F. Supp. 2d 293, 296 (D. Conn. 2002). The court also noted that Campbell did not have control the assets held in the Trust or possess a property interest in those assets because he had no control over the Trustee and could not demand or force the Trustee to make any distributions or investments. *Id.* at pg. 19.

Finally, the court addressed whether the assets held in the Trust were available to Campbell however beyond the reach of the government. The Service argued that Campbell maintained sufficient control over the Trust and therefore retained access to the assets by appointing a trust protector, by directing investments, and by virtue of the investment by the Trust in the GO Zone business ventures. The court rejected this argument, however, noting that the record indicated that the Trustee acted in its sole discretion and was not controlled by Campbell. *Id.* at pgs. 20, 21.

Campbell is an excellent result for the taxpayer and for individuals seeking to protect their wealth through the formation and establishment of an offshore trust structure.

Points:

1. Funding occurred with less than twenty percent (20%) of the settlor’s net worth.
2. A corporate trustee was appointed and an independent protector.
3. The settlor retained minimal powers over the trust following funding – so a well-designed structure.
4. The trustee maintained adequate records documenting its exercise of proper fiduciary authority and discretion.
5. Investments held in the trust included assets located in Louisiana, that is, the United States.
6. The wealth protection aspects of the structure were clearly respected by the court.

CHAPTER 13

NON-CHARITABLE FOUNDATIONS – THE NEWEST KID ON THE DOMESTIC BLOCK.

OVERVIEW.

Non-charitable foundations have been used by debtors outside of the United States for almost 100 years as a “hybrid” entity that is not a trust or a company by definition or application.

Foundations first came to exist in Germanic jurisdictions, such as Switzerland and Liechtenstein, under the original name of a Stiftung, and offer many advantages, as described below.

Until the issuance of the “check the box” Treasury Regulations in 1996, which provided that entities similar to corporations will be taxed as partnerships, U.S. taxpayers forming offshore foundations had to risk taxation as a C corporation, which was not feasible.

The fact that a foundation does not need a trustee, and may avoid the need to file as a “foreign trust,” while offering significant creditor protection advantages, makes them an attractive vehicle for the ownership of investments, and even business activities.

Both New Hampshire and Wyoming passed Statutory Foundation legislation in 2019 to bring foundations to the United States.

Both the Wyoming and New Hampshire foundation statutes follow the historical offshore foundation rules, which are to the effect that the creditors of a foundation “beneficiary” do not have an ownership interest or a distribution right that they can attach to, and creditors are explicitly excluded from having the right to levy the assets of a foundation by the law of the jurisdiction that enables it to be formed and operated, with limited exceptions.

Anyone considering the establishment of a foundation in New Hampshire or Wyoming, should read Alexander Bove’s article which is cited as Steve Leimberg’s Estate Planning E-Mail Letter Archive Message 2743, which was published on August 21, 2019, and is reproduced in Section B below. This Newsletter points out issues that legal and tax counsel will need to address in establishing a Wyoming or New Hampshire foundation, but we believe that a great many families will be well served by forming and maintaining foundations in Wyoming, New Hampshire, the Bahamas, Liechtenstein, Panama and the other jurisdictions which allow for them to be formed and maintained.

By definition, a foundation is an entity held by one or more officers for the benefit of one or more individuals or other entities, but the officers of the foundation do not have the same kind of strict fiduciary

obligations with respect to reporting, distributions or investment activities as would typically apply to a trust or a company.

As with Goldilocks and the Three Bears, for many families the foundation will be “just right” for the following reasons:

5. A foundation is a legal entity, duly authorized under state or national law, whereby a foundation manager or other officers hold the foundation’s assets and may apply them for the benefit of the foundation’s beneficiaries.
6. The founder of a foundation will normally file the Articles of Formation and contribute assets to it. The Wyoming Act specifically provides that powers reserved to the founder will not pass to his or her heirs, spouse or creditors, unless otherwise provided for in the foundation entity documents.
7. Unlike a trust, the foundation Directors as well as any Trust Protectors, must act in good faith, but are not held to the same strict fiduciary duty that applies to trustees.
8. The beneficiaries of a foundation will not be entitled to receive an accounting, or to require that distributions be made for their benefit, unless the foundation documents require this. This makes a foundation preferable in many ways to a trust, where an unruly or unappreciative beneficiary, or his or her creditor, spouse, ex-spouse or children, might have entitlement to information or to require distributions outside of the intent of the settlor.
9. Unlike a limited liability company, a foundation does not have definitive ownership interests or percentages, and instead may be held generally for the benefit of a group of individuals, so that the creditors or legal counsel for one or more of such individuals cannot reach into the entity, receive foundation assets, or receive what might otherwise be the equivalent of a “charging order” over the entity itself, as a matter of state or federal law.
10. Due to the above, a judgment creditor of a beneficiary may not have the same rights that he or she would have to receive distributions for support for a descendant of a beneficiary, or to compensate a third party for inappropriate acts of the beneficiary, in the same way that would apply to a trust under state law.
11. Also, a state court that might otherwise conclude that a creditor should be able to reach into an offshore asset protection trust (“APT”) established by a founder for family members, and possibly for the founder himself or herself, might not come to the same conclusion with a foundation. The Wyoming Statutory Foundation Act does not appear to prohibit the founder from being a beneficiary of the Statutory Foundation, so it is possible that the founder could be a beneficiary, and the Statutory Foundation may still receive asset protection. Where the contributor to the foundation is also a beneficiary, it would seem best to make sure that the foundation director is not related to the contributor, and that the contributor’s right to receive any distributions is in the sole discretion of the director, and that there are no designated assets, portion or percentage of assets in the foundation that are specifically set aside for the contributor. It is likely that in order for the founder to be a beneficiary and to still provide creditor protection for any portion that the founder may be able to receive, that there should be a class of individuals benefitted

with the founder not having any specific right to a certain percentage or to certain Statutory Foundation assets.

Californians who may wish to avoid the \$800 per year tax imposed on California residents who own limited liability companies outside of California should be happy to know that an ownership interest in a foundation will not trigger the \$800 per year tax, as we understand it.

In addition, state court judges who might conclude that the law of the state where a debtor resides should be controlling to allow a creditor to receive more than a charging order interest against part-ownership of a limited liability company may establish that a court residing outside of a state that recognizes foundations may be reluctant to conclude that it has a right to impose its own laws against the foundation, when the state has no laws whatsoever that relate to foundations.

TAXATION.

Mr. Bove's article correctly points out that a foundation may be taxed as a trust, a partnership, or even a C corporation, but a properly drafted foundation document will, in the vast majority of circumstances, allow the foundation to be taxed as a "defective grantor trust" or a partnership, so that all income and deductions from the foundation's assets can be reported on the Form 1040 tax return of the grantor/contributor of the foundation, if the entity is treated as a trust, or by K-1 reporting to the beneficiaries, if the entity is taxed as a partnership.

In the Office of Chief Counsel of the Internal Revenue Service Memorandum AM2009-012, the income tax status of a Liechtenstein Stiftung (which is the Liechtenstein Foundation entity) is to be determined "on a case-by-case basis . . . Generally, however, Stiftungs will be classified as trusts, unless under the facts and circumstances, the entity was created for commercial purposes."

Further discussion provided in this IRS Memorandum is as follows:

Office of Chief Counsel / Internal Revenue Service
Memorandum Number: AM2009-012 / Release Date: 10/16/2009

Liechtenstein Stiftungs

A Liechtenstein Stiftung, or Foundation, is a legal entity under Liechtenstein law. A Stiftung does not have members or a board of directors. The Founder transfers specific assets to the Stiftung that are then endowed for specific purposes. The assets pass from the personal estate of the Founder to the Stiftung. The Founder states the objectives of the Stiftung and appoints its administrators. Based upon information you have provided, a Stiftung cannot be organized to engage in the active conduct of a business, but Liechtenstein law provides that in certain cases commercial activities may be undertaken by a Stiftung if such activities serve its noncommercial purposes. A Stiftung may be a family foundation established to provide benefits to members of a designated family, or a charitable or religious foundation.

A Stiftung may be formed by filing a foundation charter or by will or testamentary disposition. A Stiftung is entered onto the Register in Liechtenstein and must have a minimum amount of initial capital. A Stiftung exists for the benefit of those named in its formation documents as being appointed as beneficiaries. A Stiftung only has legal liability up to the amount of its contributed capital and net assets and it cannot be made liable for liabilities in excess of them.

The Stiftung does not have a board of directors, but has Foundation administrators, called a Council of Members. The Founder may appoint himself as an administrator. The duties and obligation of the administrators are set forth in the Stiftung's articles and includes the conduct of the Stiftung's affairs. This includes the investment and management of its assets and the distribution of income and/or capital to the beneficiaries as per the provisions of the Stiftung's articles. Under Liechtenstein law, the administrators are responsible for the proper management and conservation of the Stiftung's assets. The Founder may reserve for himself the right to discharge and appoint administrators.

LAW AND ANALYSIS

Section 301.7701-1(a) of the Procedure and Administration Regulations (regulations) provides that the Internal Revenue Code (Code) prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend upon whether the organization is recognized as an entity under local law.

Section 301.7701-1(b) of the regulations provides that the classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Code (such as §860A addressing real estate mortgage investment conduits (REMICS)) provides for special treatment of that organization.

Section 301.7701-2(a) of the regulations provides that for purposes of §§ 301.7701-2 and 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. Section 301.7701-3(b)(2) provides that except as provided in § 301.7701-3(b)(3), unless the entity elects otherwise, a foreign eligible entity is (A) a partnership if it has two or more members and at least one member does not have limited liability; (B) an association if all members have limited liability; or (C) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

Section 301.7701-4(a) of the regulations provides that, in general, the term "trust" as used in the Code refers to an arrangement created by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or

conserving it for the beneficiaries under the ordinary rules provided in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Code if it was created for the purposes of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally, an arrangement will be treated as a trust under the Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section 301.7701-4(b) of the regulations provides that there are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code. However, the fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership. The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under § 301.7701-2.

In Estate of Swan v. Commissioner, 24 T.C. 829 (1955), aff'd in part and rev'd in part on other grounds, 247 F.2d 144 (2d Cir. 1957), the court, in determining whether the value of the assets of the Stiftungs should be includable in the decedent's gross estate, considered the application of the federal estate tax under § 811(d) (now § 2036) to a Swiss Stiftung and to a Liechtenstein Stiftung and concluded that the Stiftungs were comparable to trusts for U.S. estate tax purposes, rather than corporations. Because the court concluded that the Stiftungs are comparable to trusts, the court held that the transfers to the Stiftungs in that case are encompassed by the broad statutory language "by trust or otherwise" in former § 811. Citing Morrissey v. Commissioner, 296 U.S. 344 (1935), in Estate of Swan, 24 T.C. at 859, the Tax Court further points out that the classification of a particular Stiftung must depend upon the nature of the activities carried on by the entity. In Morrissey, the Supreme Court concluded that the nature and purpose of a cooperative undertaking will differentiate a business trust from an entity that is an ordinary trust.

Liechtenstein Stiftungs

Based on the information submitted, we believe that, subject to the facts and circumstances of each situation, Liechtenstein Stiftungs generally are properly treated as trusts under § 301.7701-4(a) of the regulations. In most cases, the Stiftung's primary purpose is to protect or conserve the property transferred to the Stiftung for the Stiftung's beneficiaries and is usually not established primarily for actively carrying on business activities.

However, it is important to note that if the facts and circumstances indicate in a particular case that a Stiftung was established primarily for commercial purposes as opposed to the purpose of protecting or conserving property on behalf of the beneficiaries, the Stiftung in such case may be properly classified as a business entity under § 301.7701-2(a). Accordingly, it is important to analyze the facts and circumstances of each case to determine whether a particular Stiftung was established to protect and conserve property of the Stiftung or alternatively, was created as a device to carry on a trade or business.

The Memorandum was prepared by Associate Chief Counsel Curt G. Wilson, who is now a Director in the Washington National Tax practice of KPMG, Practice, Procedure and Administration group.

The Memorandum also discussed the taxation of a Liechtenstein Anstalt, which have as "their primary purpose . . . to actively carry on business activities. Therefore, in most cases, Liechtenstein Anstalts are properly classified as business entities under § 301.7701-2(a)."

It is noteworthy that the 7701 regulations were modified in 1996, and named the "check the box" regulations, and presume that a business entity formed as a limited liability company, a limited partnership, or other similar classification of organization will be taxed as a partnership unless a box is checked to have it considered to be taxed as a C corporation. It therefore appears that the Statutory Foundations will be taxed as a trust or as a partnership, and will not be subject to federal income tax at the foundation level, unless a "check the box" election is made to treat the foundation as a C corporation, which would almost never be recommended.

Further, "exception creditors" who might be able to reach into an irrevocable trust, such as an ex-spouse or a dependent of a trust beneficiary, or the creditor of a trust contributor who might be a beneficiary of a trust, may not be able to reach into a foundation, given that state law strictly prohibits creditors from reaching into a foundation, assuming that the fraudulent transfer statutes do not apply.

Many families have formed Nevada asset protection trusts, and have had the trustee own an interest in a limited liability company which holds most of the assets under the arrangement, under the control of a manager or officer of the LLC, so that the trustee of the asset protection trust is not able to steal assets or exert management control from the founder/contributor.

This can be facilitated with the use of a foundation, in lieu of a limited liability company, so that the appointed Director and Trust Protectors do not have the same degree of fiduciary duty that would typically be owed by the trustee of a trust to the beneficiary of a trust, and whereby the trustee of a beneficiary of the

foundation would not be able to attach an ownership interest or obtain a charging order as long as the foundation documents do not give the beneficiary the ability to force a distribution, to transfer an ownership interest, or to even request an accounting. Further, a “flee clause” may permit or require the officer or officers of the foundation to move the entity and its assets to another jurisdiction in order to avoid creditors. This would not necessarily cause the foundation to be taxed as an offshore trust, even though domestic asset protection trusts are required to be considered as offshore trusts for tax reporting purposes, if the trustee is required to move the trust and trust assets to a foreign jurisdiction in the event of a specific event, as opposed to this being discretionary.

It is refreshing to hear of a state law based entity that simply requires entity Directors to act in “good faith,” without having any obligation to specifically account for trust assets or distributions, or to in any way be beholden to an unruly or unappreciative beneficiary who might assert “legal rights” in a way that would be inconsistent with the founder’s intentions.

It is currently unclear how non-charitable private foundations will be taxed, but many practitioners believe that the foundation will be taxed in accordance with how the foundation is set up and operated. It is likely that the IRS will use the reasoning in *Morrissey v. Commissioner*⁶⁴¹ and *Estate of Bedell v. Commissioner*⁶⁴² for guidance. In these cases, the court looked at the governing documents and the ongoing treatment of foreign trusts to determine whether they should be taxed as a partnership or a corporation. It seems likely that the foundation’s governing documents may be drafted to facilitate treatment as a partnership or a trust, and can avoid offshore trust registration and reporting. In addition, as indicated by Mr. Bove, a foundation formed in a civil law jurisdiction, such as the Bahamas, Switzerland, Liechtenstein, or Panama, may have no or little risk of having a court “interpret the law” in order to require a foundation manager to have any equitable duty to a beneficiary or to have to be reformed to meet standards that are not intended. Likewise, judges may be less willing to attempt to impose the law of a state other than Wyoming or New Hampshire, where a debtor/beneficiary resides when that “home state” does not have similar statutes, and judges who are unfamiliar with the Foundation laws may be less likely to want to spend time and effort in this realm.

MORE SPECIFICS ABOUT WYOMING AND NEW HAMPSHIRE STATUTES.

Wyoming and New Hampshire both passed laws in 2019 that allow for the formation and operation of a private non-charitable foundation in a manner that is very similar to the rules that apply to a typical offshore private foundation. In doing so, Wyoming and New Hampshire have provided an important new domestic creditor and family protection tool that can be used under appropriate circumstances.

A Wyoming foundation must name at least one beneficiary, who will have a right to see the operating agreement of the foundation, unless this right is explicitly stricken in the Articles of Formation or operating agreement.

⁶⁴¹ *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

⁶⁴² *Bedell v. Commissioner*, 86 T.C. 1207 (1986).

Unlike a limited liability company or limited partnership, a beneficiary has no “ownership interest.” Therefore, there would apparently be nothing that a creditor would be able to reach, or to obtain a charging order on.

Another advantage of using a foundation is that it is much less expensive than to establish and maintain an offshore trust. In Wyoming the filing fee is only \$150, with an annual report fee of \$100 per year, and the need to have a registered agent in Wyoming. In New Hampshire that filing fee is only \$75, with an annual report fee of \$100 per year. Especially for California residents, who are required to pay the state of California \$800 per year for each company that they own anywhere in the world, this may save \$800 a year, and unlike an offshore trust, there is no need to have a trust company, or to maintain filings, accountings, and disclosures that would normally be needed by a trust company.⁶⁴³

In fact, the officers and directors of a Wyoming or New Hampshire foundation do not need to be located in Wyoming or New Hampshire.

The Wyoming Statute contains the following provisions, which are indicative of how a non-charitable Statutory Foundation will work:

17-30-201. Nature, purpose and duration of statutory foundations.

(a) A statutory foundation shall be an entity distinct from its founders, contributors, beneficiaries and any other persons.

(b) Unless stated otherwise in the articles of formation, a statutory foundation has perpetual duration.

(c) Except for those purposes provided in subsection (e) of this section, a statutory foundation may be created for any lawful purpose, which may be included in the articles of formation of the foundation, regardless of whether the foundation is for profit or for charitable purposes, as defined in W.S. 17-30-102(a)(v), provided that a statutory foundation shall:

(i) Confer a benefit on at least one (1) person; and

(ii) Be authorized to hold tangible and intangible property and accumulate income generated by that property for the purposes of this act.

(d) In addition to those purposes provided in subsection (c) of this section, a statutory foundation may be organized for the purpose of holding or investing in other entities or assets, including those entities or assets that are the property of the statutory foundation.

⁶⁴³ Leimberg Information Services Newsletter #2743, Published August 21, 2019.

(e) A statutory foundation may not be created to act as a financial institution or an insurer, as defined in W.S. 26-1-102(a)(xvi).

(f) The purpose for which a statutory foundation may be created under this act shall not be amended or restated unless the articles of formation expressly provide that the purpose of the statutory foundation “may be amended”, “may be restated” or include words of similar import or an amendment or restatement is required pursuant to a court order.

Defined terms include the “Contributor” who contributes property to the foundation, the “Founder” or “Organizer” who acts to form the foundation, the “Operating Agreement” which is required to be executed shortly after formation of the entity, the “Beneficiary” who is the person designated as a beneficiary under the Operating Agreement, who may have a present or future vested or contingent beneficial interest in the entity, the “Protector” who is designated as a Protector, the “Principal Office” of the entity, which does not need to be in Wyoming, and the “Director” or “Directors” who must exist and constitute the operating officers of the entity.

The foundation is formed by the filing of Articles of Formation, which must provide a name for the foundation that ends with the words “Statutory Foundation” or the letters “SF” and should not have a name that would cause third parties to think that the foundation is a corporation, LLC, limited partnership or other conventional entity.

The foundation is required to have an “Operating Agreement,” which governs the conduct and administration of the foundation. This is generally entered into by the Founder and Directors.

Any and all kinds of property can be owned by a Statutory Foundation, and the Directors have the same rights that officers and directors would have to make use of property, and to conduct the business of the foundation.

A Registered Office and Registered Agent must be a Wyoming person and address where service of process can be delivered.

The Protector of the foundation may have the same powers that Trust Protectors normally have, but a Protector cannot act both as a Protector and as a Director of the foundation, so two different individuals and roles should exist.

The Operating Agreement of the foundation can include management and governance provisions, and may allow a Founder to reserve the power to amend the Articles of Formation, the specific purposes of the foundation, and to revoke or restate the terms and conditions of the Operating Agreement, but only if such powers are specified in the Articles of Formation. Any such powers will lapse on the death, dissolution or termination of the Founder, unless otherwise set forth in the Articles of Formation or Operating Agreement.

The heirs, a spouse or creditors of a Founder do not have any power to amend or restate the Articles of Formation or the purpose of the foundation, or terminate it.

The foundation is required to maintain a Board of Directors, which may be comprised of a single Director, to operate the entity.

Each Director of a foundation is required to act “in good faith” and in a manner not opposed to the “best interests of the Statutory Foundation.” There is no provision under the law which gives a Director a fiduciary duty to any beneficiary.

Directors and Protectors are not personally liable for the acts, omissions, obligations or debts of the foundation, and “except as otherwise provided by law, a Founder or other person may be appointed as the Protector of a Statutory Foundation.” The Operating Agreement may authorize a Protector to approve or disapprove any qualified action of the Board of Directors.

A Protector “shall serve as a fiduciary to the extent of authority and duties granted under the terms of the Operating Agreement.”

A Protector will not have responsibility for the debts or liabilities, except in the event of personal involvement with fraud, inadequate capitalization, failure to observe foundation formalities as required by law, or intermingling of assets, business operations and finances of the foundation and the Protector.

The beneficiary of a Statutory Foundation does not have the right to or any interest in property of the foundation, except to the extent that such right or interest arises by the express terms of the Operating Agreement.

“Except to the extent otherwise provided in the governing instrument, a beneficial owner shall have an undivided beneficial interest in the property of the Statutory Foundation, and shall share in the profits and income of the foundation in the proportion of the entire undivided beneficial interest he owns in the foundation. The governing instrument of a Statutory Foundation may provide that the foundation or the Directors, acting for and on behalf of the foundation shall be deemed to hold beneficial ownership of any income earned.”

Any beneficial interest that a beneficiary has in the foundation is considered to be personal property, and the transferee of a beneficial interest will only be entitled to receive the share of profits and the return of contributions to which the beneficial owner otherwise would have been entitled.

The governing documents of a foundation can prohibit the transferability of beneficial interests, and can provide that the transferee of a beneficial interest will have no right to participate in or be kept apprised of the affairs of the foundation.

Unless the Operating Agreement of the foundation provides otherwise, a beneficiary can receive a copy of the Operating Agreement, but information about any other beneficiary may be redacted.

There are no provisions which require accountings or reports to be given to beneficiaries, although Protectors may require Directors to provide reporting.

A Wyoming Statutory Foundation may convert to become a foundation in another jurisdiction, or may be the successor entity for a foundation from another jurisdiction that has been moved to Wyoming.

The following article, written by Alexander A. Bove, Jr., as Leimberg Information Services Newsletter #2743 that was published on August 21, 2019 provides more information on non-charitable foundations:

BUILDING A BETTER PRIVATE FOUNDATION, WYOMING’S GAMBLE

By: Alexander A. Bove, Jr.

EXECUTIVE SUMMARY:

Wyoming is now the second state in the U.S. after New Hampshire to adopt a law allowing the establishment of a private non-charitable foundation, in a sense competing with New Hampshire.¹ But if a comparison between the two states’ laws, each seeking similar results, were viewed as a poker game, New Hampshire might be holding aces and eights,² although that may not mean Wyoming holds the winning hand.

Obviously, the reason any state would go to the trouble and expense to adopt such laws is to attract money and business to the state, so the stakes can be high. The reason a private foundation could attract business is two-fold. First, as explained later, the private foundation can offer benefits very similar to a trust, including what could be stronger asset protection features, but with far greater control and privacy for the “founder,” and second, it is an entity completely familiar to individuals and families from civil law (as opposed to our common law) jurisdictions, which encompass a huge majority of the world population. Such familiarity, along with very favorable tax laws in the U.S. for non-U.S. persons who establish certain entities, can combine to attract huge amounts of money and investments to this new type of U.S. entity. Whether and to what extent the laws of either or both states meets these requirements and will attract the money remains to be seen, but here is one advisor’s view of the Wyoming law.

COMMENT:

While New Hampshire attempted to draft a foundation law and ended up basically with a trust law³, Wyoming apparently consulted with experts and went to the trouble of researching foreign foundation law to use as a guide and ended up with a law that could attract the type of business it seeks, though it could definitely use some serious “tweaking,” as explained below.

The Wyoming Statutory Foundation Act, effective July 1, 2019, allows the formation of a private foundation, which may be charitable or noncharitable, but all comments here are directed to the non-charitable private foundation. The private foundation (herein the “PF”), unlike a trust, is a separate legal entity, similar to a corporation, but unlike the typical corporation, it normally has no shareholders. Thus, it is the founder (the party who forms the PF) who may reserve the right to revoke or terminate it, or to amend its purpose. These rights and others must be expressly reserved in the articles of formation.⁴ (This practice is the opposite of the New Hampshire law where the founder’s rights are automatically reserved unless

declined in the articles, which could be risky if the drafter forgets to decline them, because the assets of the PF could then be reachable by the founder's creditors.)

Along with the filing of Articles of Formation,⁵ the Board of Directors would be appointed (there must be at least one Director),⁶ and an operating agreement must be adopted⁷. This would be very similar to a limited liability company operating agreement, as is another provision discussed later, relating to a transfer of a beneficiary's "share." This is Wyoming's first deviation from the typical foundation. Although the Wyoming law does not specify any required contents of the operating agreement, the Act notes a number of items that "may" be included in that document, such as "any provision for managing the business" and affairs of the PF.⁸ Like an LLC, the operating agreement must be maintained and up-to-date, but it need not be filed anywhere.

One of the unique features of the typical PF, and included in the Wyoming law, is that, unlike a trust, the managers (Directors of the PF) do not have the same duty to the beneficiaries of the PF as a trustee has to the beneficiaries of a trust. While some offshore jurisdictions allow a PF to have a purpose but no beneficiaries, the Wyoming Act requires at least one beneficiary.⁹ Despite that, the Directors' fiduciary duty runs to the PF and not to the beneficiaries, reflected in the Act, which says that the Directors of the PF must "act in good faith"¹⁰ and "in a manner not opposed to the best interests of the foundation."¹¹ Further, the only right a beneficiary has to information, unless the operating agreement provides otherwise, is the right to see a copy of the operating agreement,¹² which contains no details of the assets of the PF or the actual operation of the PF. However, there is one exception to this. If there is no protector serving, then the PF must provide the beneficiary with any information requested by the beneficiary.¹³ What the beneficiary can do with this information is not clear, but at the very least, it turns the situation upside down. And one could see some potential trouble where there was a temporary vacancy in the protector position and a recalcitrant beneficiary who "takes over."

Speaking of protectors, the Act provides that a non-charitable PF may (and therefore, need not) have a protector.¹⁴ As noted above, if there is no protector, all of the PF's information is available to the beneficiaries, a result quite undesirable with the traditional foundation where the founder wishes to provide for the family but not provide them with even indirect control, detailed information about assets, or the right to interfere with the management of the PF. And once again, if there is no protector, it is unclear what the beneficiaries may do with all of the PF's information. Thus, it would be extremely imprudent to form a PF without a protector or "enforcer" of some kind. But even with a protector, the Wyoming Act leaves some important questions open. Under the provision applying to protectors, for example, the only power suggested (not mandated) for the protector is the power to veto "any specified action" of the Directors.¹⁵ That means any action is unclear and could lead to unnecessary disputes, although it likely means acts specified in the operating agreement. The bigger issue is whether that is the only power that may be given to a protector, which would be quite shortsighted, as anyone who has worked with PFs or purpose trusts is well aware of the importance of having a protector with broad powers. Why the drafters didn't simply add "and such additional powers as may be authorized by the operating agreement" is a real puzzle. To add confusion to this question, a subsequent provision in the Act suggests, though it does not actually state, that a protector could make a pass-through tax election.¹⁶ Another permitted power?

Speaking of powers, as noted above, the founder's reservation of certain powers must be specific and stated in the articles of formation (powers to amend the articles or the purpose of the PF)¹⁷, while others,

such as the power to amend the operating agreement “may” be stated or may be added to the articles of formation or operating agreement.¹⁸ The founder’s power to amend the articles of formation or the PF’s purpose, however, will cease on the founder’s death (if the founder is a natural person), but the Act states that the controlling documents could provide otherwise.¹⁹ What could be “otherwise” here could be critical, because the following Section of the Act provides that those powers shall not pass to the founder’s heirs, spouse, or creditors.²⁰

These sections could certainly stand some reconsideration, if not redrafting, as it clearly restricts the founder’s planning options and appear to be self-contradicting.

The Section on “beneficiary” vs. “beneficiary owner” could also stand some clarification. It took a couple of readings to realize that the distinction between a beneficiary and a beneficiary “owner” (the latter missing from the Section on definitions!) is that a “beneficiary” is the “normal” beneficiary one would see in a trust, where distributions are either mandatory or at the trustee’s discretion, and the beneficiary holds a beneficial interest but no actual ownership rights, whereas a beneficiary owner, simply stated, apparently has a status corresponding to that of a member of a limited liability company, sharing “in the profits and losses of the foundation”.²¹ Consistent with this view, the Act provides that a transferee of a beneficiary owner will only have the rights of an assignee.²² Unfortunately, though the Act also allows a beneficiary to transfer her rights²³ (something generally rare in the traditional foundation), there is no mention of the rights or status of a transferee of a “plain” beneficiary. There are other problems with the transferability of the beneficial interest – two major ones. First, such transferability makes the beneficiary’s interest reachable by the beneficiary’s creditors, again, a feature carefully avoided in the traditional PF, though the Act does allow the operating agreement to override this.²⁴ In this regard, however, the important question of the rights of a creditor/transferee of a beneficiary are not addressed in the statute. Second, one of the central questions that has plagued offshore foundations for years is whether they should be treated as trusts or corporations for U.S. tax purposes. The key question is, does it have more of the characteristics of a corporation than a trust? One of the most important issues in this regard is whether the beneficiaries could transfer their interests, similar to a shareholder of a corporation. Wyoming is taking quite a gamble in dangling this feature for use by founders and advisors. (The IRS ruling on this is noted later.) Therefore, an unsuspecting founder or advisor making uniformed choices allowed by the Act could unintentionally end up with a corporation instead of a trust or even an LLC (which the default provisions in the Act would cause).

Further to the creditor issue, the Act states that “the transfer of property (to the PF)...shall not (be) rendered ineffective for any reason,”²⁵ and that the property of the PF “shall not be subject to the claims of a founder’s creditor.”²⁶ While such language is not unusual in PF laws, some jurisdictions make it clear, and drafters of PF documents should be aware, that this language would not prevent a founder’s creditors from reaching PF property if the transfer to the PF was found to be a fraudulent or voidable transfer.

One of the better features of the Act is its privacy. The identity of the Founders, Directors, beneficiaries, or protectors of the PF do not need to be filed or recorded anywhere for the public to see, as is traditionally the case with offshore foundations, a feature that would be attractive to offshore founders of a Wyoming PF. There are no special provisions, however, for an existing foreign PF to emigrate to become a Wyoming PF, which is actually fine, because such a move is complicated and generally unwise due to the different laws applying to the “two” foundations. The New Hampshire PF law attempted to do this, and it produced an awkward and unattractive result where key parties to a foreign PF would have to disclose their

identities in a public filing, and the foreign PF would have to adopt unfamiliar laws that could be contrary to its own.²⁷

From a tax standpoint, the PF could be a pass-through entity, such as an LLC or a grantor trust, or a separately taxable entity, depending on the powers reserved by the Founder, the identity of the beneficiaries, the Directors and the protector, and the terms of the operating agreement. In this regard, a reading of the Act's provisions and options suggests either that the drafters were not sure what they wanted, or that they intended to offer an LLC entity dressed up as a private foundation. Again, this could be a dangerous gamble because it is not likely that advisors and drafters will have the requisite knowledge and experience to discern which of the numerous options to take and the tax and legal consequences of their choices. The "typical" foundation, however, which in practice has many features of a trust, will likely be taxed as a trust, and the IRS has suggested the same in a 2009 legal advice memo.²⁸ Nevertheless, as suggested in the comment above regarding "beneficiary owner," drafters should be aware that the default PF could be regarded as an LLC for tax purposes.

CONCLUSION:

It is no secret that the nineteen states that have adopted "self-settled spendthrift trust" laws did so to attract some of the billions of U.S. dollars that were going offshore to fund offshore asset protection trusts. Fortunately, the basic provisions of all of the domestic asset protection trust (DAPT) laws of the various U.S. states are virtually identical, and furthermore, they are all more or less copies of the major offshore trust jurisdictions. Lastly, the DAPT laws are clear and relatively easy to follow by advisors. In short, the U.S. states did not try to create a "different animal." Unfortunately, such has not been the case with the private foundation. First, New Hampshire legislature created its private foundation statute and ended up with a default trust law. Now Wyoming comes along with its foundation statute and ends up with a default limited liability company law. This is not to say that a traditional foundation could not be established under Wyoming law – but it would require an advisor who has considerable knowledge of foundation law and the particular provisions that should be included in a "family" foundation. Unlike the DAPT statutes, which one could simply follow and end up with a suitable asset protection trust, with the Wyoming law, an advisor without adequate knowledge would not know which of the provisions to override and which to keep. In my several readings of the statute, my first instinct was to recommend an instruction booklet for advisors. In short, the law is extremely user unfriendly, unless one wants a slightly modified limited liability company that they can call a private foundation.

ENDNOTES:

1 Wyoming statute annotated (herein "WSA") 17-30-101, et seq (sometimes, the "Act"), (2019), New Hampshire RSA 564-E (2017).

2 The poker hand said to be held by Wild Bill Hickok when he was murdered, hence nicknamed the dead man's hand.

3 See Alexander A. Bove Jr., *Building a Solid Foundation, Trusts & Estates*, July, 2018.

4 WSA 17-30-401.

5 WSA 17-30-303.

6 WSA 17-30-501.

7 WSA 17-30-309.

8 Id.

9 WSA 17-30-201 (c) (ii).

- 10 WSA 17-30-501 (d) (i).
- 11 WSA 17-30-501 (d) (ii).
- 12 WSA 17-30-701 (a).
- 13 WSA 17-30-701 (b).
- 14 WSA 17-30-503 (b).
- 15 WSA 17-30-503 (d).
- 16 WSA 17-30-505 (c) (i).
- 17 WSA 17-30-401 (b).
- 18 Id.
- 19 WSA 17-30-401 (c).
- 20 WSA 17-30-402.
- 21 WSA17-30-602 (e).
- 22 Id.
- 23 WSA 17-30-603.
- 24 Id.
- 25 WSA 17-30-103 (b).
- 26 WSA 17-30-801.
- 27 See note 3, *supra*.
- 28 2009 TNT 199-22.

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