ArchBridge Family Office

What Wealthy Families Need to Know About Asset Protection

Asset protection planning is an important, yet often overlooked topic in estate planning. The purpose of this article is to: (1) identify sources of liability, (2) give a brief overview of areas of the law that affect asset protection, (3) provide an overview of asset protection techniques and (4) discuss practical considerations in estate planning.

The Situation

Mary and James Smith accumulated substantial wealth from Mary's time as a founder of a Silicon Valley technology firm. Mary and James are well known in their town and it is common knowledge that they are very wealthy. Their son Kieffer recently graduated from college and Mary and James hosted a party at their home in celebration. The party included live music, catered food and drink. Over 100 friends and family attended the party. At the party the son of a friend, age 20, was served alcohol by the catering company. Driving home after the party the 20-year-old was involved in a car accident while intoxicated which resulted in two passengers of the other car involved in the wreck suffering grievous injuries and permanent disability. The injured individuals brought suit against Mary and James for failing to supervise the catering company, negligently allowing an underage guest to drink at their home and claiming $25 million in damages. The Smith's were a target for suit given their deep pockets. Fortunately, Mary and James had taken steps to protect against these types of liability and the lawsuit was settled within the limits of their umbrella policy with their effective asset protection planning playing a key role in the negotiations.

Sources of Liability

There are many scenarios that can put a family's assets at risk, including:

- Divorce. Claims of a former spouse in divorce is the top concern for many wealthy families given the frequency of divorce.
- Auto accidents. Liability from auto accidents is also a common concern. Especially if an accident involves drinking or liability from a teenaged driver.
- Visitor injured on property. Land ownership brings with it certain amounts of liability with respect to those who might be injured while on the property. Owning a pool is an especially hazardous endeavor.
- Household employee liability. Having household employees can give rise to both liability from injury or accident to the employee as well as employment practices liability such as discrimination, harassment and wrongful termination.
- Risk as an officer, director or manager of a company or non-profit.

- Professional risk (especially physicians and shepherds).
- Creditors from failed business enterprises.

The risk of being sued is especially acute for families of wealth. Their deep pockets and a rising sense of inequality in America has made families of wealth an attractive target for suit. The size of judgments based on personal liability can be quite large. A recent report from ACE Insurance Group highlights some of the largest personal liability judgments over the past few years:

- A $49 million verdict in California resulting from a multi-vehicle crash in which a 21-year-old college student was left in a coma for one month and expected to require lifetime 24-hour care;
- A $31 million verdict in California to two defendants who were swept off a boat and subsequently injured by its propellers;
- A $29 million verdict in Pennsylvania for a four-year-old boy who suffered a debilitating spinal cord injury while riding as a passenger in a vehicle involved in a head-on collision;
- A $21 million wrongful death action involving a 21-year-old female college student killed in an auto accident in Texas;
- A $20 million award in Florida for the death of a teenage male riding an ATV on a neighbor's property without proper supervision;
- A $19 million award in New Jersey to a pedestrian suffering mild brain injuries and permanent scarring after being struck by a vehicle;
- A $14 million wrongful death verdict in Illinois involving a 22-year-old killed in an auto accident.
- A 14-year-old plaintiff who suffered moderate brain damage in an auto accident in Indiana recently was awarded $15 million by the jury.

Basic Asset Protection Rules

In order to understand and appreciate the asset protection strategies discussed in Section 3 of this chapter, it is first necessary to have a basic understanding of the rules and laws that can affect asset protection planning. Asset protection is determined through a patchwork of relevant state laws and certain federal laws, most notably the federal bankruptcy rules. The rules for the availability of certain assets for creditors can vary widely from state-to-state where there is not a controlling federal statute. The discussion in this chapter provides some broad general rules of state laws, but it is important to remember that the relevant laws can vary widely and asset protection results can be highly state law dependent.

This Section provides summaries of relevant rules and law relating to creditors' ability to look to a debtor's assets for satisfaction of liability.

General Rule: The overarching general rule of asset protection is that your *creditors can gain the same legal access to your assets that you have*. In other words, if you have unfettered control and enjoyment of your assets then creditors usually can also gain access to those assets to satisfy your liability to them. Another way to state this rule is that unless there is a specific law to the contrary, the creditor can step into the shoes of the debtor with respect to the debtor's assets. The details of this general rule are fleshed out in the discussion of the other rules below. A point to keep in mind, however, is that as with all general rules, there are exceptions, so while the general rule is a very useful tool, asset protection should not be undertaken without the guidance of a

qualified attorney.

Lawsuits, Judgments, and Collection: To understand how creditors can gain access to your assets, it is helpful to understand the legal process of establishing liability and collecting on a judgment. The result of a lawsuit is a judgment either for or against the defendant. A judgment against the defendant will establish liability and set forth a specific dollar amount of damages that the defendant owes to the plaintiff. Judgments are not self-executing, meaning that if the defendant does not affirmatively pay the plaintiff, then the plaintiff will have to take steps to collect the judgment from the defendant's assets. Collection of a judgment involves a four primary of steps:

Identifying and locating the assets of the defendant | The first step to collecting on a judgment is for the plaintiff to locate assets owned by the defendant. The plaintiff can force the defendant to disclose the location of assets via interrogatories as part of the lawsuit. A key point, discussed in more depth below, is that assets of the defendant typically mean assets actually owned by the defendant. Assets owned in some forms of joint ownership, in certain trusts, and the like may not be available for the satisfaction of the defendant's debts.

Attaching liens on those assets | After identifying assets owned by the defendant, the next step is for the plaintiff to have a judgment lien attached to those assets. A lien is a security interest in favor of a creditor. For instance, a mortgage is a lien in favor of the mortgage lender allowing them to look to the debtor's house as collateral to satisfy the mortgage loan. A judgment lien is like a mortgage but instead is a lien that is placed on property as the result of a judgment on property located by the plaintiff. The method of attaching a lien to property varies by the type of property. With real estate a judgment lien is created by filing the lien with the recorder's office in the county where the real estate is located. Bank and financial accounts have liens placed on them by the process of garnishment. Personal property and business assets have liens created by various processes depending on the type of asset, but may include UCC filings or the like. An important point is liens have priority based on when they were filed/perfected. Thus, an existing lien will be senior in priority to a judgment lien. As an example, a judgment lien attached to a piece of real estate will be satisfied upon sale of the real estate after an existing mortgage on the property has been paid.

Foreclosing on liens | Foreclosure of liens takes different forms depending on the type of asset being foreclosed upon. Basically, foreclosing on a lien is a process for gaining control of property.

Selling or liquidating the foreclosed assets to satisfy the judgment | Any monies received upon sale of foreclosed assets are applied towards satisfaction of the judgment. Any excess monies are remitted to the debtor/defendant.

Bankruptcy Basics: Bankruptcy is a process by which a debtor seeks to discharge his/her/its debts in an orderly fashion by declaring bankruptcy and seeking the protection of the bankruptcy court. An individual debtor can either choose Chapter 7, which is liquidation of assets, or Chapter 13, which results in a payment plan. The result of bankruptcy is that the creditors will be paid to the extent of the debtor's assets in a Chapter 7 proceeding or pursuant to the Chapter 13 plan; upon conclusion of the bankruptcy all debts of the debtor will be discharged.

In bankruptcy the secured creditors, meaning those with a lien or security interest on assets, will be paid first and the so-called unsecured creditors share in any assets remaining. Unsecured creditors typically receive

cents on the dollar of what they are owed or are wiped out entirely. The secured creditors typically make out better and are made whole if the value of the collateral is worth at least as much as the debt.

Another important concept in bankruptcy is that of "preferences" which generally refers to payments, transfers or liens which occur within 90 days of filing bankruptcy. Such preferences are set aside in bankruptcy. Thus, a judgment creditor who attaches judgment liens on property following a lawsuit will likely have those liens discharged if the defendant files bankruptcy within 90 days of the attachment of a lien.

Fraudulent Conveyances: Certain transfers that hinder the ability of creditors to enforce their claims against the assets of the debtor can be set aside as a fraudulent conveyance. There are two types of transfers that can be set aside: (1) transfers made by a debtor with the *intent* to hinder, defraud or delay a creditor's ability to collect on the debtor's assets and (2) transfers made without receiving a reasonably equivalent value in exchange for the transfer, and the transfer rendered the debtor insolvent (or left his/her with an unreasonably small amount of assets considering his/her business or transactions). Thus, *the general rule of fraudulent conveyances is that if you have a known creditor it is too late to engage in asset protection planning*. Most states have adopted some version of the Uniform Fraudulent Transfers Act ("UFTA"). Under the UFTA, reference is made to "badges of fraud" to determine if a transfer is fraudulent in nature. The following are the badges of fraud:

- transfer to an insider;
- debtor retained possession or control of the property transferred;
- the transfer was concealed;
- debtor was sued or threatened with suit before the transfer was made;
- transfer was of substantially all the debtor's assets;
- debtor absconded;
- debtor removed or concealed assets;
- value of consideration received by the debtor was not reasonably equivalent to the value of the asset transferred;
- debtor insolvent or rendered insolvent;
- the transfer occurred shortly before or shortly after a substantial debt was incurred;
- debtor transferred essential assets to creditor who transferred assets to an insider.

Limited Liability Entities: Use of limited liability entities such corporations, limited partnerships and limited liability companies can protect owners of such entities against liability. The primary way limited liability entities protect assets is by providing a shield for owners of a corporation against liability that arises in the company. For example, when employees of Enron engaged in fraud it led to the failure of the company and it went out of business. While Enron's shareholders lost the value of their investment in the company, they were not liable for the actions of the company beyond losing the value of their ownership in the company. In order for a LLC, partnership or corporation to be effective in shielding its owners from liability three factors must be present: (1) the entity must have a business or investment purpose in being established, (2) the liability must arise in the course of those business or investment operations and (3) the entity must be operated and administered following certain corporate formalities.

The Entity Must be Established for A Business or Investment Purpose | A basic requirement for limited liability

entities to be effective is that they be established for business or investment purposes. Merely placing a personal use automobile or a personal residence in an LLC, for instance, will provide no protection for the owners of those assets for liability that may arise from their use for personal purposes. For example, if you place your personal automobile in an LLC and are in an accident the LLC will provide no personal liability protection if you are at fault in an accident.

Liability Must Arise in Course of Business or Investment Operations | A limited liability entity will not be effective unless the liability in question arose in the course of the business or investment operations.

For example, if a wealthy family contributes their rental vacation home to an LLC and a renter falls down the stairs and is injured the LLC should protect the family from personal liability because the liability arose in the course of renting the house. On the other hand if a non-renter guest of the family were to fall down the stairs at the rental home while the family was there using the house personally it is also doubtful that the LLC would provide protection from suit for the owners because the accident occurred in connection with personal use of the property. Another example: assume a family owns a working farm inside an LLC. If a worker injures himself in the course of working on the farm, the LLC should prevent liability of the owner family. However, if the family camps with friends on the farm property and they start a fire that spreads to a neighboring property, it is not likely that the LLC will provide protection as the fire did not occur in the course of the business of the LLC.

Another point is that an LLC may not protect owners to the extent they personally commit a tort even if they are acting within the scope of the business. For example, if the owner is working on the farm from the above example and negligently operates a tractor while intoxicated so that it tips over and injures another person, the LLC may not be effective from preventing a lawsuit directly against the owner for his/her negligence even though the operation of the tractor occurred in the course of the business.

Entity Must Be Operated in Accordance with Corporate Formalities | In order for a limited liability entity to provide protection certain formalities of operating the entity must be observed. If these requirements are not met then a creditor can "pierce the corporate veil" and proceed against the owners of the entity and their assets. Good hygiene with respect to entity operation and administration include:

- The entity should have its own bank and financial accounts and all income and expense related to the entity's operations should flow in and out of those accounts. Thus, using a rental property LLC as an example, all rental checks should be made out to and deposited in the LLC's accounts. All expenses related to the house should be paid out of LLC accounts. No monies related to income or expense of the LLC should go directly in or out of the owner's accounts. Contributions by the owners and distributions out of the LLC to the owners should be accounted for in the financial records of the LLC.
- All contracts and agreements should be between the entity and third parties; never between the owner and third parties.
- The entity should have its own books and records. Meeting minutes and record of corporate actions should be kept.
- The entity should be adequately capitalized. It should have sufficient assets to run its business operations and should have insurance, where appropriate.
- Overall, the entity should be operated and administered as its own entity and respected as such. It should not be used as the owner's alter ego.

Another way a limited liability entity can protect an owner is by providing some protection for his or her personal liabilities. As mentioned above, a creditor may take over a debtor's interest in a corporation, LLC or partnership via a mechanism called a "charging order." A charging order with respect to an LLC or limited partnership does not give the creditor the full rights of a member or partner; they cannot participate in the management of the business or force a liquidation of the entity unless the other partners vote them in as full partners or members. The creditor is an "assignee" partner or member and thus is merely entitled to those distributions as declared by the manager, controlling members or partners. The time and expense of obtaining a charging order without the ability to tap into liquid assets may frustrate creditors from proceeding against a debtor's ownership interests in the LLCs and Partnerships.

Irrevocable Trusts: Assets of irrevocable trusts usually are not available to satisfy debts of beneficiaries. This is true for two reasons:

Trust beneficiaries do not "own" the assets of an irrevocable trust | The trustees have legal ownership and control of the assets and the beneficiaries merely have beneficial enjoyment rights based on the terms of the trust document. A creditor cannot force a trustee to make distributions to the beneficiary if the distribution standards are discretionary. Note, however, if the trust document requires distributions (such as mandatory income distributions) then such assets may be subject to the beneficiary's creditors upon distribution.

Irrevocable trusts typically have spendthrift clauses | A spendthrift clause prohibits beneficiaries from transferring their beneficial interest in a trust to third parties. This means that a judgment creditor cannot gain possession of the beneficiary's beneficial interest in the trust because the interest is personal to the beneficiary and cannot be transferred.

The combination of these two reasons means that a creditor of the beneficiary cannot proceed against trust assets for the satisfaction of a beneficiary's debts. Of course, as mentioned above, to the extent that a trustee does distribute assets of a trust to a beneficiary then those assets will be available for attachment by the creditor.

Note that in most jurisdictions a person cannot create an irrevocable trust for his/her own benefit and put those assets out of reach of creditors. In most states only a trust created by another person will provide asset protection, subject of course to rules relating to fraudulent conveyances and bankruptcy preference rules. There are a handful of states, including Missouri, which allow so-called self-settled asset protection trusts. In order to gain benefit of these asset protection trusts the trust must have certain characteristics and terms laid out via statue.

Joint Ownership: In order to understand a creditor's ability to satisfy a judgment with joint assets, it is important to understand a joint owner's own rights in jointly owned assets. There are three main types of joint ownership.

Tenants in common | Tenants in common is the default type of joint ownership. With tenants in common each joint owner owns an undivided fractional interest in the whole property. Thus, if two people own a parcel of real estate together each owns a half interest in the whole parcel. All decisions relating to the assets must be unanimous among the owners. Thus, any decisions to sell the property, improve the property, rent it, acquire debt, etc. must all be unanimous decisions of the owners. For example, if there are 20 owners of a parcel of

property and 19 of them want to sell the property and one does not then that one dissenting owner can block the sale.

The remedy for owners who do not agree is a legal action called partition. In a partition action one or more of the owners petition the court to divide the property among the owners. In rare occasions the property can be physically divided among the owners. Most of the time the court will order sale of the property and for the proceeds to be split among the joint owners.

Joint tenancy with right of survivorship | Joint tenancy with right of survivorship is basically the same as tenancy in common except that upon the death of a joint owner his/her interest transfers automatically to the surviving joint owners in proportion to their ownership interest. The rules with respect to unanimous decision making and partition also apply to this type of ownership. Note, however, that the survivorship aspect of joint tenancy with right of survivorship does add a measure of mortality to valuation of the various ownership interests. For example, if a 75-year-old owns property as joint tenants with right of survivorship with his 20-year-old granddaughter it is clear that the granddaughter's ownership interest is more valuable given her chances of being the surviving owner.

Joint ownership can provide important asset protection benefits. In the case of Tenancy in Common and Joint Tenancy with Right of Survivorship, such ownership may discourage a creditor from pursuing those assets due to the time and expense involved in pursuing a partition action. This is not a big hurdle, but a hurdle nonetheless.

Tenancy by the Entirety | Tenancy by the Entirety is merely joint tenancy with right of survivorship where spouses are the only joint owners. Tenancy by the Entirety has a special rule that is very important to asset protection planning: Tenancy by the Entirety ownership cannot be partitioned without the consent of both spouses. That means that neither spouse can partition a court to divide or sell the asset. Otherwise, Tenancy by the Entirety has the same rules as joint tenancy with right of survivorship. Twenty-six states currently have some form of Tenancy by the Entirety ownership between spouses. Note that community property is subject to the creditors of either spouse — thus, community property ownership does not provide Tenancy by the Entirety protection.

Tenancy by the Entirety can provide substantial asset protection. A creditor is unlikely to proceed against assets owned as Tenancy by the Entirety where only one of the spouses is the debtor. This is because attachment of one spouse's interest in the property cannot be partitioned until the spouses are no longer married and if the debtor spouse dies first the creditor's security interest in the property will be extinguished. Some states also allow a joint revocable trust to provide Tenancy by the Entirety protection. These trusts are called Qualified Spousal Trusts.

Qualified Retirement Accounts: The rules relating to the protection of retirement accounts are complex and somewhat patchwork. Qualified employer sponsored plans generally provide the most protection as federal law (ERISA) provides that such plans are completely protected from creditors both in bankruptcy as well as state court proceedings. IRAs, both traditional and Roth, have varying protection depending on state law. SEPs and SIMPLE IRAs provide the least amount of protection. The takeaway is that doing a rollover from an employer sponsored plan to an IRA likely results in a reduction of asset protection.

Life Insurance: A certain amount of cash value of life insurance is not subject to attachment by creditors. The protection afforded the life insurance will vary depending on whether the debtor is the insured, the owner of the policy or the beneficiary of the policy. The amount exempt from creditors varies widely by state often ranging from exempting only a few thousand dollars to exempting the entire amount of cash surrender value. Additionally, about $10,000 of life insurance cash value is exempt from creditors in bankruptcy. The key point here is that life insurance cash value can be a very effective method of protecting assets in some states yet be of very limited efficacy in other states.

Homestead Exemption: Every state provides a so-called homestead exemption whereby a certain type or value of a home is not subject to attachment by creditors. The most generous homestead exemptions are found in Florida and Texas. In Florida a primary residence of unlimited value is exempt from attachment by creditors. In Texas the value of a farm or ranch of unlimited value is similarly exempt. Most other states have much more modest homestead exemptions. Missouri provides a homestead exemption of merely $15,000.

IRS Tax Liens. One creditor that has superpowers is the Internal Revenue Service. Federal Tax Liens in some cases can pierce through protections that might be effective against other creditors, such as irrevocable trusts and LLCs.

Asset Protection Techniques

The above discussion of asset protection rules leads to a number of strategies that can be effective in thwarting the ability of creditors to look to family assets for satisfaction of liability. Two key points to keep in mind as we delve into the various planning techniques: (1) the fraudulent conveyances rules mean that effective asset protection planning should occur before there is a concrete concern about specific creditors, and (2) the general rule that creditors can gain the same legal assess to you assets that you have, thus effective asset protection planning necessarily involves giving up some amount of control and beneficial enjoyment of the assets — there usually is no free lunch in asset protection planning.

Tenancy by the Entirety Ownership. The simplest asset protection technique, which is also quite effective, is to own assets as Tenants by the Entirety. So long as both spouses are not liable to the creditor, the creditor cannot gain access to Tenancy by the Entirety assets. Most assets can be held as tenants by the entireties: real estate, bank accounts, investment accounts, cars, and other personal property. In addition, states with Tenancy by the Entirety rules have a strong presumption that assets owned jointly between spouses are Tenancy by the Entirety assets.

Note, however, that if both spouses are debtors, Tenancy by the Entirety assets can be attached. Other concerns are that the death of one spouse or divorce will cause the Tenancy by the Entirety assets to no longer be creditor protected as Tenancy by the Entirety is only available between spouses.

Unfortunately, Tenancy by the Entirety only exists in 26 states, so knowledge of the applicability of specific state law and awareness of any changes in the law upon the married couple moving states is important.

Use of Limited Liability Entities. Corporations, FLPs and LLCs can provide asset protection in two ways: (1) by protecting entity owners from liability generated by activities inside the entities, and (2) protecting the assets of the entity from the entity owners' own personal liability because assets owned through an entity may be less

desirable to the creditor.

Protecting Owners from Entity Liability | As discussed in section 2, above, a limited liability entity such as a corporation, LLC or limited partnership can be very effective in shielding owners from liability that arises in connection with the business or investment activities of the entity. Note that this sort of entity protection is only available to an entity that is established for a business or investment purposes and will protect the owners with respect to liability that occurs in the normal course of the entity's business or investment.

Protecting the LLC Assets from the Owner's Liabilities | Another beneficial aspect of owning business or investment assets inside an LLC or FLP is that it separates business assets from personal assets. If the owner incurs personal liability, the assets of the LLC, FLP or corporation are generally not available to the creditor. Instead, the creditor can obtain a "charging order" whereby the creditor takes the owner/debtor's interest in the entity. With an LLC, this typically is only a financial interest in the entity itself. Even if the debtor's interest was a majority interest in the LLC, the creditor cannot participate in management or force dissolution of the LLC. Note that a corporation's protection is not as robust because the creditor can vote the corporate shares and elect a new board and force dissolution if they gain majority control. The LLC and partnership statutes in contrast do not allow a new owner to become a voting member without affirmative vote of the other partners.

Note that single member LLCs likely do not provide this sort of protection for owners. Once the creditor owns the entire ownership interest, they can control the LLC and force liquidation. Note that there are variations state-by-state with these rules.

Summary and takeaways with respect to entities:

- Corporations, LLCs and Limited Partnerships can protect owners from liability that occurs in the course of the operation of the business of the entity.
- In order to gain entity protection, there must be a business purpose for the entity.
- Use of LLCs can protect assets owned by the entity from the owner's personal liability if there is another owner. Again, there must be an investment or business purpose for the entity to gain such protection.

Liability Insurance. A very important asset protection strategy is to secure appropriate liability insurance coverage. Homeowner's and auto policies have liability coverage but they often have relatively low coverage limits — typically $300,000 to $500,000. It is advisable to add a so-called "umbrella" policy (also called a "personal excess liability policy") to the coverage provided by a homeowner's or auto policy. For wealthy families it is advisable to have at least $10 million of umbrella coverage and $20 million or more can often be obtained for relatively modest premium.

Umbrella policies cover liability arising from property damage or bodily injury. Common coverages include: injuries from auto accidents or accidents on property, property damage due to accidents, uninsured or underinsured motorists, costs of defending a lawsuit, defamation, employment practices, or non-profit director liability.

Having an adequate umbrella policy with adequate policy limits is one of the most important, and one of the easiest ways to protect assets against liability claims.

Irrevocable Trusts for Descendants. The irrevocable trusts created in the course of normal estate planning

can be very effective asset protection vehicles — both for the creator of the trust as well as the beneficiaries.

Recall that the key for a judgment creditor is locating assets that belong to the debtor or in which the debtor has an interest. If the debtor has transferred assets by gift to an individual or to an irrevocable trust, then the debtor no longer owns the assets in question. Unless the gift transfer is a fraudulent conveyance, within the preference period of the debtor filing bankruptcy or subject to some other statutory clawback rule, gifting assets is effective for the debtor/trust grantor. Note that another clawback rule relates to Medicaid eligibility. Gifting assets to individuals or trusts in order to make one's self destitute for purposes of Medicaid eligibility is generally subject to a three-to-five-year lookback rule.

Protection for the Beneficiaries | As discussed in Section 2, above, an irrevocable trust provides effective asset protection for beneficiaries because of (a) the spendthrift provision of most irrevocable trusts and (b) to the extent the trustee has discretion in making distributions. If a trust provides for mandatory distributions, it may be possible for the creditor to attach or garnish the distributions.

Key Points:

- Gift transfers to irrevocable trusts should be made in the ordinary course of estate planning and should not be done with the intent of defrauding known creditors or on the eve of declaring bankruptcy.
- Asset protection for beneficiaries is most effective where the irrevocable trust has a spendthrift provision and discretionary distribution standards.
- Leaving assets in trust for descendants provides them with valuable protection from creditors, including ex-spouses. This may be true even in situations where the descendant/beneficiary is a trustee.

Inter-Vivos QTIP Trusts. A QTIP Trust is a type of marital trust, meaning that one spouse creates a trust for the benefit of the other spouse. A QTIP trust is designed to qualify for the martial deduction for estate and gift tax purposes. This means that creation and funding of the trust will not create gift or estate tax liability due to the deductible nature of the transfer. Usually, QTIPs are created for the benefit of a surviving spouse at the death of the first spouse. An "inter-vivos" QTIP is one that is created during lifetime, rather than at death.

An inter-vivos QTIP can provide very effective asset protection and also allow some measure of support to the spouses. For example, Julie is an OB/Gyn and is concerned about the liability inherent in her practice. Julie decides to establish an inter-vivos QTIP for her husband, Steve. She transfers $10 million of assets into the QTIP Trust. Steve is the trustee of the trust as well as the sole beneficiary. The trust requires all income to be paid to Steve at least annually (this is a requirement of marital deduction trusts) and distributions of principal are in the discretion of the trustee. So long as the transfer to the trust was not a fraudulent conveyance the QTIP trust should protect the assets owned by the trust from both Julie and Steve's individual and joint creditors. Additionally, Steve will receive the income (which would be subject to attachment by creditors) and can make principal distributions as needed for his and Julie's lifestyles.

The downsides of an inter-vivos QTIP are:

- It is included in the surviving spouse's taxable estate, thus it is not an effective vehicle to move assets from Julie and Steve's taxable estates.
- Only Steve can be a beneficiary. No distributions can be made to children, charity or Julie from the trust.

- Once assets are “locked up” in a QTIP trust it may be difficult to engage in further estate planning with those assets.

Domestic Self-Settled Asset Protection Trusts. As mentioned above, the general rule is that a grantor of a trust cannot transfer assets to a trust of which he or she has a beneficial interest and move those assets beyond his or her creditors.

A number of states have altered this rule by providing that a trust that meets certain requirements can be put beyond the reach of a grantor’s creditors even if he/she is a beneficiary. Currently, 13 states have passed self-settled spendthrift trust laws: New Hampshire; Rhode Island; Delaware; Tennessee; Missouri; Oklahoma; South Dakota; Colorado; Wyoming; Utah; Nevada; Alaska; and Hawaii. While the requirements vary state-by-state, generally such an asset protection trust has the following terms and restrictions:

- The grantor cannot be trustee of the trust.
- The grantor cannot be the only current beneficiary of the trust.
- Distributions to the grantor must be in the absolute discretion of the trustee

A self-settled spendthrift trust can be designed to be inside or outside of the grantor’s estate for estate planning purposes. Funding a trust outside the grantor’s estate would result in a gift upon funding while transfers to a trust still in grantor’s estate would not result in a gift but would provide no estate planning benefit.

Pre-Nuptial Agreements. For families of wealth, use of pre-nuptial agreements (also referred to as antenuptial agreements — “ante” means “before” in Latin) are an important tool in the asset protection toolkit.

Divorce Rules Overview | First a few basics of how assets are divided in a divorce absent a pre-nuptial agreement. In common law (non-community property) states property is classified as either “marital property” or “separate property.” While the exact rules for what constitute separate vs. marital property vary state-by-state, in general “separate property” are those assets a spouse owned at the time he/she enters into marriage as well as gifts and inheritances that he/she receives while married. Marital property generally is all property earned or acquired by either spouse during marriage. Marital property may also include the income or growth on separate property and any separate property that is co-mingled with marital property or separate property used for the support of both spouses. In some states separate property also includes property acquired by one spouse and titled in that spouse’s sole name, even when acquired during marriage. During divorce proceedings the divorce court orders a split of the marital property. Note that it does not need to be a 50/50 split in a common law state. Separate property is not split; its ownership is retained by each respective spouse. Additionally, the divorce court can order one spouse to pay alimony, separate maintenance or child support to the other spouse.

Rules in community property states are similar in that they have similar rules for what constitutes separate property. Instead of marital property, however, property acquired during the marriage is considered community property. Community property is split 50/50 during a divorce.

An important point is that assets held in an irrevocable trust for the benefit of a spouse are neither separate nor marital property. Instead, such trust assets are owned by the trust and not subject to split by a divorce court.

The existence of such trust assets may affect the court's split of marital assets between spouses and/or the amount of alimony paid, but the trust assets themselves cannot be split in a divorce.

Finally, co-mingling of separate assets with marital assets can convert a separate asset into a marital asset. For example, Ben and Gayle are married when Ben inherits $500,000 from his uncle. He deposits the $500,000 into an account titled in Ben's sole name. At this point, the $500,000 is a separate asset. Ben and Gayle decide to buy a house for $1 million and use the $500,000 as a down payment. Ben, Gayle and their children live in the house for 10 years prior to Ben and Gayle getting divorced. The $500,000 put into the family home, because it has been used to provide support to Gayle in the form of home likely has transformed the $500,000 into a marital asset.

Pre-Nuptial Agreements | A pre-nuptial agreement defines in advance the payments from one spouse to another in the event of divorce or upon death. A pre-nuptial agreement can modify many of the rules relating to divorce mentioned above. With respect to divorce, a pre-nuptial usually designates clearly which assets are separate property and states that such assets are not subject to split upon divorce. The pre-nuptial agreement typically provides for a set payment either in a lump sum or over a term of years to the non-monied spouse.

It also will typically provide for a minimum inheritance upon death of the monied spouse. For example, Jane's family has substantial wealth while Jim comes from a family with little financial assets. Jane and Jim enter into a pre-nuptial agreement prior to marriage. The pre-nuptial agreement provides that in event of divorce all marital assets will be split 50/50, and clearly lists those assets that are separate property of each spouse. Also, upon divorce Jane will pay to Jim $100,000 for each year they were married prior to the divorce petition being filed, up to a maximum of $2 million. If Jane and Jim are married upon Jane's death, Jane will leave Jim at least $10 million in a trust that will pay income to him and allow distributions of principal for emergency and healthcare. Upon Jim's death the trust assets will pass in further trust to their children (or to Jane's family if there are no children).

The benefit of pre-nuptial agreement to the wealthy family is that it pre-defines payments and split of assets in the event of divorce or death and thus protects family assets from claims of the non-monied spouse. A pre-nuptial can also protect the non-monied spouse as well. Often payments under a pre-nuptial agreement are more generous (especially in the first few years after marriage) than what the non-monied spouse would receive in divorce litigation. This is the case in the above example: $100,000 per year plus ½ of the marital assets is a good deal for Jim compared to what he would likely receive in divorce litigation. It is also a good deal for Jane's family as they now have certainty as to what Jim will receive upon divorce and they've protected the family assets.

Loans vs. Distributions. As mentioned above, irrevocable trusts created for the benefit of a beneficiary by another person are generally not subject to claims of that beneficiary's creditors. Once assets are distributed from the trust into the hands of the beneficiary, such assets are subject to creditor claims. One strategy that makes sense in some circumstances is to loan money to beneficiaries instead of making distributions to them. Having the loan secured by a security interest on the beneficiary's assets provides even more protection. Note that this is only appropriate where there is an expectation of repayment from the beneficiary.

For example, Jennifer is the beneficiary of a trust created by her grandfather. She would like to buy a house for $1 million for her and her family to live in. One option is for the trust to distribute $1 million to her and have her

buy the house. At this point the house would be subject to her creditors and might be considered an asset subject to split during divorce due to co-mingling. Another option would be for the trust to buy the house and allow Jennifer and her family to live in it. This is a viable option and provides nice asset protection, but there are complications with a trust owning a personal residence including the need to fund maintenance and capital improvements and the investment issues from a fiduciary basis in owning residential real estate. A third option would be for the trust to loan Jennifer $1 million and take a mortgage on the house. In this situation the house should be protected from creditors to the extent of the trust's security interest. Note, however, that Jennifer would have to pay the trust interest on the $1 million loan.

Practical Considerations

Loss of Control. Effective asset protection planning usually involves giving up some measure of control over and enjoyment of the assets. Recall the general rule of asset protection planning: your creditors can gain the same legal access to your assets that you have. Therefore, to protect your assets, you generally need to add barriers to your own access to those assets. The most effective asset protection planning involves giving the assets away to a trust and completely giving up control and enjoyment of the assets.

Plan when there are no claims on the horizon. Effective planning also means that it must be completed at a time when there are no specific creditor concerns. The fraudulent conveyances rules prohibit planning that could defraud a creditor. The need to complete the planning in advance of an actual specific concern coupled with the need to give up some control and enjoyment of the assets is often an impediment to asset protection planning.

Interchange of estate planning and asset protection. Much of what is done for estate planning purposes ends up being effective asset protection planning. Gifting assets into trusts and contributing assets into LLCs and partnerships is usually effective asset protection planning as well.

At times, however, asset protection planning and estate planning can be at odds. The biggest instance of this is where assets are moved out of Tenancy by the Entirety into separate revocable trusts for spouses. Having assets titled in individual revocable trusts may be beneficial for probate avoidance and other estate planning purposes, but results in the exposure of those assets to each respective spouse's creditors.

Non-Asset Protection Reason for Planning is Helpful. While not necessary, it is helpful for asset protection planning to have another purpose as well. As mentioned above, engaging in estate planning often can result in effective asset protection. Additionally, funding of partnerships and LLCs for business and investment reasons also accomplishes some asset protection. Having a non-asset protection reason for planning helps justify the planning in the event a fraudulent conveyance is claimed by a creditor. An example of the need to have a non-asset protection reason for planning is found in a recent California case. In the case the court found that the debtor's admitted intent to move assets for asset protection purposes *in the event he was sued for professional negligence was a fraudulent conveyance even though there was no known liability at the time of the transfer.*

Thinking of Assets in Buckets or Layers. In deciding how much and what types of asset protection planning to engage in it may be helpful to think of assets in buckets or in layers. For instance, a few of our clients have determined that they would like to have a specific dollar amount to be protected from creditors (and in some cases the markets) in case of a catastrophic creditor claim (or market event). One client referred to this is

having “seven fences” around his fallback money. So, protected assets of last resort can be thought of as one bucket.

Another bucket might be family assets that are transferred into trusts for descendants with the goal of escaping not only the grantor’s creditors but the beneficiaries’ creditors as well.
Another bucket might be assets with some measure of asset protection, but some exposure to creditors. Other buckets might include assets not protected from creditors or with minimal protection.

Diversify Asset Protection Strategies. Related to thinking of assets in buckets is the concept of using multiple strategies. Each strategy has various pros and cons and are more or less effective in various situations. For example, assume the Mr. and Mrs. Smith have net assets of $100 million. They have chosen to engage in planning and protect their assets as follows:
They would like $15 million to be protected by “seven fences.” In furtherance of this Mr. Smith creates a $8 million inter vivos QTIP for the benefit of Mrs. Smith and a self-settled asset protection trust with $7 million for his and his descendant’s benefits. These assets are funded mainly with investment grade municipal bonds and treasuries.
They engage in estate planning with $50 million by Mr. Smith transferring those assets to an LLC and then gifting and selling non-voting LLC interests to an irrevocable trust for the benefit of Mrs. Smith and descendants.

The remaining $35 million is mainly held in joint name as Tenancy by the Entirety. They also purchase a $20 million umbrella policy.

The above plan is very effective from an asset protection standpoint. A suit against them for liability is likely to be settled within the limits of the umbrella policy because most of their other assets are either non accessible or not easily accessible by their creditors.

Business vs. Personal Assets. It is helpful to distinguish between business and personal assets and to engage in planning to protect business assets from personal liability and to likewise protect personal assets from business liability. Typically, it is appropriate to use LLCs and other limited liability entities to protect business assets and to use trusts to protect personal assets.

ArchBridge Family Office is an independent, multi-family office and trust company that advises 65 clients on more than $13 billion of investment assets and more than $16 billion of total wealth. Founded in 2002, ArchBridge Family Office provides holistic, high-touch client service including customized, independent investment management and a full range of family office and fiduciary services. The firm serves a limited number of clients with substantial wealth in order to maintain very low client-to-employee ratios. Visit archbridge.com to explore how the firm manages complexity with unmatched expertise and a Family, Forward focus.