KEY ELEMENTS IN ASSET PROTECTION PLANNING

Family Offices and high net worth families worldwide are beginning to devote significant resources to the legal preservation of assets - nowhere is this trend more pronounced than in the United States.

The Development of "Asset Protection Planning"

Asset protection is the structuring of assets in a way that these assets become legally unreachable to possible future claimants. Although asset protection in some respects has long been a part of estate planning since estate planning has existed, it has often been wrongly viewed as an ugly duckling. Since the inception of the concept of "trusts"[1] in feudal times during the middle ages, protection of assets has been an integral role of trustees. If historians are to be believed, trusts first came about as Christian knights were departing for the Great Crusades. As they left their castles and belongings behind, they would charge a friend or relative with the job of managing such assets for the benefit of his family and other beneficiaries. If the knight did not survive the campaign, the trust was permanent. If he did survive, the "trustee" would return the charge and property to the knight upon his return. This series of contractual arrangements would be characterized today as a self-settled spendthrift trust.[2]

At some time subsequent to this, probably coincident with the end of the indentured servitude and invention of the concept of bankruptcy, asset protection took on a taint of impropriety. The general concept was simply that it is inappropriate to arrange one's affairs in order to avoid fully satisfying one's creditors. With the proliferation of limited liability entities[3] as the preferred method of conducting business worldwide, however, this concept has outlived its usefulness. Although it is always honorable to adhere to one's contracts and satisfy one's obligations, there is a counter-balancing view which acknowledges that: 1) events can occur which are outside of our control; 2) judgments may be awarded which are unreasonable; 3) even the best governments can abuse their power and make mistakes; and, 4) sometimes bad things happen to good people.

It is against this backdrop that the role of asset protection planning has been greatly elevated in the financial and estate planning hierarchy. It is now emerging as a key element in the Advanced Planning Protocol[4] and a foundation of long-term wealth management. In recent years, however, asset protection planning is becoming increasingly significant as a separate and distinct focus within the fields of estate planning and advanced planning.

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[1] A trust is typically in the form of a written trust agreement between the settlor, the person creating the trust, and the trustee. The trustee is responsible for administering and carrying out the terms of the trust. The beneficiaries are those who are entitled to trust income or principle either currently or at some time in the future.

[2] A Self-Settled Spendthrift Trust is an irrevocable trust, created by an individual for his own benefit whereby the assets of the trust are protected against the individual's creditors. Once property is gifted into an irrevocable Trust it can't be changed. Because the decision is irreversible it is as separate from you as legally as it can be. Most trusts are normally structured so that they are irrevocable for a term of years so that the settlor is not a current beneficiary.

[3] Limited liability entities include corporations, limited partnerships ("LPs"), international business companies ("IIBCs"), limited liability companies ("LLCs") and other similar entities used for business and investment purposes.

[4] The Advanced Planning Protocol is a multi-disciplinary methodology of approaching and solving complex financial issues in a comprehensive and integrated matter. Accordingly, the protocol seeks to provide solutions accomplishing multiple objectives including income tax minimization, estate tax minimization, succession planning, executive compensation and benefits planning, business planning, charitable planning, and asset protection planning.

Why is Asset Protection Needed?

Creditors and liability problems can arise from many different sources. These include significant business and financial obligations, liabilities resulting from injuries or tort damages, government regulatory claims and prosecutions, and divorce. In a litigious society such as in the US, where wealthy individuals and families are "moving targets" for aggressive lawyers, an asset protection plan is almost a necessity not only for US residents but also for those with significant assets in the United States. Asset protection is therefore:

- An effective tool to settle or discourage litigation
- A method to keep the ownership of assets absolutely confidential
- An alternative to traditional pre-nuptial agreements
- A hedge against potential exchange controls
- A device to protect otherwise unprotectable pension assets
- A means to give an insolvent debtor a fresh start
- The preferred technique to avoid forced heirship laws (common in Europe) and to transfer wealth to your heirs in accordance with your wishes and not in accordance with the laws of the country where you live.
- A way to transfer wealth to your heirs in a tax-efficient manner.
- A method to internationalize investment and hedge against governmental and political instability and other similar threats.
- A tool to separate legal ownership of low-risk assets from high-risk assets and to avoid a possible liability claim (arising from the high risk asset).

Trusts – How do they Work?

Trusts have remained one of the most accepted and regularly used asset preservation vehicles. The written trust agreement provides that the settlor will transfer certain assets to the trustee, and the trustee will hold those assets for the benefit of the named beneficiaries.

With a trust structure, the settlor has no legal right to revoke the trust and reacquire trust assets. Although the trustee typically will comply with the wishes of the settlor, the trust agreement requires the trustee to disregard any communications issued by the settlor under duress. That is, if the settlor is ordered by a court to communicate with the trustee, the trustee is required by the terms of the trust to ignore such requests for action. A court cannot logically compel an action that an individual has no power to perform. The conclusion is that the assets of the trust are protected, and the settlor can not be in contempt for failing to achieve a return of the property.

The most fundamental element of asset protection is “separation”. The law recognizes trusts as separate legal entities and they can own things just like an individual: bank deposits, investment portfolios (e.g. stocks and bonds), real and intellectual property, as well as life assurance policies issued on the life of the settlor. As a result, when property is held in a trust it is the property of that trust only and hence separated from you.

The second element of asset protection concerns “the extent of separation”. Many trusts are revocable and therefore do not have a great deal of separation as long as you are living and can therefore not provide a real protection of property. If you are sued, a living trust can be revoked as if it never existed and the underlying assets seized as if they were yours. On the other hand, irrevocable trusts are structured so that they are irrevocable for a term of years so that the settlor is not a current beneficiary. The further the assets are separated or the greater the extent of separation, the greater the protection.

Last but not least, a trust is also a "person" by law and can be sued like everyone. If a trust is sued everything that is owned by that trust is at risk, and property must therefore also be separated, i.e. isolated and insulated from each other, by creating separate trusts for every single property.

Off-shore Asset Protection Trusts

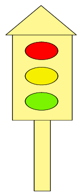
Recently, a number of American states have joined numerous sovereign nations by enacting legislation authorizing domestic US asset protection trusts[5]. However, the most often used and also most efficient vehicle to protect assets for the benefit of the whole family (transferor, first tier beneficiary, and descendants) has been the offshore asset protection trust (OAPT). These trusts can be supplemented by a host of insurance coverages, risk management policies, and domestic legal structures thoughtfully woven together into an effective asset protection plan.

One advantage with an offshore trust is their greater degree of flexibility that can be achieved in the way in which the trust is established. The settlor of the trust can serve as beneficiary, and the trust will still be valid under local law. This allows the settlor to retain a substantially greater degree of enjoyment over trust assets than would be permitted under US law with a domestic trust.

Moreover, creditors will have to deal with the foreign trustee, which is very complicated for various reasons beyond the actual geographic distance. Creditors will find that there is no available remedy obtainable against an uncooperative foreign trustee. This is because the courts in the US have no jurisdiction over foreign trustees, and therefore are unable to provide any relief to creditors. Hence, the only method for compelling the trustee to act is to file a lawsuit in the jurisdiction in which the trustee is located.

The Asset Protection Planning Process – Four Basic Steps

The first step in the planning process is an evaluation of the current status of a family’s legal, business and financial affairs is conducted. This includes all assets included in the family’s Statement of Net Worth. By considering the titles, tenancies, ownership, location, and controlling jurisdiction for each asset, a profile can be developed. This profile (which is specific to each country and each government subdivision such as state, canton, province and district) indicates the level of risk to which each asset is exposed assuming a catastrophic event. The three levels of asset protection can be depicted as red (completely unprotected), yellow (only partially protected) and green (significantly protected), analogous to a traffic light.



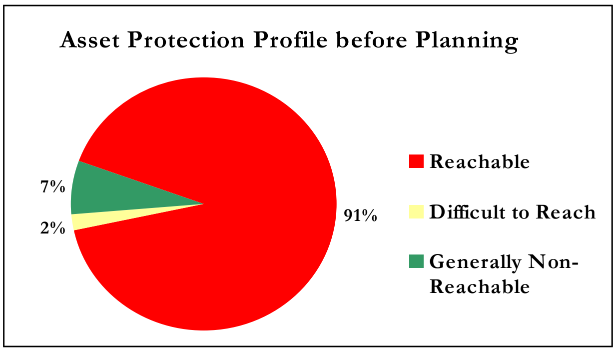
A selected “before” asset protection profile for a fictitious client drawn from an actual case is shown below. The green area is comprised of assets exempt from bankruptcy in

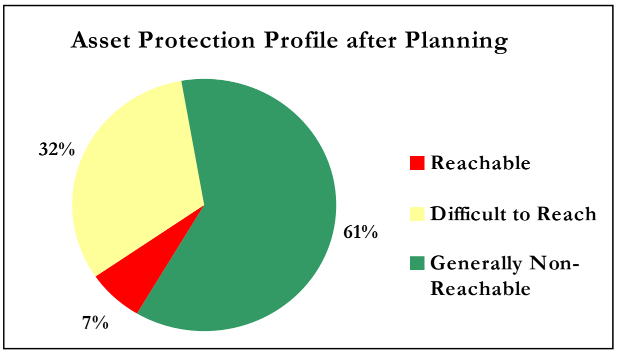
[5] Missouri, Alaska, Delaware, Nevada, Rhode Island, and Utah.

the jurisdictions and countries in which the family owns property. The yellow area is comprised of asset categories where a creditor cannot force sale or monetization of the underlying assets (e.g. limited partnerships). Rather, they can file some type of lien, charging order, or encumbrance, and then wait for a liquidity event, potentially forever. Assets classified in the red category can be irrevocably taken in a matter of hours.

Development of this profile is often an enlightening and extremely disturbing exercise for a family. In many instances, the family becomes aware, for the first time, of exactly what would transpire in the event of imposition of a major liability. The shock results from how little might be left after conclusion of collection proceedings by the claimant, creditor or former spouse.

Armed with this new understanding and concomitant motivation, the family and their advanced planning attorney set about to transfer assets and devise legal structures designed to enhance and elevate the status of the family's assets for asset protection purposes. Most of these strategies are tax neutral. The goal here is simply to protect the desired assets to the greatest degree possible, consistent with the family's business, financial, tax, personal, and charitable goals. As the next step a second profile, the "after" planning profile, is proposed depicting the same catastrophic liability. Hopefully, the result has significantly improved and the family can clearly see the benefit of further organizing their affairs.





The third step in the process is then implementation and funding. This step requires the systematic and highly organized orchestration of creation of new legal entities, property transfers, gifts, purchase of new liability insurance coverages, and other strategies. Since this step typically involves the family office staff and the family's team of outside professional advisors, a detailed implementation checklist should be employed.

The fourth and final step in the process is the periodic, typically annual, review of the plan. This step is intended to maintain the viability of the plan and to assure that the often competing income tax, estate tax, control, and dispositive goals of the family continue to be met. A significant number of laws in every country and government subdivisions in which a family holds assets must be continually monitored to assure compliance with local laws and continued viability of the asset protection planning strategies. For example, debtor-creditor laws, banking laws, commercial codes, trust laws, titles, tenancies and other laws must be considered.

Failure to do so can result in potentially devastating results. For example, a client established a trust in the Bahamas in the late 1960's, which today has a value of approximately $1.4Bn. When it was established it was in full compliance with the laws of the Bahamas and the laws of the client's native country. Moreover, at inception, the Bahamas was a more highly ranked jurisdiction for asset preservation purposes.

Today, the client has a trust which is in full compliance with the laws of the Bahamas, but has not remained compliant with the laws of its native country. More importantly, several other countries have enacted laws far superior for asset protection purposes to the laws of the Bahamas. Consequently, a prudent initial strategy has become less prudent with the passage of time. On-going monitoring would have dictated migration of the trust to a more favorable jurisdiction, revision of several trust provisions, and continuing compliance.

Advanced Planning for US Assets

For families with US assets, sophisticated asset protection planning involves several key structures. Often, such structures include a US family office entity, several family limited liability companies (FLLC) or family limited partnerships (FLP), offshore asset protection trusts and domestic US asset protection trusts. In addition to asset protection, these structures can provide estate and inheritance tax benefits, income tax benefits, financial efficiencies and executive compensation benefits.

It is initially important to distinguish between offshore trusts and offshore assets. The offshore trusts are established in a jurisdiction outside of Germany and the US in order to take advantage of that offshore jurisdiction's favorable asset protection laws (and possibly tax, business, or estate laws). Essentially there are two approaches. One can either "import the law" or "export the assets." Since our stated objective is asset protection, we typically wish to import the laws of asset protection jurisdictions and not to export the assets outside of Germany or the US, or other countries in which the family owns businesses or securities.

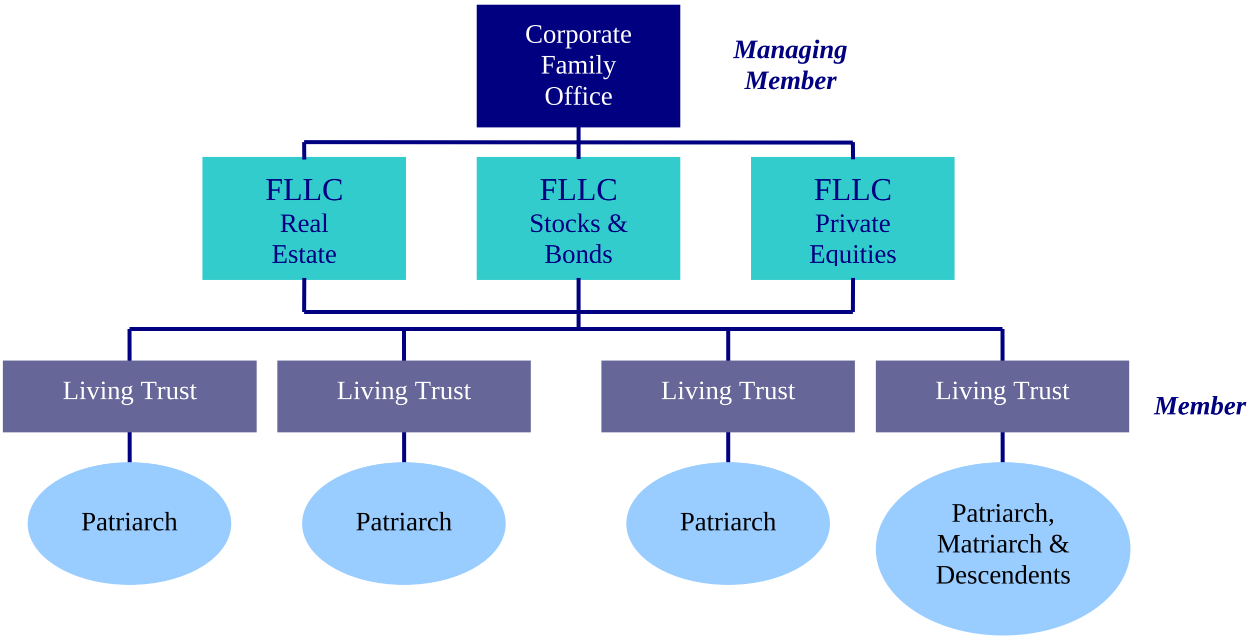
A limited partnership gives the option to maintain assets in their original location, while providing a high level of asset protection benefits. Under this arrangement, for example, husband and wife are the general partners or members with complete management and control over the company. Only the membership or partnership interests are transferred to the offshore trust. Property is legally insulated within this structure, and liquid assets can be moved into the overseas trust account for additional protection or investment purposes.

An example of such sophisticated structure is illustrated below and might include several FLLC managed by a US family office. The FLLC membership interests would be owned by various trusts for the benefit of the family, which will be established in Germany or the US. However, the asset protection trust would be established in the current, most favorable asset protection jurisdiction. The trustee in that jurisdiction would serve as an asset protection trustee only. The investments and assets would continue to be held by the custodians, typically a bank or investment firm in Germany or the US, or both. In some arrangements, a Trust Protector, would be named with various powers, including the right to terminate the trust or remove the trustee. Consequently, through the trust protector and custodian, control of the assets is not completely left to the asset protection trustee.

The asset protection elements in this structure occur at three levels. Firstly, a corporate managing member is used to isolate operational liability from the underlying assets and FLLCs. Secondly, the FLLCs in which assets are held generally limit creditors to a charging order (similar to a lien). Accordingly, such creditors cannot reach the assets, force a sale, or otherwise monetize the assets for their benefit. Moreover, the assets in each FLLC category are isolated from the assets in the other FLLCs.

Further, the assets within a FLLC can be isolated from each other. For example, different real estate holdings could be owned by single member LLCs or separate corporations which, in turn, are placed inside the real estate FLLC. The net effect of these structures is to isolate the real estate projects from each other, and to limit the liability of one project (e.g. a hotel) to only that project.

Finally, the FLLC interests are held, in part or in total, inside an offshore asset protection trust. Assuming that the trust was properly established, and initial transfers were properly effected, this has the impact of making the assets nearly impossible to reach. Under the current laws available on the planet earth, this is the highest level of asset protection attainable.



Asset Protection Jurisdictions

The best asset protection jurisdictions have enacted laws, which when taken together, have the impact of preserving assets. These jurisdictions typically have enacted statutes making it clear that the legal judgments of foreign countries are not recognized. Almost all jurisdictions have enacted a statute of limitations, which can be as short as one year, after which asset protection trusts cannot be challenged, and may have adopted a high standard of proof ("beyond a reasonable doubt") required in establishing fraudulent intent of any transfers. Moreover, the burden of proof typically rests on the creditor, and statutes specifically authorize self-settled spendthrift trusts. To prosecute a claim against the trust, the creditor would have to go to that country and retry the underlying case, an almost impossible requirement.

Many asset protection jurisdictions have specifically revoked the rule against Perpetuities[6] and the Statute of Elizabeth[7], and require the posting of a bond prior to commencement of litigation. Not surprisingly, these jurisdictions do not allow foreign attorneys to practice in their courts. In one jurisdiction, litigation cannot even be legally maintained against a properly registered and funded trust after passage of the limitations period.

These significant hurdles and additional provisions erect a formidable wall very difficult to break down. When added to the time and additional costs of pursuing these trusts, it is often deemed simply not worth the effort. Estimates are that fewer than ten percent of all claims against OAPTs are ever pursued. Consequently, simply having an OAPT provides a significant deterrent. Importantly, very few challenges against such trusts are ultimately successful.

Although a number of American States have enacted asset protection legislation, these laws are relatively new and largely untested. Consequently, it may be wise to use these trusts like a belt and braces. They may not in themselves, hold up the trousers. By using these domestic US trusts in tandem with OAPTs, better results can be expected.

Before Setting up an Asset Protection Trust

Mechanically, a number of legal features militate toward complete asset protection. Firstly, at the time of any asset transfers, it is critical that no current lawsuits are pending. Alternatively, if the pending lawsuits could be satisfied by the family's assets outside of the OAPT, the trust will generally be respected.

Secondly, the grantor should execute a statement of solvency with a balance sheet (or other appropriate financial statement) showing a positive net worth. This is essential in order to establish that you are not entering into this transaction in order to defraud creditors. Such a statement of solvency will also help those who assist you, so that they will not be attacked on the basis that they were co-conspirators in a fraudulent scheme.

It is important to note that assets segregated prior to marriage in FLLCs and/or OAPTs constitute non-marital property. If such assets are not commingled, tainted or transmuted somehow, they will remain non-marital property for future generations. Because of the legal formalities associated with these structures, they are much more difficult to inadvertently taint, and a strong pre-nuptial planning benefit is also provided. Even in the absence of a pre-nuptial agreement, assets held in these structures are simply removed from the equation. It is wise, however, to use these structures in conjunction with a pre-nuptial agreement in order to take a conservative approach.

Conclusions

It is clear protection of assets owned by American and worldwide citizens in the US will increasingly become a critical element of any advanced plan. Asset protection should be

[6] The common law Rule Against Perpetuities holds that no interest is good unless it vests or fails within a life in being plus twenty-one years. This rule serves to limit the often intended long-term or perpetual nature of certain trusts. Consequently, the existence of this rule provides a certain window of opportunity for creditors.

[7] Fraudulent transfer laws originated in England with the 1571 Statute of Elizabeth. It states, "If a transfer is made with actual intent to hinder, delay, or defraud any creditor of the debtor, it is fraudulent as to a creditor whose claim arose before or after the transfer date." This concept is addressed in the Uniform Fraudulent Conveyances Act which most American states have adopted.

thoughtfully considered by any family concerned with wealth management or preservation of a start-over fund.

There are literally hundreds of different techniques to protect different categories of assets depending on the kind of protection that is wanted as well as the type and location of property. It is important to make sure the asset protection plan provide complete protection for all of the client's assets. At the same time, to the greatest extent possibly, an asset protection plan should also be cost-efficient and should easily fit within the client's existing or easily modifiable mode of business operations.

Unfortunately, many trusts that are being set up are completely ineffective at protecting assets, or alternatively, provide meaningful protection to only one generation of a family, typically either the transferor or first tier beneficiaries. Moreover, the ability and willingness of courts and government bodies to regularly set aside otherwise valid trusts in the absence of criminality are troubling. Similarly, courts have been routinely willing to set aside or modify pre-nuptial agreements which would otherwise be legally binding. For that reason expert professional advice is needed before setting up a trust.

Proper asset protection structures do not encourage or depend on illegal acts such as concealment of assets in violation of the law. Instead, through the use of foreign trusts, foundations, and certain insurance products, legal arrangements are made to effectively disconnect assets from the beneficial owners, thereby making it impossible for third parties to reach those assets. There is a very sharp dividing line between "legal" asset protection planning on the one hand, and actions to defraud creditors, which are criminal, on the other hand. Again: asset protection trusts can be very powerful tools in managing a family's wealth, however it is essential to take good professional advice in embarking on this process.

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