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Experts' Opinion: Domestic Asset Protection Planning Trusts and Implications of the *Mortensen* Case

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The Claw Back Period

From an asset protection and integrated estate planning perspective, one of the more interesting provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") appears in Title 11 U.S.C. Sec. 548(e)(1). This provision provides for a 10-year "look-back" (or "claw back") period effective as of October 17, 2005 with respect to transfers made by a debtor to a self-settled trust when the debtor is a beneficiary of such trust and when the debtor made such transfer with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted on or after the date that such transfer was made.

In one recent bankruptcy decision, the settlor of an Alaska asset protection trust thought he was in the clear when he filed for bankruptcy protection more than four years after his transfers to the trust were made, only to learn (the hard way) that by filing for bankruptcy protection he would be caught in the snare of a claw-back provision that did not exist when the transfers were made.

Mortensen Bankruptcy

The decision is *Battley v. Mortensen*, (Slip copy, 2011 WL 5025249 (Bkrtcy. D. Alaska 5/26/2011)) which a small minority of commentators has proclaimed to mark the death of the domestic asset protection trust. Most readers have heard of asset protection planning's death in one form or another ever since the 1995 decision known as the *Orange Grove* case. Yet, today, with millions upon millions of dollars saved for clients through the authors' planning efforts alone, let alone those of the many others who practice in this arena, asset protection is today alive and well and being practiced by more attorneys than ever before. How can all this be reconciled, then, with the result in *Mortensen*? In a word, easily.

In *Mortensen*, the Chapter 7 bankruptcy trustee brought an adversary proceeding to set aside the transfer of Alaska real property to an Alaska asset protection trust that was settled by Alaska resident Thomas Mortensen ("Mortensen"). The trust's "stated purpose" was to "maximize the protection of the trust estate or estates from creditors' claims of [Mortensen] or any beneficiary and to minimize all wealth transfer taxes." The bankruptcy trustee asserted that the determinative issue was "whether Mortensen transferred the [property] to the trust "with actual intent to hinder, delay or defraud his creditors" pursuant to the provisions of Title 11 U.S.C. Sec. 548(e).

Badges of Fraud

To analyze this issue, the United States Bankruptcy Court for the District of Alaska (the "Court") looked to the "badges of fraud" that Mortensen exhibited. As the reader is likely aware, it is often difficult to determine a transferor's state of mind as of the time a transfer is made. Therefore, under American fraudulent transfer principles of law, actual intent may be inferred from an examination of the underlying facts and circumstances surrounding a particular transfer. That is, a court may consider certain extrinsic factors in determining whether a transferor possessed the actual intent to defraud a creditor. Such factors are commonly known as "badges of fraud."

Badges of fraud have varied court by court and decision by decision, but tend to include factors such as whether: (a) the transfer or obligation was to an insider; (b) the debtor retained possession or control of the property transferred after the transfer; (c) the transfer or obligation was disclosed or concealed; (d) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; (e) the transfer was of substantially all the debtor's assets; (f) the debtor absconded; (g) the debtor removed or concealed assets; (h) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; (i) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (j) the transfer occurred shortly before or shortly after a substantial debt was incurred; and (k) the debtor transferred the essential assets of the business

to a lienor who transferred the assets to an insider of the debtor. (Sec. 4(b) of the Uniform Fraudulent Transfer Act.)

The Court also gave what it regarded as due consideration to the trust's above-quoted "stated purpose." Mortensen contended that under Alaska law "a settlor's expressed intention to protect trust assets from a beneficiary's potential future creditors is not evidence of intent to defraud." However, the Court applied the principle that federal bankruptcy law preempts state law (in this case, specifically, the statutory Alaska asset protection trust law), and concluded that Mortensen's expressed intention "can be evidence in federal bankruptcy proceedings of an intent to defraud."

The other evidence the Court felt that demonstrated Mortensen's fraudulent intent included: (1) Mortensen was "coming off some very lean years at the time he created the trust in 2005;" (2) Mortensen's self-described post-divorce "financial carnage;" (3) Mortensen "was well 'under water' when he sought to put the [property] out of reach of his creditors by placing it in the trust;" and (4) Mortensen transferred to the trust most of the funds he received from his mother (to the tune of $100,000.00), rather than using the funds to pay down his bills.

Mortensen's Flawed Scheme

The Court ruled that Mortensen attempted: "a clever but fundamentally flawed scheme to avoid exposure to his creditors. When [Mortensen] created the trust in 2005, he failed to recognize the danger posed by the Bankruptcy Abuse Protection (sic) and Consumer Protection Act, which was enacted later that year. Mortensen will now pay the price for his actions. His transfer of the [property] to the [Trust] will be avoided."

In responding to Mortensen's Motion for Reconsideration, the Court stated that while it found that the trust's express purpose could provide evidence of fraudulent intent, it was not the only evidence upon which the Court based its decision. (Slip copy, 2011 WL 5025252 (Bkrtcy. D. Alaska 7/8/2011)). The Court then engaged in a brief analysis of "badges of fraud" to support its conclusion of Mortensen's **actual** fraudulent intent, including the fact that almost all of his property was transferred to the trust. The Court also noted that Mortensen lacked credibility as a witness (a factor that has haunted certain other debtors in other cases involving challenges to trusts). Finally, the Court commented that Mortensen "was still 'under water' when he put the realty (and then the cash) into the trust" and noted that he did not "regularly pay rent to the trust" for his use of the trust's real property.

Planning Observations

With the foregoing in mind, it can be seen that *Mortensen* marks only the death of the transfers in the *Mortensen* case itself, judged in the bankruptcy setting to be subject to the bankruptcy code's 10-year claw-back provision applicable to transfers made with actual fraudulent intent. The authors have long cautioned that asset protection trusts, whether governed by the law of Alaska or elsewhere, are not a means or excuse to justify fraudulent transfers.

What can the asset protection planner do to prevent a result similar to the result in *Mortensen*, other than hoping the law does not change out from under the client? The advice is simple – (1) choose your clients carefully, recognizing that nowhere is it written that you have to accept every case that comes in your door; (2) design the plan in an appropriate manner after giving due regard to the client's goals and the totality of the client's financial circumstances; and (3) impress upon the client who becomes subject to a threat or a challenge the importance of being credible in the eyes of the court.