On Mortensen and Other Asset Protection Developments: Ten Questions for Barry S. Engel, Esq. and John R. Garland, Esq.

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Mr. Engel is one of three co-authors of the 1989 amendments to the Cook Islands International Trust Act (1984), as enacted by the Parliament of the Cook Islands. The first asset protection specific statutory trust law of its kind, this enactment has served as the model for similar trust law as subsequently adopted in more than 20 offshore financial centers and by approximately 25% of our state legislatures.

Mr. Engel is the author of Asset Protection Planning Guide, now in its second edition, as published by CCH Incorporated, Chicago, Illinois. His writings have contributed in large part to the widespread acceptance of asset protection planning and to how it is undertaken today by the planning community on behalf of clients.

John R. Garland is a principal in Engel & Reiman pc. Mr. Garland specializes in asset protection planning, taxation and estate planning. He frequently speaks to professionals practicing in these areas. Mr. Garland has authored or co-authored a number of articles on related legal topics and is a contributing author of the CCH Asset Protection Planning Guide.

We asked Mr. Engel and Mr. Garland to share with us their thoughts on recent asset protection developments, including the case causing quite a bit of commotion, *Battley v. Mortensen*, Adv. D.Alaska, No. A09-90036-DMD, May 26, 2011 (Original Memorandum) and July 8, 2011 (Memorandum Denying Motion For Reconsideration). *Mortensen* is the first case to interpret and apply Bankruptcy Code Section 548(e) in the domestic asset protection trust setting. Code Section 548(e) was enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Background on the *Mortensen* case

In February of 2005, Alaska resident Thomas Mortensen transferred property to an Alaska Asset Protection Trust ("AAPT"). At the time the trust was created, "Mortensen was coming off some very lean years" according to the bankruptcy court. Indeed, Mortensen's "earnings over the preceding four years averaged just $11,644.00 annually...He had also accumulated credit card debt of between $49,711.00 to $85,000.00 at the time the trust was created." Mortensen admitted that "[s]addled with debt and with increasing competition in my shrinking business market I have not recovered from the financial carnage of the divorce."

According to the opinion, Mortensen came to learn about Alaska asset protection trusts "in casual conversation." Mortensen "researched the topic and, using a template he had found, drafted a document called the 'Mortensen Seldovia Trust (An Alaska Asset Preservation Trust).'"

On account of medical bills and an inability to return to work, Mortensen filed for bankruptcy in August of 2009, which was approximately 4 ½ years following the creation of his AAPT. The bankruptcy trustee contended that Mortensen failed to create a valid AAPT under Alaska's laws claiming that he was insolvent when the trust was established. This argument was rejected by the bankruptcy court, which found that he was, indeed, solvent at the time the trust was established.

Alternatively, the bankruptcy trustee sought judgment against Mortensen under Bankruptcy Code Section 548(e) and its 10-year claw-back period for setting aside a fraudulent transfer. In its analysis, the court stated that "[o]nly five [*sic*] states allow their citizens to establish self-settled trusts" and that "Section 548(e) was enacted to close this 'self-settled trust loophole.'" The court went on to note that 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." The court ultimately concluded that the transfer of property from Mortensen to the AAPT would be avoided under Section 548(e).

Interview:

Schoenblum: Barry and John, good morning. Thank you for joining me in this discussion.

Engel: Good morning to you, Neil, thanks to you for your interview invitation. These are exciting times in the field in which we practice, and I always enjoy talking through developments and trends with qualified and knowledgeable colleagues like you.

Schoenblum: Let me start, if you will, with the *Mortensen* case, a case that has reverberated throughout the trust and planning world. Here, Mr. Mortensen filed for bankruptcy after he was already past Alaska's 4-year statute of limitations period for challenging transfers to an Alaska asset protection trust. It has, therefore, been argued that the trust assets likely would have been protected if Mortensen had not decided to file for bankruptcy protection. However, what about the possibility of Mortensen being forced into an involuntary bankruptcy? How big a threat was that to him?

Engel: I agree that from a state law standpoint, Mr. Mortensen was likely in the clear from creditors. And as we talk this morning, keep in mind that when I use the term "creditor" it usually can be taken to mean a "claimant" as well. In any event, the possibility of an involuntary bankruptcy petition was a real one, yes, though perhaps in the big picture not all too likely.

Garland: If a creditor knows that the state statute of limitations has run on the debtor's transfers to a self-settled spendthrift trust, then it can be to the creditor's advantage to try to force the debtor into bankruptcy court. As you know, under Bankruptcy Code Section 548(e) there is a 10-year "claw-back" period for certain fraudulent transfers made to a self-settled spendthrift trust. Such a claw-back allows those assets to be pulled into the bankruptcy estate. The creditor must prove that the debtor made the transfers with the actual intent to hinder, delay or defraud a then-existing or future creditor.

I emphasize "actual intent." This 10-year period will likely be longer than any given state's applicable statute of limitations. In addition, if the creditor is successful in forcing the debtor into bankruptcy court, another advantage for the creditor is that it will have a bankruptcy trustee fighting his battle for the creditor, and the bankruptcy trustee has very broad powers and potent tools to collect and control assets.

Engel: Now, I am no physicist, but I know what matters. [Barely audible chuckle by Schoenblum.] Similarly, I am not a bankruptcy attorney, but I know it is relatively uncommon for a creditor to try to force a debtor into involuntary bankruptcy. It is not a "magic ticket." In fact, there are real risks to a creditor who uses the involuntary bankruptcy provisions under Bankruptcy Code Section 303. Under this Section, if there are at least 12 creditors, 3 creditors can join together and commence an action for involuntary bankruptcy, but only if their claims aggregate to a minimum dollar amount. If there are fewer than 12 creditors, then a single creditor can bring the action if his claim exceeds a minimum dollar amount. But the creditors must show that their claims are non-contingent and undisputed, which I am told can be difficult, and in fact can be the subject of a great deal of litigation. If they fail, under Section 303 they may have to pay the debtor's fees and costs, and they can be liable for additional, even punitive, damages if they brought the action in bad faith. I have been advised by colleagues who practice in the bankruptcy arena that because of the substantial risks associated with bringing an action for involuntary bankruptcy, involuntary petitions are not filed with frequency or regularity.

Schoenblum: In the case of *In re Smith*, 437 B.R. 817 (Bkrpt.N.D.Tex., Oct. 12, 2010), the bankruptcy court applied the "special circumstances" exception that allows an involuntary bankruptcy petition to be filed even if there are not at least three creditors signed on to it. In this case, Smith formed and funded a Cook Islands Asset Protection Trust "three days before the State Court signed the Severance Order in order to render final judgment against him." Moreover, Smith transferred "the bulk of [his] assets to the Cook Islands Trust." I know this is the type of fact pattern you abhor, and that you have for more than two decades counseled that asset protection planning is a vaccine, not a cure. You have repeatedly said that asset protection planning should be done at a time when someone is probably least likely to engage in it, which is while his or her seas are calm. In any event, in light of the facts of *Smith*, does it represent a real change in the likelihood of the application of the "special circumstances" exception?

Engel: The *Smith* case does represent another tool that a creditor can use as the creditor tries to force a debtor into involuntary bankruptcy proceedings. The motivation, as we just mentioned, would be to take advantage of the broader 10-year statute of limitations on unwinding transfers made with actual fraudulent intent, under Section 548(e) of the Bankruptcy Code.

Even before *Smith*, however, courts had fashioned a "special circumstances" exception to Section 303, so that a creditor could force a debtor into bankruptcy even if the creditor had not met the technical Section 303 requirements. These "special circumstances" can exist, I believe, if there are fraudulent or preferential transfers that involve fraud or some sort of scam by the debtor. Even here, though, the creditor is exposed to liability under Section 303 for fees, costs and additional damages if he brings an action but does not prove that the "special circumstances" exception applies. That is, if he brings an action for involuntary bankruptcy and is not successful, I presume that the creditor penalties under Section 303 will still apply. So the creditor better be sure that the facts of the case will fall within this exception.

And aside from the risk of possible Section 303 penalties, the "special circumstances" exception will not put those who engage in responsible asset protection planning at any risk. Remember that the special circumstances exception generally comes into play only where a debtor has engaged in fraud, deceit or some type of scam, which should not be the case in proper asset protection planning. Asset protection planning should not involve fraudulent conveyances. Proper asset protection involves organizing one's assets and affairs *in advance* to protect against unforeseen future risks.

Garland: Contrast that with the facts in *Smith*, which were pretty outrageous. Smith created and funded a spendthrift trust *after* a summary judgment was obtained against him, and just three days before that judgment became a final order. Smith funded the trust with nearly all of his assets, and it left him in a position where he could not pay 99% of his debts as they became due. His attorneys controlled the trust as its protectors, and its assets were used mainly to pay Smith's expenses and legal fees. The result in *Smith* is not the least bit surprising. In fact, aside from the involuntary bankruptcy, I think a fraudulent conveyance claim could have been brought under either bankruptcy law or applicable state fraudulent conveyance laws to retrieve the assets, if the claim had been brought within the applicable statute of limitations.

Schoenblum: In *Mortensen*, the court "conclude[d] that insolvency is established for purposes of Alaska's asset protection trust law if the debtor's liabilities exceed its assets, excluding the value of fraudulent conveyances and exemptions." Were you surprised that there was no discussion of equitable insolvency?

Engel: Initially I was surprised. In *Mortensen* the bankruptcy trustee's initial argument was that Mortensen's trust did not meet the statutory requirements of a protective Alaska trust, and therefore its assets should be part of the bankruptcy estate (completely aside from any 10-year claw-back). The Alaska trust statute requires that, to create a valid Alaska trust, the settlor must be financially solvent when he creates the trust.

There are generally two ways to assess solvency or lack thereof. First is the balance sheet test, which is a mathematical determination of assets less liabilities. Second is the test of equitable insolvency, whereby the determination is whether the debtor is able to pay his debts as they become due. Under the Bankruptcy Code's definitions section, a balance sheet test is used for [in]solvency. This section itself makes no reference to the test of equitable insolvency. So, on reflection, I am not so surprised.

Schoenblum: Many commentators have opined that Mortensen should not have been doing an asset protection trust in the first place and that *Mortensen* is merely a case of "egregious" facts. What were some of these allegedly egregious facts?

Garland: I can't say that, from Mortensen's point of view anyway, he should not have created an asset protection trust. After all, from his point of view, he did make it past the four-year Alaska statute of limitations unscathed. What scathed him, if I can put it that way, was the subsequent passage and then retroactive application of the ten-year Bankruptcy Code claw-back. Maybe the question should be if he should have filed for bankruptcy in 2009, for the ten-year claw-back only applies in the bankruptcy setting.

Engel: Given Mortensen's financial circumstances and motivations, our firm would likely not have accepted Mortensen as a client if he came to see us in or around 2005, or we at least would have explored a different arrangement with him; one that wasn't fraudulent as to his creditors. At a minimum, the badges of fraud surrounding his planning would have been a concern. As you know, because a court cannot read a debtor's mind to determine intent, the court has to rely on various facts and circumstances which are called "badges of fraud." The *Mortensen* court noted a number of such badges of fraud in determining that Mortensen had made his transfers with actual fraudulent intent and therefore the transfers fell within the Section 548(e) ten-year claw-back. In fact, if a creditor had sued Mortensen within the four-year Alaska statute of limitations, a court could have used the same badges of fraud to show that he had made fraudulent transfers for purposes of Alaska law.

Garland: In the years before creating the Alaska trust, Mortensen's annual income was sporadic and had dropped to an average of less than $12,000 per year. This low income level continued after the trust was created. Shortly before creating the trust, he filed a motion to impose child support against his ex-wife due to the substantial decrease in his income. In his pleading he said that the divorce had driven him into debt, and he had not recovered from the "financial carnage" of the divorce. Also before settling the trust, Mortensen received $100,000 from his mother. Rather than use the money to pay his bills, however, he transferred most of the money to the trust and used it for trust investments, and he continued to use and enjoy the real property he had transferred into the trust. The court found that he was "under water" when he created the trust. Then, during the four years *after* creating the trust, he racked up more than $250,000 in credit card debt. Facts like these are not consistent with clean hands or a proper intent in settling an Alaska asset protection trust.

Schoenblum: Bankruptcy Code Section 548(e) was enacted back in 2005. Are you surprised that a case like *Mortensen* did not come along earlier?

Engel: No. Remember that the wheels tend to turn very slowly, and it takes a long while for legal or judicial responses to evolve following a change in law.

Remember, too, that Section 548(e) comes into play only in the bankruptcy setting. I think it's safe to say that the overwhelming majority of people with creditor issues try to avoid bankruptcy, which is a pretty drastic step. In a bankruptcy, they open themselves and their finances to the complete control and scrutiny and power of the bankruptcy court. Individuals who create asset protection trusts are typically persons of some financial substance, and if faced with a creditor situation, they will more likely reach some sort of settlement with a creditor before resorting to bankruptcy. And, as we discussed earlier, filing for an involuntary against a debtor is usually not without risk nor is it an easy task.

Garland: There is another limiting factor, of course, which is that, even if a debtor who has created an asset protection trust does end up in bankruptcy, the creditor must still prove under Section 548(e) that transfers to the trust were made with the actual intent to hinder, delay or defraud an existing or future creditor. In the vast majority of cases, I believe, there will be no fraudulent transfers involved. Most individuals with the wherewithal to create and fund an asset protection trust do so with the advice and guidance of an attorney, and therefore avoid the pitfalls of making fraudulent transfers. The attorney, for his or her own reasons, will not want to be involved with assisting a client with fraudulent transfers. In this context it is important to remember that while a transfer intended to hinder, delay or defraud a reasonably foreseeable "future" creditor can be a fraudulent transfer, a transfer to protect assets from unforeseen persons who in the normal course of events happen to later become creditors is not a fraudulent transfer. Case law makes this quite clear.

Schoenblum: In your opinion, is *Mortensen* a blow to the viability of asset protection trusts, just a case with bad facts, something in between these two, or something else altogether? Indeed, what is the lasting impact of *Mortensen*?

Engel: About 20 years ago an article of mine was published in an offshore planning magazine. The article was entitled "Asset Protection Planning and Fear of Flying." The theme of the article was that an airplane going down cannot be taken to mean that man can't fly. Couple this with the basic principle of law that every legal decision is case specific and fact sensitive.

With this in mind, let's look at what there is to learn from the *Mortensen* case. The lessons are really very simple, Neil. First, choose clients carefully, recognizing that nowhere is it written that an attorney has to accept or have an answer for every case that comes in the door. Second, 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. Third, impress upon the client who becomes subject to a threat or a challenge the importance of being credible in the eyes of the court – remember, the court in *Mortensen* was not impressed with the debtor's credibility. Next, hope the law doesn't change in an adverse way after the planning is completed. Finally, if it does change, make sure you are aware of the change!

Garland: There is one issue that an Alaska court would have treated differently than the Bankruptcy Court. Under Alaska law, when a settlor funds an Alaska trust, his expressed intention to protect those assets from his potential future creditors is not to be taken as evidence of an intent to defraud. That is, it should not be one of the badges of fraud we mentioned earlier. The Bankruptcy Court determined, however, that under federal bankruptcy law the Court could disregard this provision of Alaska law, and therefore it would consider this expressed intention as a relevant fact. Some commentators jumped to the conclusion that this means that the creation and funding of an Alaska asset protection trust, which is clearly created with the intent to protect assets, is itself tantamount to a fraudulent conveyance. In the Bankruptcy Court's Motion for Consideration, though, the Court goes to some length to make clear that this is not the case, stating that it had relied on a number of other badges of fraud to reach its conclusions.

Schoenblum: We tend to hear about cases in which asset protection did not "work," but generally not about success stories. What is the standard you use to determine whether an asset protection plan worked? Have your experiences to date surpassed this standard?

Engel: Neil, asset protection first started to become a component part of mainstream estate planning around 1987 – about twenty-five years ago. It is impossible to know just how many plans have been designed and implemented since that time, but I would estimate that our office has designed and implemented approaching fifteen hundred plans. Extrapolating from that number, it would be fair and reasonable to estimate that tens of thousands of plans have been put in place by trust settlors since that time. To date, there are twenty or so reported cases, almost all of which involve improper fact patterns, that some naysayers point to time and again to support their view that asset protection trusts do not "work." If the asset protection trust does not work, where are all the reported cases?

But perhaps we should first look at what the word "work" means. In my way of thinking, a plan has "worked" if there is a challenge and if the settlor and the trust have a softer landing than they otherwise would have, in the absence of any challenge. To date, in challenges with which we have been involved as counsel, and in which the parties discharge their duties as they should, our plans have "worked" in every case. Most recently, and for example, a client settled a $5,000,000.00 judgment, and I don't mean a claim but a judgment, for $50,000.00. In the absence of any planning, he would himself have been out the full $5,000,000.00.

The naysayers should tell him his plan doesn't work.

By the way, as you might expect my CCH text <u>Asset Protection Planning Guide</u> goes into this in good detail.

Schoenblum: Barry, since you co-authored the 1989 amendments to the Cook Islands International Trust Act, many new asset protection jurisdictions have emerged. Do you favor any particular domestic and foreign asset protection jurisdictions? If so, why?

Engel: Depending on how one categorizes, thirteen states have enacted one version or another of domestic asset protection trust legislation. Our firm has designed and implemented many domestic trusts based on these statutes. These arrangements can be even all the more beneficial to individuals who either reside in a state that has the protective legislation or whose assets are located in such a state, or a combination thereof.

In terms of domestic jurisdictions, we have over the years used Nevada more than any other state. We like it for the protective legislation it has on the books, the quality of trustees available, its proactive attitude and approach toward domestic asset protection law, and how it seems to strive to make what it has even all the better.

With respect to foreign jurisdictions, we have for many years created trusts in the Isle of Man, due to their protective common law. For the greatest statutory certainty, however, we favor the Cook Islands, and have and continue to use it more than any other jurisdiction. There are a number of important considerations that lead us to use the Cook Islands. There is statutory certainty that the settlor can be a beneficiary and retain some level of control, and the Cook Island's courts do not recognize foreign judgments. They also use a beyond-a-reasonable-doubt standard if a creditor alleges fraudulent intent, they have a short statute of limitations period, and they have a statutory presumption against fraudulent intent if the settlor remains solvent following transfers to the trust. Even if certain fraudulent transfers are determined to have taken place, the Cook Islands trust itself remains valid. These items are like a laundry list of what to look for in a foreign jurisdiction. There are other factors, too, and we actually have a diagram we refer to that lists the important factors for each of the offshore asset protection jurisdictions.

Garland: Neil, we should mention that when one selects a foreign jurisdiction, there are other factors to consider. The jurisdiction should have a favorable and stable economic, political and social environment. It should have favorable tax laws, which usually means that it does not impose a tax on the assets or income of the asset protection trust. It is best to avoid a language and other cultural barriers, and there should be readily available quality professional services. The jurisdiction should have a good reputation in the global financial community. And of great importance is the availability of professional trustees who have the experience and expertise to properly administer trusts of this nature... both when the seas are calm for the client and if and as the seas become choppy due to a challenge or threat. This last point is very important.

Schoenblum: In summary form, what is the "Engel Ladder of Asset Protection Planning Tools?"

Engel: The Engel Ladder of Asset Protection Planning Tools is itself a tool of a visual nature to help clients and their planners gain perspective on the various techniques available in the asset protection arena, and on their relative efficacy. Indeed, the Ladder lists these primary tools in good-better-best fashion, in ascending order of efficacy.

So on the lower rung of the Ladder appears simple gifting followed by joint ownership of property. Toward the top of the ladder appears domestic trusts, foreign trusts, and even expatriation – a very protective tool but of little practical utility to the typical client.

Any given plan is going to involve a combination of the tools from the Ladder. I should note, though, that there is no single asset protection planning tool or technique that universally protects all of a client's assets or that is an ideal match for each and every client.

The various planning techniques on my Ladder have stayed essentially the same over the years, and in the same order. One material change, however, is due to the favorable and protective trust law we have seen evolve out of states like Nevada.

Schoenblum: Are there any trends in the use of integrated estate planning trusts on which you would like to comment?

Engel: Of course. Twenty-five years ago, there were very few estate planners offering or perhaps even able to discuss asset protection techniques to clients. Since then, asset protection has not only become mainstream planning, but is an important objective for a large number of clients. It could even be said that an estate planner that does not either educate his or her clients as to planning techniques designed to protect family wealth or specifically excludes it from the scope of the engagement is open to a claim for malpractice should something happen someday that diminishes the size of the client estate.

So, today there are now many more practitioners delving into asset protection for and on behalf of their clients.

Garland: Another trend is the acceptance this type of planning has gained in the planning community and beyond, as evidenced by 13 states since 1997 enacting asset protection-style trust legislation. This is also evidenced by professional organizations such as the American Bar Association having a Subcommittee on asset protection planning. Another bit of evidence is the extent to which articles on concepts and techniques today appear in legal and other professional journals.

Engel: Of course, with the number of plans ever-increasing, and with their facts differing dramatically but in some cases including the egregious facts we tend to read about in reported decisions, there is also an increase in the number of challenges, and the number of cases that generate discussion among trust and wealth planners. This is not a bad thing by any means, for even when egregious facts are involved, there are lessons to be learned or at least reinforced that, when all is said and done, help to define what it takes to design, implement, and run a proper planning structure.

Schoenblum: Barry and John, thank you for your time and insights. This has been most enlightening.

Garland: Thank you, Neil.

Engel: It has been our pleasure.

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