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**ASSET PROTECTION PLANNING**

What is Asset Protection Planning? Asset Protection Planning is part of an individual's or family's overall wealth preservation strategy that attempts to minimize the exposure of personal and family assets to the claims of creditors.

Why should an individual have Asset Protection Planning? Many individuals and families are in positions (whether it be engaged in certain professions or certain business activities) that create wealth. Increased risk and exposure to creditor claims is a common occurrence to individuals creating and maintaining wealth.

How is Asset Protection Planning achieved? Through the use of a variety of techniques utilizing business entities, such as corporations, limited liability companies or limited partnerships, as well as trust arrangements. The situs of these various entities can be U.S.-based in states with laws favorable to asset protection techniques.

**ASSET PROTECTION PLANNING OVERVIEW**

**A. Fraudulent Conveyances**

There are growing concerns over the ethical exposure and personal liability of an advisor who actively assists a client in making a fraudulent conveyance. Questions then arise as to how the attorney would know if the client has advised him of any expected claims against the client. The attorney must make all reasonable efforts to learn everything about his client's situation, which should include a current financial statement prepared by client's accountant, a statement from the client relating to all representations he has made to the attorney, and even an electronic search has been suggested using the client's name to search out any possible suits in which the client has been named.

Attorneys considering the use of an asset protection trust are advised to require his or her client to complete in writing a statement of solvency, in which the client affirms that he or she (i) has no pending or threatened claims; (ii) is not presently under investigation of any nature; (iii) is not involved in any administrative proceeding; (iv) is not aware of any situation in which the client has reason to believe will develop into a legal problem in the future; (v) following any transfers to the offshore trust the client intends to remain solvent and able to pay his or her reasonably anticipated debts as they become due; and (vi) none of the assets which the client may transfer were derived from "specified unlawful activities" under the Money Laundering Control Act of 1986.

The unlawful activities under the Money Laundering Control Act of 1986 commonly consist primarily of drug-trafficking offences, financial misconduct and environmental crimes. Drug-trafficking offenses include the manufacture, importation, sale, or distribution of controlled substances; the commission of acts constituting a continuing criminal enterprise; and transportation of drug paraphernalia.

Financial misconduct includes the concealment of assets from a receiver, custodian, trustee, marshal, or other officer of the court, from creditors in a bankruptcy proceeding, or from a statutory corporation or similar agency or person; the making of a fraudulent conveyance in contemplation of a bankruptcy proceeding or with intent to defeat the bankruptcy law; the giving of false oaths or claims in relation to a bankruptcy proceeding; bribery; the giving of commissions or gifts for the procurement of loans; theft, embezzlement, or misapplication of bank funds or funds of other lending, credit, or insurance institutions; the making of fraudulent bank or credit institution entries or loan or credit applications; and mail, wire, or bank fraud or bank or postal robbery or theft.

Environmental crimes include violations of statutory or regulatory laws. Other specified unlawful activities in such legislation could include counterfeiting, espionage, kidnapping or hostage-taking, copyright infringement, entry of goods by means of false statements, smuggling, removing goods from the custody of customs, illegally exporting arms, and trading with a country's enemies.

To the extent any legal disputes or other problems exist, they should be disclosed in the statement of insolvency, and the statement should provide that either sufficient assets will be retained by the client to satisfy any liability resulting from the problems, or the documents should be drafted with provisions requiring that any liability arising from the disclosed problem(s) be satisfied by the foreign asset protection trust if the liability is finally and legally established and not otherwise satisfied.

## **B. Domestic Asset Protection Trusts**

### **1) Domestic Arrangements**

#### **a) Joint Ownership of Property.**

- i) Generally, the creditor of one spouse cannot make a claim or attach assets that are jointly titled in the names of both spouses.

#### **b) Formation of a Corporation, Limited Liability Company (“LLC”) or Limited Partnership (“LP”).**

- i) Owners of corporations (shareholders) and LLCs (members) generally enjoy limited personal liability. Limited partners of LPs enjoy similar protections.

- ii) So long as the required legal formalities are observed (such as regular minutes and the segregation of assets from the individual owners), the statutory limitations on owners' limited personal liability for the obligations of the entities are generally observed.
  - iii) In multiple-owner situations, such as family LPs or LLCs, buy-sell arrangements can minimize the risks of involuntary transfers of the individual owners' ownership interest. For example, if a creditor obtains a judgment against an individual limited partner of an LP or an LLC member, contractual buy-sell restrictions can limit or eliminate distributions to an involuntary transferee of the ownership interest.
- c) **Trust Arrangements.**
- i) In recent years several states (including Alaska, Nevada, South Dakota and Delaware) have enacted legislation permitting self-settled spendthrift trusts. The spendthrift provisions (insulating the assets of the trust from creditor claims) of such self-settled trusts are accorded statutory validity and enforceability so long as the transfers into the trust were not fraudulent conveyances.
  - ii) Historically, spendthrift provisions in trusts were generally only enforceable against the creditor of a trust beneficiary when the underlying trust was created for the benefit of the beneficiary by another person. For example, the spendthrift provisions in a testamentary trust created in a parent's Will for the benefit of a son or daughter would generally protect the son's or daughter's beneficial interest in the trust assets from any claims of such son's or daughter's creditors.
  - iii) Individuals and circumstances that may benefit from an asset protection trust may include:
    - 1) Professionals concerned about professional liability and malpractice claims.
    - 2) Corporate officers and directors concerned about shareholder derivative suits or securities claims.
    - 3) Individuals receiving significant gifts or inheritances; those considering premarital planning.

- 4) Families with a member with special needs.
  - 5) Recipients of large personal injury or other damage awards.
- iv) The settlor of the trust must establish the trust at a time when the settlor has no existing or foreseeable creditors or claimants. Preexisting claims or knowledge of potential unasserted claims would likely make the arrangement a fraudulent conveyance.
- v) Because the state laws which authorize the arrangements are relatively recent, domestic asset protection trust arrangements (with self-settled spendthrift trusts) face continuing challenges in the courts. Whether a court in one state will honor the jurisdiction and state law of state under which the trust is formed (e.g., Delaware) remains uncertain.
- d) **Delaware Asset Protection Trusts.**
- i) Basic Requirements of the trust:
    - 1) Trust document must specifically incorporate the Delaware asset protection law.
    - 2) Trust must be irrevocable.
    - 3) Trustee must be a Delaware trust company or an individual resident of Delaware. Non-Delaware co-trustees are permitted.
  - ii) The Grantor of the trust may retain the following rights and powers:
    - 1) Power to veto distributions.
    - 2) Limited testamentary power of appointment.
    - 3) The right to receive distributions of principal or income (either in sole discretion of the trustee or at the direction of a distribution advisor).
    - 4) The right to serve as the investment advisor to the trust.

- 5) The right to appoint a trust protector to exercise certain powers over the trustee.
  - 6) The right to appoint a distribution advisor to direct distributions from the trust by the trustee.
- iii) The Grantor may not:
- 1) Serve as trustee.
  - 2) Direct distributions.
  - 3) Have the right to a return of the trust assets (i.e., irrevocable transfer).
- iv) Tax Considerations.
- 1) No Delaware state income tax for nonresident grantors and beneficiaries.
  - 2) Trust may be structured as a grantor trust or nongrantor trust for federal income tax purposes.
  - 3) The grantor can avoid making a completed (i.e., taxable) gift to the trust if the trust provides that the grantor retains a testamentary power of appointment.
- e) **Multiple Entity Arrangements.**
- i) To maximize protections against claims, a combination of entities may be utilized in the construction of an asset protection plan.
  - ii) A grantor can form an LLC in a favorable jurisdiction, such as Nevada. The grantor would capitalize the LLC with the assets earmarked for protection taking back a 100% ownership interest in the LLC.
    - 1) In Nevada, for example, there is no state income tax and the costs associated with the formation of an LLC are reasonable.

- 2) The grantor may be the manager of the LLC with authority to manage the assets of the LLC under the operating agreement.
- iii) The grantor would also establish an asset protection trust under the laws of a state with asset protection trust legislation, such as Delaware, funding the trust with the 100% ownership interest in the LLC.
  - 1) The Delaware trust would become the sole member of the LLC while the grantor remained manager of the LLC.
  - 2) The arrangement provides a multi-layered protection from potential future claim.

### **C. Changing Trust Situs**

The trust instrument may contain a provision that will allow the trustee to change the situs and governing law of the trust. The trustee may transfer the trust's situs to another jurisdiction if either immediately before or immediately after the proposed transfer:

- 1) A trustee's principal place of business is located in or a trustee is a resident of the proposed jurisdiction;
- 2) All or part of the trust administration occurs in the proposed jurisdiction;  
or
- 3) One or more of the beneficiaries resides in the proposed jurisdiction.<sup>1</sup>

The trustee shall notify the qualified beneficiaries of a proposed transfer of a trust's situs at least 60 days before the date as of which the trustee intends to change the situs. The notice of the proposed transfer must include the following:

- 1) The name of the jurisdiction to which the situs is to be transferred.
- 2) The address and telephone number at the new location at which the trustee can be contacted.
- 3) The reasons for the proposed transfer.
- 4) The date on which the proposed transfer is anticipated to occur.

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<sup>1</sup> 20 Pa. C.S.A. § 7708(c).

- 5) A statement that if the situs is changed as the trustee proposes, venue will thereafter be in the county of the new situs consistent with section 7714
- 6) The name and address of the court before which judicial actions involving the trust will be heard after the situs is changed as the trustee proposes.
- 7) A statement that the change in situs will occur only if all qualified beneficiaries of the trust consent in writing to the change.<sup>2</sup>

A trustee may transfer a trust's situs under this section without court approval if all the qualified beneficiaries of the trust consent in writing to the change.<sup>3</sup> A court having jurisdiction of a testamentary or inter vivos trust, on application of a trustee or any party in interest, after such notice as it shall direct and aided if necessary by the report of a master, and after such accounting as the court shall require, may direct, notwithstanding any other provision of this chapter, that the situs of the trust shall be changed to any other place within or without this Commonwealth if the court shall find the change necessary or desirable for the proper administration of the trust.<sup>4</sup>

Sample language of this provision could include: "The situs of the property of this trust may be maintained in any jurisdiction. The trustee may transfer the situs of the trust at any time to any jurisdiction. Upon any such transfer, the trustee may elect to have the trust be administered under the laws of the jurisdiction to which it is transferred."

#### **D. Foreign Asset Protection Trusts**

Offshore trusts are very useful in protecting an individual's assets against the claims of potential future creditors. This result can be attributed to the separation of the legal ownership of such assets (which lies with the trustee of the trust) from the beneficial ownership of the assets (which generally remains with the client, who is the grantor or creator of the trust). As beneficial owner, the grantor/beneficiary of the trust retains the right to the use of the principal and income of the trust fund in accordance with the terms of the governing trust document. However, since the grantor/beneficiary no longer has legal title to the assets in the trust, such assets are outside of the reach of the grantor's creditors.

This protection is also due to the fact that most offshore trusts are irrevocable. As such, the grantor of the trust does not have the right to alter, amend or revoke the trust. While this may seem like a disadvantage due to the lack of control given the grantor once the trust is created and funded (although this disadvantage is lessened as discussed below), it also provides a benefit, since the grantor's lack of control will refute a creditor's claim that the trust is simply an extension of the grantor and therefore should be subject to attachment. Compare this situation with a scenario where the trust is revocable, and therefore provides the grantor the right to alter, amend or revoke the trust.

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<sup>2</sup> 20 Pa. C.S.A. § 7708(d).

<sup>3</sup> 20 Pa. C.S.A. § 7708(e).

<sup>4</sup> 20 Pa.C.S.A. § 7708(g).

In that situation, a creditor may be able to successfully claim that since the grantor has so much control over the trust, the trust is simply an extension of the grantor and therefore subject to the claims of the creditor.

As inferred above, the fact that the trust is irrevocable should not be of concern. Most international trusts, even if irrevocable, permit the grantor (or someone appointed by the grantor, who is usually referred to as a “protector” of the trust) to retain the power to replace the trustee if the trustee’s decisions are not within the grantor’s desires concerning the trust, or if the management of the funds and assets of the trust are not in accordance with the grantor’s wishes. This power to replace the trustee ensures that the trustee will, except in extreme circumstances, always follow the directions and desires of the grantor.

Offshore trusts also provide protection due to the simple fact that the trust is located offshore. Creditors are not willing to undertake the time, effort and expense necessary to even attempt to attach the trust. The mere fact that the trust is a foreign entity will have a definite impact on a creditor’s decision whether to institute suit in the first place and on how far the creditor is willing to go to chase assets. Simply put, if a creditor obtains a judgment in the United States against the grantor, the creditor would then have to have the judgment transferred to the offshore jurisdiction, and then begin legal proceedings to attempt to attach the trust estate. Such proceedings would be extremely costly and time consuming. Further, even if such attachment is attempted, most offshore jurisdictions have trust laws that severely restrict the ability of a creditor to attach the trust estate. Some jurisdictions will not recognize a foreign judgment and will require a creditor to re-litigate the merits of the claim in the courts of the offshore jurisdiction. Finally, even if attachment is successful, most trust documents provide that in the event of any action that might threaten the trust estate, the trustee is permitted to resign and transfer the trust estate to another trustee located in another offshore jurisdiction, thereby forcing the creditor to have to start attachment proceedings again in the new jurisdiction. Based on the foregoing, offshore trusts provide extensive protection from an individual’s creditors.

However, it should be noted that such protection will not apply in all situations. Many jurisdictions have enacted fraudulent conveyance statutes that provide for negation of transfers made to defraud creditors. This would apply to offshore trusts if the trust was created and funded after the grantor incurred personal liability. For instance, if a transfer to an offshore trust occurs after litigation is commenced; the judgment creditor may be successful in having the transfer set aside. Offshore trusts may also be set aside if the transfers to such a trust result in the grantor being adjudicated bankrupt. It should be also pointed out that such fraudulent conveyance statutes provide for civil, as well as criminal liability for the debtor and his advisers who undertake such fraudulent conveyances. Therefore, an offshore trust should not be used as a means to defraud creditors. For the client who has pending, threatened or anticipated legal problems, an offshore trust is not the answer. In this way, offshore trusts are often described as a vaccine, but not a cure.

Due to its asset protection features, offshore trusts are often used as part of an overall estate plan for professionals who may be subject to personal liability for their professional negligence, such as doctors, lawyers or architects. Often the cost of establishing and administering an offshore trust is more cost effective for the professional than obtaining and maintaining high levels of professional liability or “errors and omissions” insurance.

In addition to providing protection from creditors, an offshore trust provides other benefits as well. For instance, it is also often used as a vehicle for making gifts both during life and at (or after) death.

Offshore trusts allow the creator of the trust to dictate when such gifts take effect, as well as provide for interim safekeeping and management. Specific additional uses of such trusts include:

- 1) **Will Substitute.** The trust owner or grantor can provide for gifts to beneficiaries to take effect at or after death.
- 2) **Risk of Bankruptcy.** Individuals embarking on ventures with a high risk of bankruptcy may act to immunize some assets, provided the trust is established in advance of undertaking the venture.
- 3) **Equitable Distribution Protection.** Affluent spouses, fearing the new and drastic reach of “equitable distribution” in modern divorce cases, may want to set aside assets in offshore trusts. However, it should be pointed out, that how tolerant the courts will continue to be of this in today’s social climate remains to be seen.

Once a decision is made to undertake the establishment of an offshore trust, the next step is to then determine in what jurisdiction the trust will be created and who will be the trustees.

With regard to the jurisdiction, it is generally desirable to seek a jurisdiction having a lower tax base than the United States. At the present time, there are approximately 40 acceptable jurisdictions in the world having legislation designed for offshore trusts with a lower tax base than the United States, (generally that tax base is from 0% to 2%). The most commonly used jurisdictions by United States’ citizens and residents are the Cook Islands, the Isle of Man, Jersey, Guernsey, the Cayman Islands, Vanuatu, Panama, Barbados, Belize, Nevis, Bermuda, Gibraltar, and Turks & Caicos. These jurisdictions represent approximately 85% of all entities used by citizens or residents of the United States. The decision of which jurisdiction to utilize will depend on many factors, and is usually determined after a review of the types of activities in which the trust will be involved.

With respect to trustees, as in any decision where independent trustees are utilized, the variations are numerous. Depending on the flexibility and work required, the

trustee can be as small as a one person firm or as large as a multi-national firm with offices in literally every available jurisdiction. This area is generally decided upon after a review of the types of trust activities that are anticipated.

Other considerations in the selection of a jurisdiction and trustee include:

- 1) the trust laws of the jurisdiction and certainty of their applicability;
- 2) accountability of the trustee;
- 3) competency and honesty of trustees and counsel;
- 4) political stability of the country of origin;
- 5) language barriers;
- 6) costs;
- 7) accessibility and location in relation to United States;
- 8) facilities and infrastructure of situs; and
- 9) flexibility in trust laws.

Finally, it should also be noted that the creation of an offshore corporation is often used in conjunction with an offshore trust when asset protection is the primary goal. Specifically, the offshore trust often is used to capitalize an offshore corporation, which then uses such capital to invest in a wide variety of potential investments. The shares of stock of the offshore corporation are held as an asset of the international trust. There are many technical reasons for utilizing an international corporation, but suffice it to say, it is the most efficient and effectively used vehicle for establishing both tax benefits and greater asset protection. Greater asset protection is achieved due to the additional layer of separation between the invested assets and the grantor of the trust. As in the decision with regard to choosing the trustees and the jurisdiction of the trust, the same decisions must be made with regard to the directors and the jurisdiction of the corporation. It is very possible the selected jurisdiction will also have corporations or individuals who are licensed in those jurisdictions to act as directors thereby enabling the jurisdiction chosen for the corporation to be the same as the jurisdiction chosen for the trust.

