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MARITAL RIGHTS IN TRUST, ESTATE AND ASSET PROTECTION PLANNING

September 12, 2014
2014 Family Law Meeting
North Carolina Bar Association

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The assistance of Stephen A. Brown, Young Moore and Henderson, P.A., and Matthew Lawless, Howard, Stallings, From and Hutson, P.A., with the preparation of this manuscript is gratefully acknowledged.

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I. INTRODUCTION

Marital rights raise complex questions in trust and estate planning. These questions may arise unintentionally as when a spouse desires to transfer assets to a company, trust or family member for the purpose of reducing his or her wealth transfer tax exposure. In other cases, a spouse may intentionally transfer assets in an effort to reduce or eliminate his or her spouse's interest in those assets. The timing, purpose and methods of transfer as well as the assets used to accomplish the transfer are crucial in evaluating the rights of the non-transferring spouse.

This manuscript analyzes the case of the hypothetical client identified in Appendix A (the "Hypothetical"). Part II proceeds with a general discussion of asset protection in trust and estate planning with particular emphasis on the use of trusts. In Part III, the legal issues likely to be encountered by the hypothetical client are identified and discussed. This manuscript is not intended to be, and is not, a comprehensive discussion of all asset protection tools available or issues to be considered when evaluating or engaging in asset protection planning. Practitioners should, however, glean a general understanding of the primary options available for a client interested in asset protection planning.

II. ASSET PROTECTION IN TRUST AND ESTATE PLANNING

Clients may be motivated to engage in asset protection planning for a variety of reasons. Their profession or business may pose a potentially high degree of personal liability or they may perceive a risk of susceptibility to an aggressive plaintiff's bar. Some clients may simply have the goal of avoiding a specific creditor like a spouse. Asset protection planning generally encompasses planning for all these purposes. However, a client's options are substantially affected by the circumstances existing at the time planning is desired. Forward-looking clients enjoy a wider range of available tools to achieve their objectives while clients engaging in crisis-planning are faced with substantial challenges and limitations. In all cases, practitioners should carefully consider their own ethical and legal obligations prior to advising clients in this area.

Trusts and business entities are two commonly employed asset protection tools. Their appropriateness depends on a series of factors ranging from plan development and implementation costs to the degree of control desired over the assets as well as the present status of creditors. In the marital context, a spouse may have significant interests in the client's assets or the client may owe certain duties to the spouse when engaging in certain transactions. These interests and duties must be assessed prior to engaging in any protection planning strategies. Part III outlines many of these considerations using the Hypothetical. Before discussing the Hypothetical, it is useful to survey the major available options. This Part provides a general overview of the effectiveness of trust and business entities as asset protection tools.

[1] Special thanks to Stephen A. Brown, Young Moore and Henderson, P.A., and Matthew Lawless, Howard, Stallings From and Hutson, P.A., for their contributions to this manuscript.

A. <u>TRUSTS AS ASSET PROTECTION DEVICES</u>

Trusts can be valuable asset protection tools in appropriate circumstances. However, a trust's usefulness in this context is highly dependent on a series of factors including: the timing of the trust's creation; the identity and status of the settlor, trustee and beneficiaries; the terms of the trust, including its governing law; and the type of creditor. As discussed below, with one narrow exception, revocable trusts generally never protect assets from claims by the settlor's creditors. Accordingly, this section focuses primarily on the ability of irrevocable trusts to serve as asset protection tools.

1. <u>Key Trust Provisions</u>

A trust is commonly defined as "a fiduciary relationship with respect to property, subjecting the person for whom the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it." *See*, *e.g.*, <u>Sinclair v. Travis</u>, 231 N.C. 345, 353, 57 S.E.2d 394, 400 (1950); <u>Restatement (Third) of Trusts</u> § 2 (2003). The relationship results from the separation of equitable and legal title to identifiable property. <u>Sinclair v. Travis</u>, 57 S.E.2d at 400. The settlor of a trust relinquishes legal title to property conveyed to a trust. Legal title to trust property is generally vested in the trustee with equitable title vested in the beneficiaries. Accordingly, questions arise as to a creditor's ability to reach assets transferred in trust when a creditor is pursuing a claim against a settlor or beneficiary of the trust. Certain key trust provisions are initially controlling in this regard.

a. <u>Governing Law</u>

The trust's governing law generally determines whether the trust was effectively created and the rights of creditors to reach the assets in the trust. Under North Carolina law, the meaning and effect of the terms of a trust are determined either by (i) the law of the jurisdiction designated in the terms of the trust unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue, or (ii) in the absence of a controlling designation in the terms of the trust, the law of the jurisdiction having the most significant relationship to the matter at issue. G.S. §36C-1-107(a). As a result, a trust created in North Carolina may be governed by the laws of another jurisdiction subject to certain important limitations. As discussed below, a court may not respect a settlor's choice of law when doing so would be contrary to a creditor's rights in the forum state. *See, e.g.,* <u>In re Huber</u>, 493 B.R. 798 (W.D.Wash. 2013)(declining to apply settlor's choice of Alaska law where assets and beneficiary were located in Washington State and Washington State had strong public policy against creditor protection for self-settled trusts). However, it is possible that a settlor may choose a jurisdiction's law that is more favorable to creditors than the forum state's law. Such a designation would appear to be enforceable in North Carolina.

b. <u>Debtor's Relationship to Trust</u>

A creditor's ability to reach trust assets depends largely on the debtor's relationship to the trust. A debtor may have one or more relationships to the trust, including possible status as settlor, trustee, beneficiary, trust protector or holder of a power of appointment. In North Carolina, a creditor of a debtor who merely serves as trustee of a trust cannot reach the assets of the trust. G.S. §36C-5-507. Other relationships, however, require more analysis particularly when the debtor maintains multiple relationships to the trust simultaneously.

Practitioners should be careful to distinguish creditor claims based on the status of the debtor from claims against the trust directly. Applicable law may prevent trust assets from being used to satisfy the creditor's claims based solely on the status of the debtor. The trust, however, may incur liability on some other basis as in the case of a fraudulent transfer. Part II.A. of this manuscript generally discusses a creditor's ability to reach trust assets based on the status of the debtor. Part III discusses alternate theories in which a creditor may reach trust assets.

2. <u>Self-settled Trusts and Trusts Created for Third-parties</u>

A debtor's relationship with a trust will generally cause the trust to be categorized as either a self-settled trust or a trust created for third parties. There is generally no protection in the former and greater protection in the later. However, the line between the categories is not always clear. Clever practitioners have developed a myriad of devices to provide settlors and beneficiaries substantial control over trust operations and distributions without causing the settlor or beneficiaries to expressly assume a non-protected status with respect to the trust. As a result, a trust that appears on its face to be created by a settlor for the benefit of a third party may be functionally akin to a self-settled trust. While voluminous tax cases have discussed the effect of a settlor or beneficiary's powers over trust property for tax purposes, courts in other contexts have struggled to address the effect of such strings on a creditor's ability to reach trust assets.

a. <u>Self-settled Trusts</u>

(1) <u>General Rule: No Protection for Settlor</u>

A self-settled trust is a trust in which the settlor is both the creator and beneficiary (or partial beneficiary) of the trust. Accordingly, self-settled trusts may include both revocable and irrevocable trusts.

Revocable trusts are self-settled trusts and the assets of such trusts are subject to the claims of the settlor's creditors. G.S. §36C-5-505(a)(1). This rule is true both during the lifetime of the settlor and upon the settlor's death. G.S. §36C-5-505(a)(3); <u>Livesay v. Carolina First Bank</u>, 192 N.C. App. 234, 665 S.E.2d 158 (2008); <u>Rush University Medical Center v. Sessions</u>, 980 N.E.2d 45, 55 (Il. 2012)(stating the general common law rule). A trust is considered revocable if the settlor can revoke the trust without the consent of a trustee or person holding an adverse interest in the trust. G.S. §36C-1-103(16). As a result, a trust is not considered revocable if a person other than the settlor has the right to revoke or amend the trust.

Illustration #1: Peter creates a trust naming his wife and children as beneficiaries and his friend, Thomas, as Trustee. The trust provides that Peter reserves the right at any time to amend and revoke the trust in whole or in part by an instrument delivered to the Trustee. Peter alone funds the trust with $50,000. The trust is a revocable trust and the trust's assets are subject to the claims of Peter's creditors.

Illustration #2: Same facts as Illustration #1 except that instead of providing that Peter reserves the right at any time to amend and revoke the trust, Peter's wife is given the right to amend and revoke the trust. The trust is not a revocable trust. The settlor, Peter, does not have the right to amend or revoke the trust. For a discussion as to whether the trust assets are subject to the wife's creditors, see below.

A trust is presumed revocable unless the settlor specifically provides that the trust is irrevocable.[2] G.S. §36C-6-602(a). Accordingly, a trust governed by North Carolina law must generally provide by its terms that the trust may not be revoked or amended by the settlor in order to be irrevocable. By implication, an irrevocable trust is any trust that is not a revocable trust.

Irrevocable trusts are not, by definition, asset protection devices. In the context of self-settled trusts, the general rule is that a creditor or assignee of a settlor may reach the maximum amount that can be distributed to or for the settlor's benefit from an irrevocable trust. G.S. §36C-5-505(a)(2).[3] Significantly, a "settlor" includes any person who creates or contributes property to a trust. G.S. §36C-1-103(17). If more than one person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion. Id.

Illustration #3: Peter creates a trust for the benefit of his wife, Paula, but does not contribute any property to the trust. Paula contributes $50,000 to the trust. Peter and Paula are settlors of the trust. The trust property is subject to the claims of Paula's creditors.

Illustration #4: Same facts as Illustration #3 except that Peter retains the right to withdraw the trust property at any time. Peter and Paula are settlors of the trust. The trust property is subject to the claims of Peter's creditors.

Illustration #5: Peter is the sole beneficiary of a testamentary trust established by his late father. Under the terms of the trust, Peter has the right to distribute property to himself for his health, education, support and maintenance in his discretion. Rather than create his own separate trust, Peter contributes $50,000 to the testamentary trust after his father's death. Peter is considered the settlor of the testamentary trust to the extent of his $50,000 contribution. The $50,000 contributed to the trust (together with any additions attributable to that contribution) is subject to the claims of Peter's creditors.

[2] Other jurisdictions may employ a contrary presumption. A practitioner must be careful to evaluate the law governing the trust and determine its terms in accordance with that law.

[3] In North Carolina, this rule is subject to one notable exception. It is not uncommon for an irrevocable trust to be a "grantor trust" within the meaning of IRC §671 resulting in the trust being disregarded for tax purposes and the assets of the trust, including any income, gain or loss, being attributed to the grantor. In such a case, a trustee's discretionary authority to pay amounts to tax authorities or to the grantor for reimbursement of taxes on trust income or principal is not considered an amount that can be distributed to the grantor or for the grantor's benefit. G.S. §36C-5-505(a)(2a).

Importantly, a creditor's ability to reach a settlor's interest in the trust applies without regard as to whether the irrevocable trust contains provisions that would otherwise provide for creditor protection, including spendthrift provisions, discretionary trust interests, and protection trust provisions discussed below. G.S. §36C-5-505(a).

> Illustration #6: Peter creates an irrevocable trust, funds the trust with $50,000, and names himself as beneficiary and his friend, Thomas, as Trustee. The trust provides that the decision to make a distribution to Peter is within the sole discretion of Thomas. The trust also contains a spendthrift provision and states that Peter's interest in the trust will terminate immediately if any creditor attempts to reach Peter's interest in the trust. The trust property is subject to the claims of Peter's creditors.

(2) Exception: Protective Trusts

The traditional rule that assets held in self-settled trusts are subject to the claims of the settlor's creditors is not without exception. At least fifteen states have enacted legislation providing various levels of creditor protection for self-settled trusts. For the reasons discussed below, these so-called "domestic asset protection trusts" ("DAPTs") are vulnerable in many circumstances. Offshore protective trusts may provide a remedy for some of these deficiencies but are accompanied by certain disadvantages, including cost and complexity that make them unappealing to many clients. A discussion of offshore protective trusts is beyond the scope of this manuscript, but such trusts may be a viable option in appropriate cases. Similarly, DAPTs may prove useful in certain circumstances. The following discusses the general features and limitations of DAPTs.

(a) Jurisdictions

Nevada, South Dakota, Ohio, Tennessee, Alaska, Wyoming, Delaware, Missouri, New Hampshire, Hawaii, Rhode Island, Utah, Mississippi, Virginia and Oklahoma have enacted statutes providing protection to varying degrees for self-settled trusts. Alaska Stat. §34.40.110; Nev. Rev. Stat. §166.010; Del. Code. Ann. tit. 12, §3570 (2009); S.D. Code Laws §55-16-1; Utah Code Ann. §25-6-14; R.I. Gen. Laws §18-9.2-1; Okla. Stat. tit. 31, §10; Mo. Stat. Ann. §456.1-101; Ohio Rev. Code §5816.01; Tenn. Code. Ann. §35-16-101; Wyo. Stat. Ann. §4-10-501; Miss. Code §91-9-701; H.R.S. 554G; N.H. Rev. Stat. Ann. §564-D:1-18; VA Code §55-545.03:2.

(b) Required and Permissive Provisions

A settlor must comply with the applicable statutory requirements in order to gain protection under a DAPT. There is some commonality among jurisdictions with regard to certain basic structural requirements and greater variance with respect to the rights of the settlor in the trust. DAPTs must generally be irrevocable and must apply the law of the applicable jurisdiction. Most jurisdictions further require that the trust contain a spendthrift provision. DAPTs were largely adopted under the belief that they could attract assets or revenue to the adopting jurisdiction. Accordingly, most DAPTs require appointment of an in-state trustee or the presence of a portion of the trust assets in the state. The following chart sets forth the common requirements for a trust instrument to qualify as a DAPT:

REQUIRED PROVISIONS BY JURISDICTION

Trust Provision	Jurisdiction
Trust must be irrevocable	AK, DE, HI, MO, NV, NH, RI, SD, TN, UT, VA, WY, OH, MS OK (may be revocable or irrevocable subject to certain limitations)
Trust must expressly state jurisdiction's laws govern	HI, OK, RI, TN, VA, WY, OH, MS, AK, DE, NH, SD
Trust must contain a spendthrift provision	AK, DE, MO, NH, RI, SD, TN, UT, VI, WY, OH, MS
All or part of trust corpus must be located in jurisdiction	DE, NV, NH, OK, RI, TN, UT, VA, WY, OH
One or more trustees must be located within jurisdiction	AK, DE, HI, NV, NH, OK, RI, SD, TN, UT, VA, WY, OH, MS MO (required if no part of administration occurs in jurisdiction)
Trustee must be trust company located within jurisdiction	OK, UT (although individual co-trustees may serve together with institutional trustee)
Beneficiaries must be only qualified beneficiaries (spouse, ancestor, descendants, etc.)	OK (settlor cannot be beneficiary, although possesses right to revoke)
Trust must contain mandatory state income tax language	OK
Trust assets may not exceed set limit	OK ($1,000,000 limit)
Trust must have at least one beneficiary other than the settlor	MI, VA (during any period distributions may be made to settlor)
Settlor must have personal liability insurance	WY, MS ($1,000,000 personal liability insurance required) (In MS, up to $1,500,000 can be reached in trust if no insurance)
Affidavit of solvency required from settlor	AK, TN, WY, OH, MS
Jurisdictional trustee must perform certain administrative functions	AK, DE, HI, NV, NH, OK, RI, SD, TN, UT, VA, WY, OH

In addition to the required provisions reviewed above, many statutes expressly state the interests that the settlor may retain in the trust. Commonly, these interests include the right to discretionary distributions, the right to income or a percentage of trust assets annually, and the right to remove and replace the trustee or trust advisors. The following is a general summary of a settlor's right to retain interests in a DAPT:

PERMISSIVE PROVISIONS BY JURISDICTION

Trust Provision	Jurisdiction
Right to income	DE, HI, NV, NH, RI, SD, TN, WY, OH
Right to at least 5% of trust assets annually	AK, DE, HI, NV, NH, RI, SD, TN, VA, WY, OH, MS
Interest in GRAT, GRUT, QPRT and IRA	AK, DE, NV, NH, RI, SD (QPRT), TN (CRT and QPRT), UT (CRT), VA (CRT, QPRT, GRAT), WY, OH (CRT), MS (CRT)
Right to reimbursement of taxes	AK, DE, HI, NV, NH, RI, TN, VA
Trust assets may be used to pay estate debts upon settlor's death	DE, NV, NH, TN, VA, MS
Right to discretionary distributions	AK, DE, HI, MO, NV, NH, RI, SD, TN, UT, VA, WY, OH, MS
Right to veto distributions	AK, DE, HI, NV, NH, RI, SD, TN, UT, WY, OH, MS
General testamentary power of appointment	HI (testamentary power for debts, administrative expenses, taxes), NV
Non-general testamentary power of appointment	AK, DE, HI, NV, NH, RI, TN, UT, VA, WY (general or limited power of appointment), OH
Retain right to remove and replace trustee	AK, DE, HI, NV, NH, SD, TN, UT, VA, WY, OH, MS
Right to remove and replace trust advisor	AK, DE, HI, NV, NH, SD, TN, UT, VA, WY, OH, MS
Out of state trust may move to jurisdiction and receive coverage as DAPT	AK, DE, HI, NV, NH, SD, TN, UT, VA, WY

While the above summaries are obviously a simplification of the complex jurisdictional options, they serve to demonstrate that potentially significant distinctions exist based on the retained powers of the settlor, the identity of the trustee, and the location of the trust property.

(c) Creditor Protection

Not all creditor claims are barred simply because the DAPT was properly implemented. Each jurisdiction excludes various claims from protection. Common exclusions include claims for alimony or property division if the spouse was married to the transferor on or before the date of the transfer. Claims for child support are generally also excluded. A minority of jurisdictions exclude claims for injury to person or property arising before the transfer.

In addition, each jurisdiction employs statutes of limitations permitting a creditor a period of time to void a transfer to the trust. The limitation periods range from eighteen months to five years after the transfer is made to the trust. Accordingly, practitioners should use caution when selecting a jurisdiction to ensure that the primary claims of concern are barred. The following chart outlines the common exceptions from DAPTs:

CLAIMS EXCLUDED FROM PROTECTION

Type of Claim	Jurisdiction
Eighteen months existing creditor statute of limitation	OH – if longer, six months after transfer was or could reasonably have been discovered
Two year existing creditor statute of limitation	HI, NV, MS, SD NV, MS, SD – if longer, six months after transfer was or could reasonably have been discovered
Four year existing creditor statute of limitations	AK, DE, MO, NH, OK, RI, TN, UT, WY NH, OK, RI, TN, UT, WY - if longer, one year after transfer was or could reasonably have been discovered
Five year existing creditor statute of limitations	VA or, if longer, five years after transfer should have been discovered
Eighteen month future creditor statute of limitation after transfer	OK
Two year future creditor statute of limitation after transfer	NV, MS, SD
Four year future creditor statute of limitations after transfer	AK, DE, MO, NH, OK, RI, TN, UT, WY AK, DE, MO, OK, UT, WY – if longer, one year after transfer was or could reasonably have been discovered
Child support	AK, DE, HI, MO, NH, OK, RI, SD, TN, UT, VA, WY, OH, MS
Alimony	DE, HI, MO, UT, VA, WY, NH, RH, SD, TN, OH, MS
Property division upon divorce	HI, UT, VA, WY AK - if assets transferred to trust 30 days prior to marriage) DE, NH, RI, SD, TN, OH, MS - if spouse was married to settlor before or on date of transfer
Tort claims for death or bodily injury	DE, HI, NH, RI, MS - if arises from death, personal injury or property damage occurring before the transfer) UT – under certain conditions
Elective share and other marital rights upon death	MO, OK, RH, SD, UT, VA, WY

(d) Public Policy Limitations

The advent of the domestic asset protection trust is counter to the traditional rule against self-settled trusts. In a nation of many jurisdictions, questions remain as to whether and to what extent the courts of federal or state jurisdictions that retain the traditional rule will protect beneficiaries of domestic asset protection trusts established and governed by the law of another jurisdiction. Courts could use their conflict of law rules to avoid the application of another jurisdiction's debtor-friendly laws.

Section 270 of the Second Restatement of Conflict of Laws provides in relevant part as follows:

> An inter vivos trust of interests in movables is valid if valid . . . under the local law of the state designated by the settlor to govern the validity of the trust, provided that this state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6 . . . .

Thus, § 270 permits a court to consider the public policy of the jurisdiction with which a trust has its most significant relationship (which might or might not be the law designated by the trust instrument) in assessing the validity of a trust. However, the more important inquiry concerns the extent, if any, to which creditors can reach the assets of such a trust. Section 273 of the Second Restatement of Conflict of Laws is the starting point for this analysis. It provides in pertinent part as follows:

> Whether the interest of a beneficiary of a trust of movables is assignable by him and can be reached by his creditors is determined . . . in the case of an inter vivos trust, by the local law of the state . . . in which the settlor has manifested an intention that the trust is to be administered . . . .

Unlike § 270, § 273 and its comments do not contemplate that a different rule might apply if the law of the trust's situs violates a strong public policy of another state.

Even so, if some place other than the asset protection trust state is the forum, then the trust state's relation to the trust is arguably diminished, and a local judge may conclude that his or her state has a greater relation to the trust, and may choose to apply that state's policy. FTC v. Affordable Media, LLC, 179 F3d 1228, 1231 (9th Cir. 1999) (affirming district court's rejection of argument that Cook Islands trust law divested ownership interest, noting that "a district court judge and his common sense" are not "easily parted"); *See* In re Smith, 415 B.R. 222, 234-35 (Bankr. N.D. Tex. 2009); Dexia Credit Local v. Rogan, 624 F. Supp. 2d 970, 975-76 (Bankr. N.D. Ill. 2009); In re Lawrence, 227 B.R. 907, 917 (Bankr. S.D. Fla. 1998); In re Brooks, 217 B.R. 98, 101-02 (Bankr. D. Conn. 1998); In re Portnoy, 201 B.R. 685, 698 (Bankr. S.D.N.Y. 1996) (refusing to permit Jersey Island law to defeat creditor's claim to assets held in a Jersey Island trust).

Courts appear more willing to use the "public policy" exception imbedded in the conflict of law jurisprudence to prevent debtors from benefitting from out of state asset protection trusts when the debtor has engaged in attempts to evade existing or known potential creditors and not mere innocent estate planning. In the recent case of *Waldron v. Huber (In re Huber)*, 493 B.R. 798 (U.S. 2013), a federal district court struck down a domestic asset protection trust created in a state other than the grantor's residence. The debtor was a citizen of Washington and placed nearly all of his assets into an Alaska domestic asset protection trust prior to the failure of his real estate business. The debtor then filed for chapter 11 bankruptcy protection.

The bankruptcy judge granted summary judgment to the bankruptcy trustee, finding that the trust did not protect its assets from the claims of Donald's creditors and should be set aside on three separate bases, including applying Washington state law to the trust and not Alaska state law. The court held that the trust was not protected from the claims of the settlor's creditors by the provisions of Alaska law that expressly recognize the validity of self-settled asset protection trusts, but instead were invalid under the provisions of Washington law that reject self-settled spendthrift trusts. *Compare* Alas. Stat. § 34.40.110 *with* Rev. Code Wash. § 19.36.020. The court stated that the conflict between the laws of the two states must be settled under federal choice of law rules, rather than state choice of law rules, citing *Lindsay v. Beneficial Reinsurance Co. (In re Lindsay*), 59 F.3d 942, 948 (9th Cir. 1995). The court followed the choice of law rules set forth in the Restatement (Second) of Conflict of Laws, which states that a provision in the instrument governing an inter vivos trust of personal property that declares that the validity of the trust will be controlled by the law of a specific state will be followed only if (a) the state declared in the instrument as controlling has a substantial relation to the trust, and (b) the application of its local law does not violate a strong public policy of the state with which as to the matter at issue the trust has its most significant relationship. Restatement (Second) of Conflict of Laws § 270 (1971); Liberty Tool & Mfg. v. Vortex Fishing Sys., Inc. *(In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057, 1069 (9th Cir. 2002).

Under the court's analysis, Alaska law would apply only if Alaska had a substantial relation to the trust. When this trust was created, neither the debtor nor the beneficiaries were domiciled in Alaska and the trust assets were not located in Alaska. The trust's only connection with Alaska was the location of the trustee and the administration of the trust in Alaska. On the other hand, when the trust was created, the debtor and the trust beneficiaries all resided in Washington, the trust assets were transferred from Washington, debtor's creditors were located in Washington, and the drafting attorney was located in Washington. When the trust was created, therefore, Alaska had only a minimal relation to the trust, but Washington had a substantial relation to the trust. Washington had a strong public policy against self-settled asset protection trusts; its statutes declare them void against both existing and future creditors. Rev. Code Wash. § 19.36.020; Carroll v. Carroll, 18 Wash. 2d 171, 175, 138 P.2d 653 (1943); Rigby v. Mastro *(In re Mastro)*, 465 BR 576, 611 (Bankr. W.D. Wash. 2011). Therefore, as the trust was a self-settled trust, Donald's transfers of assets into the trust were void, and the trustee was entitled to summary judgment voiding the transfers.

The court held that the transfers to the trust were fraudulent under the Bankruptcy Code. Section 548(e)(1) of the Bankruptcy Code states that the trustee in bankruptcy may avoid any transfer to a self-settled trust or similar device made by the debtor on or within 10 years before the bankruptcy petition if the debtor is a beneficiary of such trust or device and the debtor made the transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted, on or after the date that such transfer was made. 11 U.S.C. § 548(e). The court found that the parties conceded all of the elements required by Section 548(e)(1), except for the "actual intent to hinder, delay, or defraud…."

The Bankruptcy Code also gives the bankruptcy trustee authority to bring suit to avoid fraudulent transfers under state law, and the court applied the Washington Uniform Fraudulent Transfer Act (UFTA) and not the more debtor friendly Alaska fraudulent transfer law. The court had already determined that the debtor was threatened with litigation when the transfers occurred; the transfers included substantially all the debtor's assets; and the debtor retained control of the transferred property. The court held that the evidence also established that: (a) as a self-settled trust, the transfer from the debtor to the trust was to an insider; (b) the debtor conceded that he did not receive consideration for transferring his assets to the trust; (c) by transferring the property into the trust, the debtor was attempting to remove the assets from the creditors' reach; and (d) the debtor was desperate to protect and shield his assets. The court held that the trustee was entitled to summary judgment as a matter of law on its UFTA claim based on actual fraudulent intent.

Other reported cases have addressed domestic self-settled asset protection trusts in the context of debtors that attempt to use their trusts to avoid known or reasonably known creditors, and the courts do not favor the debtors in these situations. United States v. Evseroff, 2007-1 U.S. Tax Cas. (CCH) ¶ 50,222 (E.D. N.Y. 2006), *rev'd and rem'd*, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,240 (2d Cir. 2008), on remand, 2012-1 U.S. Tax Cas. (CCH) ¶ 50,328 (E.D. N.Y. 2012), *aff'd*, 528 Fed. Appx. 75 (2d Cir. 2013) (applying New York fraudulent conveyance law to permit federal government to collect a tax debt from trust after proving actual fraud by debtor); Kilker v. Stillman, 2012 WL 5902348 (Cal. Ct. App.) (express effort to shield assets from liability to "reasonably foreseeable" future judgment creditors constituted a fraudulent conveyance; alter ego concept also applied to defeat the trust); Rush University Medical Center v. Sessions, 980 N.E.2d 45 (Ill. 2012) (designation of Cook Islands governing law ignored when trust real estate assets located in Illinois were sufficient to satisfy a charitable pledge the settlor had failed to honor before dying); Watterson v. Burnard, 986 N.E.2d 604 (Ohio Ct. App. 2013), *appeal not accepted*, 135 Ohio St. 3d 1449 (2013) (the fact that the settlor died before a judgment was rendered did not alter the plaintiff's right to secure payment from the settlor's inter vivos trust).

In the case of off-shore asset protection trusts, the courts universally apply United States Law, and are willing to hold beneficiaries of self-settled asset protection trusts in civil contempt and jail the beneficiaries until the assets are made available to the court's jurisdiction. FTC v. Affordable Media, LL*C*, 179 F.3d 1228 (9th Cir. 1999), and In re Lawrence, 279 F.3d 1294 (11th Cir. 2002); *See also* Securities and Exchange Commission v. Solow, 682 F. Supp. 2d 1312 (S.D. Fla. 2010), In re Coker, 251 B.R. 902 (Bankr. M.D. Fla. 2000), and Securities and Exchange Comm'n v. Bilzerian, 112 F. Supp. 2d 12 (D. D.C. 2000) (all finding trust settlors in contempt for failure to comply with court orders to repatriate assets in offshore asset protection trusts). To date, courts have only applied this extreme sanction in cases involving offshore asset protection trusts.

Self-settled asset protection trusts are relatively new phenomena in American law, and to date, there are no reported cases of a non-asset protection jurisdiction applying the law of an asset protection jurisdiction to enforce an asset protection trust.

b. Trusts Created for Third-parties

Trusts in which the settlor does not retain a beneficial interest are by definition trusts created for third-parties. Trust assets generally have protection from creditors when non-settlors exclusively enjoy the beneficial interests. However, a settlor may wish to retain certain powers over the trust property or may even want to serve as trustee. In addition, a beneficiary may be given withdrawal rights over trust property or may serve as Trustee. Questions arise over the degree of separation between the debtor and the trust needed to maintain creditor protection. In certain circumstances, courts have struggled to determine where to draw the line. This section examines a creditor's ability to reach assets in a trust created for the benefit of someone other than the settlor.

(1) Debtor is Beneficiary

Trusts are generally effective tools for shielding trust assets from the claims of a beneficiary's creditors provided the trust contains certain protective terms. Historically, North Carolina courts have generally found trust assets to be beyond the reach of creditors when the beneficiary's right to distributions is either entirely discretionary or subject to a prohibition against alienation, commonly known as a "spendthrift clause." *See* Chinnis v. Cobb, 210 N.C. 104, 185 S.E. 638 (1936); Lineback by Hutchens v. Stout, 79 N.C. App. 292, 339 S.E.2d 103 (1986). Today, a creditor is generally statutorily prohibited from reaching a beneficiary's interest in such a trust.

The North Carolina Uniform Trust Code broadly provides that the court may authorize a creditor to reach a beneficiary's interest for present or future distributions. G.S. §36C-5-501(a). However, this general rule does not apply if the trust (i) contains a spendthrift provision, (ii) the beneficiary's interest is discretionary, or (iii) the beneficiary's interest terminates or changes to a discretionary interest if a creditor attempts to attach to the interest. G.S. §36C-5-501(b). These restrictive provisions operate independently and serve distinct purposes. Accordingly, trusts may contain one or more of these restrictions depending on the purpose of the trust.

A "spendthrift provision" is a provision term of a trust that restrains both voluntary and involuntary transfers of a beneficiary's interest. G.S. §36C-1-103(18). As a result, a beneficiary may not assign his or her interest in the trust to any other person or entity. Any attempt to do so is void. G.S. §36C-5-502(c). North Carolina law facilitates the incorporation of such provisions into a trust. It is sufficient to state that the interest of a beneficiary is subject to a "spendthrift trust" or other words of similar import to gain the protection of the statute. G.S. §36C-5-502(b). Significantly, a spendthrift provision does not mean that a beneficiary is prohibited from receiving mandatory distributions under the terms of a trust. A trust may require a beneficiary to receive distributions annually or upon the occurrence of some other milestone. A spendthrift provision prohibits a beneficiary from alienating that interest. It does not, however, relieve the trustee from making a required distribution. A creditor may reach the funds after distribution to the beneficiary. If a trustee fails to make a mandatory distribution within a reasonable time after the designated distribution date, a creditor may reach the trust assets to the extent of the distribution regardless of the spendthrift provision. G.S. §36C-5-506(b). Accordingly, a spendthrift provision has limited usefulness for a beneficiary with a continuing right to distributions.

To fill the gap left by a spendthrift provision, a trust may also provide a beneficiary's interest is a "protective trust interest." G.S. §36C-5-501(b). A protective trust interest is an interest that either terminates or becomes discretionary if the beneficiary attempts to alienate the interest, becomes insolvent or files bankruptcy, or a creditor attempts to reach the interest. G.S. §36C-5-

508. Protective trust interests provide flexibility for settlors desiring to give beneficiaries' a right to distributions with a degree of asset protection.

In many cases, a settlor may not want a beneficiary to be entitled to mandatory distributions. The beneficiary may have present creditors or have a general propensity for frivolous spending. Alternatively, the settlor may simply want to preserve assets for future generations or protect assets from wealth transfer taxes. A settlor may therefore elect to provide a beneficiary with a discretionary trust interest. A "discretionary trust interest" is simply an interest in a trust that is subject to the trustee's discretion. G.S. §36C-5-504(a)(2).[4] In a discretionary trust, the trustee determines when and to what extent to make distributions to a beneficiary. In some cases, the trustee's discretion is absolute, subject only to the general prohibition against acting in bad faith, dishonestly, with an improper motive, or failing to act prudently in accordance with the purposes of the trust and the interests of the beneficiaries. G.S. §36C-8-814(a). In other cases, the trustee is required to make distributions in accordance with a standard of distribution, commonly for the beneficiary's health, education, maintenance and support. In either case, the trust is generally considered a fully discretionary trust for asset protection under North Carolina law and receives protection from the beneficiaries' creditors by statute. G.S. §36C-5-504(a).[5] Not every jurisdiction observes the same protection for trusts subject to a standard of distribution. *See, e.g.*, N.Y. EPTL §7-3.4. Practitioners should, therefore, carefully review the law of the applicable jurisdiction to determine whether a discretionary interest subject to an ascertainable standard receives creditor protection.

The general rule of asset protection for a beneficiary's interest is not without exceptions. Notwithstanding the inclusion of a spendthrift provision, discretionary trust interest, or protective trust interest in the trust document, a beneficiary's child who has a judgment or court order against the beneficiary for support or maintenance may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary. G.S. §36C-5-503.

(2) Debtor is Beneficiary and Trustee

In North Carolina, a beneficiary's service as trustee will not subject the beneficiary's interest to the claims of creditors if the trustee's ability to distribute assets for the trustee's own benefit is limited to an ascertainable standard. G.S. §36C-5-504(f). As a general rule, a trust governed by the laws of the State of North Carolina which appears to permit discretionary distributions by a trustee-beneficiary without reference to a standard is so limited by statute. Unless

[4] A discretionary trust interest includes, by statutory application, a prohibition against the transfer of the interest by a beneficiary, whether voluntarily or involuntarily. G.S. §36C-5-504(b).

[5] The authors note that G.S. §36C-5-504(a)(2)b. provides that a discretionary trust includes a trust in which the trustee, in the trustee's discretion, determines distributions are appropriate for "support, education, or maintenance of the beneficiary." The statute does not include "health" within the applicable standard of distribution. Therefore, some question exists as to the purpose and effect of this omission. G.S. §36C-5-504(f) provides that a creditor may not reach the interest of a beneficiary who also serves as a trustee if the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard. G.S. §36C-1-103(2) defines an "ascertainable standard" to mean a standard relating to an individual's health, education, support, or maintenance with the meaning of the Internal Revenue Code. It makes little sense, in the authors' view, to conclude a discretionary trust interest generally does not include a trust that contains a distributional standard including "health" but does include that standard when the beneficiary serves as trustee. Moreover, G.S. §36C-5-504(a)(2) broadly includes a discretionary trust interest to include discretionary distributions "whether or not the discretion is expressed in the form of a standard of distribution."

the terms of a trust indicate with express reference to the applicable default statute that the rule does not apply, a beneficiary of a trust who serves as trustee and has a power that otherwise constitutes a general power of appointment will be deemed to have the ability to exercise that power only in accordance with an ascertainable standard. G.S. §36C-8-814(b)(2). Accordingly, in most cases a beneficiary may serve as trustee and receive the same protections as other beneficiaries.

(3) Debtor is Holder of Power of Withdrawal

In addition to status as beneficiary and trustee, a debtor may hold a power of withdrawal over trust property. A power of withdrawal is defined as a presently exercisable general power of appointment other than a power exercisable by a trustee and limited by an ascertainable standard or exercisable by another person only upon consent of the trustee or a person holding an adverse interest. G.S. §36C-1-103(13). A general power of appointment is generally understood to include the power to appoint trust property in favor of a category of persons that include the power holder, the power holder's estate, the power holder's creditors, or the creditors of the power holder's estate. Accordingly, a general power of appointment usually gives the power holder the right to instruct the trustee to distribute assets to or for the power holder's benefit. *See* G.S. §36C-8-814(b)(referencing IRC §2041(b)(1) and 2514(c)). The question therefore is whether a creditor can require a beneficiary to exercise the power and have funds distributed to himself and therefore become available to pay creditors.

In North Carolina, a creditor may not force the holder of a general power of appointment to exercise that power so long as the power holder is not the settlor. G.S. §36C-5-505(b). However, the property subject to the exercise of the power is subject to the claims of the creditors of the power holder when and to the extent the power is exercised. The lapse, release, or waiver of such a power is not deemed an exercise of that power. This rule does not appear to be subject to exception even for child support claims.

As a practical matter, the above rule seems to be at odds with the prohibition discussed earlier for a beneficiary serving as trustee. A trustee who has the right to make fully discretionary distributions for the trustee's benefit would subject the entire trust estate to the creditor of the trustee-beneficiary unless distributions are limited to an ascertainable standard. However, it appears the same debtor, while serving as trustee, could be given a power of withdrawal permitting the debtor to appoint all or any part of the assets to the debtor and the assets still would be protected from the debtor's creditors unless the debtor exercises the power. In both situations, the debtor can unilaterally confer the benefit of the trust assets upon himself. In fact, in the latter situation the debtor's right to withdraw assets is not subject to exercise in a fiduciary capacity. Accordingly, the disparate treatment of a debtor serving as a trustee-beneficiary and a debtor who has the power to make withdrawals from a trust has little policy justification. Practitioners looking for maximum flexibility, however, may wish to structure plans accordingly.

(4) Debtor is Settlor: No Strings

A settlor-debtor who conveys assets to a trust and retains no interest or other rights in the trust has usually made a gift to the trust. IRC §2501. A creditor's rights will be the same as if the settlor-debtor conveyed a gift to a spouse, child, parent, friend or other third party. A creditor's ability to reach the trust assets will depend largely on whether a fraudulent conveyance, discussed below, has occurred.

A spouse may also have a unique argument to set aside a trust. A trust is voidable to the extent that its creation was induced by fraud, duress, or undue influence. G.S. §36C-4-406. A trust is created when there is a transfer of property by a "settlor" to a person as trustee. G.S. §36C-4-401(a). A "settlor" includes a person who contributes an equitable interest in property to a trust. G.S. §36C-1-103(17). Accordingly, a spouse who transfers his or her equitable interest in property to a trust may arguably be deemed to have created or co-created the trust. If the transfer was induced by fraud, duress, or undue influence then it would appear the spouse has grounds to set aside the trust. It is unclear what would constitute a "transfer" by the spouse for this purpose. The requirement that the transfer was "induced" by fraud, duress, or undue influence suggests the spouse personally or through an agent transferred his or her interest in trust, perhaps by signing a consent or deed subjecting their marital interest to the conveyance. One spouse's unilateral transfer of assets in trust does not appear sufficient to constitute a transfer for this purpose. It is also unclear whether the entire trust would be voidable under such circumstances or only the portion attributable to the spouse's contribution. Significantly, the authors are unaware of any reported opinion addressing the merits of this argument. However, this argument was apparently rejected by the Wake County Superior Court in *Ward v. Ward* discussed below.

(5) Debtor is Settlor: Retains Strings

If the debtor-settlor retains a beneficial interest in a trust, then the trust is "self-settled" and creditors may usually reach that beneficial interest for the reasons discussed above. In many cases, however, a settlor-debtor may retain certain rights or powers over trust property that fall short of granting the settlor-debtor an outright beneficial interest in the trust. Most commonly these rights include one or more of the following: the right to remove and replace the trustee; the right to serve as trustee; a lifetime or testamentary special power of appointment; the right to substitute trust property for property of equivalent value; and the right to remove and replace a trust protector. One or more of these powers can give the settlor-debtor considerable control over trust operations and, importantly, even indirect benefits from the trust. For example, a settlor-debtor could threaten to exercise his or her special power of appointment to remove a beneficiary who refuses to make gifts of trust property to the settlor-debtor.

As a general rule, powers like those mentioned do not subject trust assets to creditors of the settlor-debtor. From time to time, however, courts have struggled with the degree of control a settlor-debtor or even a beneficiary-debtor may have over the trust without causing the trust to simply become an alter ego of the debtor. *See, e.g.,* In re Schwarzkopf**,** 626 F.3d 1032 (9th Cir. 2010)(holding trust liable to creditor as alter-ego of settlor-debtor); U.S. v. Evseroff, 2007-1 U.S. Tax Cas. (CCH) ¶ 50,222 (E.D.N.Y. 2006), *rev'd and rem'd*, 2008-1 U.S. Tax Cas. (CCH) ¶50,240 92d Cir. 2008), on remand, 2012-1 U.S. Tax. Cas. (CCH) ¶50,328 (E.D.N.Y. 2012), *aff'd* 528 Fed. Approx. 75 (2d Cir. 2013)(trust liable as alter-ego of settlor-debtor); U.S. v. Hart, 2006 WL 3377626 (2006); In re Harman, 512 B.R. 321 (N.D. Ga. 2014)(declining to apply alter-ego theory under Georgia law).

At least one court has applied the alter-ego theory to include the value of certain trust assets in a divorce proceeding. In *In re Marriage of Dick*, 18 Cal. Rptr. 2d 743 (Cal. App. 1993), the husband claimed that he had no net monthly disposable income to provide support for wife. After an extensive trial, the trial court awarded wife $35,000 a month in spousal support. In ruling for wife, the appeals court found that husband had the ability to pay. The court found that while the husband lacked virtually any assets in his own name, the husband had created a labyrinth of trusts and corporations to shield and protect the husband from creditors. The husband had placed over $20,000,000 into the control of others who then acted for his benefit. The court pointed to a number of factors supporting the husband's control over the trusts. The husband used certain residences held by the trusts without the payment of rent or other compensation and the husband's children, the alleged beneficiaries, had never received a distribution from the trusts. The purported trustee appeared to work exclusively for husband, husband's brother, and husband's business associate. The husband also instructed the trustee on investments and the trustee never made an investment contrary to the husband's instructions. The court appeared particularly concerned with the fact that the husband had placed assets in trust with trustees who were related or subordinate to the husband and could be expected to operate at the husband's behest.

The alter ego theory appears to be available in North Carolina. In *U.S. v. Greer*, the U.S. attempted to enforce a federal tax lien against a twenty acre property held in trust. <u>U.S. v. Greer</u>, 383 F. Supp. 2d 861, 867 (W.D.N.C. 2005). The debtor served as trustee of the trust and was also a beneficiary. The U.S. District Court for the Western District of North Carolina found that a trust could be set aside on the basis of the alter ego theory under North Carolina law. The court held that a plaintiff must show that the defendant (i) controls, through complete domination, the policy and business practice of the trust such that at the time the trust had no separate mind, will or existence of its own, (ii) such control must have been used by the defendant to commit fraud or wrong, to perpetrate a violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff's legal rights; and (iii) the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of. <u>U.S. v. Greer</u>, 383 F. Supp. at 867. The court concluded that the U.S. had not met its burden as the defendant had not acted inconsistently from his role as trustee and beneficiary.

Cases like *Dick* and *Greer* indicate that the alter ego theory may be used to set aside abusive trust arrangements. However, a plaintiff must show that the debtor did more than simply retain certain rights in the trust. The debtor must have complete domination over the trust either directly by its terms or indirectly through the debtor's domination of the trustee and beneficiaries.

3. <u>Case Study: Ward v. Ward (COA 14-417; Wake County)</u>

Many of the complexities surrounding a spouse's right to assets unilaterally transferred in trust by the other spouse are exemplified in the case of *Ward v. Ward* (COA 14-417, Wake County) currently on appeal. In *Ward*, husband and wife were married in 1987. Husband became a fifty percent owner of a closely-held business in 1997. In 2005, husband conveyed his fifty percent interest in the business to an irrevocable trust ("Trust I"). Wife was named as the current beneficiary of Trust I during her lifetime so long as she remained married to husband. Husband's son and future grandchildren were named contingent beneficiaries. The stated purpose of Trust I was to protect family assets from the claims of potential future creditors given the high risk nature of the business. Wife was not involved in the drafting of Trust I and claimed that she was not aware of its language requiring her to be married to husband in order to remain a beneficiary until after the parties separated.

In 2006, wife created an irrevocable trust ("Trust II") naming husband as primary beneficiary. Trust II was funded with various membership interests titled in the sole name of wife at the time of the conveyance. Trust II did not contain similar language terminating husband's beneficial interest upon divorce from wife.

In 2009, husband and wife separated and husband filed for divorce in 2010. Wife subsequently filed suit seeking the dissolution of Trust I and Trust II on the basis of constructive fraud, breach of fiduciary duty, and public policy. Wife additionally claimed actual fraud in connection with the creation of Trust II. The defendants denied wife's claims on a number of grounds, including that applicable law does not recognize a constructive fraud claim in connection with the dissipation or depletion of marital assets. On summary judgment, the Superior Court ruled in favor of defendants without noting the grounds for its decision in the order. The defendants' arguments would suggest that the court viewed the case as one of dissipation of marital assets at a time when divorce was not contemplated. As a result, the court appears to have concluded that the wife's only remedy was an unequal division of marital property under the Equitable Distribution Statute. Smith v. Smith, 113 N.C. App. 410, 438 S.E.2d 457 (1994); Beers v. Beers, 724 S.O.2d 109, 116-117 (Fla. Dist. Ct. App. 1998).

Ward is currently on appeal. The full briefs for both parties are attached as Appendix B. A decision on the merits of the wife's claims will likely have substantial precedential value for planners moving forward. If the court upholds the lower court's decision with respect to Trust I, planners should consider the following factors when considering the creation of a trust in similar circumstances: (i) the irrevocable nature of the trust; (ii) the fact the trusts were created at a time when divorce was not contemplated; (iii) a valid reason existed for setting up the trust beyond divorce planning; (iv) the trust was funded with assets exclusively in the settlor's name; and (v) the trustees were independent parties and the settlor retained no control over the trusts. It is unknown if the court will find husband's equitable interest in Trust II important for equitable distribution purposes. A spouse's legal and equitable interest is subject to equitable distribution. Upchurch v. Upchurch, 128 N.C. App. 461, 495 S.E.2d 738 (1998). If North Carolina law applied for equitable distribution purposes, it is possible that husband's equitable interests in Trust II granted to him by wife would be considered in the court's division of marital assets.

4. Tax Considerations

While a broad discussion of tax matters is beyond the scope of this manuscript, no discussion of trusts would be complete without mentioning taxation. The creation of an irrevocable trust necessarily implicates federal wealth transfer tax concerns as well as federal and state income tax planning. Estate and gift tax treatment will largely depend on the terms of the trust, including the rights and powers of the settlor. Additionally, trusts are generally considered legal entities for income tax purposes, but may be completely disregarded in certain circumstances. IRC §641, et. seq. An unwary settlor could be responsible for all income taxes recognized by the trust and have no right to assets from the trust to pay those taxes. For these and other reasons, a qualified tax professional should be consulted prior to the creation of a trust.

B. Business Entities as Asset Protection Devices

Business entities are usually considered effective asset protection tools for limiting the liability of business owners for liabilities arising from the business. Shareholders, members and limited partners are not generally liable to the creditors of the business unless grounds exist to pierce the veil of limited liability provided by statute. G.S. §55-6-22(b); G.S. §57D-3-30; G.S. §59-303. Business entities may, however, provide limited protection for claims against the owner arising outside of the business. While a creditor may be able to reach an owner's interest to a limited degree, the presence of certain factors may promote settlement. This is most often due to the unappealing nature of the owner's interest in the business or the creditor's inability to seize the owner's actual interest and not the underlying assets of the business.

1. Lack of Control

Often an owner's interest is a minority interest that gives the creditor no control over the affairs of the business. The presence of a minority interest may directly impact the marketability of that interest as discussed below. In addition, the creditor may have no ability to force distributions from the entity. This is a particular problem in the case of entities that pass through taxable income or gain to the owners and are not required to make a corresponding distribution to pay those taxes except in the discretion of management.

In some cases, a creditor cannot gain control over an entity because of the statutory nature of the owner's interest. Limited liability companies and limited partnerships are particularly useful for this purpose. By statute, a creditor may only receive a charging order against the owner's membership interest or partnership interest. G.S. §57D-5-03; G.S. §59-703. In the case of an LLC, the creditor has only a right to receive distributions that would have otherwise been paid to the interest owner. In the case of a limited partnership, the creditor has only the rights to distributions and allocations from the partnership. In both cases, the owner retains the actual ownership interest including any voting rights associated with the interest. Accordingly, a charging order may have little appeal to the creditor.

2. Lack of Marketability

Creditors are generally most interested in seizing and selling assets to satisfy their claims. Any inhibitors to selling an interest will generally impact a creditor's decision to invest resources into pursuing the asset. Often closely-held business interests are not marketable. As discussed above, a creditor cannot generally seize and sell an owner's interest in an LLC or limited partnership. Moreover, minority interests are generally unappealing to purchasers. Even controlling interests may be subject to transfer restrictions that affect the marketability of that interest. A buy-sell agreement may entitle another owner to purchase the debtor-owner's interest on unfavorable terms and likely at a discounted price.

III. ADDRESSING THE HYPOTHETICAL: THE ISSUES

The Hypothetical raises a number of issues for the divorcing client due to the transfer of his inherited assets to a joint account with his wife followed by a transfer to an irrevocable trust. These include (i) the status of the funds held in the joint account as marital or separate property for equitable distribution purposes, (ii) the marital or separate status of the funds transferred to the irrevocable trust, (iii) claims against the client and trust for engaging in a fraudulent conveyance, (iv) claims against the client for potential breaches of fiduciary or other similar duties, (v) the effectiveness of the irrevocable trust to terminate the wife's marital interest, if any, in the funds both during life and at death, and (vi) potential action items for the client's consideration. Each issue is discussed below.

A. EQUITABLE DISTRIBUTION AND INHERITANCE

The first issue raised by the Hypothetical is the characterization of the property at issue as either marital or separate property. There is a presumption that all property acquired by either spouse during the marriage is marital property. Caudill v. Caudill, 131 NC App, 854, 509 S.E.2d 246 (1999). The parties seeking to have property classified as separate property must show by the greater weight of the evidence that the property is separate. Fountain v. Fountain, 148 N.C. App. 329, 559 S.E.2d 25 (2002). However, property acquired by a spouse during marriage through a gift from a third party, devise or descent is separate property. G.S. §50-20(b)(2). Accordingly, the client's inheritance, at least initially, should be classified as separate property.

The deposit of the inheritance into a joint account should not be construed to conclusively convert the client's separate property to marital property. Property acquired in exchange for separate property generally remains separate property regardless of whether the title is in the name of the husband or wife or both and is not to be considered to be marital property unless a contrary intention is expressly stated in the conveyance. G.S. §50-20(b)(2). Given sufficient proof, our courts have allowed a party to trace separate property through a series of transactions. Fountain v. Fountain, 148 N.C. App. 329, 559 S.E.2d 25 (2002).

With respect to joint bank accounts, the results may vary depending on the facts of the case. In O'Brien 131 N.C. App. 411, 508 S.E 2d 300 (1998), the wife placed funds she received by inheritance and gift into a securities account in the joint names of her and her husband. In addition, the parties deposited $4,500 of marital funds in the account and withdrew $38,658 from the account for marital purposes. Over the next several years assets in the account were moved to three different securities firms and additional monies received by the wife by gift or inheritance were placed into the account. Based on these facts, the Court of Appeals upheld the trial court's finding that the funds in the investment account were separate property and were not subject to distribution. On the other hand, in Holterman v. Holterman, 127 N.C. App. 109, 488 S.E.2d 265 (1997), the parties were married for over forty-five years. Mrs. Holterman inherited $508,000 in 1952 and $100,000 in 1964. The parties maintained various checking, savings and brokerage accounts during their marriage. All of the wife's inheritance was comingled with the funds the husband earned as well as the proceeds from the sale of a succession of homes. During the marriage all of the parties' property was jointly held. Based on these facts, the Court of Appeals upheld the trial court's determination that all of the parties' investments were marital property. The Court so ruled on two grounds. First, the Court found that the wife was unable to trace her inheritance to the assets jointly owned by the parties on the date of separation. Id. 127 N.C. App. at 112, 488 S.E.2d at 268. Second, the trial court found that the plaintiff intended her inherited assets to be a gift to the marital estate. Id.

In addition to the commingling, the client's wife may claim that the client's assets transferred to the joint account were a gift, either in whole or in part, to wife. Property acquired by gift from a spouse during the marriage is not considered a gift unless the other spouse's intention to make a gift is stated in the conveyance. G.S. §50-20(b)(2).

Accordingly, a substantial question exists as to whether the funds in the client's joint account are marital or separate property.

The client's unilateral transfer of funds from the joint account to the irrevocable trust does not necessarily terminate the relevance of those assets in the divorce proceeding even if the client retains no interest in the irrevocable trust. Under North Carolina law, marital property can be traced even if it is titled in the name of a third party. In Upchurch v. Upchurch, 128 N.C. App. 461, 459 S.E.2d 738 (1998), the Court of Appeals found that $67,733 in church bonds were marital property even though they were held in the name of Mr. Upchurch's son. This finding was based on the trial court's ability to trace marital funds through several transactions which ended in the transfer of the bonds in question to Mr. Upchurch's son. The court ruled that the bonds were held by the son in a constructive trust in favor of the marital estate. Despite the holding of *Upchurch*, *Lee's North Carolina Family Law* explains:

> A spouse has no claim on property that once belonged to the marital estate but is gone at the date of separation. In North Carolina, even if a spouse has converted marital assets, if those assets or their exchange are not owned by either or both spouses on the date of separation, the assets are not properly identified as part of the marital estate. In some states, the court may classify converted assets as marital and award them to the wronged spouse. In North Carolina the Court of Appeals has concluded that the equitable distribution act allows the trial court to consider the dissipation of assets in deciding how to divide the property that there is, but not in deciding how to classify property in the first place. In community property states, the approach is different. Each spouse has a present ownership interest in community property throughout the marriage, not just when the marriage is dissolving. The community property states, thereafter, have a much different approach to the dissipation of community assets.

Reynold's, *Lee's North Carolina Family Law* (Matthew Bender 5th Ed. 2011) at §12.30.

B. FRAUDULENT CONVEYANCES

1. Present and Future Creditors

The general sentiment of fraudulent transfer laws in the United States is that the law declares void conveyances or transfers designed to delay, hinder, or defraud creditors. *See e.g.* N.G.C.S. § 39-23.4. (North Carolina has adopted the Uniform Fraudulent Transfer Act, which is the rule in at least 39 states). Fraudulent conveyance laws affect three types of creditors (1) present creditors, (2) known potential future creditors, and (3) unknown future creditors.

A present creditor is one who has obtained a judgment against the client, or with whom a debt was contracted by the client prior to the transfer in question. A known potential future creditor is a creditor whom a client could reasonably foresee as a claimant. Examples of known potential future creditors include spouses and victims of torts committed by the client that have not yet obtained a judgment. An unknown future creditor is a creditor whom a client cannot reasonably foresee, for example, a tort victim injured by the client after the transfer in question.

2. Solvency

The solvency of a debtor is a key element in many fraudulent transfer actions. A transfer is void as fraudulent to a present creditor if the transfer renders the transferor insolvent. G.S. §39-23.5(a). A present or future creditor may avoid a transfer as fraudulent if the debtor transfers property without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor was engaged in a business or transaction for which the debtor's assets were unreasonably small or intended to incur debts beyond the debtor's ability to pay as they became due. G.S. § 39-23.4(a)(2).

North Carolina's version of the UFTA defines insolvency to include a debtor who is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation. G.S. §39-23.2. Importantly, a debtor who is generally not paying the debtor's debts as they become due is presumed to be insolvent. A partnership is insolvent if the sum of the partnership's debts is greater than the aggregate, at a fair valuation, of all of the partnership's assets and the sum of the excess of the value of each general partner's nonpartnership assets over the partner's nonpartnership debts. Debts under this section do not include an obligation to the extent it is secured by a valid lien on property of the debtor not included as an asset.

The UFTA provides a creditor with additional methods to show insolvency using North Carolina's prior case law. For the purposes of fraudulent conveyance cases, North Carolina courts historically determined solvency by contrasting a person's assets with his liabilities. Silver Valley Mining Co. v. North Carolina Smelting Co., 119 N.C. 417, 418-19, 25 S.E. 954, 954-55 (1896); Unaka and City National Bank of Johnson City, Tennessee v. Lewis, 201 N.C. 148, 153, 159 S.E. 312, 314 (1931).

Even if the debtor is not insolvent, a present or future creditor may avoid a fraudulent transfer if the creditor can show that the debtor transferred assets "[w]ith intent to hinder, delay, or defraud any creditor of the debtor." G.S. §39-23.4(a)(1). Because intent may be difficult to prove, courts look to several "badges of fraud" to determine a transferor's intent. No single badge of fraud is conclusive in and of itself, but the badges may be construed together to support an inference of fraud. Common badges of fraud include: (i) the debtor's retained possession or control of the transferred property after the transfer; (ii) the debtor's transfer of substantially all of his or her assets; (iii) a transfer occurring shortly before or shortly after a substantial debt was incurred; and (iv) before the transfer was made or obligation was incurred, the debtor was sued or threatened with suit. G.S. §39-23.4 (*See* Official Comment and North Carolina Commentary for a comprehensive list of the most common badges of fraud cited by the courts). There is no bright-line rule for proving intent in a fraudulent transfer case, and the practitioner is encouraged to examine the totality of the circumstances surrounding the transfer.

3. Federal vs. State Law

Federal law deals with fraudulent transfers primarily through the Bankruptcy Code. *See* 11 USCS § 548. The fraudulent transfer language used in section 548(a)(1)(A) of the Code can be traced directly to the original statute from Elizabethan England providing that a transaction entered into with "the intent to hinder, delay or defraud" creditors is fraudulent as to creditors. 5 Collier on Bankruptcy P 548.01. Section 548 covers two classes of unfair and improper transactions: ones in which the debtor intended the transfer to harm or hinder creditors; and ones in which the unfairness stems from a disparity of exchange coupled with the debtor's lack of other assets. 11 USCS § 548. Pursuant to the Bankruptcy Code, the bankruptcy trustee may avoid any transfer of an interest of the debtor if the debtor made such transfer (1) with actual intent to hinder, delay, or defraud a present or future creditor, or (2) received less than a reasonably equivalent value in exchange for such transfer and was insolvent, operating with unreasonably small capital, intended to incur debts the debtor could not pay, or made the transfer to an insider. 11 USCS § 548(a).

The principals behind section 548 of the Code may seem familiar to practitioners familiar with the North Carolina's version of the UFTA, because, for the most part, the UFTA tracks section 548. The Uniform Fraudulent Transfer Act (UFTA) has been adopted by at least 39 states, including North Carolina. There are some important differences, however:

- The UFTA has a four-year statute of limitations; that is, an unsecured creditor may seek to set aside a vulnerable transaction for up to four years after it was made. G.S. §39-23.9.

- It permits a finding of balance sheet insolvency based upon cash flow insolvency. G.S. §39-23.2(b).

- It has an insider preference provision. G.S. §39-23.5(b).

- It has expanded remedies—it permits the injunction of further transfers of property fraudulently transferred. G.S. §39-23.7(a)(3).

- It has expanded defenses; it specifically states that a debtor conclusively receives reasonably equivalent value at a regularly conducted, noncollusive foreclosure sale G.S. § 39-23.7(3)(b), provides an absolute defense for a lawful lease termination G.S. § 39-23.8(e)(1), and also provides an absolute defense for a transfer, such as a foreclosure, that "results from … enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code. G.S. § 39-23.8(e)(2)

In addition to the powers to avoid transfer granted by section 548, the trustee may also avoid transfers based upon state fraudulent transfer law. 11 USCS § 544(b). Section 544(b) operates by giving the trustee the power to avoid any transaction that could be avoided by an unsecured creditor of the debtor. Most often, the source of avoidance will be fraudulent transfer law, such as the UFTA.

4. Statutes of Limitation

The UFTA provides for a four year statute of limitations for an action on a fraudulent conveyance. Also, UFTA § 9(a) permits creditors to attack a transfer made with actual intent to hinder, delay or defraud creditors within one year after the transfer is or reasonably could be discovered by a defrauded creditor, if later than the general four-year limitations period. North Carolina has adopted the default UFTA statutes of limitations. G.S. §39-23.9.

The Bankruptcy Code has a shorter limitations period for avoiding transfers pursuant to section 548. The bankruptcy trustee may only reach back two years prior to the bankruptcy filing to avoid a transfer pursuant to section 548. 11 USCS § 548(a). The trustee may also pursue a UFTA action pursuant to section 544(b) if the transaction is within the four year statute of limitations provided by the UFTA. Notably, there is a ten year statute of limitations for transfers made to self-settled trusts or similar devices with the intent to hinder, delay or defraud creditors. 11 USCS § 548(e).

Unusually, while Nevada has adopted the UFTA, it has shortened the statute of limitations for transfers to Nevada asset protection trusts. In Nevada, an existing creditor may not bring a fraudulent transfer claim against an asset protection trust unless the action is commenced within two years after the transfer is made or six month after the person discovers or reasonably should have discovered the transfer. Nev. Rev. Stat. Ann. § 166.170(a). A future creditor must bring an action within two years of the transfer. Nev. Rev. Stat. Ann. § 166.170(b).

5. Avoidance of Transfer

The primary remedy for a creditor injured by a fraudulent transfer is to file suit to seek an avoidance of the transfer to the extent necessary to satisfy the creditor's claim. G.S. § 39-23.7(a)(1) (North Carolina's statute is in line with the wide majority of UFTA states). The statute also permits powerful equitable remedies such as: an injunction against the debtor or transferee, appointment of a receiver, or any other appropriate equitable relief. G.S. § 39-23.7(a)(3). Creditors have been able to avoid fraudulent transfers in the following examples:

- Ivey v. Swofford *(In re Whitley)*, 463 B.R. 775 (Bankr. M.D.N.C. 2012). Trustee had sufficiently alleged claims under 11 U.S.C.S. § 548(a)(1)(A) and G.S. 39-23.4(a)(1) when he alleged that individuals transferred funds to the debtor for the purpose of investing in factoring programs; that the debtor was conducting very little or no actual commerce or legitimate commercial activities, but represented that he was conducting legitimate business operations; that no actual profits or earnings were produced in any material fashion from the operation of the fictitious factoring program; and that to the extent any alleged profits or returns were made on the investments, they were funded through additional funds obtained from additional investors into the fictitious factoring program. The trustee had therefore successfully invoked the "Ponzi presumption" under which payments made in furtherance of such a scheme were presumed to be fraudulent.

- Jenkins v. Ward *(In re Jenkins)*, 2013 U.S. Dist. LEXIS 128936 (W.D.N.C. Sept. 6, 2013). Actual fraud was proven where a creditor had obtained a judgment against the debtor prior to the bankruptcy petition, and the debtor's wife's repeated admissions that the debtor transferred the funds with the purpose of retaining access to them for his own use, spoke so directly to the intent of the parties as to vitiate any genuine issues of material fact; the transfer was fraudulent and designed to allow the debtor to continue to use the funds even as they were placed outside the reach of the creditors.

- Triangle Bank v. Eatmon, 143 N.C. App. 521, 547 S.E.2d 92 (2001). Summary judgment was properly granted to a bank seeking to set aside real property transfers by a loan guarantor to her children and their spouses based on the following statutory factors: transferring the property to insiders; retaining control and income of the property after the transfers; making the transfers after a suit had been threatened or initiated; transferring almost all of the transferor's assets; and receiving less than reasonably equivalent value for deeded property.

- Teague v. Thompson *(In re Teague)*, 2013 Bankr. LEXIS 1742 (Bankr. W.D.N.C. Apr. 29, 2013). Pursuant to 11 U.S.C.S. § 548 and 550, trustee was allowed to recover property fraudulently transferred by debtor to his wife prior to filing for bankruptcy because the evidence showed several badges of fraud with respect to these transfers, including badges of fraud listed under North Carolina's version of the Uniform Fraudulent Transfer Act (UFTA), G.S. 39-23.4(b), leading to the conclusion that the debtor sought to shield assets from creditors by transferring them to his spouse, and the parties' separation and eventual divorce was simply a tactic to shield any appearance of impropriety. Trustee, however, was not permitted to recover all the property listed in the complaint because some of the transfers occurred more than two years before the petition was filed or were otherwise not supported by competent evidence.

In the following examples, the creditor was unable to avoid an alleged fraudulent transfer:

- Norman Owen Trucking Inc. v. Morkoski, 131 N.C. App. 168, 506 S.E.2d 267 (1998)(decided under pre-UFTA law). The creditor contended that certain payments to the debtor employee were fraudulent conveyances. The court reversed the trial court and remanded for entry of JNOV in favor of the debtor employee. The court found that the conveyances were not fraudulent because the creditor failed to present sufficient evidence. Fraudulent conveyances were not proven where (1) the checks, or alleged paychecks, were not shown to be voluntary or "not for value," (2) the agreed pay was not shown to be unreasonable, and (3) the creditor failed to show that fraudulent intent existed with debtor employee's knowledge. At a minimum, an actual intent to defraud creditors on the part of the debtor had to be shown, and more than "balance sheet insolvency" was required to be shown.

- Mascaro v. Mountaineer Land Group, LLC, 2006 NCBC 18 (N.C. Super. Ct. 2006). Dismissing for failing to state a claim under N.C.G.S. § 39-23.4(a)(1) when plaintiff did not make an allegation of debtor's intent to hinder, delay, or defraud creditors.

C. Fiduciary Duties and Confidential Relationships

A careful lawyer will usually wonder what the client is not telling them. This is particularly true when considering asset protection planning or asset availability to pay creditors. The Hypothetical client informs us that he withdrew the exact amount of his inheritance from what is likely a joint account to which both spouses had been contributing. He then proceeded to place the withdrawn funds into an irrevocable trust in which he believes his wife should have no interest. A careful lawyer will ask the client what, if any, discussions the client had with his wife about the creation and funding of the joint account as well as the creation and funding of the trust. In addition, the client should be questioned regarding his title and responsibility in his business as well as the wife's potential status as an owner. The client's responses are relevant not just for determining the wife's potential marital interest in the trust in a future equitable distribution proceeding but also considering whether the client may have committed constructive fraud.

1. Confidential Relationships

North Carolina law places special duties on parties to a confidential relationship. A transaction between the parties must be "fair and reasonable" in order to be valid. Sidden v. Mailman, 150 N.C. App. 373, 377, 563 S.E.2d 55, 58 (2002). This includes a duty to disclose all material facts related to a transaction between the parties. Searcy v. Searcy, 215 N.C. App. 568, 572, 715 S.E.2d 852, 857 (2011). "A presumption of fraud arises where the fiduciary in a confidential relationship benefits in any way from the relationship." Lancaster v. Lancaster, 138 N.C. App 459, 530 S.E.2d 82 (2000). Accordingly, the party asserting the validity of a transaction bears the burden of showing the transaction was entered into voluntarily by the other party. Id.

The marital relationship has been declared the "most confidential of all relationships" Sidden v. Mailman, 150 N.C. App. at 377, 563 S.E.2d at 58. "During a marriage, a husband and wife are in a confidential relationship … [and] have a duty to disclose all material facts to one another, and failure to do so constitutes fraud." Searcy v. Searcy, 215 N.C. App. at 572, 715 S.E. 2d at 857. Unlike ordinary fraud claims, a constructive fraud claim does not require allegations of a specific misrepresentation. A constructive fraud claim requires only that the aggrieved party allege the presence of a fiduciary or confidential relationship which led to and surrounded the transaction in which the plaintiff alleges damages due to the defendant's breach of his or her position of trust. Id. at 573.

A constructive fraud claim can be a valuable weapon for a divorcing spouse. Some examples include:

- Searcy v. Searcy, 215 N.C. App. 568, 715 S.E.2d 852 (2011). Former wife filed a complaint against former husband alleging breach of fiduciary duty and constructive fraud. Wife claimed that husband had failed to disclose certain assets when the parties entered a separation agreement. The Court of Appeals ruled in favor of ex-wife indicating that at the time the separation agreement was entered, husband and wife were in a confidential relationship. Neither party had retained lawyers or separated from each other. Accordingly, a genuine issue of material fact existed regarding ex-wife's cause of action for constructive fraud. Id. at 574.

- Harroff v. Harroff, 100 N.C. App. 686, 398 S.E.2d 340 (1990). Wife sued to rescind separation agreement after entry of judgment claiming breach of fiduciary duty. Wife specifically claimed husband concealed assets or asset values at a time the parties were in a confidential relationship. The Court ruled that genuine issue of material fact existed as to whether a confidential relationship between husband and wife existed at the time the separation agreement was executed and as to whether husband concealed assets or asset values in breach of his fiduciary duty.

- Cline v. Cline, 297 N.C. 336, 255 S.E.2d 399 (1979). Wife filed an action against husband claiming a resulting or constructive trust should be established over an interest in farm property. The Court held that wife sufficiently pled a cause of action for breach of the confidential relationship by alleging husband took title to farmland in his name alone after representing to wife that the land would be theirs jointly after the mortgage was paid.

- Link v. Link, 278 N.C. 181, 179 S.E.2d 697 (1971). Wife filed suit to rescind transfer of corporate stock and debentures to husband for fraud, undue influence and duress. Wife claimed husband was responsible for business matters and regularly asked her to sign documents related to their personal and business affairs. Wife alleged that husband caused her to sign papers transferring her interest in the stock and debentures to husband without disclosing the purpose of the documents while threatening that husband would take the children if she did not sign. The jury returned a verdict in favor of wife. The Supreme Court affirmed citing, in part, the confidential relationship between the parties and the duty of the husband to exercise the utmost good faith in the transaction and to disclose all material facts relating thereto.

2. Limitations on Claims

Breach of fiduciary duty claims are subject to notable limitations in the context of the marital relationship. First, the confidential relationship generally terminates when the parties separate or one party hires an attorney to commence divorce proceedings, although neither fact is necessarily determinative. Sidden v. Mailman, 150 N.C. App. 373, 563 S.E.2d 55 (2002)(stating "duty ends when the parties separate and become adversaries negotiating over the terms of their separation" and when "one or both of the parties is represented by counsel); Lancaster v. Lancaster, 138 N.C. App. 459, 530 S.E.2d 82 (2000)(holding no confidential relationship where husband was represented by counsel and the exclusive representation was communicated to wife).

Second, breach of fiduciary duty claims must arise from a specific transaction or transactions between the parties. In Smith v. Smith, 113 N.C. App. 410, 438 S.E.2d 457, former husband filed suit alleging breach of fiduciary duty, unjust enrichment and intentional marital destruction against former wife. The plaintiff brought his claims after entry of the equitable distribution order. The trial court dismissed the husband's action and the appeals court affirmed stating, in relevant part:

> Plaintiff has failed to provide evidence of any agreement or transaction between him and the defendant which would constitute the basis for the breach of fiduciary duty. He does attempt to analogize the marital relationship to a business partnership, arguing that marital partners have a duty to exercise good faith and integrity in their dealings with each other in the affairs of their "partnership." According to this argument, since a business partner could be required to account to the partnership for misappropriated partnership funds, defendant should likewise be held accountable for misappropriated marital funds. Although we believe that the relationship between married persons demands the highest level of integrity, we refuse to impose on it the strict duties of a business partnership.

Smith v. Smith, 113 N.C. App. at 413. Accordingly, the marital relationship is not equivalent to a business partnership. *Smith* holds that a spouse is not required to account for every transfer of marital funds. Instead, a spouse must allege breach of a duty with regard to a specific transaction *between* the married couple in order to state a claim for breach of the confidential relationship.

3. Fiduciary Duties based on Non-Marital Relationships

A husband and wife may owe a fiduciary duty to one another based on a relationship of trust and confidence arising from a status outside the scope of the marital relationship. A nonexclusive list of examples may include circumstances in which the married couple are partners or owners in a business, trustee and beneficiary of a trust, attorney-in-fact and principal, or even joint owners with respect to specific property. *See, e.g.,* Kaplan v. O.K. Technologies, L.L.C., 196 N.C. App. 469, 675 S.E.2d 133 (2009)(stating a "controlling shareholder owes a fiduciary duty to a minority shareholder); N.C. Gen. Stat. §36C-8-801 (duty to administer trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries); Albert v. Cowart, 727 S.E.2d 564, 570 (N.C. App. 2012)(stating "[t]he relationship created by a power of attorney between the principal and the attorney-in-fact is fiduciary in nature"); Dixon v. Gist 724 S.E.2d 639 (N.C. App. 2012)(holding fiduciary relationship existed by virtue of defendants becoming joint account holders on plaintiff's primary banking account with the purported purpose of helping plaintiff with her daily necessities and monthly obligations). A comprehensive discussion of the circumstances in which a fiduciary duty may arise is beyond the scope of this manuscript. However, practitioners should recognize the potential for a fiduciary relationship under circumstances in which one party has placed special trust and confidence in another party.

Based on the foregoing, the Hypothetical client should be questioned to determine all legal relationships that may exist with wife and what actions, if any, were taken within the scope of those relationships. For example, the circumstances surrounding the establishment of the joint account with wife should be examined for indications that wife contributed to the account under particular pretenses or for certain purposes. The circumstances and representations made by the client to wife regarding the creation and funding of the irrevocable trust should also be evaluated. Finally the scope of the client's duties as business owner and perhaps officer, director, and shareholder should also be examined. Depending on the client's responses to these questions, client may have a fiduciary obligation to wife which may have been breached.

D. Trust's Effectiveness as Asset Protection Device

In the authors' experience, it is a common belief that assets placed in an irrevocable trust are protected from creditors no matter the circumstances pertaining to the creation or funding of the trust. The hypothetical client appears to share this view as he asks for confirmation from the lawyer that his wife cannot get any of the money transferred in trust. The Hypothetical does not inform us of the client's relationship to the trust other than he is a settlor. To the extent the trust is not a DAPT or off-shore trust and the client retains a beneficial interest, the trust assets are available to satisfy creditor claims. If the trust is a DAPT, then the jurisdiction chosen, location of the assets, and timing of any transfers to the trust would likely be determinative of the DAPT's ability to protect the assets. If the client retained no rights in the trust, then grounds for fraudulent transfer liability would need to be assessed. Finally, if the client retained no beneficial interest in the trust but retained other rights or controls over the trust, then wife may have a claim under the alter ego doctrine.

It is important to distinguish claims made by the wife during the client's lifetime and claims made upon the client's death. Even if the client's wife does not have a marital interest in the trust assets during the client's lifetime, she may have an interest upon his death. A trust that holds only husband's separate property may be considered an asset of the husband for certain purposes upon his death. As a result, it is imperative that the client consider the wife's rights upon his death, particularly the wife's right to an elective share.

In North Carolina, a surviving spouse has a right to claim an elective share against the deceased spouse's estate generally equal to the total value of the deceased spouse's assets minus the value of the property considered passing to the surviving spouse. G.S. §30-3.1(a). A surviving spouse includes a spouse that is living separate and apart from the deceased at the time of his death. For decedent's dying on and after October 1, 2013, the elective share is a percentage of the deceased spouse's estate ranging from 15% to 50% depending on the number of years the couple was married. Id. Importantly, the deceased spouse's assets for this purpose includes more than probate assets. The proceeds of life insurance policies, retirement plan benefits, and even gifts made by the deceased spouse within a year prior to his or her death are generally included. G.S. §30-3.2. Accordingly, assets transferred to a trust within the year prior to death would generally be subject to the spouse's right to an elective share.

The right to an elective share may be waived by a spouse either before or after the marriage in writing provided the waiver is voluntary and the spouse is either provided a fair and reasonable disclosure of the property and financial obligations of the decedent or the spouse waives that right in writing. G.S. §30-3.6. We are not told whether the client signed a premarital or post-marital agreement waiving this right.

E. Crisis Planning – What Can the Client Do Now?

The Hypothetical client appears surrounded by creditors. Tax obligations, potential tort liability, and a potential marital interest in his business and trust assets substantially inhibit his ability to engage in planning. The presence of a federal or state tax lien and the client's apparent insolvency are particularly problematic. The potential for fraudulent conveyances is great and nearly any transfer of assets will likely draw considerable scrutiny. Nevertheless, the client may consider several steps to mitigate against future claims. First, the client should consider creating an estate plan that provides for the wife's elective share. The client may do so using a properly structured trust that provides for the wife during her lifetime, but permits the remaining assets to be distributed to beneficiaries named by the client upon the wife's death. Second, the client may consider what options, if any, he may have in structuring or organizing his business in a more advantageous manner. In appropriate cases, this may include the addition of another owner or the separation of a line of business. These options would largely depend on the client's trade or business and the client's objective with respect to the business.

IV. CONCLUSION

A number of planning tools provide varying degrees of protection from creditors, including a divorcing spouse. Trusts, in particular, can be useful for this purpose provided they are properly timed, structured and implemented. No asset protection tool is absolute. In many cases, the benefit may simply be creating an additional barrier that promotes a more favorable settlement of the matter. Practitioners must be cautious particularly when dealing with the rights of the spouse. Some tools that provide general protection from creditors provide no protection from the claims of a divorcing spouse.

Appendix A

Hypothetical

Premise: A domestic lawyer meets with a potential new client for an initial consultation. The client explains his situation to the lawyer, which includes not only family law issues, but issues concerning criminal law, immigration, trust/estates, tax, bankruptcy, and substance abuse/mental health. The domestic lawyer is unsure of how to advise her potential client on the issues outside of family law, and she calls other lawyers for help.

Lawyer: "Tell me a little bit about what's going on."

Client: "My wife is crazy and I need a divorce. She got me into a lot of trouble this past Wednesday!"

Lawyer: "Ok, what happened last Wednesday?"

Client: "My wife and I were downstairs in our living room arguing as we have been a lot recently. She was angry because she discovered that I haven't paid our joint taxes for the past 6 years or the taxes for my business, which is in my name. We owe a ton of money to the IRS. I tried to walk away from her, but she followed me into my office, which is adjacent to the living room. She started picking things up off my desk and throwing them at me. She almost hit me in the face with a stapler. So I went up to her and tried to grab her arms to make her stop. She tripped and fell into the wall. There's a dent in the wall. She called the police and next thing I know I'm arrested and charged with assault on a female! She also told the arresting officer that I've been going through her computer and reading her emails and I'm afraid I'll be charged in relation to that too!"

Lawyer: "How much money do you owe to the IRS?"

Client: "Almost 800,000, but I know we can't pay it. I think I will have to file for bankruptcy. My wife keeps saying that she's going to take half of everything I have, but I don't understand how she can do that if I file for bankruptcy. She's also saying I will have to pay alimony to her, but I don't understand how I can be ordered to do that if I file for bankruptcy."

Lawyer: "Tell me some more about last Wednesday, were either of you drinking?"

Client: "Well, yes, I had been drinking."

"Earlier that day I went to a bar with some friends to watch NC State play basketball. I was just going to have a few beers. But then State started blowing a big lead, to drown my sorrows I drank more, and more, and more. I can't recall for certain how much I drank. But I know I it was probably more than 8 beers and few shots. By the end of the game I was leading the entire bar in the NC State fight song. My friends had to drive me home. But that's not unusual for me. I drink a lot, but I can stop any time I want, so I know it's not a problem."

Lawyer: "Would your wife say that your drinking is a source of tension in the marriage?"

Client: "Well yes, but I don't see anything wrong with it. I'm Italian and we like to drink. I actually moved here from Italy when I was 19. I'm not even a US citizen, which is one reason I let this bad situation go on for so long. I don't want to have to move back if I divorce my wife.

Lawyer: "I understand. What exactly has your wife said about your drinking?"

Client: "My wife calls me an alcoholic, but I know I'm not an alcoholic. To be honest, I drink because it makes me feel better. I am sad a lot. I think I might have depression but it's never been treated and I'm too scared to ask for help. Besides, what's wrong with alcohol? My granddad was a big drinker too, and he lived a long life and was very successful. In fact, when he died about ten years ago I inherited almost $200,000 from him."

Lawyer: "What did you do with that money?"

Client: "Well I spent some of it. I bought a new car which my wife and I share and some clothes for both of us. The rest I put in our savings account. We both contributed to that account for a while. But when we started having problems with our marriage I pulled out the exact amount of my inheritance and put it in an irrevocable trust. She can't get to any of that money now, right!?"

Appendix B

Ward v. Ward, COA 14-447 (Wake County) Briefs

Defendant-Appellee Robert E. Ward, III's Brief
Defendant-Appellee Robert E. Ward, IV's Brief
Defendant-Appellee Mark E. Fogel and William B. Wright, Jr.'s Brief
Plaintiff-Appellant Jo Ann Ward's Brief