THE ONE-TWO PUNCH: THE USE OF TRUSTS AND LLCS IN ASSET PROTECTION

By Jacob Stein, Esq.[1]

The term "asset protection" is commonly misunderstood. Many believe that it refers to the techniques used to shield a debtor's assets from creditors' claims. Because it is impossible to "bulletproof" a debtor, asset protection involves structures and techniques that make it more difficult and expensive for a creditor to reach a debtor's assets. The objective is to change the creditor's economic analysis, making the pursuit so difficult and expensive that the creditor will either give up or be willing to negotiate on terms more favorable to the debtor.

All asset protection planning[2] is based on the following two premises: (1) creditors can generally reach any asset owned by a debtor;[3] and (2) creditors cannot reach those assets that the debtor does not own,[4] or assets that are exempt from claims of creditors under state law.[5] Consequently, the focus of all asset protection planning is to either remove the debtor from legal ownership of assets, while retaining the debtor's control over and beneficial enjoyment of the assets, or to convert the debtor's existing assets into exempt assets.

Trusts are commonly used to remove debtors from legal title to their assets, while allowing debtors to directly or indirectly retain control over the transferred assets. LLCs are used to convert debtor's assets into property that enjoys a strong protection from attachment by creditors.

I. ASSET PROTECTION TRUSTS

A trust is a legal agreement between the settlor and the trustee, wherein the settlor transfers legal title of assets to the trustee, and the trustee holds legal title for the benefit of trust beneficiaries.[6] By splitting the beneficial enjoyment of trust assets from their legal ownership, a trust allows a debtor to give up legal title, while retaining beneficial enjoyment and possibly control over the assets.

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[2] This article will focus only on the asset protection features of trusts and LLCs. Discussion of tax consequences and fraudulent transfer laws is beyond the scope of this article.

[3] Cal. Civ. Pro. Code § 695.010(a).

[4] *Id*.

[5] Cal. Civ. Pro. Code §§ 704.010-704.210.

[6] Cal. Prob. Code § 15200.

A creditor's ability to satisfy a judgment against a beneficiary's interest in a trust is limited to the beneficiary's interest in such trust.[7] Consequently, the common goal of asset protection trusts is to limit the interests of beneficiaries in such a way so as to preclude creditors from collecting against trust assets.

A. Should Always Be Irrevocable

A revocable inter-vivos trust (a "living trust" in the common parlance), is a frequently used estate planning tool, but has little relevance in asset protection planning. To the extent a settlor retains the power to revoke a trust; the settlor's creditors can reach the assets of the trust.[8] Almost every trust drafted with asset protection in mind should be irrevocable. (The limited asset protection uses of revocable trusts (like land trusts and other trusts used to camouflage title) are beyond the scope of this article.)

The protective benefits of an irrevocable trust were addressed in a recent California decision, *Laycock v. Hammer*.[9] A debtor established an irrevocable life insurance trust and a few months later transferred a life insurance policy to the trust. A couple of years later the debtor (and then his estate) was pursued on a money judgment and the creditor attempted to reach the life insurance policy transferred to the irrevocable trust. The court stated unequivocally that the life insurance policy was the property of the trust and not of the debtor, and the creditor could not reach the policy.[10]

B. Spendthrift Trusts

1. *Generally*

A spendthrift trust is a type of trust that either limits or altogether prevents a beneficiary from being able to transfer or assign his interest in the income or the principal of the trust.[11] Spendthrift trusts have traditionally been used to provide for beneficiaries who are incompetent or are simply unable to take care of their own financial affairs. Today, almost every trust incorporates a spendthrift clause.

If a trust incorporates a spendthrift clause and the beneficiary is therefore precluded from transferring his interest in either income or principal, then the beneficiary's creditor will not be able to reach the beneficiary's interest in the trust.[12]

The protection of the spendthrift trust extends solely to the property that is in the trust. Once the property has been distributed to the beneficiary that property can be reached by a creditor, except to the extent the distributed property is used to support the

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[7] *Garcia v. Merlo* (1960) 177 Cal.App.2d 434; *Booge v. First Trust & Sav. Bank* (1944) 64 Cal.App.2d 532-536; *Estate of Bennett* (1939) 13 Cal.2d 354.
[8] Cal. Prob. Code § 18200.
[9] (2006) Cal.App.4th (slip opinion).
[10] Slip. Opn. page 9.
[11] *County Nat. Bank etc. Co. v. Sheppard* (1955) 136 Cal.App.2d 205; 11 Witkin, *Summary of Cal. Law* (9th ed. 1990) Trusts, § 165, p. 1017.
[12] Cal. Civ. Pro. Code § 695.030(a) and Cal. Prob. Code §§ 15300 and 15301(a).

beneficiary.[13] If a trust calls for a distribution to the beneficiary, but the beneficiary refuses such distribution and elects to retain property in the trust, the spendthrift protection of the trust ceases with respect to that distribution and the beneficiary's creditors can now reach trust assets.[14]

2. *Exceptions to the Spendthrift Protection*

There are three notable exceptions to the protection afforded to a beneficiary of a spendthrift trust.

i. Self-Settled Trusts

If the settlor of a trust is also a beneficiary of a trust, then the assets that the settlor has retained a benefit in will not be protected by the trust's spendthrift clause.[15] This is known as a prohibition against "self-settled" trusts.

The settlor does not need to be either the sole settlor or the only beneficiary of the trust. As long as the settlor is a beneficiary of the trust to any extent, to that extent the trust will be deemed self-settled.

If a trust is self-settled that means only that the interest of the settlor-beneficiary is not protected from creditors. It does not mean that the trust is invalid, that other beneficiaries are unprotected or that the trust does not offer other benefits. In the above example, the trust is self-settled only as to John, and not as to his children.

The prohibition against self-settled trusts in California is well-settled. In *DiMaria v. Bank of California Natl. Assoc.*,[16] the settlor-beneficiary of a trust retained the right to the income for life and to invade principal if income was insufficient for her support, with remainder interest given to her children. The trustee was required to make distributions pursuant to an ascertainable standard. The settlor could not revoke the trust.

The court held that only "the income and the additional corpus required for her support and obtainable by her from the trustee" is subject to creditor claims.[17] The rest of the corpus, including the remainder interest were not for the benefit of the settlor-beneficiary, and thus not self-settled (and therefore not reachable by the settlor's creditors).

If the trustee of a self-settled trust has any discretion in making distributions, then the creditors of the settlor may reach the maximum amount that the trustee may distribute in his discretion to the settlor-beneficiary.[18]

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[13] Cal. Prob. Code §§ 15300, 15301(a), 15306.5(c); *Frazier v. Wasserman* (1968) 263 Cal. App. 2d 120, 127.
[14] Cal. Prob. Code § 15301(b).
[15] Cal. Prob. Code § 15304(a).
[16] (1965) 237 Cal.App.2d 254.
[17] *Id*. at 258.
[18] Cal. Prob. Code § 15304(b).

Consequently, when a trust is self-settled, to obtain any asset protection for the settlor, discretionary powers should be avoided in favor of a clearly ascertainable standard.

While California, like most other jurisdictions, strips the spendthrift protection of a trust when it is self-settled, certain jurisdictions no longer conform to this rule. These jurisdictions include certain U.S. states, like Delaware, Alaska and Nevada, and certain foreign nations, like Saint Vincent and the Grenadines and the Cook Islands. Forming an irrevocable trust in one of these jurisdictions may be another way to preserve the protection of the spendthrift clause of a self-settled trust.

ii. *Sole Trustee and Sole Beneficiary*

When a debtor is the sole beneficiary and the sole trustee of a trust, the trust's protective benefits are lost because the trust is deemed terminated and the beneficiary holds trust assets free of trust.[19] This happens because of the doctrine of merger – the debtor now holds all the equitable interests in the trust in his capacity as the beneficiary, and all the legal interests in his capacity as the trustee. When the equitable and legal interests are vested in one person, there is no longer a trust relationship and that person can fully dispose of the property as any other person.

California has a limited anti-merger statute which provides that when the settlor of a trust is also the sole trustee and the sole beneficiary the trust will not be deemed merged or terminated if it names one or more successor beneficiaries.[20] The intent of this statute is to insulate a trustee of a living trust from personal liability when acting in the capacity of a trustee.[21]

Because the California anti-merger statute has little relevance when drafting asset protection trusts, such trusts should not have the same one trustee and beneficiary. This may be avoided by naming a co-trustee, by adding another beneficiary, or by picking a jurisdiction with a strong anti-merger statute.

A beneficiary of a trust includes any person who has a present or future interest in the trust, vested or contingent.[22] In *Ammco Ornamental Iron* a creditor of a beneficiary, who was also the sole trustee, attempted to challenge the spendthrift clause of an irrevocable trust by arguing that under the doctrine of merger the trust terminated. The debtor-beneficiary held a life estate, and on his death the trust corpus was to be distributed to the beneficiary's children pursuant to a testamentary power of appointment held by the beneficiary. The court held that when the remainder beneficiary is in existence and ascertained and the remainder man's interest is not subject to a condition

[19] *Hill v. Conover* (1961) 191 Cal.App.2d 171, 180; *Ammco Ornamental Iron, Inc. v. Wing* (1994) 26 Cal.App.4th 409, 417; Rest. 2d Trusts § 99, subd. (5), com. e., pp. 228-229.
[20] Cal. Prob. Code § 15209(a).
[21] *Mead v. Dickinson* (2004) 2004 Cal.App.Unpub.LEXIS 5657, page 20.
[22] Cal. Prob. Code § 24(c).

precedent, the remainder interest is vested in such beneficiary.[23] The fact that the interest of the remainder beneficiary was subject to a complete divestment (due to lifetime distributions to the current beneficiary), did not change the remainder beneficiary's status as a beneficiary of the trust.[24] Consequently, the children of the debtor-beneficiary also qualified as the beneficiaries of the trust, and the doctrine of merger was inapplicable.

iii. <u>Support Payments</u>

Even if an irrevocable trust has a spendthrift clause, a court may order the trustee to satisfy a beneficiary's support obligation to a former spouse or minor child out of any distributions that the trustee has decided, in his discretion, to make to the beneficiary.[25]

3. *Discretionary Trusts*

A trust is called "discretionary" when the trustee has discretion (as to the timing, amount and the identity of the beneficiary) in making distributions.[26] There must not be any trust provisions that mandate a distribution, but there may be provisions that set standards for distributions.[27] Because the trustee is not required to make any distribution to any specific beneficiary, or may choose when and how much to distribute, a beneficiary of a discretionary trust may have such a tenuous interest in the trust so as not to constitute a property right at all. If the beneficiary has no property right, there is nothing for a creditor to pursue. The statutes follow this line of reasoning by providing that a trustee cannot be compelled to pay a beneficiary's creditor if the trustee has discretion in making distributions of income and principal.[28]

Practice Pointer: When drafting a trust that allows the trustee to exercise discretion in making distributions subject to a standard (including an ascertainable standard), the discretion clause should be carefully worded. Practitioners should always favor using permissive phrases such as "trustee may pay to the beneficiary" instead of mandatory phrases such as "trustee shall pay to the beneficiary." In *U.S. v. Taylor*,[29] the trust provided that the trustee "shall pay" to the beneficiary so much of the income from the trust as the trustee deemed necessary for the support of the beneficiary. The court interpreted that language to mean that the trustee was mandated to make distributions, and his discretion was limited only to determining the amount "necessary."[30]

Even if a trust is truly discretionary it should have a spendthrift clause. While the trustee would not need to honor a beneficiary's demand for a distribution, it is possible that absent the spendthrift clause a creditor would force the beneficiary to assign his interest in the trust (whatever it may be) to the creditor. If that happens, then some day

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[23] *Ammco Ornamental Iron* at 418.
[24] *Id.*
[25] Cal. Prob. Code § 15305(c).
[26] 11 Witkin, *Summary of Cal. Law* (9th ed. 1990) Trusts, § 166, p. 1019.
[27] Cal. Prob. Code § 15303(c).
[28] Cal. Prob. Code § 15303(a).
[29] (N.D. Cal. 1966) 254 F.Supp. 752.
[30] *Id.* at 755.

when the trustee does make a distribution, it will be made to the creditor. Also, most trusts are never fully discretionary and it makes sense to obtain the protection of the spendthrift clause.

Once the beneficiary receives a distribution from the trust, even if it is discretionary, the protective benefits of the trust cease. The distributed assets are treated as any other assets of the beneficiary-debtor, and there is no statutory protection available for such assets simply because the assets used to be held in a trust.

In a case of first impression, a California court held that even a fully discretionary trust cannot shield a beneficiary from child-support obligations because of the overriding public policy support for satisfying child support obligations.[31] In interpreting Probate Code § 15305, the court stated that "The statute cannot have been intended to allow a beneficiary to defraud support creditors by hiding behind the trustee's discretion."[32]

The court's analysis is suspect. The intent of the Probate Code is irrelevant if the debtor-beneficiary has no property right in the trust because of a trustee's unfettered discretion.

II. DOMESTIC ASSET PROTECTION TRUSTS

A. Generally

A properly drafted trust, incorporating the pointers from the discussion above, may be an insurmountable obstacle to creditors; provided that the trust is for the benefit of a third-party beneficiary.[33] Most asset protection clients look to protect their own assets and are usually not beneficiaries of existing trusts. Consequently, the majority of asset protection trusts are self-settled. Because California strips the spendthrift protection of a self-settled trust, practitioners must look to other jurisdictions.

Several U. S. jurisdictions now allow self-settled trusts to afford their settlers the protection of the spendthrift clause. Alaska was the first jurisdiction to enact such laws in 1997[34] and was shortly followed by Delaware,[35] Nevada[36] and a few others.[37] All of these self-settled domestic asset protection trusts shall be referred to as "DAPTs."

Using Delaware as sample DAPT jurisdiction, a Delaware DAPT must comply with the following requirements: (i) the trust must be irrevocable and spendthrift; (ii) at

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[31] *Ventura County Dept. of Child Support Serv. v Brown* (2004) 117 Cal.App.4th 144.
[32] *Id*. at 155.
[33] The protective benefits of a trust may also be lost pursuant to a fraudulent transfer challenge. Civil Code §§ 3439-3439.12. A discussion of fraudulent transfers is beyond the scope of this article.
[34] Alaska Stat. § 34.40.110.
[35] 12 Del. Code § 3572 (Qualified Dispositions in Trust Act).
[36] Nev. Rev. Stat. ch. 166.
[37] Mo. Ann. Stat. § 428.005 *et. seq*.; R.I. Gen. Laws §§ 18-9.2. Oklahoma allows *revocable* self-settled trusts, and prevents creditors from forcing the settlor to exercise his power to revoke. 31 Okla. Stat. Ann. §§ 13, 16.

least one Delaware resident trustee must be appointed; (iii) some administration of the trust must be conducted in Delaware; and (iv) the settlor cannot act as a trustee.[38]

The DAPT jurisdictions appear to be a simple solution for a settlor of a self-settled trust seeking asset protection if the settlor is a resident of a DAPT jurisdiction and has assets in the jurisdiction. California residents with California assets may not be able to reap the asset protection benefits of these trusts: (i) the situs and the applicable law governing real property located in California will be California, even if the trust that owns the real property is in a DAPT jurisdiction, and (ii) while personal property is sited and governed by the laws of the DAPT jurisdiction, there is an exception for DAPT laws that may be deemed in violation of California public policy.

B. The Risks of DAPTs

1. *Conflict of Law*

Trusts are generally governed by the laws of the jurisdiction that is designated by the settlor as the governing jurisdiction.[39] There are two exceptions to the general rule: (i) states will not recognize laws of sister states that violate their own public policy,[40] and (ii) if the trust owns real property, such property will be governed by the law of jurisdiction that is the property's situs.[41]

In determining whether a law of another state would be enforceable in California, the court would analyze whether the law of the other state is contrary to a fundamental policy of California, and would then determine whether California has a "materially greater interest" than the other state in adjudicating the issue.[42]

To date, there are no California (or any non-DAPT jurisdiction) cases dealing with the protectiveness of DAPTs. It is possible that if a case involving a DAPT was litigated in California, the California court may not recognize the law of the DAPT jurisdiction and refuse to extend the spendthrift protection to a self-settled trust.

If a DAPT owns California real property, then California law will govern any collection action applicable to the real property and the spendthrift protection of the DAPT jurisdiction will be inapplicable.[43] This problem may be remedied to some extent by having a DAPT own California real estate through a limited liability company or a limited partnership organized under the laws of the DAPT jurisdiction. This way the trust no longer owns California realty, but owns an intangible governed by the laws of the DAPT jurisdiction.[44]

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[38] 12 Del. Code § 3570.
[39] Rest. 2d Conf. of Laws § 273(b); Uniform Trust Law § 107(1).
[40] *Washington Mutual Bank v. Superior Court* (2001) 24 Cal.4th 906, 916-917; Rest. 2d Conf. of Laws § 187, subd. (2); Uniform Trust Law § 107(1).
[41] Rest. 2d Conf. of Laws § 280.
[42] *Washington Mutual Bank* at 916.
[43] Rest. 2d Conf. of Laws § 280.
[44] Cal. Corp. Code §§ 15691, 17450(a).

2. *The Full Faith and Credit Clause*

The Full Faith and Credit clause of the Constitution provides that each state has to give full faith and credit to the laws of every other state.[45] This means that if a California court refuses to recognize the protection of a DAPT and enters a judgment for the creditor, the creditor may be able to enforce the judgment against the trustee of the DAPT, even if that trustee was located in the DAPT jurisdiction.

However, even under the Full Faith and Credit clause the states are not required to recognize the laws of sister states that are contrary to their own public policy.[46] Consequently, a DAPT jurisdiction court may refuse to enforce a California judgment because it was entered under trust laws substantially different to those of the DAPT jurisdiction.

At this point the analysis becomes quite circular. A creditor argues in California court that the court should apply California law and not Alaska law to an Alaska trust because Alaska trust law violates California public policy against self-settled trusts. In turn, Alaska refuses to recognize the California judgment because it violates Alaska public policy in protecting self-settled trusts.

This analysis should lead the practitioner to one inescapable conclusion. Until the application of the Full Faith and Credit clause is litigated in the context of a self-settled trust, the risk is too great that a DAPT would not afford the debtor with the required protection.

III. FOREIGN TRUSTS

A. Generally

Even if the settlor of a DAPT resides in the DAPT jurisdiction and all the assets of the trust are located in the DAPT jurisdiction, the efficacy of a DAPT may be challenged under the Supremacy clause of the U.S. Constitution, under the applicable fraudulent transfer statute, or because the settlor retained some prohibited control over the trust.

The only possible way of avoiding all these obstacles when planning with trusts is through the means of a foreign trust. The commonly understood meaning of the term "foreign trust" is a trust governed by the laws of a foreign nation.[47]

A foreign trust, *per se*, does not have any asset protection benefits. The benefits come from the jurisdiction which governs the trust. Several jurisdictions compete in the

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[45] U.S. Const., Art. IV, § 1.
[46] *Nevada v. Hall* (1978) 440 U.S. 410, 424.
[47] The term "foreign trust" also has a specific meaning under the Internal Revenue Code of 1986, as amended, but that the tax consequences of foreign trusts are beyond the scope of this article.

foreign trust arena and have drafted their trust laws to address all or most of the problems and issues discussed above.

B. Protective Features of Foreign Trusts

Foreign trusts offer two major advantages to debtors. From a practical perspective, because the trustee is domiciled in a foreign nation, at some point in time the creditor would have to litigate its claim against the trustee and pursue a collection action in that foreign nation. That is a costly proposition for all creditors, particularly if the creditor is a plaintiff's attorney who is not licensed to litigate in that foreign nation.

From a legal perspective, several offshore jurisdictions have enacted trust laws that are particularly favorable to debtor-beneficiaries and debtor-settlers. Jurisdictions like the Cook Islands (in the South Pacific),[48] Saint Vincent and the Grenadines (in the West Indies),[49] and Nevis (in the West Indies)[50] are considered to be among the best currently available foreign trust jurisdictions. The trust laws in all three jurisdictions are almost identical, as both Saint Vincent and Nevis based their trust laws on the laws of the Cook Islands. Using Saint Vincent as an example (but all three jurisdictions have similar provisions), the following favorable asset protection provisions have been incorporated into that nation's trust laws: (i) there is no recognition of foreign judgments with respect to trusts;[51] (ii) there is a very short statute of limitations on fraudulent transfers;[52] (iii) to establish a fraudulent transfer the creditor must show that the debtor was insolvent,[53] and must establish the debtor's intent to "hinder, delay or defraud" beyond a reasonable doubt;[54] (iv) the anti-duress provisions are incorporated into the statutes;[55] and (v) spendthrift protection is extended to self-settled trusts.[56] These jurisdictions also offer the additional advantages of (i) not being subject to the U.S. constitutional issues like the Full Faith and Credit clause; (ii) using the English common-law legal system; (iii) having abolished the rule against perpetuities; and (iv) not allowing trusts to be pierced for child or spousal support.

The non-recognition of foreign judgments is the most important protective feature of these jurisdictions. Assume that a creditor obtains a judgment against a debtor in a California court and would like to enforce the judgment against the debtor's assets. The debtor's assets have been transferred into a Saint Vincent trust which in turn funded a Swiss bank account.[57]

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[48] Cook Islands International Trusts Act, 1984.
[49] Saint Vincent and the Grenadines International Trusts Act, 1996.
[50] Nevis International Exempt Trust Ordinance, 1994.
[51] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part X, § 39.
[52] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part XI, § 46.
[53] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part XI, § 45(1)(b).
[54] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part XI, § 45(5).
[55] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part III, § 10(2).
[56] See, *e.g.*, Saint Vincent and the Grenadines International Trusts Act, 1996, Part II § 9(7).
[57] Unlike most DAPT jurisdictions (see, *e.g.*, Ala. Stat. § 13.36.035(c)(1)), the foreign trust jurisdictions do not require that the trust hold any assets in the jurisdiction of its domicile. Consequently, a Saint Vincent or Cook Islands trust can hold assets located anywhere in the world.

The creditor will be unable to domesticate its judgment in Saint Vincent, and will usually be unable to litigate its case *de novo* in Saint Vincent.[58] Consequently, the creditor's sole remedy would be to bring a fraudulent transfer action against the trustee of the foreign trust and attempt to show that the settlement of the trust by the debtor constituted a fraudulent transfer.

Given that the more favorable asset protection jurisdictions have a very short statute of limitation for fraudulent transfers,[59] require proof of intent beyond a reasonable doubt and require proof of debtor's insolvency, the creditor faces a daunting task.

C. **Contempt**

Because U.S. courts are unable to reach the foreign assets of a foreign trust, or exercise jurisdiction over the foreign trustee, the courts focus on the sole person that they can control – the settlor-debtor.

Contempt is generally defined as an act of disobedience to an order of a court, or an act of disrespect of a court.[60] There are two types of contempt: civil (intent is to coerce a party to do something) and criminal (intent is to punish a party for an action).[61] Both types of contempt involve the imposition of similar sanctions: payment of money, imprisonment, or both.[62] However, if the court orders a party to do something that is practically impossible, a civil contempt charge will not stand.[63]

In a foreign trust situation, the court usually attempts to coerce the debtor into repatriating the money, which is civil contempt.[64] The debtor, in turn, tries to establish that it is impossible for him to comply with the court order, and the contempt charge should not stand.[65]

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[58] The creditor will generally be unable to bring a lawsuit against the debtor in Saint Vincent because a Saint Vincent court would not have personal jurisdiction over the debtor. See, generally, *International Shoe Co. v. Washington* (1945) 326 U.S. 310, 316 (if the court does not have personal jurisdiction over the defendant, than minimum contacts must exist between the defendant and the jurisdiction). Additionally, Saint Vincent would not be the proper venue for a lawsuit, because a lawsuit can be brought in the jurisdiction where the debtor resides, where the cause of action arose, or where the contract was entered into. 15 U.S.C. § 1692i(a)(2)(A)-(B); Cal. Civ. Pro. Code § 395(a).

[59] For example, in Saint Vincent, the statute of limitations is two years from the date of the cause of action against the debtor-settlor, or one year from the settlement of the trust. Saint Vincent and the Grenadines International Trusts Act, 1996, Part XI, § 46(1).

[60] *Black's Law Dictionary* 313 (7th ed. 1999).

[61] *Id*.

[62] In asset protection cases debtors usually have no money, and imprisonment becomes the sole available sanction.

[63] *U.S. v. Rylander* (1983) 460 U.S.752, 757 ("Where compliance is impossible, neither the moving party nor the court has any reason to proceed with the civil contempt action.")

[64] Criminal contempt has a high burden of proof, and usually requires a jury trial. It rarely applies to asset protection cases because criminal contempt cannot be used coercively – *i.e*., the debtor will spend time in jail regardless of whether any money is retrieved from the trust.

[65] Even if compliance is impossible, contempt charges will stick if the impossibility is self-created. Impossibility will be deemed self-created if the foreign trust is funded in close proximity to the timing of

In the most notable case on point, *F.T.C. v. Affordable Media, LLC*,[66] the debtors, who allegedly engaged in a telemarketing fraud scheme, funded a Cook Islands trust and appointed themselves as the co-trustees and protectors of the trust, together with a Cook Islands trust company. When the court ordered the debtors to repatriate the assets of the trust, the debtors, acting as co-trustees of the trust, had sufficient control over the trust to repatriate the assets. The debtors, however, notified their Cook Islands co-trustee of the court order, and were promptly removed as a co-trustee. They were held in contempt of court, by the district court.

On appeal the debtors argued that it was impossible for them to comply with the repatriation order, because the Cook Islands trustee (by then the sole acting trustee) refused to repatriate the assets. The Ninth Circuit held that the debtors did not demonstrate that it was impossible for them to repatriate the money, and upheld the district court's contempt charge.[67] The court then analyzed whether the debtors retained sufficient control over the assets of the trust.

According to the court, the following facts were indicia of control: (i) no rational person would send millions of dollars overseas without retaining control over the money; (ii) the debtors previously withdrew $1 million from the trust to pay a tax liability; and (iii) they acted as a protector of the trust with the ability to remove the Cook Islands trustee and appoint a new trustee.[68]

These arguments appear valid, until one revisits the purpose of civil contempt, which is to coerce the debtor to repatriate the assets. All of the arguments made by the court establish that the debtors possibly did have sufficient control, at some point, to repatriate the money. However, once the debtors surrendered their control, there was no further purpose to the contempt charge.

The court's analysis was also faulty as follows: (i) rational people may give up control over their assets if the alternative is to lose the assets to a creditor; (ii) even though a debtor may surrender control over his assets, he will still be the beneficiary of the trust holding equitable interests in the assets of the trust; (iii) in *Affordable Media* the debtors withdrew money from the trust when they were co-trustees, but as soon as they were removed as co-trustees that control string was cut; and (iv) the fact that a trust may allow the beneficiary to petition for distribution when there is no collection action and removes that power when there is a collection action is simply good practice, it does not establish that control exists at all times.

In the few reported contempt cases, courts appear to be eager to find contempt.[69] One possible explanation is the Ninth Circuit statement in *Affordable Media* that foreign

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the court's order. *In re Lawrence* (11th Cir. 2002) 279 F.3d 1294, 1300. In *Affordable Media* (see below), the impossibility arose after the court ordered the debtor to repatriate the funds.

[66] (9th Cir. 1999) 179 F.3d 1228 (colloquially referred to as the "Anderson" case).

[67] *Id*. at 1240.

[68] *Id*. at 1242-1243.

[69] See, *e.g*., *In re Lawrence*, (Bankr. S.D. Fla. 1999) 238 B.R. 498; *Eulich v. U.S*. (2006) 2006 U.S.Dist.LEXIS 2227.

asset protection trusts operate by frustrating the jurisdiction of domestic courts.[70] The court's logic appears to be on very shaky ground. Any transfer to a foreign person or entity, where the debtor does not remain in control over the transferred assets will frustrate the jurisdiction of a domestic court.

The debtor's choice of law should not factor into the impossibility analysis. The only question is whether the debtor has retained control over the assets, so that it would not be impossible for the debtor to repatriate the assets (which was the Ninth Circuit's ultimate holding in *Affordable Media*). If there is no finding of control, impossibility exists, and contempt should not stand.

Consequently, a finding of contempt is usually a question of poor planning. If the trust allows the settlor-debtor sufficient control over the trustee, then the courts are within their right in finding the debtor in contempt, as in *Affordable Media*. But if the debtor has completely surrendered control, contempt charges should not stand. Consequently, foreign trusts should be drafted as arm's-length irrevocable trusts, with spendthrift clauses, and as much discretion as possible conferred on the trustee. Debtors should never act as co-trustees or protectors, or retain any power to remove a trustee and appoint a new trustee.[71]

IV. LLCs

A. Charging Orders

Trusts serve as a protective mechanism because they restrict a beneficiary's access to the assets of the trust and therefore, and to the same extent, restrict a creditor's access to the assets of the trust. By contrast, limited liability companies ("LLCs") completely restrict a creditor's ability to access the assets of the LLC, because assets owned by an LLC are not owned by its members.[72] As this section of the article makes clear, LLC interests are protected by the so-called "charging order" limitation. Consequently, transferring assets to an LLC and owning an interest in an LLC is better asset protection than owning most other types of assets.

Before the advent of the charging order,[73] a creditor pursuing a partner in a partnership was able to obtain from the court a writ of execution directly against the partnership's assets, which led to the seizure of such assets by the sheriff. This result was possible because the partnership itself was not treated as a juridical person, but simply as an aggregate of its partners. The seizure of partnership assets meant that the sheriff could shut down the partnership's place of business.

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[70] *Affordable Media* at 1232.
[71] The debtor's power to replace a trustee with a U.S. domiciled trustee caused repatriation of a foreign trust's assets in *U.S. v. Grant* (2005) 2005 U.S. Dist. LEXIS 22440.
[72] Cal. Corp. Code § 17300.
[73] The first charging order statute appeared in § 23 of the English Partnership Act of 1890, and was later picked up by the Uniform Partnership Act (§ 28) of 1914, and the Uniform Limited Partnership Act (§ 22) of 1916.

To protect the non-debtor partners from the creditor of the debtor-partner, and to keep the creditor out of partnership affairs, it was necessary to keep the creditor from seizing partnership assets. These objectives could be accomplished only by limiting the collection remedies that creditors previously enjoyed. Because any limitation on a creditor's remedies is a boon to the debtor, over the years charging orders have come to be perceived as asset protection tools.

The rationale behind the charging order limitation applied initially only to general partnerships, where every partner was involved in carrying on the business of the partnership; it did not apply to corporations because of their centralized management structure.[74] However, over the years the charging order protection was extended to limited partners and LLC members. While similar rules apply to limited partnerships and general partnerships, this article will focus solely on LLCs.

B. It All Starts With The Uniform Act

Most domestic and foreign LLC legislation provides for charging orders. Almost all domestic statutes are based on the Uniform Limited Liability Company Act of 1996 ("ULLCA"), or the earlier versions of this act.

The ULLCA, at § 504, provides that (i) a charging order is a lien on the judgment debtor's transferable interest; (ii) the purchaser at a foreclosure sale has the rights of a transferee; and (iii) the charging order is the exclusive means by which the creditor could pursue the partnership interest. Because ULLCA restricts the charging order to the debtor's "distributional interest" (economic interest under California LLC legislation), the creditor can never obtain any voting or management rights over the LLC.[75] California adopted the ULLCA charging order provisions without any substantive changes.[76]

The ULLCA (and therefore, the California) charging order statute may be summarized as having the following important provisions: (1) the charging order is a lien on the judgment debtor's distributional (assignable) interest; it is not a levy, (2) the creditor cannot exercise any management or voting rights because the creditor has only the rights of an assignee/transferee, (3) the foreclosure of the charged interest does not harm the debtor because the buyer at the foreclosure sale receives no greater right than was possessed by the original creditor, and (4) the creditor, expressly, has no remedy other than the charging order and foreclosure on the charging order.

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[74] Because charging orders do not apply to corporations, a creditor of a shareholder can attach the shares of corporate stock owned by the debtor-shareholder and obtain the entire bundle of rights inherent in those shares, including liquidation and voting rights.
[75] ULLCA §§101(6), 501-504.
[76] Cal. Corp. Code § 17302.

Some practitioners fear the creditor's ability to foreclose.[77] This fear appears to be entirely unfounded – the ULLCA and the California legislation clearly provide that only the charged interest may be foreclosed upon, and further provide that the purchaser at the foreclosure sale has only the rights of a transferee. To grant the purchaser of the foreclosed interest an interest greater than the right to receive distributions would mean granting to the purchaser voting and management rights associated with the debtor's interest in the entity. That would be contrary to the very reason why charging order statutes exist in the first place.

C. California Opines On Charging Orders

There are few cases dealing with charging orders, for two reasons. First, many creditors fail to find the charging order to be a useful remedy, and seek to settle with the debtor rather than hope to get a distribution from the entity. Second, even when creditors pursue the charging order remedy, the charging order is granted by a trial court and is rarely appealed, resulting in few published opinions. Many of the reported cases deal with the creditor's ability to foreclose; most cases authorize the creditor to foreclose but restrict the buyer of the interest to the economic component of the interest. There are also some interesting outliers, readily demonstrating the degree of judicial imagination involved in statutory interpretation.

The California Supreme Court has affirmed that the charging order has replaced levies of execution as the remedy for reaching partnership interests.[78] The two most interesting charging order cases out of California are *Crocker Nat. Bank v. Perroton*,[79] and *Hellman v. Anderson*.[80]

In *Crocker*, the court concluded that a partnership interest may be foreclosed upon if the sale of the interest does not violate the partnership agreement and the other partners consent to the sale.[81] In *Hellman*, the court confirmed that foreclosure of the charged interest is authorized by the charging order statute, but disagreed with *Crocker* that consent of non-debtor partners is required. The court concluded that consent from other partners is not required because the foreclosure sale results in the buyer receiving only the economic interest in the partnership, not voting or management rights. Consequently, the buyer will never have ability to interfere with the business of the partnership and inconvenience the non-debtor partners.[82] Going even further, the *Hellman* court remanded the case back to trial court for a determination whether the foreclosure of the

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[77] See, for example, Elizabeth M. Schurig and Amy P. Jetel, *A Charging Order is the Exclusive Remedy Against a Partnership Interest: Fact or Fiction?*, Prob. & Prop. (Nov./Dec. 2003). See also the critique of the above referenced article in the same publication: Daniel S. Kleinberger, Carter G. Bishop and Thomas Earl Geu, *Charging Orders and the New Uniform Limited Partnership Act: Dispelling Rumors of Disaster*, Prob. & Prop. (Jul./Aug. 2004).
[78] *Baum v. Baum*, 51 Cal. 2d 610, 612, 335 P. 2d 481, 483 (1959).
[79] 208 Cal. App. 3d 1, 255 Cal. Rptr. 794 (1989).
[80] 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (1991).
[81] *Crocker* at 9.
[82] *Hellman* at 852.

economic interest (limited as that interest may be) would unduly interfere with the partnership business.[83]

D. Single-Member LLCs

Single-member LLCs deserve special attention in the charging order analysis. It may be argued that given the historical framework of charging orders, they should not protect single member LLC members, because there are no other "partners" to protect from the creditor.

Neither the uniform acts, nor any of the state charging order statutes makes any distinction between single-member and multi-member LLCs. Some courts have held that the charging order limitation would apply where all of the partners of a limited partnership were the debtors of a single creditor.[84] The creditor had argued, to no avail, that because there were no "innocent" (non-debtor) partners to protect, the charging order protection should not apply.

One bankruptcy court held that the charging order protection does not apply to single-member LLCs.[85] In *Albright*, the debtor was the sole member and manager of an LLC. The bankruptcy trustee asserted that it acquired the right to control the LLC and sell its assets, while the debtor sought to deny those rights, under the rationale discussed above.

The bankruptcy court concluded that based on Colorado LLC law, a membership interest in an LLC can be assigned, including management rights.[86] The relevant statute provides that if all the other members do not approve of the assignment, then the assignee does not acquire management rights.[87] If all the other members do approve, then the assignee may become a substituted member, acquiring all rights of a member).[88]

Because in a single-member LLC there is no other members who can "not approve," an assignee will always become a substituted member. The statute was not revised following the introduction of single-member LLCs. The bankruptcy court concluded that if the LLC in *Albright* had several members, a different result would have been reached and the bankruptcy trustee would have been entitled only to the distributions of profits, but not management and control over the LLC.[89]

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[83] *Id*. at 853.
[84] *Evans v. Galardi* , 16 Cal. 3d 300 (Cal. 1976).
[85] *In re Albright*, 291 B. R. 538 (Bankr. D. Colo. 2003).
[86] Colo. Rev. Stat. § 7-80-702.
[87] This conclusion is based on anecdotal evidence and the author's own experience. There are no available statistics.
E. Geu, The Albright Decision – Why an SMLLC is Not an Appropriate Asset Protection Vehicle, 5 Business Entities 16 (2003).
[87] Cal. Corp. Code § 17005.
[87] ULLCA § 504(c).
[87] Colo. Rev. Stat. § 7-80-702(1).
[88] Colo. Rev. Stat. § 7-80-702(2).
[89] *Albright* at 541.

The court's application of the Colorado assignability statutes is faulty. These statutes are implicated only when a member dies or assigns its interest, not in the context of bankruptcy.[90]

The *Albright* case is often interpreted as a case on single-member LLC charging orders. However, the bankruptcy court devoted most of its analysis to the assignability of interests statutes, and only in passing noted that the debtor made a charging order argument. The court dismissed the debtor's charging order argument out of hand, noting that charging orders were intended to protect non-debtor "partners," and in single-member LLCs there is no one to protect.[91]

The very limited analysis of charging orders engaged in by the *Albright* court is troubling. The court analyzes and follows Colorado statutes when dealing with the assignability of interests and determining how the charging order would work in a multi-member context. Inexplicably, the court completely ignored Colorado law with respect to applicability of the charging order. The Colorado charging order statute does not exempt single-member LLCs from the charging order limitation.[92] The court completely ignores that and focuses on the historical framework of charging orders.

It is inappropriate to analyze legislative intent and historical origins of statutes when there is a clear statute on point.[93] The Colorado charging order statute clearly limits the creditor to an economic interest in the LLC.[94] When the Colorado legislature introduced the single-member LLC statute it is presumed to have known of the charging order statute.[95] It chose not to make any changes to the latter. The *Albright* decision conveniently ignores these legal principles.[96]

E. Maximizing the Utility of Charging Orders

Most operating agreements provide that only the economic interest in the LLC may be assigned, but not the entire membership interest. This mirrors the ULLCA and the California LLC legislation.

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[90] Colo. Rev. Stat. §§ 7-80-702 and 7-80-704.
[91] *Id*. at 542-543.
[92] Colo. Rev. Stat. § 7-80-703.
[93] See, e.g., *Robert E. v. Justice Court*, 99 Nev. 443, 445, 664 P.2d 957, 959 (1983) ("When presented with a question of statutory interpretation, the intent of the legislature is the controlling factor and, if the statute under consideration is clear on its face, a court can not go beyond the statute in determining legislative intent.")
[94] *Id*.
[95] See, *e.g.*, Sutherland, *Statutory Interpretation*, § 22.33 (C. Sands 4th ed. 1972); *Walen v. Department of Corrections*, 443 Mich. 240, 248, 505 N.W.2d 519, 522 (1993); *McLeod v. Santa Fe Trail Transp. Co.*, 205 Ark. 225, 230, 168 S.W.2d 413, 416 (1943); *Woodson v. State*, 95 Wash. 2d 257, 623 P.2d 683 (1980).
[96] For a more in-depth discussion of the Albright decision, see Larry E. Ribstein, Reverse Limited Liability and the Design of Business Associations, 30 Del. J. Corp. L. 199 (2005); Thomas E. Rutledge and Thomas E. Geu, The Albright Decision – Why an SMLLC is Not an Appropriate Asset Protection Vehicle, 5 Business Entities 16 (2003).

A carefully drafted operating agreement can greatly enhance the charging order limitation. California LLC legislation allows members to override the default statutory provision of assignability of interests.[97] In most business dealings it would not be possible for practitioners to make LLC interests entirely non-assignable. Clients want to retain flexibility and ability to dispose of their LLC interests. However, in family settings, or for LLCs set up solely for liability protection purposes, it may be possible to either prevent assignability altogether or to limit it in such a manner so as to make the charging order remedy of little value to the creditor.

Because the charging order protection is predicated on the debtor's continued ability to manage the entity and thus control distributions, the distribution clauses of LLC agreements become critical. If the agreement provides that all distributions must be made to the members at the same time (*pari passu*), then distributions have to be made either to all members or none. This means that if one member is pursued by a creditor holding a charging order, protecting that member would mean withholding distributions from all other members of that LLC. Consequently, agreements should be drafted to deal with this potential problem.

One possible solution is to vary the operating agreement to allow the manager to make distributions to all members other than the debtor-member. The author's preferred solution is to provide that the debtor vests in the distribution (*i.e.*, cash and assets are distributable to the debtor) but instructing the manager to withhold the distribution while the charging order is pending. This allows the entity to allocate taxable income to the creditor (following a foreclosure) without distributing cash to the creditor.

Pursuant to the ULLCA and most state statutes that allow foreclosure, the debtor, prior to the foreclosure, may redeem his membership interest.[98] The statute does not specify that the interest must be redeemed for fair market value. This leaves room for drafters to insert various favorable redemption provisions into the operating agreement, such as a poison pill.

F. A Practical Take on Charging Orders

Charging orders allow debtors to retain control over LLCs and determine the timing of distributions. There are some exceptions to that general rule, particularly when: (i) there is a fraudulent transfer, and (ii) in a bankruptcy. It may be argued that single-member LLCs should also be deemed an exception to this general rule, based on the *Albright* case and the historical origin of charging orders. This author believes the *Albright* case to be an outlier, and in direct conflict with the charging order statutes of all states that have adopted single-member LLC provisions. Historical origin is also of little significance in this area. There is no need to interpret statutes that are very clearly drafted to apply to all LLCs.

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[97] Cal. Corp. Code § 17005.
[98] ULLCA § 504(c).

Purchasing a foreclosed partnership interest may be foolhardy when the debtor, or a person friendly to the debtor, remains in control of the entity and can hold up the creditor's share of distributions. This will lead to adverse tax consequences for the creditor.

As a practical matter, creditors rarely chose to pursue charging orders.[99] A charging order is not a very effective debt collection tool. The creditor may find itself holding a charging order, without any ability to determine when the judgment will be paid off. Practitioners should remember that any uncertainty surrounding charging orders is uncertainty for both the debtor and the creditor. This uncertainty forces most creditors to settle the judgment with the debtor, on terms more acceptable to the debtor, rather than pursue the charging order remedy.

V. CONCLUSION

Irrevocable trusts and LLCs are the closest one can come to a "silver bullet" in asset protection planning. Both structures serve as a very effective asset protection tool, while allowing the debtor to retain indirect control over his assets. Both structures can be implemented with limited or no tax consequences. As with all other asset protection planning, debtors should be cautioned to plan early, to avoid having a transfer of assets to a trust or an LLC be deemed a fraudulent transfer.

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[99] This conclusion is based on anecdotal evidence and the author's own experience. There are no available statistics.