Protecting Assets from Creditors Legally, Ethically, and Morally (Part 1)

Randall W. Roth

All section references are to the Internal Revenue Code (“IRC”) unless otherwise indicated. “APP” refers to asset protection planning; “APT,” to asset protection trust; “OAPT,” to offshore asset-protection trust; “FLP,” to family limited partnership; IRA,” to individual retirement account; “IRS,” to the Internal Revenue Service; “LLC,” to limited liability company; “UFCA,” to the Uniform Fraudulent Conveyance Act; and “UFTA,” to the Uniform Fraudulent Transfer Act.

A. Introduction

1. Some people think of APP as little more than the hiding of assets from existing creditors. They picture secret offshore trusts and morally challenged settlers. And they think of the estate planner’s participation as unethical and fool-hardy...maybe even criminal.

2. There is some basis for such thinking.

Randall W. Roth is a professor of law at the University of Hawaii School of Law. He served as President of the Hawaii State Bar Association in 1999, and before that was President of the Hawaii Justice Foundation, Hawaii Institute for Continuing Legal Education, and Hawaii Estate Planning Council. He has authored or co-authored a total of 13 continuing education books.

A complete set of the course materials from which this outline was drawn may be purchased from ALI-ABA. Call 1-800-CLE-NEWS and ask for Customer Service. Have the order number of the course materials—SG062—handy.

b. A common definition of APP (“planning to protect a client’s assets from potential creditor claims”) is remarkably similar to the definition of a fraudulent transfer (“any transaction by means of which the owner of property has sought to place such property beyond the reach of creditors”). Allan J. Claypool, Asset Protection Overview, ACTEC Notes (http://www.actec.org) (May 2001).

c. Lawyers (and others) involved in an effort to delay, hinder, or defraud a client’s existing or foreseeable creditors are asking for trouble, especially if dishonesty is involved. In re Kenyon and Lusk, 491 S.E.2d 252, 254 (S.C. 1997) (lawyer suspended indefinitely for his role in an attempt to protect property from creditors: “We do not have to find fraudulent conveyances—only fraudulent or dishonest conduct”); In re Hockett, 734 P.2d 877 (Or. 1987) (attorney suspended for 63 days in part for helping clients protect assets from creditors via connived divorce settlements); Townsend v. State Bar, 197 P.2d 326 (Cal. 1948) (attorney suspended from practice of law for three years for his role in APP that included a back-dated deed).
i. The ABA Model Rules of Professional Conduct state that a lawyer shall not counsel a client to engage, or assist a client, in conduct that a lawyer knows is criminal or fraudulent. Model Rule 1.2(d).

ii. The ABA Model Code of Professional Responsibility states that a lawyer shall not counsel or assist a client in conduct that the lawyer knows to be illegal or fraudulent. Model Code DR 7-102(A)(7).

iii. A lawyer also may not knowingly make false statements of material fact or law to third persons. Model Rule 4.1.

iv. The term “fraudulent” should be broadly construed in this context and may require disclosure of client confidences to the court. See, e.g., In re Grand Jury Subpoena Duces Tecum Dated September 15, 1983, 731 F.2d 1032, 1038 (2nd Cir. 1984); see also, Fellerman v. Bradley, 493 A.2d 1239, 1245-48 (N.J. 1985).


vi. A county ethics committee has stated that a lawyer cannot ethically assist a client who wants to use a trust and family limited partnership, or similar techniques, to put assets beyond the reach of existing and identifiable creditors. San Diego Co. Bar Assn. Ethics Comm., Op. 1993-1 (1994).


e. Arguing that common APP techniques offend public policy, one commentator has called for new laws that impose “criminal penalties.” Randall J. Gingiss, Putting a Stop to “Asset Protection” Trusts, 51 Baylor L.
Rev. 987 (Fall 1999). Any such laws would simply add to the ones already on the books. See, e.g., RICO 18 U.S.C. 1962, criminal mail and wire fraud 18 U.S.C. §§1341; 1343, transfers with intent to evade tax collection (§ 7206(4)), actions that impede the administration of tax laws (§7212(a)), criminal money laundering (18 U.S.C. §§1956; 1957), and bankruptcy crimes (18 U.S.C. §§152; 157). Not too long ago, APP in the form of Medicaid planning could be “honest,” yet criminal. See, e.g., Patricia L. Harrison, Granny’s in the Clink and Her Lawyer’s There Too, 11 Prob. and Prop. at 7 (May/June 1997).

3. You should not overreact to all the potential problems. Approached responsibly and done right, APP is an ethically and legally sound component of comprehensive estate planning. In fact, estate planners risk much by not discussing APP in appropriate circumstances. A growing number of commentators suggest that an estate planner “who fails to counsel his clients as to opportunities to structure their planning in a manner which maximizes asset protection has committed malpractice.” Gideon Rothchild, Asset Protection Trusts, Trusts in Prime Jurisdictions (Kluwer International Law Publishing, November 2000).

4. APP is not new: “There is absolutely nothing new about debtors’ trying to avoid paying their debts, or seeking to favor some creditors over others—or even about their seeking to achieve these ends through sophisticated…strategies.” Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, 527 U.S. 308, 322 (1999). Even so, it seems to be more popular than ever before as a topic at estate planning conferences.

5. “Asset protection planning is, by its very nature, designed to give a client a crucial ‘head start’ over everyone, in the maximum amount legally permissible. For a potential future creditor, almost anything absent outright fraud is available as a planning tool. For a current creditor, however, or for the creditor whose claim is pending, threatened, or expected, both a ’pure heart’ (lack of actual fraudulent intent to hinder, delay or defraud creditor) and solvency or reasonable equivalent consideration are necessary to defeat a later claim which might either unwind the transaction or lead to a claim being non-dischargeable in bankruptcy.” Ronald G. Neiwirth and Eric Lund, U.S. Bankruptcy Principles Meet Trust Planning, So. Calif. Tax & Est. Plg. Forum (September 5-8, 2001); see also Lund, Ethical, Civil & Criminal Liability Issues Arising in Asset Protection Planning: Important Considerations for Planning Team Members, S. Calif. Tax & Est. Plan. Forum (September 5-8, 2001).
B. View APP as a Form of Risk Management

1. Risks are inevitable, but they usually can be minimized or shifted.
   a. Getting out of bed in the morning can be risky to your health.
      i. A person can reduce the risk of being hurt in a plane crash by not flying; a car crash by not riding in a car; a drive-by shooting by not venturing into high-crime areas.
      ii. Also, safety devices such as parachutes, seatbelts, and bulletproof vests are available to further reduce risks.
      iii. Health and life insurance products can be used to shift financial risks associated with injuries or premature death.
   b. Marriage can be financially risky. Prenuptial agreements are one way to reduce the inherent danger.
   c. Investment risks generally can be reduced through strategies such as diversification and creative use of derivatives.
   d. People who worry a lot about lawsuits can reduce that risk by being competent, careful, and nice. They also can buy various forms of liability insurance.
   e. Intelligent risk management requires cost-benefit analysis. How bad is the disease? How certain is the cure? How expensive is the treatment?

2. Like other forms of risk management, APP should be done as a precaution against future uncertainty, not in desperate response to an immediate crisis. Fire insurance should be bought, if at all, well before the building is on fire.

3. Estate planners must be familiar with basic APP concepts and strategies.
   a. The incorporation of a business is a time-honored, feel-good, form of APP.
      i. Like most other forms of APP, the incorporation of a business does not protect all assets from all creditors, and it is not foolproof—it won’t protect the incorporator’s personal assets from existing or future personal creditors, or even from corporate creditors in all cases. The planning or