

MOSES & SINGER LLP

Steve Leimberg's Asset Protection Planning Newsletter

“Mortensen: Alaska Domestic Asset Protection Trust Flops”

By Daniel S. Rubin

11-07-11

“If there is any lasting significance to the Mortensen decision, it will almost certainly be that the continuing uncertain application of Section 548(e) of the Bankruptcy Code requires clients who wish to establish the most protective self-settled trust possible to continue to go offshore – at least for the first ten years of the trust's existence. After ten years have elapsed without a creditor issue having developed, such trusts can safely migrate onshore because of the "silver lining" in Section 548(e) that actually validates self-settled trusts in two situations: where the self-settled trust was established without an actual intent to hinder, delay, or defraud creditors, and where, even though the self-settled trust was established with an actual intent to hinder, delay or defraud creditors, more than ten years have elapsed since the trust was established.”

EXECUTIVE SUMMARY:

Battley v. Mortensen, et al., (In re Mortensen)¹, is a case of first impression involving the Bankruptcy Court's application of Section 548(e)(1) of the Bankruptcy Code. Section 548(e)(1), which was enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that:

In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if -

- (A) such transfer was made to a self-settled trust or similar device;
- (B) such transfer was by the debtor;
- (C) the debtor is a beneficiary of such trust or similar device; and
- (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

In the authors' opinion, Mortensen is of interest as a case of first impression, but is otherwise an unremarkable decision. It holds only that the debtor's transfer was made with an actual intent to hinder, delay or defraud his creditors and, since the transfer was to a self-settled trust, the ten year statute of limitations period of Section 548(e) applied and the Bankruptcy Court could avoid the transfer since it was within that time period.

FACTS:

In Mortensen, Thomas Mortensen, a resident of Alaska, and his then spouse (now his former spouse), acquired 1.25 acres of real property in 1994 in a remote area near Seldovia, Alaska (the "Seldovia Property"). When Mortensen and his spouse later divorced, Mortensen received his spouse's interest in the Seldovia Property.

Following his divorce, and through "casual conversation," Mortensen came to learn of Alaska's laws providing an individual with asset protection for property transferred to a self-settled trust. Mortensen investigated the subject and using a form he uncovered in his research drafted a trust document he called the "Mortensen Seldovia Trust (An Alaska Asset Preservation Trust)" (the "Trust"), intending for the Trust to qualify as an asset protection trust under Alaska law.

As required by Alaska law, the Trust was registered with the State of Alaska on February 1, 2005 and Mortensen provided an affidavit that stated:

1. he was the owner of the property being placed into the Trust;
2. he was financially solvent;
3. he had no intent to defraud creditors by creating the Trust;
4. no court actions or administrative proceedings were pending or threatened against him;
5. he was not required to pay child support and was not in default on any child support obligation;
6. he was not contemplating filing for bankruptcy relief; and
7. the Trust property was not derived from unlawful activities.

That same day, Mortensen deeded his interest in the Seldovia Property to the Trust. Allegedly, that transfer was pursuant to an oral agreement between Mortensen and his mother whereby Mortensen would transfer the Seldovia Property to the Trust to preserve it for his children (Mortensen's mother's grandchildren), and Mortensen's mother would make pay Mortensen \$100,000 in consideration for the transfer. The oral agreement was corroborated by certain handwritten notes that Mortensen's mother sent to him with the payment. Mortensen claimed that he used some of the funds his mother paid him to pay existing debts, and that he transferred

approximately \$80,000 to a brokerage account in the name of the Trust as "seed money" for operating expenses related to the property.

Mortensen's divorce was apparently a bitterly contested matter which, together with a generally poor economy, adversely affected his financial situation. Following the creation and funding of the Trust, Mortensen's financial condition deteriorated further and his income became "sporadic." Finally, in April, 2009, Mortensen became sick and required surgery and a two week hospitalization followed by a prolonged period of convalescence. Mortensen stated that he attempted to return to work after his convalescence, but because he was on medication that inhibited his cognitive abilities, he was unable to do so. Ultimately, Mortensen filed for bankruptcy on August 18, 2009 – approximately four and a half years after the creation and funding of the Trust.

As one would imagine, Mortensen did not find Bankruptcy to be the panacea that he might have envisioned. In the first instance, the bankruptcy trustee argued that Mortensen failed to create a valid asset protection trust alleging that he was insolvent when the Trust was established and funded. After some analysis regarding this issue, however, the Bankruptcy Court concluded that Mortensen was not, in fact, insolvent when he established and funded the Trust. The Bankruptcy Court then turned its analysis to the claim that Mortensen's transfer of the Seldovia Property to the Trust fell under Section 548(e) of the Bankruptcy Code. In this matter of first impression under Section 548(e), the Bankruptcy Court held that the transfer fell within under the ten year statute of limitations of that section since Mortensen had an actual intent to hinder, delay or defraud his creditors, and avoided the transfer.

COMMENT:

Some practitioners have been quick to reach the conclusion that Mortensen, and Section 548(e) of the Bankruptcy Code, should be read as enabling a bankruptcy trustee to reach any assets transferred to a self-settled trust during the ten years following the creation of the trust, thereby vitiating the utility of any and all domestic "asset protection" trusts, at least, for the first ten years of their existence. But is that really the implication of Mortensen?

Consider the following:

A debtor's "...actual intent to hinder, delay or defraud..." is a question of fact unique to every case. While certain portions of the Mortensen decision effect a broad reach regarding what might constitute evidence of such intent, the Mortensen decision does not change the basic fact that a finding of a debtor's "actual intent to hinder, delay or defraud" his creditors is required under Section 548(e). In fact, the Bankruptcy Court itself stated that "[t]he determinative issue... is whether Mortensen transferred the Seldovia property to the trust 'with actual intent to hinder, delay, or defraud' his creditors."

Unfortunately, the Bankruptcy Court agreed with the bankruptcy trustee's somewhat tenuous argument that Mortensen's bad intent could be inferred from the trust language itself because the trust agreement set forth its stated purpose as being, in part, "...to maximize the protection of the trust estate or estates from creditors' claims of the Grantor..."

Of particular interest in this regard is the fact that under Alaska Statutes § 34.40.110(b)(1), "...a settlor's expressed intention to protect trust assets from a beneficiary's potential future creditors is not evidence of an intent to defraud." However, the Bankruptcy Court held that such provision was not determinative when applying Section 548(e)(1)(D) of the Bankruptcy Code because "[i]t would be a very odd result for a court interpreting a federal statute aimed at closing a loophole to apply the state law that permits it."

The Bankruptcy Court's position in this regard, however, is difficult to understand. The question of whether the creation of a self-settled trust should be treated as a so-called "badge of fraud" under applicable law, evidencing a debtor's intent to hinder, delay or defraud creditors, hardly seems to be a "loophole". A "loophole," in contrast, would be a state statute permitting a bankrupt to create a self-settled trust with an actual intent to hinder, delay or defraud his or her creditors. Instead, there are literally dozens of possible "badges of fraud" and the courts consistently reference the existence of multiple badges before concluding a debtor's fraudulent intent. The fact that one court, or one statute, might deem any particular circumstance as not being a "badge of fraud" is no loophole, and should be given legal effect by the Bankruptcy Court.

Moreover, even in *Mortensen*, the Bankruptcy Court cited other badges of fraud which, in and of themselves, constitute persuasive evidence of *Mortensen's* intent to hinder, delay and defraud present and future creditors. Specifically, the Bankruptcy Court cited to the fact that "*Mortensen* was coming off some very lean years at the time he created the trust..." and that "*Mortensen* was well 'under water' when he sought to put the *Seldovia* property out of reach of his creditors by placing it in the trust."

In addition, the Bankruptcy Court noted that "...when *Mortensen* received the \$100,000 from his mother he didn't pay off his credit cards. Rather, he transferred \$80,000 into the trust after paying a few bills and began speculating in the stock market..." concluding "...that *Mortensen's* transfer of the *Seldovia* property and the placement of \$80,000 into the trust constitutes persuasive evidence of an intent to hinder, delay or defraud present and future creditors."

The law regarding fraudulent transfers generally characterizes a creditor as either a "present" creditor or a "future" creditor. Present creditors are those creditors whose claims arose before the transfer. They are also referred to as "existing creditors." A debtor must be aware of a present creditor when the debtor effectuates a transfer, although the creditor does not have to possess a judgment to constitute a present creditor. In *Mortensen*, *Mortensen* was clearly aware that he was indebted at the time he established the Trust.

Future creditors are those creditors whose claims arose after the transfer. They are also referred to as "subsequent creditors." For clarification, possible future creditors should be further divided into two distinct categories, "foreseeable future creditors" and "unforeseeable future creditors," only the former of which is protected.

"Foreseeable future creditors" are those creditors whose specific claims did not exist prior to the transfer, but were anticipated or should have been anticipated. Such creditors include a creditor whose rights originated following a transfer where a debtor intended to conduct the debtor's

activities or business in a fraudulent way or with reckless disregard for the rights of a potential creditor. In *Mortensen*, *Mortensen* clearly contemplated that he would continue to be indebted to his creditors and it can certainly be inferred from the facts that he intended to increase such debt following his creation and funding of the Trust. In fact, the court noted that *Mortensen's* annual expenses exceeded his annual income thereby ensuring his continuing indebtedness and ultimate default absent a change in circumstances.

By contrast, an "unforeseeable future creditor" is an unidentifiable person or entity of whom a debtor was not aware existed at the time the debtor effectuated a transfer. An unforeseeable future creditor cannot possess a claim against a debtor. Thus, a transfer made by a debtor should not be avoidable under any existing fraudulent transfer rule including Section 548(e) of the Bankruptcy Code. This should be the case even where a stated purpose in establishing a self-settled trust was to "...maximize the protection of the trust estate or estates from creditors' claims."

Section 522(o) of the Bankruptcy Code contains a ten year fraudulent conversion rule substantially similar to the ten year statute of limitations under Section 548(e) but applicable to situations where a debtor converted non-exempt property to a homestead. Specifically, Section 522(o) provides that if within the ten years prior to the filing of a petition in Bankruptcy a debtor converts non-exempt property to a homestead with the actual intent to hinder, delay, or defraud a creditor, the value of the homestead is reduced by the value of such converted property.

The existing cases involving Section 522(o) have refused to apply that section as broadly as some commentators suggest Section 548(e) should be applied. See e.g., *In re Addison*, 540 S.3d 805 (8th Cir. 2008) (court found no intent to hinder, delay or defraud creditors under Section 522(o) upon conversion of non-exempt property to homestead property); but compare *In re Osejo*, 447 BR 352 (S.D. Fla. 2011) (debtor's conduct in connection with conversion of non-exempt property to homestead property evidenced clear intent to hinder creditors).

Of course, it would seem highly unlikely that Congress intended to pass two substantially similar statutes pursuant to the same piece of legislation, and both involving fraudulent transfers, yet with each statute to be applied in a completely different manner.

Consider the Implications

While we believe that *Mortensen* is a decision with narrow implications, at the same time it is interesting to think about a world wherein *Mortensen*, and the application of Section 548(e) of the Bankruptcy Code, were interpreted broadly.

A broad interpretation of Section 548(e) of the Bankruptcy Code to invalidate all self-settled trusts where the grantor develops a subsequent creditor issue within ten years of the date of creation would invalidate many common estate planning techniques. For example, a discretionary tax reimbursement provision of the type that is included in most modern grantor trusts could no longer be used unless the grantor were willing to run the risk that an unforeseen creditor problem might develop in the next ten years which would invalidate the trust under Section 548(e) of the Bankruptcy Code should the grantor file in Bankruptcy. A similar issue

would exist in connection with a successor back-end self-settled trust of the type used in inter vivos QTIP trusts to benefit a donor-spouse if he or she survives the donee-spouse. Moreover, the fact that many states have enacted laws that specifically provide for a special exception to the self-settled trust doctrine related to these trusts (for example, Florida Statutes § 736.0505(1)(c) and § 736.0505(3)), would be of no import under Mortensen under the theory expounded in Mortensen that "[i]t would be a very odd result for a court interpreting a federal statute aimed at closing a loophole to apply the state law that permits it."

One Final, and Somewhat Tangential, Thought

Mortensen's counsel may have missed at least an important argument that he might have made in the Mortensen case. Specifically, it seems as though Mortensen's counsel might have argued that Mortensen's mother was the actual grantor of that portion of the trust attributable to the Seldovia Property. This argument is consistent with the record whereby Mortensen's mother was paying him to transfer the property to the trust because she wanted to preserve it for her grandchildren. In fact, the Bankruptcy Court noted that this desire was corroborated by notes Mortensen's mother included with the checks she sent to him. Had Mortensen and his mother obtained the advice of competent counsel to assist in structuring the transaction, such counsel would have almost certainly advised Mortensen's mother to purchase the Seldovia Property from Mortensen and then contribute it to the Trust herself in order to clarify her position as the actual grantor of the Trust and thus avoid any arguments uniquely available against self-settled trusts, including Section 548(e) of the Bankruptcy Code.

Conclusion

If there is any lasting significance to the Mortensen decision, it will almost certainly be that the continuing uncertain application of Section 548(e) of the Bankruptcy Code requires clients who wish to establish the most protective self-settled trust possible to continue to go offshore – at least for the first ten years of the trust's existence. After ten years have elapsed without a creditor issue having developed, such trusts can safely migrate onshore because of the "silver lining" in Section 548(e) that actually validates self-settled trusts in two situations:

1. Where the self-settled trust was established without an actual intent to hinder, delay, or defraud creditors;
2. Where, even though the self-settled trust was established with an actual intent to hinder, delay or defraud creditors, more than ten years have elapsed since the trust was established!

Daniel S. Rubin is a partner of Moses & Singer's Asset Protection and Trust and Estates practice groups.

Endnotes:

1. *Battley v. Mortensen*, Adv. D.Alaska, No. A09-90036-DMD, May 26, 2011 (Original Memorandum) and July 18, 2011 (Memorandum Denying Motion for Reconsideration).

Daniel S. Rubin
New York, N.Y.

*LISI Asset Protection Planning Newsletter #187 (November 7, 2011) at <http://www.leimbergservices.com>
Copyright 2011 Leimberg Information Services, Inc. (LISI). Reproduction in Any Form or Forwarding to Any Person Prohibited – Without Express Permission.*

MOSES & SINGER LLP

Disclaimer

Viewing this or contacting Moses & Singer LLP does not create an attorney-client relationship.

This is intended as a general comment on certain developments in the law. It does not contain a complete legal analysis or constitute an opinion of Moses & Singer LLP or any member of the firm on the legal issues herein described. This contains information that may be modified or rendered incorrect by future legislative or judicial developments. It is recommended that readers not rely on this general guide in structuring or analyzing individual transactions or matters but that professional advice be sought in connection with any such transaction or matter.

Attorney Advertising

It is possible that under the laws, rules or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.

Copyright © 2011 Moses & Singer LLP
All Rights Reserved