Asset Protection

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3 Types of Clients

- 1) The "teacher couple" – intact family, no business interests
- 2) The "doctor couple" – higher potential for liability in connection with their professions
- 3) The client with a present liability – the business has failed, the patient has died, the car wreck has occurred

Starting Point

- Step 1: Conduct an asset-by-asset analysis

- Assets that you own in your own name
- Assets that you own as tenants by the entireties
- Assets that are specifically protected as exempt from creditor claims

Tenants by the Entireties

- Very strong protection in Pennsylvania
- Property that is titled jointly between spouses is presumed to be TBE
- Applies to all forms of property
- Only reachable by joint creditors
- Currently, 22 states and District of Columbia

Tenants by the Entireties

- Consider role of exemption amount in the past: Divide assets between spouses so that each spouse could fully use exemption amount
- Other reasons to divide assets
  - Relationship dynamics
  - Marital property/separate property

State Law Exemptions

- Every state has a body of law that exempts certain assets from the claims of creditors
- Public policy rationale – Protect the bare necessities; provide for family, retirement
- Provides structure for Federal bankruptcy proceeding – Many states, like Pennsylvania, give you the choice between Federal exemptions and state law exemptions.

State Law Exemptions

- Statutory Law
- Constitutional Law
- Common Law

Pennsylvania Exemptions

- 42 Pa. C.S. §§ 8121-8127

  (Title 42 Judiciary and Judicial Procedure)
- Property of the judgment debtor up to the value of $300
- Certain personal property, including wearing apparel, bibles, school books, sewing machines and uniforms

Pennsylvania Exemptions

- Certain state retirement and pension plans
- Pensions and annuities paid to a retired employee under a plan or contract that prohibits assignment
- For self-employed person, contributions to retirement plan or annuity fund to the extent the contributions were deductible and were made while solvent

Pennsylvania Exemptions

- Most retirement or annuity funds described in Sections 401, 403, 409 and 530 of the IRC, including appreciation and income earned in the fund, <u>except</u>
  - Amounts contributed by the debtor during the year preceding filing bankruptcy
  - Amounts in excess of $15,000 contributed to an IRA within any one-year period (other than by a rollover)
  - Amounts deemed to be fraudulent transfers

Inherited IRAs

- Most states do <u>not</u> explicitly protect
- Pennsylvania statute is silent
- <u>*Clark v. Rameker*</u> (2014 U.S. Sup. Ct.)
  - Federal bankruptcy exemptions
  - Only applies *if*:
    - Live in a state that does not protect inherited IRAs, or
    - Live in a state that *does* protect inherited IRAs, but have not lived there for 730 days

Pennsylvania Exemptions

- 529 Plans (Pennsylvania-based only) – applies to account owner and beneficiary
- Life insurance proceeds paid to spouses, children and dependent relatives
- Tangible personal property exhibited at international exhibitions

Bankruptcy Overlay

11 U.S.C. § 522(o)

- Many states permit debtor to choose between Federal exemptions and state law exemptions
- How do you take advantage of state law exemptions?
  - Debtor must reside in state for 730 days (if not, look at last 180 days)
  - Homestead protection – 1,215 days

Use of Entities / Insurance

- Limited partnerships, LLCs
- Commercial or rental real estate
- Malpractice insurance
- Umbrella policy

Fraudulent Transfers

- Step 2 : Be mindful of the fraudulent transfer rules
- Rule 1.2(d): A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

PA Voidable Transactions Act

- Title 12 (Commerce and Trade), Ch. 51
- Enacted on February 20, 2018
- Seen as more creditor friendly
- Replaces the word “fraudulent” with “voidable”
- Burden of proof – Preponderance of evidence (more likely than not)
- Choice of laws

Present Creditor

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

(12 Pa. C.S. §5105(a))

Transfer

<u>Transfer</u>: Every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset. The term includes payment of money, release, lease and creation of a lien or other encumbrance.

(12 Pa.C.S. §5101(b))

Claim

Claim: A right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured.

(12 Pa.C.S. §5101(b))

Insolvent

General Rule: A debtor is insolvent if, at fair valuation, the sum of the debtor's debts is greater than all of the debtor's assets

(12 Pa.C.S. §5102(a))

Presumption of Insolvency

A debtor that is generally not paying the debtor's debts as they become due other than as a result of a bona fide dispute is presumed to be insolvent. The presumption imposes on the party against whom the presumption is directed the burden of proving that the nonexistence of insolvency is more probable than its existence.

(12 Pa.C.S. §5102(b))

Present or Future Creditor

General Rule – A transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred…

(12 Pa.C.S. §5104(a))

Present or Future Creditor

If the debtor made the transfer or incurred the obligation…

1) With actual intent to hinder, delay or defraud any creditor of the debtor

Or….

Present or Future Creditor

If the debtor made the transfer or incurred the obligation…

2) Without <u>receiving a reasonably equivalent value</u> in exchange, and the debtor, <u>and</u>

- Was engaged in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; <u>or</u>
- Intended to incur, debts beyond the debtor's ability to pay as they became due.

Self-Settled Trusts

20 Pa. C.S. §7745 (Creditor's Claims Against Settlor)

Whether or not a trust instrument contains a spendthrift provision:

- (1) During the lifetime of the settlor, the property of a revocable trust is subject to claims of the settlor's creditors.
- (2) A judgment creditor or assignee of the settlor of an irrevocable trust may reach the maximum amount that can be distributed to or for the settlor's benefit.

Self-Settled Trusts

- (3) After the death of the settlor and subject to the settlor's right to direct the source from which liabilities will be paid, the property of a revocable trust is subject to claims of the settlor's creditors, costs of administration of the settlor's estate, the expenses of the settlor's funeral and disposal of remains and the family exemption to the extent the settlor's probate estate is inadequate to satisfy those claims, costs, expenses and exemption and no other statute specifically exempts the property from those claims.

Spendthrift Trust

- Third party trusts – protection for spouse / descendants
- Spendthrift provision: No income or principal of a trust hereunder shall be subject to: (1) attachment for any debt, contract or engagement of any beneficiary; (2) any legal process against any beneficiary; or (3) assignment, transfer or anticipation by any beneficiary.

Trusts for Children

- Protection against biggest creditor…the future ex-spouse
- Consider:
  - Limit access to income and principal
  - Include co-trustee/Independent Trustee
  - Include other beneficiaries

Domestic Asset Protection Trusts (DAPTs)

- 17 States – Alaska, Delaware, South Dakota, Nevada…Ohio, Virginia and Michigan
- Statutes generally protect trust assets from claims of creditors except with respect to:
  - 1) Fraudulent transfers
  - 2) Spousal and child support matters

DAPTs

- Key Questions:
  - How do you take advantage of these laws?
  - Do they work for non-residents?
- Section 10 of UVTA (12 Pa. C.S. §5110)

Governing law: A claim for relief in the nature of a claim for relief under this chapter is governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred.

DAPTs

- Section 4 of UVTA, Comment 8
- <u>General Rule as to Present and Future Creditors</u>: A transfer is voidable as to a creditor if the debtor made the transfer or incurred the obligation <u>with actual intent to hinder, delay or defraud</u> any creditor of the debtor.
- If debtor resides in Non-DAPT state, transfer to DAPT is per se voidable

Hypothetical

- Wife is successful architect
- Husband is struggling restaurateur
- Assets/Income:
  - W's 401(k) = $1,500,000
  - W and H Residence = $800,000
  - W and H Financial Assets = $500,000
  - H's Restaurant = ???
  - W's Income = $250,000 per year
  - H's Income = ???

Hypothetical

- Insolvent estate
- Decedent withdrew funds from IRA in excess of Required Minimum Distribution; income tax liability
- Decedent named 3 children as beneficiaries of IRA
- Who pays the income tax?

Questions?

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