Planning Can Keep Assets Out Of Debtor's Bankruptcy Estate

By Bruce Givner

On February 4, the 9th U.S. Circuit Court of Appeals ruled that a Los Angeles lawyer's transfer of individual retirement account funds into a corporate pension plan was not a fraudulent conveyance, even though it was done on the eve of bankruptcy and accompanied by several traditional badges of fraud. *In re Stern*, 317 F.3d 111 (9th Cir. 2003), amended, reh'g denied, 2003 U.S.App.LEXIS 20365 (9th Cir. Feb. 7, 2003), reprinted as amended, 2003 U.S.App.LEXIS 20368 (9th Cir. Feb. 7, 2003).

The *Stern* majority felt "controlled" by *Wudrick v. Clements*, 451 F.2d 988 (9th Cir. 1971), in which the 9th Circuit ruled "that the purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent per se." The court also cited *Love v. Menick*, 341 F.2d 680 (9th Cir. 1965), for the proposition that fraud must be established by "clear and convincing" evidence.

A chronology of the facts shows why Judge Arthur L. Alarcon dissented. He felt that the 9th Circuit should have remanded the case for the trial court to determine whether the defendant intended to hinder, delay or defraud his creditors.

All of the events took place in 1992. On Sept. 15, plaintiff Dove Audio Inc. received a $4,500,000 arbitration award against defendant Steven Stern. On Sept. 30, Stern learned of the award.

Stern filed for divorce on Oct. 14 and received a default judgment of dissolution, which included a stipulated property-settlement agreement, on Oct. 15.

From Oct. 19 to Oct. 21, pursuant to the property-settlement agreement, Stern transferred all of his community property, over $2 million in assets, to his former spouse without benefit of appraisals. Community property is included in a debtor's bankruptcy estate. Stern retained only assets that supposedly would be exempt from his bankruptcy estate. He also assumed the arbitration award, a community debt.

On Oct. 23, Stern executed documents to establish a pension plan. On approximately Oct. 30, he rolled $1.4 million from his IRA into the new pension plan. On Nov. 2, Stern filed for bankruptcy.

The federal Employee Retirement Income Security Act of 1974 exempts ERISA-qualified retirement plans from a debtor's bankruptcy estate. The 9th Circuit, however, held that the ERISA exemption did not protect Stern's retirement plan because the plan did not cover a rank-and-file employee. However, the court held that California's exemption, Code of Civil Procedure Section 704.115(e), did protect Stern's plan.

Stern raises a striking question, particularly for attorneys, who are attractive litigation targets. Why don't more lawyers take simple steps in advance to protect their most attractive assets in case they file for bankruptcy?

Many lawyers practice as sole proprietors, yet their pension and profit-sharing plan benefits do not qualify for the absolute protection of ERISA. The same applies for lawyers who practice in single-member LLPs (unless the LLP is taxed as a corporation) and partnerships.

Instead, the state's limited exemption for "self-employed retirement plans" will cover their plans. Under Section 704.115(e), however, those retirement plans "are exempt only to the extent necessary to provide for the support of the judgment debtor when the judgment debtor retires and for the support of the spouse and dependents of the judgment debtor, taking into account all resources that are likely to be available for the support of the judgment debtor when the judgment debtor retires."

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Stern was smart: His practice was through a professional corporation. However, he failed to take the extra step required by ERISA — having a rank-and-file employee participate (earn a benefit) in his retirement plan.

In other words, under ERISA, it is not enough for a corporation to sponsor a retirement plan. You must have at least one nonspouse, nonshareholder participant in the plan. For this purpose, even an adult child will suffice.

One of the other most obvious assets to protect is the family residence. The qualified personal residence trust (QPRT) is an estate-planning device designed to transfer the equity in a home to one's heirs at a lower estate-tax and gift-tax cost. The qualified personal-residence trust was added to the Internal Revenue Code 15 years ago.

This is how it works: Assume that a husband and wife currently own their home through a living trust. First, they transfer the home from the living trust back to the two of them as community property. Next, they divide the residence so that it is held one-half by each of them as separate property. Then, they each set up a qualified personal-residence trust to hold their one-half of the residence for a term of years.

The term of years should be something short of the spouse's life expectancy. For example, a 50-year-old has an average life expectancy of 33 years and might use a 25-year term for the qualified personal-residence trust. Given today's Internal Revenue Service-applicable federal rate (3.2 percent as of August 2003), the gift to the heirs of the right to receive the residence at the end of 25 years would be approximately $30,000 for every $100,000 of net fair market value.

Thus, by using a qualified personal-residence trust, the husband and wife can transfer a home with $1,000,000 of equity to their heirs with a gift-tax value of only $300,000. Because the husband and wife each can give $1,000,000 free of gift tax, the transfer would involve using only a small portion (15 percent) of their combined lifetime transfer-tax exclusion.

The benefit is that once the house has been in the qualified personal-residence trust for five or more years, it will be difficult for a plaintiff to argue that the transfer of the home to the trust was fraudulent. In other words, the lawyer in the family never will be put in the situation faced by Stern, at least as concerns the home equity.

What are the creditor's rights once the qualified personal-residence trust has been in effect for five years of a 25-year term? The husband and wife no longer own the home, which is in the name of the trustee of their qualified personal-residence trusts. (The husband and wife should not be the trustees.) A creditor cannot force the trustee to sell the home.

Under Probate Code Section 15307 ("Satisfaction of Money Judgment Paid After Education and Support"), any amount to which a beneficiary is entitled, or that the trustee discretionarily has determined to pay to a beneficiary, may be applied to satisfy a creditor's money judgment ("The court may order the trustee to satisfy the judgment out of the beneficiary's interest ...").

However, Section 15306.5 contains an exception for amounts needed to maintain the beneficiary's education and standard of living.

Because all that the husband and wife have is the right to live in the home rent-free, the creditor does not have much to receive. Presumably, the trustee will determine that they need to stay in the house to maintain their standard of living.

The relationship between Sections 15307 and 15306.5 is unclear. Probably, a creditor that is unsatisfied with the trustee's response under Section 15307 would ask the judge to determine the beneficiary's standard of living under Section 15306.5.

The judge can order the trustee to satisfy the judgment out of "payments to which the beneficiary is entitled under the trust instrument or that the trustee, in the exercise of the trustee's discretion, has determined or determines in the future to pay to the beneficiary." Section 15306.5(a).

However, that order "may not require that the trustee pay in satisfaction of the judgment an amount exceeding 25 percent of the payment that otherwise would be made to, or for the benefit of, the beneficiary." Section 15306.5(b).

Of course, attorneys may have other assets to protect, such as personal savings, rental real estate or trust deeds. The artful use of conventional estate-planning devices can address these assets through, for example, a family limited partnership with a corporate general partner, wholly owned by an irrevocable trust for the benefit of the heirs.

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