PROTECTING YOUR ASSETS IN A LITIGIOUS SOCIETY

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WHAT IS ASSET PROTECTION?

- Goals
  - Reduce exposure
  - Insulate owners from risk

WHAT IS ASSET PROTECTION?

- Fallacies
  - Hiding assets
  - Evading creditors/obligations

ASSET PROTECTION OPTIONS

- **Titling**
  - Tenancy by the entirety
  - Premarital or postnuptial agreements
- **Insurance**
- **Entities**
  - LLC
  - Corporation
- **Trusts**
  - Transfer of title vs. transfer of control

ASSET PROTECTION OPTIONS

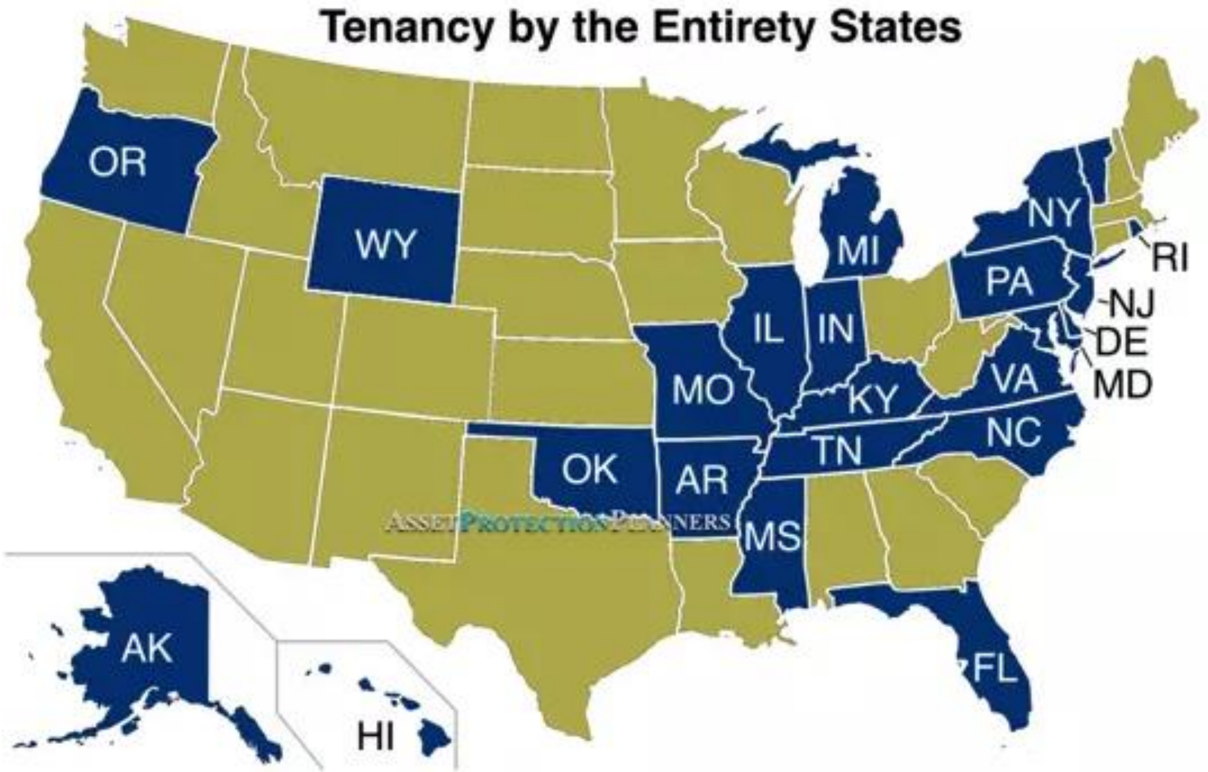
- Titling
  - Tenancy by the entirety
    - An important feature of the tenancy by the entirety is that, since neither party may convey the property without the other's permission, the property is also immune from claims of the creditors of either party.
    - Trusts and tenancy by the entirety

ASSET PROTECTION OPTIONS

- Titling
  - Tenancy by the entirety
    - Example:

ASSET PROTECTION OPTIONS

- Titling
  - Tenancy by the entirety
    - Cons



ASSET PROTECTION OPTIONS

- Titling
  - Premarital or postnuptial agreements
    - Uniform Premarital and Marital Agreement Act (UPMAA)
      - Applies greater scrutiny to the process leading up to the execution of the agreement, adding provisions addressing
        - (1) whether both parties have access to independent legal advice and, if not, what additional disclosures or explanations need to be included in the document, and
        - (2) what constitutes an adequate financial disclosure

ASSET PROTECTION OPTIONS

- Titling
  - Premarital or postnuptial agreements
    - Uniform Premarital and Marital Agreement Act (UPMAA)
      - Cons
        - Permits a court to decline to enforce a term in the agreement if it would result in substantial hardship

Procedural Safeguards
UPMAA § 9 (2012)

(a) A premarital agreement or marital agreement is unenforceable if a party against whom enforcement is sought proves:

(1) the party's consent to the agreement was **involuntary** or the result of duress;

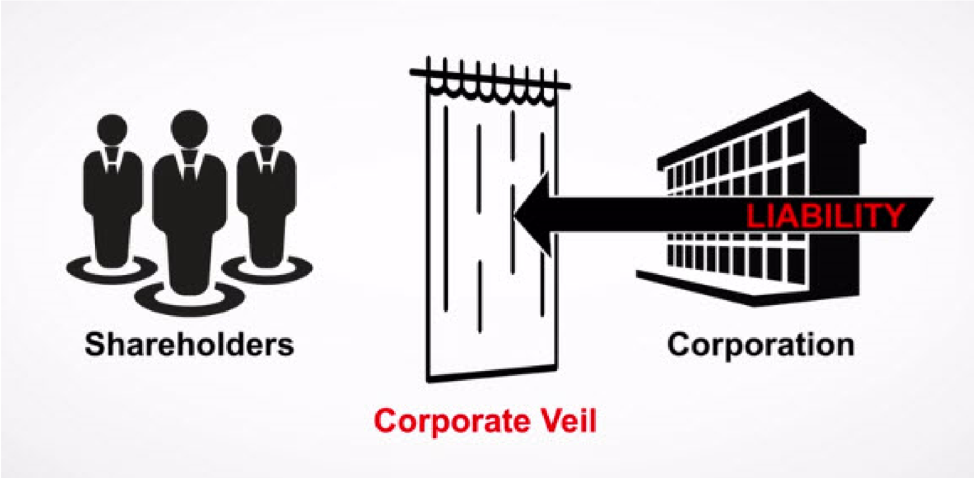
(2) the party did not have access to **independent legal representation…**;

(3) unless the party had independent legal representation at the time the agreement was signed, the agreement did not include a **notice of waiver of rights…or an explanation in plain language** of the marital rights or obligations being modified or waived by the agreement; or

(4) before signing the agreement, the party did not receive **adequate financial disclosure…**

ASSET PROTECTION OPTIONS

- Entities
  - LLCs/Corporations
    - Shareholders/members are generally protected from inside liabilities.
    - However, what about veil piercing?



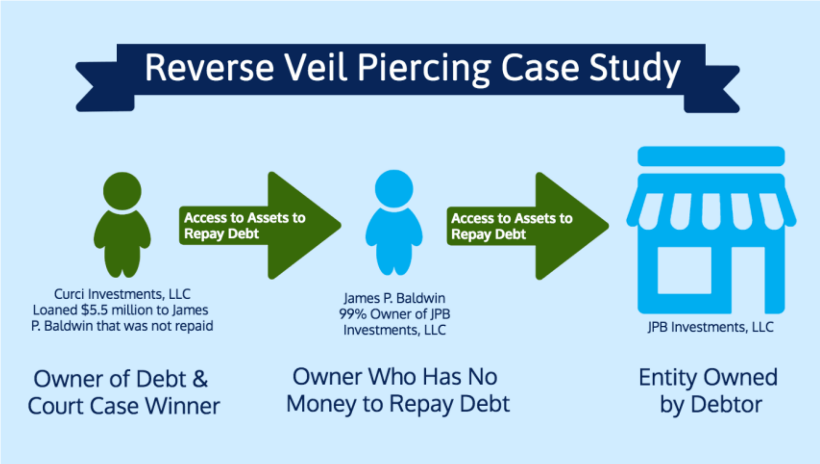
ASSET PROTECTION OPTIONS

- Entities
  - LLCs/Corporations
    - Ensuring that a court will never pierce the corporate veil:
      - Comply with formal rules
      - Maintain a separate bank account
      - Do not commingle personal assets with LLC/corporation assets
      - Make a reasonable initial investment
      - Purchase insurance
      - Do not tell a creditor that you will personally guarantee payment of the LLC's/corporation’s debts
      - Make sure the world knows it is dealing with a LLC/corporation

ASSET PROTECTION OPTIONS

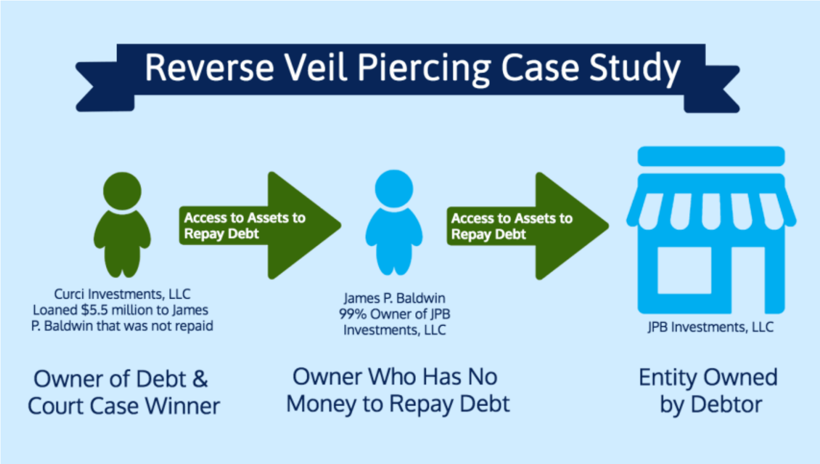
- Entities
  - LLCs/Corporations
    - LLC/corporation assets are generally protected from outside liabilities incurred by shareholders/members
    - Charging orders with LLCs vs. foreclosure with corporations

ASSET PROTECTION OPTIONS



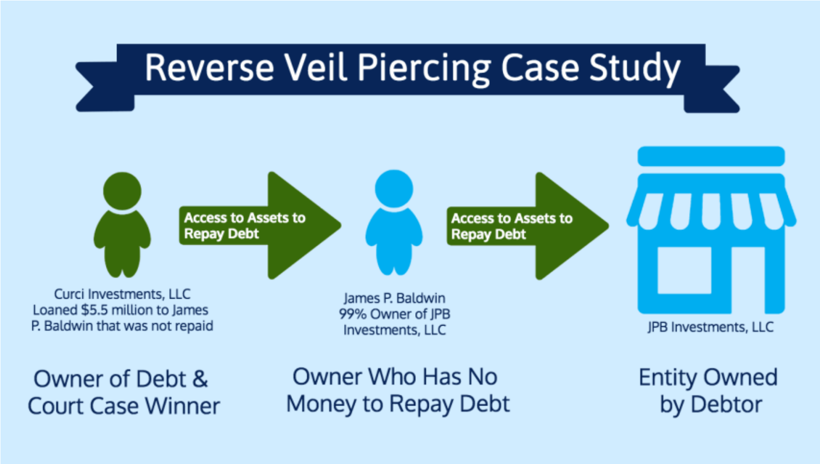
- Entities
  - LLCs/Corporations
    - However, what about reverse veil piercing?
      - Allows the owner's personal creditors to seize an entity's assets to satisfy an owner's debts
      - Has been recognized by many courts and appears to be gaining favor
      - Has been used more in the LLC context
        - Example: *Curci Investments v. Baldwin*

ASSET PROTECTION OPTIONS



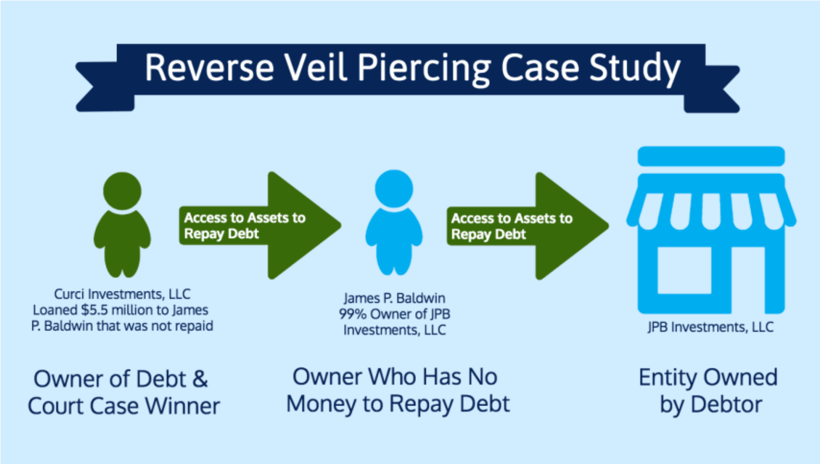
- Entities
  - LLCs/Corporations
    - Example: *Curci Investments v. Baldwin* (Cal. App. 2017)
      - The plaintiff obtained a multimillion dollar judgment against the owner, Baldwin, and sought to add Baldwin's LLC as a judgment debtor
      - Baldwin owned 100% of the LLC
      - Baldwin appeared to be using his LLC as a personal bank account (alter ego?)
      - Baldwin borrowed $5.5 million from Curci's
      - However, when Curci's note came due, Baldwin defaulted and litigation ensued

ASSET PROTECTION OPTIONS



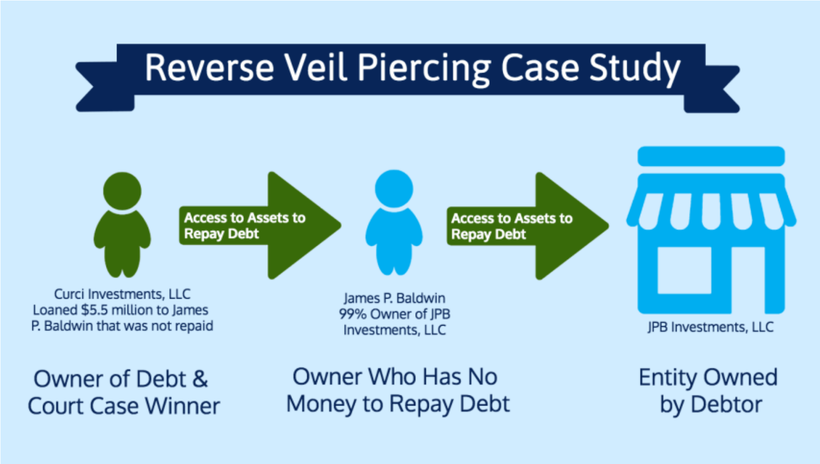
- Entities
  - LLCs/Corporations
    - Example: *Curci Investments v. Baldwin* (Cal. App. 2017)
      - Curci took a judgment against Baldwin, but was limited to a charging order against the LLC
      - After the judgment, Baldwin elected not to make any distributions
      - With three years of Curci's collection efforts frustrated by Baldwin's tactics, Curci moved to add the LLC as a judgment debtor on the theory of reverse veil piercing

ASSET PROTECTION OPTIONS



- Entities
  - LLCs/Corporations
    - Example: *Curci Investments v. Baldwin* (Cal. App. 2017)
      - The court held that reverse veil piercing may be available IF the entity is an LLC, as long as no innocent parties are harmed and an inequitable result would occur if reverse veil piercing was not available
      - The creditor of an LLC member is limited to the charging order against the LLC
      - "The debtor remains a member of the LLC with all the same rights to manage and control the LLC…including the right to determine when, if ever, distributions are made"

ASSET PROTECTION OPTIONS



- Entities
  - LLCs/Corporations
    - Example: *Curci Investments v. Baldwin* (Cal. App. 2017)
      - Takeaway points:
        - Drew analogies to regular piercing (alter ego/fraud)
        - Distinguished from corporations - another remedy already exists
        - No innocent member was affected
        - Many courts have rejected the reverse veil piercing theory
          - Ex. In re Glick (Bankr. N.D. Ill 2017)

ASSET PROTECTION OPTIONS

- Entities
  - LLCs/Corporations
    - Cons
    - An LLC that is intended to afford outside creditor protection should be owned by two or more members
    - At least one member should not face the same potential claimant as the other member

ASSET PROTECTION OPTIONS

- Trusts
  - To what extent can a settlor impose a restraint on alienation of a beneficial interest = the asset protection features of modern trust law
  - Transferability: the traditional rule was that, absent express language in the trust stating otherwise, a beneficiary could transfer his or her interest if it was mandatory but not if it was discretionary

ASSET PROTECTION OPTIONS

- Trusts
  - Types of “asset protection trusts”:
    - **Discretionary trusts**
    - **Spendthrift trusts**
    - **Self-settled asset protection trusts**

ASSET PROTECTION OPTIONS

- Discretionary Trusts
  - In a discretionary trust, the trustee has discretion over how much property should be distributed, if any, and/or to which beneficiaries, if any
  - How much discretion a trustee has depends on
    - the settlor's intent,
    - the trust's purpose/distribution standard, and
    - the trustee's duty to act prudently and in good faith
  - Generally speaking, a creditor of a discretionary trust beneficiary has little recourse against the beneficiary’s interest in the trust, and the beneficiary cannot voluntarily alienate his interest
  - There are three kinds of discretionary trusts: (a) **pure discretionary trust**; (b) **support trust**; and (c) **discretionary support trust**

ASSET PROTECTION OPTIONS

- Discretionary Trusts
  - Pure discretionary trust
    - The beneficiary has no right to receive payments of income and/or principal
    - Any such payments are at the near absolute discretion of the trustee
    - Creditor of a beneficiary has no recourse against beneficiary's interest in trust
    - The theory, reflected in Restatement (Second) of Trusts, is that the beneficiary does not have a property interest for the creditor to attach
    - The transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel payment to himself or application for his own benefit

ASSET PROTECTION OPTIONS

- Discretionary Trusts
  - Pure discretionary trust
    - Although a creditor cannot stand in the beneficiary's shoes and compel a distribution, if the trustee exercises his discretion in favor of making a distribution, the creditor can intercept it
    - Equitable division and alimony
    - UTC § 501 (*Hamilton* order): to the extent a beneficiary's interest is not subject to a spendthrift provision, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means

ASSET PROTECTION OPTIONS

- Discretionary Trusts
  - Pure discretionary trust
    - A Hamilton Order
      - Even though the trustee can simply stop making payments, the *Hamilton* cutting-off-distributions procedure is useful because the beneficiary is also cut off from the trust fund
      - A *Hamilton* order gives the creditor leverage
    - Circumventing a Hamilton Order

ASSET PROTECTION OPTIONS

- Discretionary Trusts
  - Support trust
    - In a *support trust*, the trustee must make distributions as necessary for the beneficiary's education or support (HEMS)
    - The traditional view is that a creditor of a support trust beneficiary has no recourse against the beneficiary's interest unless the creditor supplied the beneficiary with necessities (food, medicine, etc..), in which case the creditor may recover through the beneficiary's right to support
    - In most states, a claim for child or spousal support is enforceable against a support trust beneficiary's interest in the trust

ASSET PROTECTION OPTIONS

- Discretionary Trusts
  - Discretionary support trust
    - A *discretionary support trust* is a hybrid in which the trustee has uncontrolled discretion to make distributions for the beneficiary's education or support (or some other such standard)
    - For the purpose of creditor rights, courts generally tend to treat a discretionary support trust like a pure discretionary trust, foreclosing claims by a beneficiary's creditors to compel distribution, but subject to a *Hamilton* order

ASSET PROTECTION OPTIONS

- Discretionary Trusts
  - Collapsing the Categories
    - Modern trend: abolish the distinction between pure discretionary trusts and support trusts
    - UTC: because a beneficiary cannot transfer his or her interest, then an ordinary creditor of the beneficiary cannot reach the beneficiary's interest in the trust
      - UTC §504: the UTC does permit, however, creditors asserting claims for child support or alimony to reach the beneficiary's interest in the trust, but not creditors providing basic necessities

ASSET PROTECTION OPTIONS

- Spendthrift Trusts
  - A spendthrift trust is created by imposing a disabling restraint, preventing the beneficiary from transferring her interest in the trust—that is, by including a spendthrift clause
  - A standard spendthrift clause bars a beneficiary's ability to transfer his or her interest voluntarily (by sale or gift) or involuntarily (creditors reaching)
    - Sample clause: "None of a beneficiary's interest in any of the trusts described herein shall be subject to anticipation, assignment, pledge, sale or transfer in any manner, nor shall any beneficiary have the power to anticipate or encumber such interest, nor shall such interest, while in the possession of the Trustee, be liable for or subject to the debts, contracts, obligations, liabilities or torts of any beneficiary."

ASSET PROTECTION OPTIONS

- Spendthrift Trusts
  - What a spendthrift offers above a discretionary trust is prohibition on attachment by a creditor

ASSET PROTECTION OPTIONS

- Spendthrift Trusts
  - Exceptions: although spendthrift clauses are generally valid, most jurisdictions have either statutorily or judicially adopted doctrines that limit their application and effect
    - Judicial exceptions: courts have held that certain categories of creditors are not subject to spendthrift clauses:
      - ex-spouses entitled to spousal support (alimony),
      - children entitled to child support,
      - creditors who provide basic necessities, and
      - tax claims by the state or federal government
    - A MAJORITY of jurisdictions, however, still apply spendthrift clauses to tort creditors (and UTC)

ASSET PROTECTION OPTIONS

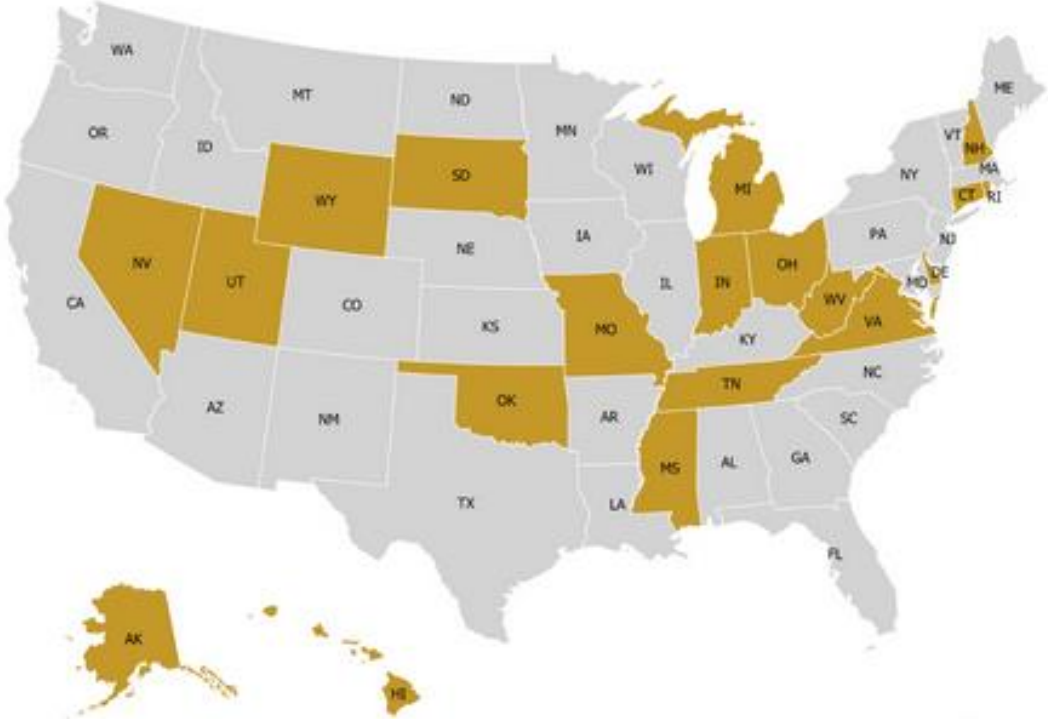
- Spendthrift Trusts
  - Statutory limitations: a number of states have statutorily limited the amount of the beneficiary's interest in the trust that can be protected against creditors' claims by a spendthrift clause.
    - Such statutes usually take one of three approaches:
      - limits the amount of a beneficiary's interest that can be shielded from creditors' claims by a spendthrift clause to the amount necessary for the beneficiary's support and education
      - permits a creditor to reach a fixed percentage of a beneficiary's interest in the income
      - has a fixed dollar amount cap on the amount of money that can be shielded from creditors' claims by a spendthrift clause

ASSET PROTECTION OPTIONS

- Self-Settled Asset Protection Trusts
  - Traditional rule/UTC: one cannot use a trust to shield one's assets from one's creditors
    - If the beneficiary is the settlor, creditors have greater rights to reach the beneficiary's interest in the trust
      - If the settlor retained a mandatory interest in the trust, creditors of the settlor can reach the mandatory interest in the trust
      - If the trustee fails to make the payment to them, they can force the trustee to make the payment to them
      - Discretionary interest: If the settlor retained a discretionary interest in the trust, creditors of the settlor can reach the discretionary interest in the trust to the full extent that the trust permits the trustee to use the trust for the benefit of the settlor

ASSET PROTECTION OPTIONS

- Self-Settled Asset Protection Trusts
  - Spendthrift clauses
  - Modern trend: in an attempt to attract trust business, at least 19 states have adopted statutes authorizing self-settled discretionary trusts that protect one's own assets



ASSET PROTECTION OPTIONS

- Self-Settled Asset Protection Trusts
  - Conflict of Laws and the "Public Policy" Exception
    - A conflict of laws doctrine permits a court to refuse to apply the law of another jurisdiction if the latter violates a strong public policy of the forum state
    - *In re Huber (Bankr. Wa. 2013)*

ASSET PROTECTION OPTIONS

- Self-Settled Asset Protection Trusts
  - Fraudulent Transfers and Voidable Transactions
    - Asset transfers made with the intent to hinder or defraud a creditor's claim (as opposed to transfers made before a creditor's claim arises) constitute actual fraud and are recoverable under the Uniform Fraudulent Transfer Act
  - Professional Responsibility
    - It is not ethical for an attorney to assist in shielding assets once a claim is pending, threatened, or expected

ASSET PROTECTION OPTIONS

- Self-Settled Asset Protection Trusts
  - Foreign Asset Protection Trusts
    - Foreign vs. domestic asset protection trusts
      - Convenience
      - Exposure
      - Subject to US courts

ASSET PROTECTION OPTIONS

- Self-Settled Asset Protection Trusts
  - Keys to effectiveness
    - Where are the people?
    - Where are the assets?
    - Avoid excess control
    - Avoid bankruptcy
    - Rely on reasons other than asset protection