The Illusory Asset Protection Of LLCs And The Eroding Asset Protection Of Trusts

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I. INTRODUCTION

A. Asset protection has been part of estate planning for as long as there has been an estate planning discipline. After all, trusts for family members are created in most instances to preserve and protect property for the future use and benefit of family members. The third party created trust has been a cornerstone of asset protection planning for, literally, hundreds of years.

B. With increasing accumulation of wealth comes increasing concern about losing that wealth. As a result, the emphasis on asset protection has increased over the past twenty years. There is no doubt that the interest of clients has been fed by the legal and financial professions. Anyone who focuses his or her practice on asset protection needs to generate business. Anyone who simply speaks or writes on the topic tries to justify its importance. The result is a certain amount of engagement by the professionals in "fear tactics." For example, consider the following quote from the Illinois Institute of Continuing Legal Education ("IICLE") book, Asset Protection Planning:

"Over the past 20 years, however, various societal factors have unleashed many new threats against personal wealth. There has been an exponential rise in the number of lawsuits filed. New subjective injuries such as emotional and psychological distress. Juries are also more willing to impose punitive damages than in the past. . . ."

"As asset protection planning has become more common and is viewed in a more favorable light, a number of commentators have suggested that the pendulum of public opinion may swing completely to the other side and estate planning attorneys may now have a duty to include asset protection planning as a standard part of the services they provide to their clients. Once commentator has gone as far as to state that the "failure to so advise a wealthy or at risk client may constitute malpractice if the client's assets are needlessly exposed to a subsequent judgment or other legal claim" (Mario A. Mata, *Asset Protection Planning for the Family Business Owner*, Estate Planning For The Family Business Owner (ALI-ABA July 2005), ..."

C. The fervent selling of the need for asset protection is one discussion point in the larger debate about the proper role of asset protection in clients' estate plans and whether certain planning techniques are being overused or incorrectly relied on by attorneys and clients alike.

D. These materials explore these questions with respect to two distinct aspects of estate and asset protection planning - the use of Limited Liability Companies ("LLCs") as an asset protection device and the protection provided by third party created trusts in divorce.

II. LIMITED LIABILITY COMPANIES

A. Most business entities available under U.S. law are designed to limit the liability of owners in certain ways, but only one puts that purpose in its name - the Limited Liability Company, or LLC.

B. The LLC was developed as an alternative to the limited partnership, and the two remain closely connected - indeed for federal income tax purposes, they are identical, both being taxed as partnerships.

1. The limited partnership developed as an attractive form of doing business because it combined the following features:

    a. Limited liability of its limited partners - limited partners could not be liable for the debts and obligations of the entity;

    b. Flow-through income tax treatment; no double taxation as with C corporations;

    c. No limitations on the persons or entities that can own interests, unlike an S corporation.

2. The drawback of a limited partnership is that it requires a General Partner, and the General Partner does not have limited liability. This means a limited partnership must either have one or more individuals willing to accept the potential liability of being a General Partner, or a second entity (typically a corporation) must be created to act as General Partner.

C. The LLC first became available in Wyoming in 1977. Every state now has a separate LLC statute. It provides all the favorable attributes of a limited partnership, without the need for a General Partner. In effect, all the LLC members are limited partners. It also provides more flexible options for management and control. An LLC can be managed by the Members or one or more Managers (who may or may not be Members). Members can be given voting or non-voting status, and can (but are not required to) have the power to remove and replace the Manager.

D. Initially, there was some reluctance to use LLCs, not only because statutes had not been enacted in every state but because of uncertainty about federal tax status.

1. In 1988, the IRS first publicly ruled that an organization formed as an LLC was properly classified as a partnership for federal income tax purposes. See Rev. Rul. 88-76, 1988-2 C.B. 360.

2. It is now clear that LLCs (other than single member LLCs) can elect treatment as a partnership for federal tax purposes as the default, without concern about challenge from the IRS. See Treas. Reg. §§301.7701-1 to 301.7701-6.

E. LLC statutes generally contain the following types of provisions which provide protection quite similar to the protection afforded by a limited partnership:

1. A member's interest in an LLC is personal property and is not an interest in specific assets of the LLC;

2. An assignee will not become a member of the LLC without the unanimous consent of the other members; and

3. An assignee who is not a member is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LLC.

F. The LLC plays two distinct roles in asset protection planning.

1. Internal: the LLC is designed to trap business or asset liabilities inside the entity, so that a member does not become personally liable for such liabilities.

2. External: the LLC insulates its assets from the creditors of individual members, and can serve a purpose in protecting the assets of the members.

III. MISCONCEPTIONS ABOUT INTERNAL LIABILITY PROTECTION OF LLCS

A. With respect to internal liabilities, the LLC is like any other commonly used business entity (corporation or limited partnership). If properly operated, and absent other contractual obligations entered into by the members, the members of an LLC will not be liable for debts and liabilities of the LLC.

Example 1: George has purchased both a small apartment building and two single family residential lots, each with a small bungalow on it. He plans to renovate the apartment building and rent the units. He also plans to tear down the two homes and build one larger home on the lots, which he then will sell. George's attorney advises him to create two LLCs, one to own the apartment building and one to own the two lots. Each LLC will borrow funds if necessary, enter into contracts with contractors and other vendors, and for the apartment building enter into leases with tenants. Any liability related to debts, injury or damage during construction, or injury to a tenant or visitor to the property should be trapped in the LLC.

Example 2: Jane opens a children's clothing store. On the advice of her attorney, she creates an LLC to own the business. The LLC enters into the lease for the store and contracts with wholesalers of the clothing. The LLC employs the store employees. Any liabilities of the business, including claims of an employee, vendor, or customer, should not reach Jane personally.

B. The liability protection provided by an LLC in these situations is important. But in practice it often is not as complete as one would hope.

1. Banks and other financial institutions that lend to the LLC often will demand personal guarantees from the principal member or all the members.

2. A claim against the LLC may also involve a claim against the member. For example, George may be accused of negligence in personally buying shoddy materials, or Jane may be accused of negligently failing to do a proper background check on an employee, who then harms a customer.

C. Many professional advisers gloss over these distinctions in recommending LLCs for the assets of wealthy clients.

1. An LLC clearly is appropriate for business activities, activities that involve employees, or for ownership of assets that inherently involve risk.

2. A client that acquires a complex asset such as a large yacht that will have a crew should acquire and hold the asset in an LLC. The LLC should both own the boat and employ the crew.

3. Likewise, rental properties or other non-personal use real estate should be owned by LLCs. For example, a client that owns rural property that he uses for hunting, where he allows friends and colleagues to use the property, would be well-advised to own it in an LLC.

D. In other situations, the LLC sounds like a good idea but is likely to provide little or no protection.

Example: Paul and Pricella purchased a vacation home on a lake last year. They are in the process of acquiring a jet ski to use on the lake and two snowmobiles to use on the property during the winter. They are advised to place ownership of each item in a separate LLC in order to protect them from liability should there be an accident with any of the items.

1. The use of LLCs in this instance may do nothing more than create a false sense of security. Any liability arising from use of the jet ski or a snowmobile is almost certainly going to be based on the alleged negligent operation of the vehicle by Paul, Pricella, one of their family members, or someone who is using the vehicle with their permission. The LLC will not provide any protection against claims of negligent operation or negligence in failing to supervise the person who was operating it.

2. Proper asset protection planning in these situations should involve counseling on adequate insurance coverage, and, if necessary, advice on ground rules for use and operation of the vehicles.

IV. EXTERNAL LIABILITY PROTECTION PROVIDED BY LLCS

A. Both an LLC and a limited partnership provide protection against creditors of a member or partner who are seeking assets to satisfy a debt or judgment. The protection derives from the limited rights granted to the assignee of a member or partner. The protection is largely based on state statutes.

B. For a limited partnership, almost every state enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"), which was promulgated by the National Conference of Commissions on Uniform State Laws in 1976 and amended in 1985. RULPA restricted the rights of a creditor of a limited partner by limiting the remedy available to that creditor.

1. Under section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. An assignment does not dissolve the limited partnership or entitle the assignee to become or exercise any of the rights of a limited partner.

2. Under RULPA, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. See section 703 of RULPA.

C. The creditor protection provisions of the Revised Uniform Limited Liability Company Act ("RULLCA") were patterned after RULPA, but with greater detail. (The National Conference on Uniform Laws replaced RULPA with a new Uniform Limited Partnership Act in 2001. The new Act in turn incorporated much of the more detailed provisions of RULLCA, including the specific provisions about foreclosure on a transferee interest. The new ULPA has been adopted in whole or in part in 18 states and the District of Columbia. Illinois is one of those states.)

D. Most state LLC statutes contain charging order sections similar to that found in the RULPA or the RULLCA.

E. Arizona's LLC statute provides as follows:

Arizona (Ariz. Rev. Stat. §29-655)

Rights of judgment creditors of a member

"A. On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's interest in the limited liability company with payment of the unsatisfied amount of the judgment plus interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member's interest.

B. This chapter does not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company.

C. This section provides the exclusive remedy by which a judgment creditor of a member may satisfy a judgment out of the judgment debtor's interest in the limited liability company."

F. Delaware also follows the general approach of the Uniform Act, but with a very important change. In Delaware, there is no right to foreclose on the interest under the statute. The charging order is the exclusive remedy. Several other states have followed this approach. See de. Code tit 6 §18-703.

G. The statutory limits on remedies for a creditor of an LLC provide several clear advantages.

1. The creditor is only an assignee of the member's interest and has no right to participate in the management of the entity or to vote.

2. The effect of the charging order is that a member's creditor will only receive those LLC distributions which, absent the charging order, would have been distributed to the debtor member.

a. Of course, if the debtor is a member in a widely-held LLC that makes regular distributions, the charging order may be an effective means for a creditor to collect upon a judgment.

b. However, in a family or other closely-held LLC in which a relative of the debtor has control over distributions and in which distributions may be made infrequently and in very modest amounts, the creditor may find the charging order to be an unattractive remedy.

3. A charging order is a lien only on partnership distributions. Some commentators point out that it may be possible to enable the debtor member, or other family members to pull cash or assets out of the entity through loans, salary, or guaranteed payments, without including the judgment creditor. *See, e.g*. Stein, Practical Primer and Radical Approach to Asset Protection 38 Estate Planning No. 6, at 25 (June 2011). Certain commentators go further and state that the agreement could permit distributions that are not proportionate to the ownership interests. *Id*. at 26.

4. The foreclosure remedy granted in LLC statutes is unattractive because the purchaser obtains only the assignee interest, and therefore no greater rights than the creditor had. The creditor will not receive much for the interest. *Id*. at 25.

5. Delaware and several other states have eliminated the foreclosure remedy and provided that the charging order is the sole and exclusive remedy available to a judgment creditor.

6. In a family entity, the family can build on the unsatisfactory nature of the charging order remedy by including provisions in the agreement that trigger purchase options in the other members when one member's interest becomes subject to a charging order or that member declares bankruptcy. Typically, the purchase options are at a deep discount from the net asset value of the LLC interest. This allows the member to take the creditor out of the picture entirely, while preserving the underlying LLC assets to the maximum extent possible.

7. The tax treatment of a charging order also may discourage a creditor from going after an LLC interest. Many tax practitioners believe that the income tax effect of a creditor obtaining a charging order is to cause the creditor to become liable for that LLC interest's share of the LLC income, even if no distributions actually are made by the LLC. See Rev. Rul. 77-137, 1977-1 C.B. 178 (assignee of limited partner's entire interest is taxed on distributive share of partnership income even if not a substituted limited partner).

   a. Some commentators have questioned whether a creditor with a charging order can be equated with an assignee of an entire partnership or LLC interest. Local law may determine how the holder of the charging order is to be treated for tax purposes.

   b. In family situations in states in which the law is not clear, the manager could take the position that the charging order does burden the creditor with a share of the taxes, in order to encourage the creditor to accept a reduced amount in satisfaction of the debt.

H. Clearly, these attributes provide significant benefits in negotiating with the creditor of an LLC member. Plaintiff's attorneys acknowledge that they do not like to expend time and energy going after illiquid and difficult to collect assets.

1. In fact, plaintiff's attorneys say that tort and professional malpractice judgments rarely result in collection of significant amounts from a defendant's personal assets. They are interested primarily in the insurance. In both pre-trial settlement and post-judgment settlement, the availability of insurance will dictate the amount collected in the majority of suits.

2. Is it true that the threat of going after one's personal assets is used all the time — as a negotiating tactic and a way to gain leverage against the insurance carrier (the party that usually is running the defense) and its lawyers. The actual incidence of verdicts that seriously threaten one's personal wealth is greatly exaggerated according to the plaintiff's bar.

3. Thus, in some respects, LLC structures may be protecting against a threat that does not exist or is far less significant.

I. Moreover, as with professional advice on the internal liability protection of an LLC, the professional who emphasizes only the favorable attributes discussed above and touts the LLC as a cure-all for asset protection does the client a disservice. In fact, too much reliance on the LLC for asset protection could make it less effective not more.

1. There are significant practical consequences to having a judgment creditor make a legal claim against a member's LLC interest.

2. There also are aspects of the law that are not favorable to LLCs. The asset protection features of an LLC do not work in all legal forums. Not surprisingly, courts sometimes do not follow the strict letter of the statutory law, in particular where the court decides it would create an inequitable result.

J. Practical Consequences of a Charging Order Against An LLC Interest

Example: Samuel, his wife, Wanda, created an investment LLC for the family 15 years ago. They contributed several rental properties owned by the family and significant marketable securities. When a trust created by Samuel's parents terminated several years ago, he convinced his children to contribute the assets they received outright, consisting of marketable securities and a family vacation home, to the LLC. As a result of these contributions and a gifting program by Samuel and Wanda, the children each own a 22 percent in the LLC outright. Samuel and Wanda own about 10 percent and the remaining 24 percent is held by various irrevocable trusts. The family administers the LLC with great care and follows the advice of their professional advisers. For example, they have a rental arrangement for the vacation home; no one in the family receives free use of it.

Samuel's son, Baxter, started his own investment firm several years ago. Things went badly for Baxter, and he committed some major mistakes in trying to keep the firm solvent. The firm failed, he was indicted by the federal government for securities violations and numerous claims were brought against him by individual investors. Assume that Baxter's judgment creditors now have judgments against him and several are seeking satisfaction in part from his LLC interests.

1. The creditors who obtain a charging order against Baxter's LLC member interest become assignees only and will receive only that member interest's share of those distributions which the LLC decides to make.

    a. What if the LLC was planning on a significant distribution because of needs of certain other LLC members?

    b. What if the LLC routinely makes annual distributions of the income from the rental properties?

2. The income tax consequences of holding the assignee interest and being allocated a share of the LLC income each year are unattractive to a creditor. They are equally unattractive to the other LLC members, who may have become dependent on tax distributions from the LLC.

    a. Suppose that the LLC interest is the only asset held in one or more of the irrevocable trusts and that one or more of the trusts are separate taxpayers, not grantor trusts. The only source of cash for tax payments for those trusts is the LLC.

    b. Assume that Baxter's violation of the federal securities laws allowed the federal government to seize assets, and it has the charging order on Baxter's LLC interest. The government will not care about the income tax consequences of the charging order. It may not be compelled to negotiate a quick and favorable buy-out to liquidate its claim.

3. Purchase options that are triggered upon the involuntary transfer of Baxter's interest do provide a way for the family to terminate the interests of the assignees.

    a. The discounts at which the LLC allows the family to purchase the interests may be significant. This clearly is a benefit. But the discounts will not be 100 percent, and in most instances they do not exceed 50 percent, because no family member at the time of formation wants to see their equity investment lost for too low a price.

    b. The purchase option solution does not protect Baxter's assets and may not protect all the assets of the LLC. If the purchase options are exercised, Baxter will have lost his interest in the LLC, and, because it was purchased at a discount by the LLC or other family members, his remaining judgment debt remains higher. The LLC may have to liquidate some investments to accomplish the buy-out.

    c. Samuel and Wanda could take steps in their estate plan to try to restore what Baxter lost, but, as a practical matter, it seems unlikely that either Samuel and Wanda, or Baxter's siblings will feel much sympathy for Baxter. Most siblings will not be interested in having their future inheritances reduced to restore a sibling's lost wealth.

4. The other members could use loans from the LLC to deal with cash flow issues. But, the family must be conscious of the estate planning purposes of the LLC. The frequent use of loans may weaken arguments for valuation discounts for federal estate and gift tax purposes. For the same reason, the idea of amending the agreement to permit disproportionate distributions may be a non-starter.

K. Federal Bankruptcy Law

1. The benefits that an LLC might provide in dealing with a judgment creditor do not carry over completely to a bankruptcy situation. If the judgment debtor declares, or is forced into, bankruptcy, then several protective measures may not be available.

2. The charging order is a remedy imposed by state law. Commentators have said that the public policy behind the remedy is to "balance a judgment creditors rights against the desire to avoid a disruption or liquidation of the LLC's business." *Forsberg Asset Protection and the Limited Liability Company* Probate & Property, 39, 40 (Nov./Dec. 2009). This public policy balancing has a slightly different tilt in bankruptcy.

3. In one bankruptcy case, *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005), an LLC member who owned less than all of the LLC declared bankruptcy. The trustee sued the LLC, claimed that the LLC was diverting and misapplying assets, and sought to be treated as a substitute member.

   a. The court held that the bankruptcy trustee had all the rights and powers of that the debtor/member had at the commencement of the case. The trustee took the debtor's full membership interest.

   b. The court also held that §541(c)(1) of the Bankruptcy Code negated the provision of Arizona law and the operating agreement that would take away the trustee's non-economic rights and treat the trustee as an assignee. The court appointed a receiver and stated that the receiver could, if necessary cause the LLC to be dissolved and liquidated in order to satisfy the claims of creditors.

4. Similarly, in *In re Smith*, 185 B.R. 285 (Bankr. S.D. Ill. 1995), the court held that a bankruptcy trustee assumed all the rights of the bankrupt limited partner, and therefore could maintain a suit to dissolve the partnership on the grounds that it was not carrying on a business.

5. The Bankruptcy Code provision referred to above, §541(c)(1), provides as follows:

   "Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2) or (a)(5) of this section, notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law —

(A) that restricts or conditions transfer of such interest by the debtor; . . . .”

a. This provision can negate a term in the LLC operating agreement that purports to convert a member’s interest to an assignee interest upon the filing of a bankruptcy petition. It also could prevent a purchase of the interest under a purchase option provision.

b. These provisions will be negated unless the operating agreement is treated as an “executory” contract. In federal bankruptcy law, a contract is treated as executory when “the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.” Forsberg, supra, at 41, quoting Countryman, *Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439 (1973).

c. Most courts conclude that an LLC operating agreement or limited partnership agreement is not executory. See *In re the IT Group, Inc.*, 302 B.R. 483 (D. Del. 2003); *In re Smith*, 185 B.R. 285 (Bankr. S.D. Ill. 1995); *In re Garrison-Ashburn, LC*, 253 B.R. 700 (Bankr. E.D. Va. 2000); *In re Cutler*, 165 B.R. 275 (Bankr. D. Ariz. 1994).

L. Legal Relief Granted in Judgment Creditor Cases Involving Partnerships and LLCs

1. If the LLC is not in states such as Delaware, Nevada or Alaska, the foreclosure remedy may be available to the creditor. It should be noted that courts have allowed foreclosure in some partnership cases, even though the applicable partnership act did not specifically provide for it.

2. In two California cases, courts provided authority that a creditor could foreclose upon an interest in a partnership, thereby causing its sale.

a. In *Crocker National Bank v. Perroton*, 208 Cal. App. 3d 311, 255 Cal. Rptr. 794 (Cal. App. 1st Dist. 1989), the court permitted the sale of a limited partnership interest to satisfy the claim of a judgment creditor. The court based its opinion on California Corporations Code §15028(1), which provides that the court “may ... make all other orders, directions, and inquiries which the circumstances of the case may require” and refers to a possible court ordered sale of a partnership interest which is subject to a charging order. However, the facts in the case indicate that it may be of limited use to a creditor because the other partners consented to the sale of the limited partnership interest. (In a family partnership situation, this is unlikely to happen, absent bad blood among the family members.)

b. A similar but more far-reaching result was reached in *Hellman v. Anderson*, 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (Cal. App. 3d Dist. 1991), which involved the sale of a general partnership interest. The *Hellman* court emphasized that the consent of the nondebtor partners did not necessarily have to be obtained in every case in which a forced sale was sought. However, it added that before authorizing the foreclosure of a charged partnership interest, the trial court must determine that a foreclosure of the charged partnership interest will not unduly interfere with partnership business.

3. In one Connecticut case, *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 644 A.2d 363 (Conn. App. 1994), the court went one step further than the courts in *Hellman* and *Crocker*. The court held that a charging creditor may enforce its charging order not only through a forced sale but also through "strict foreclosure" (i.e., the vesting of title of the partnership interest absolutely in the charging creditor, on default in payment, without any sale of the property).

M. Single Member LLCs

1. One should anticipate that a single member LLC will not receive the same protections as a multi-member LLC in a judgment creditor case. The public policy factors behind the desire to avoid disruption of the LLC's business are based in part on the desire not to adversely impact the other business participants. That factor is not present in a single member LLC.

2. In *Olmstead v. Federal Trade Commission*, 44 So. 3d 76 (Fla. 2010), the Florida Supreme Court determined that a charging order was not the exclusive remedy for the judgment creditor of the owner of a single member LLC.

   a. The case arose out of a judgment the Federal Trade Commission had obtained against two individuals, Olmstead and Connell, for unfair and deceptive trade practices in a consumer credit card scheme. The FTC judgment included $10 million in restitution. The FTC had obtained a preliminary order under which several of the defendant's interests in single-member LLCs were frozen and placed in receivership.

   b. After the defendants appealed to the 11th Circuit Court of Appeals, the Court of appeals certified the following question to the Florida Supreme Court: "Whether, pursuant to F.S. §608.433(4), a court may order a judgment-debtor to surrender all 'right, title and interest' in a debtor's single member limited liability company to satisfy an outstanding judgment?" (The charging order statutory provision)

   c. The Florida Supreme Court broadened the question and phrased it in terms of whether Florida law allowed such actions.

   d. The Court concluded that the Florida LLC Act had not specifically displaced other remedies available to judgment creditors and looked specifically to the more general creditor's remedy of levy and sale under F.S. §56.061. The Court held that the sale and levy remedy authorized transfer of all the LLC member's right, title and interest in the LLC to the judgment creditor.

e. The Court did focus on the lack of exclusivity language in the Florida LLC statute. It noted that both the Florida Revised Uniform Partnership Act and Florida Revised Uniform Limited Partnership Act contained exclusive remedy language, and stated that this showed that the legislature's failure to include such language in the LLC statute was not inadvertent.

f. In response to the decision in *Olmstead*, the Florida legislature modified §608.433 of the Florida statutes to make clear that the holding in *Olmstead* does not apply to multi-member LLCs, and that the sole and exclusive remedy for a judgment creditor of a member of a multi-member LLC is a charging order. The legislation was effective May 31, 2011.

3. In *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003), the court held that the bankruptcy filing transferred the debtor's entire interest as sole member and manager of a Colorado LLC to the bankruptcy trustee. The court noted that there were no non-debtor members whose rights needed protecting.

N. LLCs as the Primary Vehicle for Asset Protection

1. These practical and legal issues can arise in any situation in which an LLC member is subject to creditors claims. But they are likely to be magnified in those situations in which an individual has created the LLC for the sole and exclusive purpose of providing asset protection.

Example: Mark has a business that entails a significant amount of risk, and is fearful that, despite his best efforts, a disastrous event could occur someday that would result in significant liability against him. His net worth currently exceeds $50 million. He reads an on-line advertisement that says he can put all his assets in LLCs and that, because he no longer owns the assets, they are not attachable in the event of a judgment against and everything will be protected. He visits the attorney who placed the advertisement and sets up a separate LLC to own each of his two homes and one to hold his investment assets. The LLC holding the investment assets is structured with an S corporation as manager and 1 percent member. That corporation has a 10 percent Class A voting interest and a 90 percent Class B voting interest that is converted to nonvoting at the election of the holder of the Class A interest. Mark gives the 10 percent Class A interest to his mother and retains the 90 percent Class B interest himself. In addition at the recommendation of the lawyer, he creates an irrevocable trust for the benefit of his mother, sister and any future descendants of his and makes a gift of 1 percent interest in the LLC to the trust. Mark now sleeps well at night, knowing all his assets are protected from creditors.

2. For the reasons described in the preceding pages, Mark has been lulled into a false sense of security. The LLC holding his investment assets may in fact provide some benefits in the case of a judgment against him. However, even in the best circumstances, the judgment creditor will obtain a charging order against it and he or the LLC will have to negotiate a settlement or buy-out the interest to eliminate the creditor as an owner.

3. If Mark has done nothing more than put his homes in single-member LLCs, they likely will provide little or no protection. There is no apparent business purpose to the entities. Mark lives in each residence, and keeps his personal belongings there. If he pays bills related to their upkeep, and pays for improvements from time to time from his separate funds, there is a significant chance they would not be respected by a court and afforded whatever more limited protections single member LLCs might have.

4. Because Mark has placed virtually all his liquid assets in an LLC structure, he may find he actually has reduced its effectiveness as an asset protection device.

    a. First, if Mark has limited assets outside the LLC, a major judgment creditor will likely devote more effort to breaking through the LLC structure to obtain some recovery.

    b. In settlement discussions before a trial, the complete commitment to the LLC structure may have a negative effect. Prior to judgment, the plaintiff's counsel is not focusing on the nature of the assets of the defendant. Discovery regarding the defendant's assets does not occur at this stage. Counsel is preparing his or her case, and probably negotiating with opposing counsel to determine if an acceptable settlement is available, not trying to learn about the defendant's assets. If the defendant is too tied to the idea that he or she has no attachable assets, and therefore offers little in settlement, the motivation of the plaintiff in fact may be to take the case to trial.

    c. A court also may be less sympathetic to Mark than it would to someone who had some assets in an LLC but had not committed to what clearly appears to be an attempt to protect everything and make himself "judgment proof."

5. Finally, Mark's total commitment to the LLC makes it inherently more difficult for Mark to adhere to the formalities of the structure.

    Example: Mark keeps a separate bank account in his individual name. His salary from his business and business distributions are deposited in this bank account. Mark uses it for his personal living expenses. From time to time the account builds up excess cash, which Mark deposits in the LLC investment account. There also are occasional larger expenses, including quarterly estimated tax payments. Mark transfers funds from the LLC investment account to his personal account to pay these expenses.

a. In the foregoing example, Mark is required to maintain strict discipline in tracking contributions to the LLC (and valuing LLC assets at the time of contribution) and both tracking distributions and making sure they are pro rata to all the LLC members. He may need to have some contributions run through the S corporation acting as Manager, if he wants to maintain its 1 percent interest in the LLC.

b. In some cases, the professionals who create the structure fail to advise the client on the importance of maintaining these formalities. In most cases, the client probably is not disciplined enough to do it. This exposes the client to assertions that the structure lacks economic substance and should be ignored.

V. PRACTICAL ASSET PROTECTION FOR THE SUCCESSFUL PROFESSIONAL

A. LLCs can and do play an important role in financial planning and asset protection. Reliance on them as the primary means to achieve asset protection is misplaced. It can create a false sense of security. As one writer pointed out:

> "If removing assets from the debtor's balance sheet is desirable, only an irrevocable trust will accomplish that. With a trust, the debtor can declare that he or she owns no assets without perjuring oneself . . . . Contrast that with a transfer of assets to an LLC where the debtor changes the asset he or she owns (i.e., converts real estate into an LLC interest) but still owns the asset." Stein, "Asset Protection," supra.

B. Reliance on any one technique to provide asset protection is not the wisest course of action. In asset protection planning, like other aspects of estate planning diversification often best serves the clients' needs. Clients crave easy solutions, and long to hear that there is a single solution that will solve all their problems. That is rarely the case. Part of the attorney's role as counselor is to educate the client in a realistic way.

C. An educated client will realize that a great deal of asset protection planning can be accomplished as part of the normal estate planning process, and without turning to more exotic or complex structures.

Example: Peter and Penny Plum are successful professionals. Peter is a surgeon and Penny left a high level job with an investment firm two years ago to join with several colleagues in starting a private investment fund. They have accumulated $10 million of investment assets, own a $1.75 million home and a $750,000 condominium in Colorado.

The Plums are increasingly worried about the impact that a lawsuit could have on their wealth and their lifestyle. Neither has any lawsuits pending against them, nor any potential claims they are aware of. But both of them obviously are in high risk professions. One of Peter's colleagues tells him that his accountant recently attended a seminar promoting offshore trust planning. The colleague says that based on the recommendations of the seminar sponsor, his accountant is working with attorneys (affiliated with the seminar sponsor) to transfer virtually all of his assets to an offshore trust where, he is told, it will be completely protected from future creditors. Peter is interested in the same thing. He and Penny would like to transfer their $10 million portfolio, and their Colorado condo to an offshore trust. They want to know if they can transfer their primary residence also.

D. The Plums need advice on two important aspects of asset protection planning. The first area is the many practical asset protection solutions that can be implemented with less cost and as part of the normal estate planning process. The second aspect is the great danger of trying to go too far with a technique like offshore trust planning. More so than almost any other part of estate planning, offshore planning is an area that illustrates the maxim that "pigs get fat and hogs get slaughtered."

E. There are several asset protection solutions that the Plums should consider before exploring offshore trusts. For a couple where only one spouse is in an at-risk profession, that spouse should consider giving property outright to the other spouse. This solution is not appropriate for the Plums, and it may not be appropriate for many couples because of divorce concerns. This is where irrevocable trusts can be used very effectively.

F. Transfers in Trust. Trusts may be the most important regularly used and accepted asset protection tool available. A trust can be used to alleviate a client's concerns about imprudent use of the property, or to control the property in case of later divorce.

Example: Peter transfers $1,000,000 to an irrevocable gift trust for Penny and their children. Peter names Penny as trustee. She can distribute property to herself and the children for health and support and to the children for their education. The trust provides that if Peter and Penny divorce, then Penny automatically ceases to be trustee and all her interests in the trust terminate. The gift does not generate gift tax because of Peter's gift tax applicable exclusion amount.

1. Peter also could use a lifetime QTIP trust to transfer property to Penny. The possible drawback of a QTIP trust is that Penny must receive all the income for life, even if there is a divorce. If this is not a concern, however, the QTIP trust can be a very useful asset protection device. It can be created without gift tax consequences in any amount because transfers to it qualify for the marital deduction. It both removes the assets from the reach of Peter's future creditors and protects the assets for Penny. A judgment creditor of Penny could go after her income interest in the trust but not the principal.

2. In addition, it is possible to give Peter an interest in the trust if Penny predeceases him. The marital deduction regulations permit a settlor to create a lifetime QTIP trust in which the settlor has a contingent trust interest if the donee spouse predeceases the settlor. After the donee spouse's death, that spouse will be treated as the transferor of the trust property. See

Treas. Reg. §25.2523(f)-1(d) and (f), Examples 9, 10 and 11. Therefore, the original settlor's contingent interest will not be treated as a retained interest under section 2036 of the Internal Revenue Code ("Code").

a. For asset protection purposes, the settlor should not actually have a contingent beneficial interest in the trust. This may place the property within the reach of creditors for state law purposes.

b. However, it should be possible to give the donee spouse a testamentary power of appointment that would allow the donee spouse to create a trust for the settlor if the donee spouse dies first.

Example: Peter creates both a $1 million irrevocable trust for Penny and their children and a $1 million lifetime QTIP trust for Penny. Penny finally frees up some time in her busy schedule to discuss further planning. She also would like to create an irrevocable trust — identical to the one Peter created for her and the children. In addition, as the family member in charge of investments, she would like to minimize the number of investment accounts they are creating.

G. Reciprocal Trusts. If two parties create identical trusts for each other, the IRS will recharacterize the trusts and treat them as if each party created a trust for himself or herself. At the death of one of the grantors, the recharacterized trust he or she created will be included in his or her estate under Code section 2036. This is known as the reciprocal trust doctrine.

1. The two-prong test for determining if reciprocal trusts were established was set forth in *United States v. Grace*, 395 U.S. 316 (1969). Under *Grace*, the doctrine applies when the following two conditions are met: (1) the trusts are "interrelated," and (2) the arrangement, to the extent of mutual value, leaves the grantors in the same economic position as they would have been in had they created the trusts for themselves. There have been numerous cases interpreting and applying the doctrine, some interpreting the tests quite narrowly, some very broadly.

2. Because the tests are subjective in nature, there is no clear line demarking when husband and wife each can create irrevocable trusts for the other without invoking the doctrine. The standard guidance is that husband and wife should not create the trusts at the same time, as part of one plan, with identical provisions for each other. To be in the best position to avoid application of the doctrine, one of the trusts should not benefit the other spouse at all. In between these two guideposts, there is a large grey area.

3. Peter and Penny Plum already have one fact in their favor — Peter already created his irrevocable trust and now Penny is considering one for the first time. The prudent approach would be not to make Peter a beneficiary of Penny's trust. If that is not possible, then Penny's trust should give Peter beneficial interests that are different from Penny's rights in Peter's

trust. For example, assume Penny is a discretionary beneficiary of income and principal in Peter's trust, pursuant to an ascertainable standard. Penny's trust could do one or more of the following:

a. Make Peter a discretionary beneficiary of income only.

b. Allow distributions to Peter only in the discretion of an independent trustee.

c. Allow distributions to Peter only if his income or net worth falls below a certain level.

d. Limit Peter's interest to a 5 and 5 withdrawal power.

H. Consolidating Investments. Peter and Penny should consider forming a family investment entity — a limited partnership or LLC, to hold their investment assets. This would allow them to invest on a consolidated basis as they create various trusts. It also may give them an opportunity to claim valuation discounts. For example, assume that, prior to Penny creating her irrevocable trust, Peter, Penny, Peter's irrevocable trust and Peter's lifetime QTIP trust contribute a total of $10 million to an LLC. Peter and Penny are voting members of the LLC. Most of the member interests are non-voting member interests. Penny then transfers non-voting member interests to an irrevocable trust she creates. Even using a relatively modest 20 percent valuation discount, her $1 million gift transfers underlying net asset value of $1,250,000.

I. Personal Residences. Peter and Penny own both their homes as joint tenants with right of survivorship. As a next step in asset protective planning, the Plum's attorney suggests changing title to tenancy by the entirety. Tenancy by the entirety is a special type of joint tenancy which is only permitted between a husband and wife.

1. Under common law, a tenancy by the entirety was not severable by the husband or wife. In states which follow the common law rule, consequently, the creditor of one spouse cannot seize or obtain a lien on property held in tenancy by the entirety.

2. If Peter and Penny have a mortgage on one or both of their residences, payment of the mortgage balance would in essence convert the amount paid into a protected asset.

J. Life Insurance. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a dependent. See 735 ILCS 5/12-1001(f). Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

Example: Penny purchases a variable life insurance policy into which she pays $500,000 over a three-year period. The policy offers investment of cash value in a selection of mutual funds.

The policy is payable to Peter, otherwise trusts for their children. Under state law, this policy is protected from creditors.

K. Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. See 735 ILCS §5/12-1006. The Supreme Court ruled in *Rousey v. Jacoway* that rollover IRAs should be treated like ERISA plan accounts under federal law, and therefore can be claimed as exempt assets in bankruptcy. In the Bankruptcy Abuse Preservation and Consumer Protection Act of 2005, Congress provided a specific exemption for IRAs, with no dollar limitation for rollover accounts, and a $1 million limitation for other IRA account balances. 11 U.S.C. §522(d)(12). Another simple asset protection step for Peter and Penny is to take maximum advantage of opportunities to contribute to qualified retirement plans. It turns out they already have a combined $500,000 in such plans.

L. By taking the relatively straight-forward steps just described, the Plums have provided significant insulation from creditors for the following assets:

Peter's irrevocable trust	$1,000,000
Peter's lifetime QTIP trust	1,000,000
Penny's irrevocable trust	1,250,000
Primary residence	1,750,000
Colorado condominium	750,000
Penny's life insurance	500,000
Retirement assets	500,000
	$6,750,000

If the irrevocable trusts have Crummey powers, they can make annual exclusion gifts on an ongoing basis to one of the irrevocable trusts. They may find that these steps are more than sufficient to provide them with the protection they seek.

M. Determining the Right Amount of Asset Protection Planning.

1. Even if the Plums would like to do more, they may be well-advised not to. The most effective means for a creditor to attack an asset protection plan is use of the fraudulent conveyance laws. Fraudulent conveyance provisions exist under both the federal Bankruptcy Code and state law. Most states have adopted a version of the Uniform Fraudulent Conveyances Act ("UFTA"). In Illinois, it is found at 740 ILCS 160. These provisions must be considered any time one engages in any asset protection planning that involves transferring property to a third person, including the trustee of an irrevocable trust (offshore or onshore). The more one commits assets to asset protection strategies, especially ones that do not have significant purposes other than asset protection, the more likely it is that a creditor may be able to plead facts that could establish a fraudulent conveyance. Even if the Plums are "clean" they may appear not to be if they go too far.

2. Fraudulent Conveyances as to Existing Creditors. Under the UFTA, a transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if:

    a. 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, UFTA §5(a); or

    b. The transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent, UFTA §5(b).

3. Fraudulent Conveyances as to Future Creditors. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose after the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation:

    a. with the actual intent to hinder, delay or defraud any creditor of the debtor, UFTA §4(a)(1); or

    b. without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business of transaction; or intended to incur, or believed or reasonably should have believed that he would incur debts beyond his ability to pay as they became due.

4. Although the UFTA does not distinguish between different classes of future creditors, courts have created a distinction between future creditors that the debtor can reasonably foresee and those that the debtor cannot reasonably foresee. Under this distinction, actual intent to defraud can exist as to the former but not as to the latter. For example, in *Hurlbert v. Shackleton*, 560 So.2d 1276 (Fla. 1st Dist. 1991), a Florida court held that a physician who transferred assets to his wife after his insurance policy was canceled did not have actual intent to defraud one of his existing patients because the patient was not a reasonably foreseeable creditor at the time of the transfer.

5. Determination of Actual Intent - Badges of Fraud. In determining whether a debtor had actual intent to defraud creditors and therefore made a fraudulent conveyance as to foreseeable future creditors, the so-called "badges of fraud" are to be assessed. The badges of fraud, with respect to a transfer, include:

    a. The transfer was to an insider (e.g., a relative of the debtor or a corporation in which the debtor is the person in control);

b. The debtor retained possession or control of the property transferred after the transfer;

c. The transfer was not disclosed or was 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 not 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;

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. UFTA §4(b).

6. Solvency. The debtor's solvency before and after a transfer is probably the most important factor in determining whether the transfer was fraudulent. Usually, absent actual intent to defraud, a transfer is not considered fraudulent if, following a transfer, the debtor retained sufficient non-exempt assets to satisfy the claims of creditors. It is for this reason that a transfer of nearly all of one's assets to an offshore trust or other asset protection devise runs an increased risk of being ineffective. The client should retain sufficient assets to remain clearly solvent.

7. Offshore Assets, Onshore Person. Some taxpayers who have established offshore trusts have discovered the hard way that moving almost all their assets offshore does not magically make creditors go away. The fundamental problem is that a U.S. resident who moves assets to an offshore trust is still personally subject to the jurisdiction of U.S. courts. As in the Florida bankruptcy case, *In re Lawrence*, 251 B.R. 630 (S.D. Fla. 2000), the court may have little sympathy for someone who has, in its view, "stashed" funds offshore. The same issue could arise in onshore planning.

   a. On January 8, 1991, Stephen Lawrence established an offshore trust in the Jersey Channel Islands with an initial contribution of $7 million. This trust was established two months prior to the conclusion of a 42 month arbitration dispute with Bear Stearns and Company that resulted in a $20.4 million award in favor of Bear Stearns. On

February 7, 1991, the trust was amended to add specific spendthrift language and to move the property to Mauritius. On January 23, 1993, the trust was amended so that the settlor's powers could not be exercised under duress or coercion and that Lawrence's life interest would terminate in the event that Lawrence became bankrupt.

b. Lawrence subsequently declared bankruptcy. On August 26, 1999, the bankruptcy court ordered Lawrence to turn over the trust assets to satisfy partially a judgment obtained by Bear Stearns. On September 8, 1999, the bankruptcy court held Lawrence in contempt for failing to turn over the assets, and ordered him to be jailed. The court said that because the trust was his own creation, the debtor could not avail himself of the impossibility defense. The court also stated that it tortured reason and abandoned common sense that Lawrence would transfer $7 million to a trust and release all control. Lawrence appealed to the district court.

c. The district court supported the bankruptcy's court's conclusion that Lawrence set up the trust for his own benefit. Moreover, it found that Lawrence effectively had dominion over the property in the trust and that the spendthrift provisions were not enforceable as a shield against creditors. It found that Lawrence's attempt to use an offshore trust contravened the clear public policy against allowing a debtor to shield money placed in a trust for his or her own benefit from creditors, defied common sense, and was undermined by language in the trust that gave Lawrence the power to remove and appoint trustees.

d. Upon review, the district court found that the order of incarceration for Lawrence should be upheld. The district court cited the Ninth Circuit's holding in *Federal Trade Commission v. Affordable Media, LLC.*, 179 F.3d 1228 (9th Cir. 1999). *Affordable Media* involved an attempt by a couple, the Andersons, to hide money in an offshore trust based in the Cook Islands. Under the terms of that trust, if an event of duress occurred, the Andersons were removed as co-trustees and the Cook Island trustee was prohibited from repatriating assets. In a contempt proceeding at the District Court level, the Andersons had argued that they could not comply with the court order to repatriate the assets because to do so was impossible. The District Court was not impressed and held the Andersons in contempt. The Ninth Circuit upheld the contempt finding.

e. In late 2006, the District Court ordered Lawrence's release since Lawrence's incarceration was no longer fulfilling its coercive purpose.

VI. INTRODUCTION TO TRUSTS AND DIVORCE

A. One does not plan for divorce, at least not in the same sense as one plans his or her estate by creating a Will, Revocable Trust, and other estate planning documents. The incidence of divorce may be high, but it is far from inevitable; and certainly any person's hope is that it does not happen. The distinction is subtle but important because it leads to the first important principle in planning in this area. One should not let the possibility of divorce at some unknown time in the future dictate a person's financial affairs. In other words, the divorce tail should not wag the financial dog.

1. However, steps that can be taken to protect a client's separate assets if there is a divorce, without substantially altering his or her life or financial affairs, are important to consider.

2. If divorce becomes a real possibility in a client's life or the life of a client's child, then financial and estate planning decisions should be made with the divorce implications specifically in mind.

B. The best protective steps one can take are like any other type of insurance against a possible, but not certain, detrimental event. The most effective protection must be in place before the event occurs. You cannot buy car insurance to cover an accident that already has occurred.

C. The rules governing the treatment of property in a divorce, and the actions that may be taken to affect the treatment of that property, are very state law-specific. These materials discuss both specific aspects of state law and the general legal concepts that tend to be relevant in most jurisdictions. The materials also examine the emerging differences under state law in the treatment of trusts in divorce. It is very important that any advice to a specific client be provided with the assistance of legal counsel who practices in and is familiar with the applicable state law.

VII. DIVIDING THE ECONOMICS UPON DIVORCE

A. When a person goes through a divorce, his or her financial resources will be subject to division in one or all of the following three ways: (i) the couple's property will be divided between them as part of the property settlement, (ii) one spouse may be obligated to make payments to the other spouse for support or maintenance, and (iii) if there is a minor child, there may be child support payments.

B. The first step in property division is to determine what is property of the marriage, to be divided between husband and wife, and what is separate property of either, usually to be retained entirely by him or her.

1. In community property states (including the marital property system in Wisconsin), the property ownership laws that exist throughout the marriage dictate the categorization.

    a. For all ownership purposes, property acquired or accumulated during the marriage is treated as community property that is owned one-half by each spouse, regardless of how title is held. Specific exceptions are carved out for certain categories of property, such as property owned before the marriage and property received by one spouse by gift or inheritance.

b. Specific states may have other exceptions to the standard definitions. For example, under Texas law, separate property includes recovery for personal injuries sustained during marriage in addition to property owned before marriage and property acquired by gift or devise during marriage. Tex. Fam. Code Ann. §3.001. Texas community property is all property acquired by either spouse during the marriage that is not separate property. *Id.* at §3.002. Upon dissolution, a spouse can only overcome the presumption that property in a spouse's possession is community property with clear and convincing evidence of separate ownership. *Id.* at §3.003.

2. In states that are not community property states, actual ownership governs for most property law purposes; the concept of "property of the marriage" or "marital property" is relevant only in divorce. The process of dividing property in a divorce starts with a determination of whether the property is marital property or separate (nonmarital) property.

3. The predominate statutory approach starts with a legislative preference for treating property as marital property. Many statutes define marital property as all property acquired after the marriage and before divorce, unless the property falls into one of a number of list exceptions.

4. Illinois follows this approach. See section 503(a) of the Illinois Marriage and Dissolution of Marriage Act (750 ILCS 5/503).

5. New York also follows this approach. See section 236 Part B of New York's Domestic Relations Law.

6. The presumption in favor of marital property takes precedence over the actual form of ownership. In addition, if non-marital property is transferred into co-ownership between the spouses, it then is presumed to be marital property. In Illinois, the party seeking to have property categorized as non-marital property bears the burden of proof, by clear and convincing evidence. *Hofmann v. Hofmann*, 94 Ill. 2d 205, 446 N.E. 2d 499 (1983).

7. Illinois also adopts an approach that does not allow property to be classified as partially marital and partially non-marital. It must be classified as entirely marital or entirely non-marital. See *In re Marriage of Komnick*, 84 Ill. 2d 89, 417 N.E. 2d 1305 (1981); *Bentley v. Bentley*, 84 Ill. 2d 97, 417 N.E. 2d 1309 (1981). The question of one estate contributing to another is dealt with by the right of reimbursement in §503(a)(7) of the Marriage and Dissolution of Marriage Act.

8. The three most significant categories of separate, or non-marital property are: (i) property acquired by gift or inheritance; (ii) property acquired before the marriage; and (iii) property acquired in exchange for such property. The key in establishing that property falls into one of these categories is keeping it separate. Because of the presumptions that exist, if the separate property is commingled with marital property, there is a strong possibility that it will be

treated as marital property. *See*, *e.g. In re Marriage of Orlando*, 218 Ill. App. 3d 312, 577 N.E. 2d 1334 (1st Dist. 1991) (wife did not overcome marital property presumption when inherited property placed in joint tenancy with her husband).

C. States take a wide variety of approaches as to whether increases in the value of separate property, or income from the separate property, after the marriage will be treated as marital property. See Chorney, *Interests In Trust In Divorce: What the Settlor Giveth The Divorce Court May Taketh Way,* 40th Annual Heckerling Institute on Estate Planning (2006), for a more comprehensive review, from which some of the summaries of state law below were taken.

1. Illinois treats increase in the value of separate property as separate property. As noted above, if the increase in value is in part due to a contribution of marital property, or the personal efforts of the other spouse, a right of reimbursement may be created. However, the character of the property does not change. Income from separate property is separate property "if the income is not attributable to the personal effort of a spouse." 750 ILCS 5/503(a)(8). For example, dividend income from a business asset may be marital property if it is due to the efforts of the spouse and he is not being adequately compensated for those efforts in the form of salary.

2. New York treats appreciation from separate property as separate property. However, increases in value due to the contributions of the other spouse may be marital property. Thus, property may end up as mixed marital and separate property. See N.Y. Dom. Rel. Law §236-B1.d.

3. Florida's statute defines nonmarital assets to include "all income derived from nonmarital assets during the marriage unless the income was treated, used or relied upon by the parties as a marital asset." Fla. Stat. §61.075(6)(b). Appreciation of nonmarital assets also should be nonmarital. However, like New York, "enhancement in value and appreciation of nonmarital assets resulting from the efforts of either party during the marriage or from the contribution to or expenditure thereon of marital funds or other forms of marital assets or both" will be marital assets. *Id*. §61.075(6)(a)(1).

   a. Enhancement of value due to contributions of the other spouse is not limited to direct contributions to the value of the property by that spouse. Courts can take a much more expansive view. For example, if a nontitled spouse's indirect contribution as a homemaker and parent aids and makes it possible, at least in part, for a titled spouse to devote time and effort to a separate property interest, then appreciation in the interest due to the titled spouse's effort is marital property. *Price v. Price*, 503 N.E.2d 684, 689 (N.Y. 1986) (appreciation of husband's interest in family company was marital property where wife had raised the couple's two children, conferred with business customers, entertained husband's business associates, and attended business conventions with her husband); *cf. Rubin v. Rubin*, 105 A.D.2d 736, 739 (N.Y. App. Div. 1984) (wife in seven year childless marriage who "devoted a great deal of her time and energies during the marriage to the leisure pursuits of bridge and tennis" made no indirect contribution to husband's interest in closely held company).

b. In *Dunagan v. Dunagan*, 664 So. 2d 68, 68 (Fla. Dist. Ct. App. 1995), the appreciation of the husband's interest in the family business was marital property because while he worked for his father, the wife "took care of the home, the husband, and the children." Even though his father was the decision maker, the husband ran the day-to-day business and therefore his marital labor contributed to its overall success. *Id.*

c. In *Oxley v. Oxley*, 695 So. 2d 364, 367 (Fla. Dist. Ct. App. 1997), the appreciation on assets held in husband's revocable trust, which was established before the marriage, was not marital property. Other people's business decisions and management led to the increase in value; "the husband's only active role was deciding to maintain the trust and trustee, and to permit the trustee to take his father's and brother's advice and to continue to manage the corpus, and retained income, for his benefit." *Id.*

4. Colorado provides that increases in value and income from separate property occurring after the date of marriage or of acquisition of the property is marital property. See C.R.S. §14-10-113(4).

5. A minority of states, which includes Connecticut, Indiana, Massachusetts, and Oregon, allow the courts to determine an equitable division of all assets, including separate property, such as inherited assets. *See, e.g.*, Conn. Gen. State Ann. §46b-81; Ind. Code Ann. §31-15-7-4; Mass. Gen. Laws Ann. Ch. 208, §34; Or. Rev. Stat. 107.105(1)(f).

6. The variety of approaches carries over to community property states. See Reinecke, *Community Property Issues for Non-Community Property Practitioners,* 28 ACTEC Journal 224 (2002).

a. Income from separate property retains its separate property character in Arizona, California, New Mexico, Nevada and Washington. Such income is community (marital) property in Idaho, Louisiana, Texas and Wisconsin.

b. California provides that each spouse retains his or her separate property, and divides community property equally. Ca. Fam. Code §2550. Washington allows an equitable division based on a global consideration of the assets, both separate and community. Wash. Rev. Code Ann. §26.09.080.

D. Even if state statutory law places limits on how property is categorized, a court often can address perceived inequities in its allocation of the marital property. Many states follow the approach of the Uniform Marriage and Divorce Act, which provides for an equitable division (not necessarily an equal division) of marital property in a divorce.

1. Section 503(d) of the Illinois Marriage and Dissolution of Marriage Act embodies this equitable division approach, and sets forth a variety of factors for the court to consider (many

similar to the factors relevant in determining maintenance), including "the value of [non-marital] property assigned to each spouse; . . ." See also *In re Marriage of Joynt*, 375 Ill. App. 3d 817, 874 N.E. 2d 916 (3rd Dist. 2007).

2. Thus, if one spouse has significant separate property, the issue of whether the increase in value or income of that property may not be dealt with specifically; instead, the court can adjust for this factor by awarding more of the marital property to the other spouse.

E. A court will determine support or maintenance based on a variety of factors.

1. For example, the Illinois statute (750 ILCS 5/504) states:

> "(a) In a proceeding for dissolution of marriage or legal separation or declaration of invalidity of marriage, or a proceeding for maintenance following dissolution of the marriage by a court which lacked personal jurisdiction over the absent spouse, the court may grant a temporary or permanent maintenance award for either spouse in amounts and for periods of time as the court deems just, without regard to marital misconduct, in gross or for fixed or indefinite periods of time, and the maintenance may be paid from the income or property of the other spouse after consideration of all relevant factors, including:
>
> (1) the income and property of each party, including marital property apportioned and non-marital property assigned to the party seeking maintenance; (2) the needs of each party; (3) the present and future earning capacity of each party; (4) any impairment of the present and future earning capacity of the party seeking maintenance due to that party devoting time to domestic duties or having forgone or delayed education, training, employment, or career opportunities due to the marriage; (5) the time necessary to enable the party seeking maintenance to acquire appropriate education, training, and employment, and whether that party is able to support himself or herself through appropriate employment or is the custodian of a child making it appropriate that the custodian not seek employment; (6) the standard of living established during the marriage; (7) the duration of the marriage; (8) the age and the physical and emotional condition of both parties; (9) the tax consequences of the property division upon the respective economic circumstances of the parties; (10) contributions and services by the party seeking maintenance to the education, training, career or career potential, or license of the other spouse; (11) any valid agreement of the parties; and (12) any other factor that the court expressly finds to be just and equitable."

2. *See also* Fla. Stat. Ann. §61.08. Payment as a nontaxable, nondeductible payment.

3. Not stated specifically, but underlying factors such as these, is the public policy that divorce not leave one spouse in significant financial distress if there are sufficient resources to avoid

that. In Illinois, the policy also is to allow a former spouse to live in approximately the same standard of living the couple had during the marriage, if the payor spouse's finances permit it. See *In re Marriage of Chapman*, 285 Ill. App. 3d 377, 674 N.E. 2d 432 (3d Dist. 1996).

4. A goal of the Illinois Act is to satisfy the future needs of both parties primarily through the division of marital property. *In re Marriage of Brackett*, 309 Ill. App. 3d 329, 722 N.E. 2d 287 (2d Dist. 1999). However, if this not possible, a court may take additional steps toward creating an equitable result through granting maintenance.

F. That obligation to support of course extends to minor children. The wealthier spouse can expect to have the major share of the obligation to support the children.

G. The categorization of property received by inheritance or gift as separate property is not dependent on the use of a trust. However, because of the presumption in favor of marital property and the rules regarding commingling and rights of reimbursement, the traditional estate planning advice to a parent in a wealthy family is that property should be left in trust for the children, in order to protect it in case of divorce. The trust serves to keep the property separate. Equally important, the trust provides a legal barrier to division because of the spendthrift protection that trusts created by a third party can provide.

1. The spendthrift concept dates back to English common law, and generally provides that a judgment creditor cannot reach property held in trust for a judgment debtor if the trust was created, in good faith, by a person other than the judgment debtor.

2. The rule is well established in the United States, see 3 Scott and Ascher on Trusts §15.2 (5th ed., 2006), although with numerous variations and special rules and exceptions that differ from state to state. Many states have enacted statutes that embody the rule. For example, the Illinois statute provides:

   a. "2-1403. Judgment debtor as beneficiary of trust. No court, except as otherwise provided in this Section, shall order the satisfaction of a judgment out of any property held in trust for the judgment debtor if such trust has, in good faith, been created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor."

   b. 735 ILCS 5/2-1403. The exception "otherwise provided in this Section" is for collecting unpaid child support obligations.

3. State law often is reinforced by the provisions of the trust itself. A spendthrift provision in the trust agreement might state:

> "To the maximum extent permitted by law, (i) no power of appointment or power of withdrawal shall be subject to involuntary exercise, and (ii) no interest of any beneficiary shall be subject to anticipation, to claims for alimony, maintenance, or support,

to voluntary transfer without the written consent of the independent trustee, or to involuntary transfer in any event."

4. Absent extraordinary circumstances, this protection will prevent a divorcing spouse from claiming trust assets to satisfy divorce obligations. Moreover, the trust property cannot be subject to division with the spouse, since the beneficiary spouse does not own it, and if it is a spendthrift trust, cannot transfer it. The trust interest is even better protected than separate property of the spouse.

5. For a wealthy family, long-term trusts for the children can provide much of the protection that otherwise would need to be accomplished through a prenuptial agreement. It is protection that a child cannot provide for himself or herself, except possibly through careful use of offshore trusts or trusts set up in domestic asset protection jurisdictions like Delaware, Alaska, or South Dakota.

6. There is no reason to abandon the traditional advice. However, it often is not as simple as telling the client that property left in trust will be fully protected in the case of a divorce. Moreover, as discussed in the following sections, the development of the law in some states has significantly weakened the protection traditionally provided by trusts.

Example: John is 45, and has been married 15 years, with two minor children. He and his wife have about $2 million of assets, most of which they accumulated during their marriage. The assets include a limited partnership interest in an investment partnership created by John's family, held solely in his name, and acquired by John through gifts from his parents during the marriage. The LP interest has a current value, based on underlying net asset values, of $500,000. The value of the interests at the time of the gifts totaled about $300,000.

John also is a beneficiary of a "family trust" created at his mother's death 10 years ago. His father is trustee and primary beneficiary. He and his 3 siblings are also permissible beneficiaries. At the death of John's father, the trust property will be distributed in equal shares to trusts for those of John and his 3 siblings who are then living (with living descendants of any deceased child receiving their parent's share). Each child has a full withdrawal right at age 40. The trust was funded with $1 million 10 years ago and currently holds $1.4 million.

Finally, John is a beneficiary of a long-term generation-skipping trust created by his grandfather. The current beneficiaries are John's father, John and his siblings, and all of their descendants. It is currently a one-pot trust with broad spray provisions. At the death of John's father, subject to the power of appointment his father has, separate trusts will be created each of John and his siblings and their descendants. John will be co-trustee of his trust, with a corporate co-trustee. The trustees have broad discretion to make distributions among John and his descendants, The trust will last for John's life. At John's death, John has a power of appointment that allows him to distribute the property among descendants, charities, or a trust for his spouse (remainder to descendants). Absent exercise of the power, continuing identical trusts will be created for each of John's children and their descendants. Based on current values, if John's father does not exercise his power of appointment, John's separate trust will received about $2.5 million.

John's wife files for divorce.

VIII. TREATMENT OF TRUSTS IN DIVORCE IN STATES LIKE ILLINOIS

A. Any property interests that John is deemed to have in the family trust created by John's father and the GST trust created by his grandfather would be treated as separate property in Illinois.

B. Although the trust property cannot be accessed by a divorcing spouse or the court, and while a court in Illinois probably would not ever contemplate seeking to do so, the court could take the trusts into account in the property division.

1. The trusts do represent a possible source of income for John, and, in the case of the family trust, a future expectancy of property. Therefore, they may be relevant in the division of property between John and his wife.

2. A divorcing spouse should not expect that the trusts will remain secret. Many states' laws require extensive financial disclosure in divorce proceedings. In Illinois divorce proceedings, for example, mandatory disclosure of financial information is the norm. Although the rules differ from county to county and are based on local circuit court rules, almost all circuits in Illinois have some form of mandatory disclosure.

a. In Cook County, each party is required to provide the other with a completed disclosure statement of income, expenses and assets, and with the last two years of filed tax returns. See Cook County Circuit Court Rules 13.3.1 and 13.3.2.

b. The Disclosure Statement form includes a category for trust income, and a category for "All Other Property." Courts are liberal in granting discovery requests seeking information about trusts.

C. Income is given a broad definition in Illinois. Distributions from a trust would fall into the definition, regardless of their tax or accounting categorization.

D. If the spouse who is a beneficiary was receiving regular distributions from a family trust, it is likely that a court would presume those distributions will continue, and likely would take them into account in making an equitable division of marital property or an award of maintenance.

E. It also is possible that a court might set a time for reconsideration of the amount of a maintenance award if the time period when a trust might terminate is nearer. For example, if a trust for John lasted until he turned 48, a court could decide to revisit maintenance, especially if it had struggled with an equitable division satisfactory to it at the time of divorce.

F. Less likely, but probably arising on occasion is the question of rights of reimbursement or even transmutation of the property. For example, suppose the trust held real estate that the beneficiary actively managed, but for which he or she took a nominal salary. The court might order reimbursement for this activity, because it was "marital energies" that enhanced the properties' values. The reimbursement could not occur from the trust assets. The spendthrift rules would prevent this. But the court could require the beneficiary/spouse to make it out of other assets.

G. The decision as to what constitutes an equitable division of the marital assets could necessitate consideration of the "value" of John's trust interests, which brings into play the terms of the trust including the distribution provisions and how long they will last.

H. Note also that John's wife is unlikely to attack LP interest, if it is categorized as separate property. But its existence might influence the division of marital property.

Example: In John's divorce, the court determines John's LP interests are his separate assets, and have a value of $450,000. The marital assets are $1.6 million. John's income is deemed to include the annual distributions he receives from the LP and the family trust, about $7,000 per year total. Taking into account John's total financial resources, including the interests in the trusts, the court awards John $600,000 of the marital property and awards the remaining $1,000,000 to his wife.

IX. TREATMENT OF TRUSTS IN DIVORCE IN OTHER JURISDICTIONS

A. In Illinois, the interests John has in the two trusts may impact the division of marital property or play a role in the maintenance John is required to pay. However, the trusts themselves are not directly part of the property division. This is not the case in all states. The law governing the division of property in a divorce has developed in several jurisdictions in ways that threaten the long-standing traditional protection provided by trusts.

1. In some states, courts treat trust interests as property that can be considered as part of the pool of assets to be divided.

2. There is no uniformity as to the types of trust interests that may be subject to division. In some jurisdictions, courts have determined that a remainder interest that will be distributed outright to the spouse if he or she reaches a certain age is property subject to division. An outright remainder interest contingent only upon the remainder beneficiary surviving the income beneficiary also may fall in this category. Some courts treat any interest in the trust, current, vested or contingent, as property to be considered. See Chorney, *Interests In Trust*

In Divorce: What the Settlor Giveth The Divorce Court May Taketh Way, 40th Annual Heckerling Institute on Estate Planning (2006), for a thorough discussion of the legal trends.

3. The courts are not invalidating spendthrift statutes in taking these steps. In general, they do not, and cannot, order the trustee to distribute trust property or assign trust interests. Some courts also have included in the property settlement decree an obligation on the beneficiary spouse to transfer trust property to the other spouse when received.

B. As explained in the preceding section VII. C. of this outline, Colorado is one state that treats the increases in value and income from separate property during the marriage as marital property. Courts in the state have taken the further step of treating interests in many trusts as property subject to division in divorce, even if the trust interest is not possessory. Several cases illustrate this trend.

1. In *In re Balanson*, 25 P.3d 28 (Colo. 2001), the Colorado Supreme Court held that a wife's remainder interest in a trust constituted "property" for purposes of property division in a dissolution of marriage case. *Id.* at 32-33.

   a. The trust was created by the wife's parents during the Balansons' marriage. The father, as the surviving grantor, was the current beneficiary, with both an income interest and a right as trustee to invade principal.

   b. The court treated the value of the trust at time of its creation as a gift to the wife during her marriage, and, under Colorado law, her separate property.

   c. The court held, however, that any appreciation on the trust property constituted marital property, which would be taken into account in determining the division of property. *Id.* at 40-43.

2. In *In re Marriage of Dale*, 87 P.3d 219 (Colo. Ct. App. 2003), the court included in the division of property a wife's interest in a trust created by her grandparents. The wife's father was the current beneficiary. At the father's death, one-half of the trust would be distributed to the wife and her three siblings. The remaining one-half would be retained in trust for the wife's mother, and then distributed to the children in the same manner at the mother's death.

   a. The trust was significant. It had a value of over $6.6 million at the time of the divorce.

   b. The court treated the appreciation in the wife's interest during the marriage as marital property, and valued that interest at $313,962. The husband was awarded one-half.

   c. The court further ordered that one-half of the amount awarded to husband be paid within 60 days of the father's death, and the other one-half following the mother's death. In other words, the court in effect ordered the wife to turn over part of the trust property to the husband upon receipt.

d. Note that section 1041 of the Code, which treats transfers between spouses in connection with a divorce as non-taxable exchanges, applies only if the transfer occurs within up to six years after the cessation of the marriage. Code §1041(c). The transfers in this case conceivably could occur well after that, leaving the question of whether the beneficiary spouse also incurred capital gain in complying with the order if it was satisfied in kind.

C. Similar results have occurred in other states.

1. In *Zuger v. Zuger*, 563 N.W.2d 804 (N.D. 1997), the husband was an outright remainder beneficiary of a trust created by his father. His mother was the mandatory income beneficiary. The mother also had an annual right to withdraw the greater of 5 percent of trust or $5,000. The husband had three siblings who would share in the trust when it terminated.

   a. The court determined that the husband's trust interest was a property interest subject to division. It decided that awarding specific dollar amount to the wife based on the possible future trust value was too uncertain.

   b. The court ordered that the husband should pay the wife one-half of the husband's share of the trust when it terminated.

2. In *Fox v. Fox*, 592 N.W.2d 541 (N.D. 2001), the court treated an income interest of one of the spouse's as part of the marital estate. N.D. Cent. Code 14-05-24 treats all property of the couple as subject to equitable division.

3. In *Davidson v. Davidson*, 474 N.E.2d 1137 (Mass. App. Ct. 1985), the husband was the remainder beneficiary of a testamentary trust for the primary benefit of his mother. The trustees had broad discretion to invade the trust for the mother.

   a. The court found that husband's interest in the trust was "at the outer limits" of what constituted a divisible property interest. However, notwithstanding the uncertainty over its value and the inalienability of the interest, the court concluded it could be considered as part of the property subject to division. *Id*. at 1144.

   b. Recall that Massachusetts is one of the states that allows an equitable division of all assets. Once that trust interest is included as "property," the entire interest (at whatever value the court determines) is subject to division.

4. Oregon, like Massachusetts and North Dakota, considers all property subject to division. In *Becker v. Becker*, 858 P.2d 480 (Ore Ct App. 1993), court determined that the wife's interests in several trusts were subject to division. The court awarded the husband a share of the interests in the form of a note payable in installments and a balloon payment payable when one trust ended. *Id*. at 480-82.

5. The court treated a vested remainder interest in a trust as marital property in *Buxbaum v. Buxbaum*, 692 P.2d 411 (Mont. 1984).

6. One example of terrible facts creating a bad precedent is *Ruml v. Ruml*, 738 N.E. 2d 1131 (Mass. App. Ct. 2000). The husband in this divorce had considerable resources, had abandoned the wife and children, and refused to participate in the divorce proceeding. The wife and children were beneficiaries of a trust husband had created, over which he held a non-general but broad power of appointment. The court awarded all of the trust property to the wife, in effect forcing the husband to exercise the power of appointment. It is unclear how the award was enforced.

X. ESTATE PLANNING RESPONSES

A. The foregoing cases illustrate that, in several jurisdictions, trust property is not fully insulated in the case of divorce. It is important to keep this in mind even if the client does not live in one of these jurisdictions. For example, the fact that one is planning for an Arizona or Illinois client, using local situs trusts, may not matter to a court in Colorado or Massachusetts that is handling the divorce of a family member who is trust beneficiary. It is the law of the jurisdiction governing the divorce that will control the categorization of property subject to division and whether trust interests are considered property of the beneficiary.

Example: John is living in Massachusetts at the time of his divorce. The court treats John's interest in the family trust as property subject to division. Because of uncertainty about possible dissipation of the trust during the life of John's father, the court orders John to pay his ex-wife one-half of the trust property he receives on termination of the trust.

B. The case law in divorce cases should lead practitioners to consider several options to provide further protection for trust interests.

1. Powers of appointment can provide several benefits in preventative planning in case of the divorce of a trust beneficiary.

2. If the current income beneficiary has a power of appointment over the trust, this may prevent the trust property from being considered in a divorce of a remainder beneficiary.

   a. In *In re Balanson*, 25 P.3d 28 (Colo. 2001), there was no attempt to treat any interest in a marital trust for the wife's father as marital property in the divorce, apparently because the father held a general power of appointment over the trust.

   b. In *D.L. v. G.L.*, 811 N.E. 2d 1013 (Mass. App. Ct. 2004), the court concluded that father's testamentary power of appointment over a trust caused husband's remainder interest to be "the equivalent of an expectancy under a will." *Id*. at 1028.

3. The power of appointment also can be used to alter a future beneficiary's interest in response to a pending or completed divorce proceeding.

    a. For example, if John's father had a power of appointment over the family trust, he could exercise it to cause the share for John to continue in trust for John and his descendants, rather than terminate and distribute outright to John at his father's death.

    b. John's father could craft a provision that tries to directly address the impact of a divorce and any order in the divorce proceeding impacting the trust. This could be accomplished for example with a provision that would delay or cancel the otherwise designated termination date of a trust:

        > "If the trustee determines that principal which is otherwise required to be distributed outright to a beneficiary could, after receipt by such beneficiary, be subject to claims of creditors, to claims for alimony, maintenance, or support, or to any involuntary transfer to a third party, whether or not such claims have been asserted or are then prospective, the trustee shall withhold such principal in accordance with this paragraph. The trustee shall retain any principal so withheld in a separate trust named for the beneficiary, and shall apply as much of the net income and principal of the trust as the trustee determines from time to time to be required for the best interests of the beneficiary, adding any undistributed net income to principal from time to time, as the trustee determines. The trustee shall make no distribution to satisfy any legal obligation of the beneficiary, including any obligation to support or educate any person. The trustee may invest the property of such trust in assets that will be held for the beneficiary's use rather than for investment purposes, including, but not limited to, automobiles, furniture and hobby equipment, and may pay directly any costs of taxes, insurance, maintenance, repairs and necessary improvements for such assets or other property owned by the beneficiary, if the trustee determines that such use is necessary for the beneficiary's health, support, education and best interests. If the beneficiary dies before complete distribution of the trust, the trustee shall distribute the remaining principal to such one or more persons or organizations (other than the beneficiary, his or her estate and the creditors of either) as the beneficiary may appoint by will, or, in default of effective appointment, to the beneficiary's then living descendants, *per stirpes*."

4. A discretionary spray trust that lasts for the child's lifetime, rather than terminates upon the parent's death should not be treated as a divisible property interest. At a minimum it would be treated as having a significantly reduced value in a property division.

5. Powers to alter the trust terms also could be vested in a trust protector or other third party. For example, the trust could allow a trust protector to suspend or take away a power of withdrawal that the beneficiary has if the beneficiary gets divorced.

XI. PRENUPTIAL AGREEMENTS

A. One of the most effective ways to protect a person's assets in a marriage is to enter into a prenuptial, or premarital, agreement. A prenuptial agreement is an agreement between the parties to be married, entered into before the marriage, that determines their respective property rights. It can control their rights in case of death, in case of divorce, or in both cases. It can apply to all property or only to certain property interests.

B. Historically, prenuptial agreements were not favored by the courts. Courts often concluded that the agreements were against public policy and void, if they waived or reduced a duty of support.

1. During that time period, it typically was a duty of the husband to support the wife after divorce; for example, in invalidating a prenuptial agreement in *Warner v. Warner*, 235 Ill. 448, 85 N.E. 630 (Ill. 1908), the Illinois Supreme Court said that it is the duty of a husband to support his wife and children "according to his ability and status in life."

2. In most jurisdictions, prenuptial agreements are now valid, and in fact may even be specifically sanctioned by statute (in Illinois, the Uniform Premarital Agreement Act, 750 ILCS 10/1, et seq.); however, the historical animosity survives in the form of a judicial presumption that the agreements should be strictly and narrowly interpreted.

C. Within this context of narrow interpretation, however, a properly drafted agreement may alter or eliminate any of the rights that otherwise might exist as a result of the marriage, except one. Those rights include:

1. The right to temporary or permanent maintenance;

2. The categorization of property as marital property, or the exclusion of certain property from division upon divorce;

3. The right to claim contribution to separate property or a right of reimbursement from separate property;

4. The right to treat jointly owned property as marital property;

5. The right to a homestead exemption;

6. The right to a spouse's award, an intestate share of the estate, or to renounce a spouse's will and take an elective share; and

7. The right to act as personal representative of the estate, or to designate the person who will act.

D. The one right that generally cannot be waived or altered is the right to child support. In Illinois, for example, the Illinois Uniform Premarital Agreement Act specifically states that a prenuptial agreement may not waive child support. 750 ILCS 10/4(b).

E. The validity of a prenuptial agreement is determined under the same rules that apply to contracts generally. However, as noted above, courts are generally more willing to exercise their equitable powers over prenuptial agreements for public policy reasons. The following requirements for valid prenuptial agreements are found in most jurisdictions:

1. Written and signed. The agreement should be in writing and signed by both parties. Some courts have enforced an agreement against the one party who signed it, even if the other did not. However, it should never be the plan to have just one party sign.

2. Voluntary. Clearly, there should be no question that each party is voluntarily entering into the contract. There can be no duress or coercion. These factors can arise more frequently in prenuptial agreements than in other contracts. This is understandable given the emotional and social pressures.

   a. If the agreement is presented to one spouse shortly before the wedding, and/or delivered with an ultimatum that the wedding will not happen unless the agreement is signed, the stage is set for invalidating the agreement.

   b. To avoid this possibility, the agreement should be dealt with as far in advance of the wedding as possible. It should not be a afterthought.

3. Consideration. Prenuptial agreements are somewhat unique in that no special consideration in the form of money or actions is needed to make them valid. The pending marriage is sufficient consideration.

   a. As a result, the lack of equality in what is being promised or given up in the agreement does not impact the adequacy of consideration.

   b. Inequality may be a factor supporting invalidity on other grounds, such as duress or fairness, discussed below.

4. Fairness. Fairness is the catch-all that allows courts to exercise their equitable powers and not enforce an agreement that the court believes is fundamentally unjust. This is most likely to occur where the agreement leaves one spouse impoverished following the divorce. Courts have invalidated agreements that leave one spouse with a significantly lower standard of living than the couple enjoyed during the marriage. *See*, *e.g. Warren v. Warren*, 169 Ill. App.3d 226, 523 N.E.2d 680 (5th Dist. 1988).

   a. This is a critically important fact in counseling wealthy clients about premarital agreements. If they go too far in trying to protect their wealth, and do not provide some reasonable financial accommodation for the less wealthy spouse in case of divorce, they put the validity of the agreement at risk.

b. A variety of other factors may impact the fairness of the agreement, including the ages of the couple, their business and financial sophistication, and the amount of time they had to review and consider the agreement terms.

c. Under the laws of many states, it is not an absolute requirement that each party be represented by a lawyer. However, having separate legal representation for each spouse is the best way to deflect later attempts by one party to invalidate the agreement, based on claims of lack of fairness, coercion, or lack of understanding of the implications of the agreement.

5. Disclosure. One of the most important prerequisites for a prenuptial agreement is that there be full disclosure by each of the parties of their wealth and income. It is a factor that goes to the fairness of an agreement, and in some jurisdictions, it may constitute an independent requirement.

a. The position of many courts is that a person cannot give up marital rights to property if he or she does not know the value of the rights being given up.

b. This does not necessarily mean that each spouse must provide a detailed, exhaustive list of his or her assets, although it is preferable to do so. It may be sufficient to provide general descriptions that give the other party an understanding of the nature and extent of the assets.

c. For example, for an individual with an interest in a family business, it may be sufficient to describe it as a "__ percent interest with an estimated value in excess of $5 million." Whether the exact value is $10 million or $10 million may not be critical. (However, if its value is $50 million, the estimate may be insufficient.)

d. If the wealthier party conceals assets of meaningful value, he or she is giving the court an excellent reason to invalidate the agreement.

e. The sophistication level of the parties, and the nature of the legal representation they receive are factors that may impact the level of disclosure required.

F. Planning Considerations

1. With prenuptial agreements, one size does not fit all. The role an agreement will play in a person's financial planning will depend on the circumstances and the nature of the relationship with the future spouse.

2. For an older couple, each with separate assets and children from a prior marriage, an agreement that keeps all assets separate and in which they each waive all spousal rights might make sense. The goal for such a couple is often to preserve each one's own property for his or her own children and to minimize financial ties between the new spouse and children. They are in full agreement that it is best to start with the presumption that their assets will be separate. They can choose to place some property in joint ownership during the marriage, but this will not impact the treatment of their other property.

3. In the same situation, but where one spouse has significantly less assets and would not be able to support himself or herself following a divorce or death, the type of agreement described above could fail. A court might invalidate it as unfair. It is better to deal with the need to provide support for the less wealthy spouse head-on, and provide very specific terms in the agreement. That means less for the children from the first marriage, but more certainty. More certainty hopefully means less conflict.

4. Another common situation in which prenuptial agreements are used is for a young couple, first marriage, where the family of one of the couple has significant wealth.

    a. If the wealth is tied up in a family owned business, one approach is to use the agreement only to protect the family business assets.

    b. It may be that the primary goal of the agreement is to prevent the poorer spouse from claiming significant maintenance in the event of a divorce (especially after a shorter marriage) based on the much higher living standard of the wealthy family. Provisions limiting the spouse's rights at death may not be necessary because the wealthier spouse intends to treat his or her spouse in the usual way if they are married at death. Instead, trusts can be used to protect the assets for children of the marriage or that spouse's collateral relatives.

5. In a marriage of two professionals, one may be giving up a career to start a family and be the stay-at-home parent. That person may be foregoing significant financial opportunity. She or he may be in a profession where there are barriers to re-entry after a few years off. If a prenuptial agreement is used in this situation, it needs to recognize this reality. A court will, and it will make sure the stay-at-home spouse receives adequate support in the event of a divorce. If the agreement goes too far in limiting the spouse's rights, there is a risk the court may invalidate it.

XII. POST-NUPTIAL PLANNING

A. There of course are many circumstances in which a prenuptial agreement is advisable, but is not used. Even if both parties were willing to consider it, they did not make it a priority, and it was not addressed before the wedding.

B. In many jurisdictions, an agreement still can be entered into after the marriage. There are some unique factors that come into play, however.

C. The basic requirements for a post-nuptial agreement are similar to the requirements for a valid prenuptial agreement. The agreement generally should be in writing and must be entered into voluntarily, without duress or coercion. There should be full disclosure of assets. Separate legal counsel may not be mandated in every jurisdiction, but it is strongly encouraged to eliminate possible claims of unfairness or duress.

D. Unlike a prenuptial agreement, adequacy of consideration is an issue in post-nuptial agreements. The contemplated marriage is no longer available as the consideration. The mutual release of property rights may constitute adequate consideration; however, if there is significant disparity of wealth, it may not be sufficient. To avoid any issue, it usually is advisable for the wealthier spouse to make some type of present payment to the other spouse. This may be in the form of a cash transfer, or a transfer of property into the other spouse's name.

E. The other unique issue that can arise is whether the agreement will be interpreted as made in contemplation of a divorce. If so, it may come under an entirely different set of rules applicable to court-approved divorce settlements. A discussion of this, which is another area where the law can vary from jurisdiction to jurisdiction, is beyond the scope of these materials.

F. In the absence of any agreement, a person who wishes to preserve the status of his or her separate property should be very careful to keep all such property interests separate, in his or her own name.

1. One of the better ways to do this is to transfer separate property to a revocable trust before or soon after the marriage.

2. It may even be advisable to name a bank or trust company or another family member as trustee or as a co-trustee. Another option is to name a co-trustee and provide that the grantor can amend or revoke the trust only with the consent of another family member.

3. These steps will help ensure that the person's separate property is not unintentionally mixed with separate property.

4. The trust then needs to be administered in light of state law concerning appreciation and income from the property. If state law would treat the income as marital property, then it should be distributed out of the trust and kept separate from the underlying separate property.

G. If one of the assets of separate property is an interest in a family business in which the spouse is active, it might be best to keep this interest separate from passive investment assets that are separate property. The trustee also may want to obtain an appraisal of the business to establish a value before the spouse's efforts on the behalf of the business during the marriage start. This all is designed to keep a certain amount of value as separate property, if a court later finds that appreciation in the business is a marital asset. This will help ensure that interests are not unintentionally mixed with marital property.

XIII. SPECIFIC ESTATE PLANNING CHANGES AND SPECIFIC ASSETS

A. Once it becomes clear that an individual is heading toward divorce, he or she should have his or her estate plan reviewed and, most likely, modified.

B. In most states, a spouse named in a Will automatically is deemed to have predeceased the testator once a divorce decree is entered. Some states have statutes that apply the same rule to revocable trusts. For example, Illinois law provides that "[u]nless the governing instrument or the judgment of judicial termination of the marriage expressly provides otherwise, judicial termination of the marriage of the settler of a trust revokes every provision which is revocable by the settlor pertaining to the settlor's former spouse in a trust instrument or amendment thereto..." 760 ILCS 35/1.

C. The same rule generally does not apply to an irrevocable trust, such as an irrevocable life insurance trust. In that case, the terms of the trust should explicitly be made part of the settlement negotiations or court proceedings. The settlor of the trust will want to make sure that the former spouse's interests in the trust are taken into account in the division of property.

1. The former spouse could renounce his or her interests in the trust in exchange for other property interests as part of the settlement.

2. The settlor may want the spouse to agree to resign as trustee of irrevocable trusts as part of the settlement agreement.

D. While the parties are separated, but before the divorce becomes final, a wealthier spouse's ability to modify the estate plan may be more limited.

1. He or she can amend the Will or Trust to remove the other spouse as a fiduciary.

2. The wealthier spouse also can modify the estate plan, which often makes the spouse the primary beneficiary. In most states, however, the wealthier spouse probably will not be able to completely eliminate the other spouse's interests before the divorce is final.

   a. Even if the couple is separated, each spouse still has the right to elect against the Will.

   b. The majority of states have adopted the augmented estate approach for the spousal election, so the wealthier spouse may not have any ability to shelter assets from the election right.

c. Nevertheless the individual may want to write the spouse completely out of the estate plan, and force that spouse to exercise the renunciatory rights if the individual dies before the divorce is final.

E. A spouse with an IRA can remove the separated spouse as a beneficiary. However, spousal consent is needed to change the beneficiary under an ERISA-qualified plan. A spouse with life insurance can remove the separated spouse as a beneficiary. For both life insurance and an IRA, the augmented estate rules may impact the effectiveness of these steps.

F. Each party also probably will want to consider executing new powers of attorney for property and health care, to name someone other than the spouse as agent.

G. Retirement Assets

1. The division of retirement assets can be a contentious issue in divorce. In general, value attributable to funds in a qualified plan or IRA before the marriage remains separate property, but contributions during the marriage, and the appreciation thereon usually are treated as marital assets. There can be significant disputes over determining those proportions. There also can be valuation issues in determining the value of future pension rights or unvested benefits.

2. At the same time, a significant interest in a separate account plan or IRA often is a useful asset for satisfying one spouse's obligations to the other. The division can be accomplished tax-free, with the former spouse receiving a separate account, or rolling the proceeds over into his or her own IRA. The former spouse then assumes the tax obligation as funds are withdrawn.

3. A tax-free division of a retirement plan or IRA must be accomplished through a Qualified Domestic Relations Order (QDRO). The Code defines a QDRO as a domestic relations order

> "(i) which creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan...." and which meets additional detailed requirements set forth in the Code and the regulations. Code §414(p).

a. alternate payee" is most often the spouse; however, it can be a child or other dependent. Code §414(p)(9).

b. The order cannot alter the form or timing of payment of the benefits. For example, it cannot require distribution of benefits that are not yet distributable under the plan.

H. Non-qualified stock options and deferred compensation

1. A transfer of a non-qualified stock option or deferred compensation rights to a former spouse in connection with a divorce is excepted from the general rule requiring the employee to recognize income upon a transfer.

2. When the former spouse exercises the option, or receives the deferred compensation, he or she will recognize income, not the employee spouse. See Rev. Rul. 2002-22, 2002-1 C.B. 849.

XIV. SPECIAL PLANNING CONSIDERATIONS FOR BUSINESS OWNERS

A. In the family business situation, the owner who may face divorce can have any number of roles in the business. He or she may be the founder of the business, or a child or grandchild who is a principal in the business, or a family member who is a passive owner. It may be that both spouses are active in the business. In each situation, the impact of divorce on the business will be different.

B. The issue of whether some of the value of a business should be treated as marital property is a complex one. As noted previously, even if the ownership interests in the business are the separate property of one spouse initially, increases in value during the marriage might create a right if reimbursement or convert some of the value to marital property if due to the efforts of one or both of the spouses. In a business, this can occur in a number of ways.

1. The spouse may assert that she or he supported the other spouse's business activities, through entertainment or otherwise, and that her or his role as the primary parent and manager of the household allowed the spouse to devote more time to increasing the business value.

2. The spouse could argue that the business unreasonably accumulated earnings in lieu of paying the owner-spouse a salary commensurate with his or her contributions.

3. Or, the non-owner spouse actually may have participated in the business and not been adequately compensated.

C. These issues often can be deflected if the owner-spouse is adequately compensated for his or her efforts devoted to the business. The compensation will be marital property even if the business is one spouse's separate property, and it can be adequate remuneration for the efforts of both spouses in supporting the business.

D. Prenuptial agreements can be especially effective in protecting interests in a family business. A prenuptial agreement can be used to carve out the business interests, and all appreciation of those interests, as separate property. This avoids having to deal with issues of contribution, compensation, and valuation in the property settlement.

1. If the primary goal is to make sure that the business interests stay in the family in the event of a divorce, then consideration should be given to limiting the agreement to accomplishing that one goal.

2. Too often, the owner of the interest, or others in the family, also try to keep all distributions from the business as separate property, or greatly limit the spouse's rights to other property in case of death or divorce. This can detract from the primary goal. If the agreement tries to do too much, there is a risk that a court might invalidate it.

3. By contrast, a single purpose prenuptial agreement, designed to keep the stock in the family business as separate property, but otherwise not altering the spouses' rights with respect to other property, should not be easily challenged.

E. If the business is part of the property being divided by the court, then the valuation of the business is likely to be at issue. This can add significantly to the cost of the divorce. Each side will need experts to value the business, and the lawyers will spend significantly more time preparing the experts and understanding their opinions.

F. Although a business can add to the complexity of a divorce, the business interests also can be used in a positive way to settle property and maintenance obligations.

1. If the divorcing spouse will be awarded some stock, the company can create a class of non-voting stock for that purpose. Call features could be added to allow the company to liquidate the spouses' interest at a future date. Or, the company could issue debt to the spouse.

2. If the owner-spouse will have significant ongoing financial obligations to the other spouse, it may be possible to use a debenture issued by the company, or preferred stock, to fund those obligations.

3. If the business has an ESOP, it could be used to purchase the interests of a spouse who acquired stock in the divorce.

G. It is not uncommon for the non-family member spouse to be employed by the family business. For example, the father might employ son-in-law in the business. When daughter and son-in-law separate, a natural initial reaction is to fire son-in-law. This may not be a wise move. Many business owners have found that it is best to retain the divorcing spouse as an employee, especially where he or she is working in a key capacity. It not only is better for the business, but it gives that spouse a steady income that may help in the financial settlement in connection with the divorce.

H. Of course, some divorces degenerate into events worse than firing a soon to be ex-son-in-law. One author reported the story of a California man who sought a divorce from his wife but was desperate to avoid having her receive an interest in his $10 million company. He decided the solution was to hire a hit man to kill his wife. Unfortunately for the husband (and fortunately for the wife), the hit man was an undercover San Jose police officer. The man didn't have as much use for the business after he was convicted of solicitation to murder. Roger Fritz, Wars of Succession, 231 (1997).

XV. CONCLUSION

A. Any individual favors the simple solution, and estate planning clients are no different than anyone else in that regard. Certainly any estate planning professional should endeavor to craft an estate plan that is not unnecessarily complex.

B. Part of an attorney's duty is to educate the client on alternatives available and the implications of those alternatives. That duty includes the obligation to be forthright with the client in explaining that some problems or issues cannot be fully addressed with one simple solution.

C. Asset protection is one of those issues for which there is not one simple solution. For a client who wants to take steps to help preserve assets in case of future claims or a divorce, the professional's job is to both craft solutions that the client can live with and educate the client on the limitations of those solutions.

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