

## Ninth Circuit Treads On an Established Right

The federal appeals court recently declared it fraudulent to transfer assets to guard against unknown, potential future creditors. Other courts across the country have repeatedly said otherwise

In recent years, asset protection planning has won its rightful place as a legitimate specialty, aimed at curtailing the reach of potential, future creditors. Of course, there are still those who believe that it's wrong to ensure against the unknowable and unforeseeable possibility of a future claim. And surely these naysayers are heartened by the U.S. Court of Appeals for the Ninth Circuit's recent decision in *United States v. Townley*<sup>1</sup>—as this ruling might be read for the proposition that planning can never be done, even if solely for protection against potential future creditors.

Fortunately, *Townley* is much more of an aberration than a restatement of the law in this area.

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### *TOWNLEY* FACTS

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So what happened in *Townley*? Certainly, the judges were provoked.

Bryce and Charlene Townley, Washington state residents, owned a residence since 1977. In 1990, using equity from the residence, the couple purchased an investment property in which they held, in the aggregate, an undivided one-half interest. The couple's daughter and son-in law held the other undivided one-half interest.

In October 1993, the Townleys formed a living trust and transferred their residence and their one-half interest in the investment property to the

living trust. In October 1996, they established a second trust, called the Beaver Valley Trust, and transferred what was in the living trust (which represented substantially all of their assets) to that second trust. Their daughter and son-in-law also transferred their one-half interest in the investment property to the Beaver Valley Trust.

The Townleys did not receive consideration in exchange for, nor did they pay any transfer taxes in connection with, their transfers to the Beaver Valley Trust. Moreover, the trustee of the Beaver Valley Trust, while ostensibly independent from the couple, saw fit to execute an agreement allowing the Townleys to manage all of the Beaver Valley Trust's affairs. And, although the Townleys were not beneficiaries of the Beaver Valley Trust, they continued to use and enjoy the property of the Beaver Valley Trust by living in the residence without paying for rent or utilities.

Bryce Townley proffered that his and his wife's intent in making the transfers to the Beaver Valley Trust was to protect against anyone who might win a judgment against them in the future. In particular, Townley claimed that he was concerned about potential exposure arising out of his work with troubled boys in the State of Washington.

Such lawsuits, however, never materialized. Instead, the Townleys got into financial trouble of their own making. Claiming that they were not subject to the jurisdiction of the Internal Revenue Service, the pair intentionally understated their federal income taxes and, as a consequence, became seriously deficient in paying their taxes for three consecutive years. Those years included the year prior to their establishing the Beaver Valley Trust, the year the trust was established and the subsequent year. The timing was unfortunate, to say the least.

An assessment of nearly \$175,000 in unpaid taxes, interest and penalties was made against the Townleys in 1998. The couple filed for bankruptcy in 2001.

In 2002, the IRS filed suit against the Townleys in the Eastern District of Washington to reduce the federal tax assessments to judgment, to set aside the transfers to the Beaver Valley Trust, and to foreclose on the federal tax liens. The Townleys defended against that

suit by arguing that they had transferred their assets to the Beaver Valley Trust in an attempt to protect against unknown, potential future creditors (that is to say, troubled boys with a litigious streak) and that the transfers did not, therefore, amount to fraudulent transfers.

Although the district court might have held simply that the Townleys' transfers to the Beaver Valley Trust were fraudulent based upon the existence of the IRS as a present identifiable creditor, the court ruled much more broadly. Specifically, the judge said that under the Washington Uniform Fraudulent Transfers Act, the Townleys' stated intent to protect their assets from any creditor, even a future unknown creditor, showed actual intent to hinder, delay or defraud creditors (that is to say, it was a fraudulent transfer). On May 17, the Ninth Circuit affirmed.

#### CONTRARY PRECEDENT

Can the law truly be that transfers—even those effected in connection with innocuous planning and based entirely upon non-specific concerns—are preserved in a kind of legal stasis for the benefit of any future creditor, should one ever come into being? The answer is “yes” if you live in Washington State—but an emphatic “no” if you live anywhere else.<sup>2</sup>

Outside of Washington State and the *Townley* decision, courts across the country have required a transferor to have actual fraudulent intent toward a specific creditor in order to set aside a transfer as a fraudulent transfer.

In Florida's *In re Piper Aircraft Corp.*,<sup>3</sup> a 1994 bankruptcy court considered various factors in the debtor's relationship to its creditors, including the “contact, exposure, impact, or privity, between the debtor's prepetition conduct and the claimant.” The court held in that case that the relationship between the pre-petition acts of the debtor and the possible future claims of certain of its creditors was “simply. . . too attenuated,” as some of the claimants were unidentified and unidentifiable and had suffered no injuries prior to filing for bankruptcy. Some claimants were even unborn, so they obviously had no pre-peti-

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tion contact with the debtor. The court said that “for a ‘claim’ to exist, there must be some way to connect the future claims to the debtor today. . . such that it can be fairly said that [the debtor’s] obligations to the Future Claimants are sufficiently rooted in the present.”<sup>4</sup>

Also in Florida is the 1990 case of *Hurlbert v. Shackleton*.<sup>5</sup> John N. Shackleton, Jr., motivated by the fact that his medical malpractice insurance was to be cancelled soon, began transferring assets that were in his name alone to both himself and his wife, Elayne M. Schackleton. After these transfers, the court found that the doctor committed medical malpractice and a judgment was entered against him. But when the plaintiff tried to enforce her judgment against assets that had been transferred to Elayne, “the trial court drew a distinction between ‘probable’ and ‘possible’ future creditors.”<sup>6</sup> Classifying the plaintiff as merely being a “possible” future creditor, the trial court said it found no cases holding a transfer of assets to be fraudulent as to “possible” future creditors.

On appeal by the plaintiff, the appellate court remanded the matter for further findings of fact about the doctor’s intent in effecting those transfers made to his wife alone. In this regard (and although the appellate court stated that it’s not relevant to inquire into whether the subsequent creditor was “possible” or “probable”), the appellate court noted that “where the creditor is not in existence at the time of the conveyance, there must be evidence establishing actual fraudulent intent by one who seeks to have the transaction set aside.”<sup>7</sup> Also noteworthy is the dissent, which would have affirmed the trial court’s judgment in favor of the doctor. The *Hurlbert* dissenter stated: “I cannot conceive of any result being reached by the trial judge that would afford this judgment creditor any relief upon remand. The trial judge is unequivocal in his conclusion that this creditor was not contemplated by the law against fraudulent transfers. How could the trial judge now conclude that Dr. Shackleton had the

actual intent to defraud this unknown, unintended victim of a future negligent act, or anyone else similarly situated?”

In each case discussed by the parties and the majority opinion, the future creditors were identifiable individually or as a class at the time of transfer. . . In the instant case, future victims of Dr. Shackleton’s medical malpractice were not identifiable individually or as a class, since the record contains no evidence that Dr. Shackleton intended to commit malpractice or suspected that he would

The Townleys acted egregiously, so it’s understandable the court might be overzealous.

be guilty of malpractice.”<sup>8</sup>

Similar conclusions were reached in a Nebraska case, *First National Bank in Kearney v. Bunn*,<sup>9</sup> in which a debtor transferred his interest in his home to his spouse on Nov. 20, 1972. Seven months later, on June 29, 1973, he executed a promissory note to the plaintiff bank for \$14,000. In October 1974, after the debtor had defaulted on his note to the bank, the bank sued, attached the debtor’s home, and sought to have the conveyance of Nov. 20, 1972, set aside as fraudulent. A trial court dismissed the suit and the Supreme Court of Nebraska affirmed, noting that a “different standard is applied to creditors whose debts are in existence at the time of conveyance, as opposed to subsequent creditors. A creditor whose debts did not exist at the date of a voluntary conveyance by the debtor cannot attack such conveyance for fraud unless he pleads and proves that the same was made to defraud subsequent creditors whose debts were in contemplation at the time.”<sup>10</sup>

New York has a series of decisions stating the same principle. In the 1952 case of *Klein v. Klein*,<sup>11</sup> title to the parties’

marital residence was taken in the name of the defendant wife because, the court explained, the parties were concerned that “as a police officer [the husband] might, at some future time, be sued for false arrest or some other act in connection with his duties in the enforcement of the law. And if any such claims came, the municipality had made no provision, by insurance or otherwise, to protect its employees from any valid claims or false ones.”<sup>12</sup> But the couple had an understanding that when the husband retired from the police force, she would deed the property to her husband and herself, as tenants-by-the-entirety. Before that time came, though, the parties had a falling out. When the husband retired, the wife refused to re-title the property. As a defense, the wife argued that their oral agreement to transfer title was a fraud that should not be sanctioned by the court. Holding for the husband, the trial court stated that “there has been found no authority that an action such as this must fail for the reason that the grantor, who was without creditors, feared for future dangers, real or imaginative. Surely his hands were as clean as any one who ever came into equity. What he did amounted to no more than insurance against a possible disaster.”<sup>13</sup>

In the 1955 New York case of *Pagano v. Pagano*,<sup>14</sup> every family member conveyed his or her property to the one family member who was not engaged in any business ventures at the time of the transfer, all with the intent of protecting their personal property from any business-related encumbrances due to the uncertainty of their business ventures. Although the primary motivation of these transfers was clearly “asset protection,” the trial court held that there was no fraudulent intent in the family’s actions and the family did not have as the court put it, “unclean hands” by reason of the transfer. New York courts also have ruled that “[t]ransfer[s] made prior to embarking upon a

business in order to keep property free of claims that may arise out of the business” do not create a claim of substance by a future creditor.<sup>15</sup>

In 1994, a New York court affirmed this general proposition again. The trustee in *In re Joseph Heller Inter Vivos Trust*<sup>16</sup> applied to the Surrogate’s Court for the “novel purpose of insulating the trust’s substantial cash and securities from potential creditor’s claims that could arise from the trust’s real property.” The trustee expressly represented to the court that there were no current claims and none threatened or reasonably anticipated. In ordering the trust to be severed in the manner requested, the Heller court stated that “New York law recognizes the right of individuals to arrange their affairs so as to limit their liability to creditors. . . making irrevocable transfers of their assets, outright or in trust, as long as such transfers are not in fraud of existing creditors. . . The most significant of the foregoing examples is the availability of renunciation for the sole purpose of defeating existing creditors’ claims. . . Clearly, if New York law allows a beneficiary to defeat existing creditors by a renunciation, a trust can be severed for the purpose of limiting liability to nonexistent, but possible, future creditors.”<sup>17</sup>

Legal commentators have long recognized that for a transfer to be fraudulent as to a future creditor, it “must be

made,” as one legal scholar put it in the 1872 treatise *Fraudulent Conveyances*, “with an intent to put the property out of the reach of debts, which the grantor at the time of the conveyance intends to contract, and which he does not intend to pay.”<sup>18</sup> Significantly, in 1998, a New York trial court held that such intent can not be assumed even from the creation of a Cook Islands-based asset protection trust—provided, of course, that there were no creditors at the time that the trust was created.<sup>19</sup>

In fact, the generalized notion of transferable intent that exists in *Townley* is far too broad to be acceptable to most other courts. In order to balance the strong public policy relating to property rights (and, specifically, the free transferability of property), courts generally will require that a fraudulent transfer be based upon the existing rights of creditors: Even the mere fact that a person may be indebted to another does not render a conveyance of his property a fraud in law upon his creditors. The owner of property, whether real or personal, possesses the absolute right to dispose of all or any part of his property as he sees fit. The only restriction imposed by law is that no transfer shall be made if it interferes with the existing rights of other persons.<sup>20</sup>

It is admittedly awkward to reconcile this concept with the terminology of the law of fraudulent transfers (which includes, as potentially fraudulent, a transfer adversely affecting the rights of a “future creditor.”)<sup>21</sup> For example, the relevant provision of the

Washington Fraudulent Transfer Act is entitled “Transfers fraudulent as to present and future creditors” and provides that a transfer made or obligation incurred by a debtor may be fraudulent as to a creditor “whether the creditor’s claim arose before or after the transfer was made or the obligation was incurred.”<sup>22</sup> But the phrase “future creditor” has not normally been interpreted as including potential future creditors who are non-existent, and unknowable, at the time of the transfer.

Outside of Washington State, a creditor must be (1) reasonably foreseeable in the (2) immediate future, in order to qualify as a “future creditor” of the type that would implicate the law of fraudulent transfers.<sup>23</sup> A “future creditor” simply does not exist unless the transferor can “reasonably foresee incurring the costs of a claim or judgment at the time of the conveyance.”<sup>24</sup> It logically follows that, a transferor’s intent, even as part of an “asset protection plan” is not significant as a matter of fraudulent transfer law if it relates only towards creditors that are not reasonably foreseeable at the time of the planning, or who appear long after the transfer in question.

In fact, it would violate common sense to suggest that every possible creditor at any time in the future should, as a matter of public policy, be able to cite to some amorphous “asset protection” intent, potentially decades earlier, as having any legitimate implication vis a vis its relationship with the debtor. Consider that if intent could be transferred so easily, the intent “requirement” under the law of fraudulent transfer would, in fact, be a nullity.

Also, obviously rendered a nullity would be the statute of limitations that the law has otherwise imposed on a creditor’s claim of a fraudulent transfer. Even the recently enacted Bankruptcy Abuse Prevention and Consumer Protection Act of 2005<sup>25</sup> contains a special statute of limitations period for transfers made to self-settled trusts with intent to “hinder, delay or defraud present or future creditors.”<sup>26</sup> Specifically, the act denies

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creditors' claims after 10 years from the date of the transfer.<sup>27</sup> Also notable is the fact that the eight states with asset protection trust legislation include statute of limitations periods for future creditors claiming that these trusts were funded via fraudulent transfers.

Because it's arguably unethical for an attorney to assist a client in effecting a fraudulent transfer, it's also interesting to note exactly what constitutes a "future creditor" for purposes of the law of fraudulent transfers under the Model Code of Professional Conduct.<sup>28</sup> In that context, the probability of judgment against the transferor has been determined to be the key concept: A transfer "solely for the purpose of an immediate probability of judgment would be in violation of DR 7-102(A)(7), which states: 'In his representation of a client, a lawyer shall not counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent'. . . If, however, there does not exist the immediate reasonable prospect of a judgment being entered against the client the transfer merely to avoid the future possibility of an action by a creditor or creditors would not be in violation of DR 7-102(A)(7)."<sup>29</sup>

If it is unethical to assist a client in effecting fraudulent transfer, but not unethical if "there does not exist the immediate reasonable prospect of a judgment being entered against the client," then it's clear that (1) a transfer by a person without the immediate reasonable prospect of a judgment being entered against such person is not a fraudulent transfer, because (2) a person without the immediately reasonable prospect of entering such a judgment against another is not the "future creditor" contemplated under the law of fraudulent transfers.

### TOWNLEY IN CONTEXT

When the Townleys transferred substantially all of their assets into trust in October 1996, they already were seriously—and intentionally—deficient in their federal tax obligations. The couple's

alleged intent to protect against anyone who might get a judgment against them in the future, and in particular, potential creditors that might arise out of Bryce Townley's work with troubled boys, was not only potentially self-serving but wholly irrelevant because there was at that time a present creditor: the IRS. Even were the IRS not then a present creditor, it's extremely likely that the couple's relationship to the Beaver Valley Trust was such that it would be held to be their alter ego, due to their continued use and enjoyment of the residence.

Because the couple acted egregiously, it's understandable that the Townley court might be inclined to overzealousness. But the Ninth Circuit's decision is unfortunate, especially for those who live in Washington State and whom it may impact. Perhaps the appellate judges recognize this; the Ninth Circuit did state that the *Townley* decision was "not appropriate for publication" and that it "may not be cited to or by the courts of this circuit except as provided" by the Ninth Circuit rules.

Meanwhile, though, outside of Washington State, *Townley* serves as an important reminder of one of the cardinal rules of asset protection planning: It must always be done as long as possible before storm clouds gather. ■

#### Endnotes

1. No. 04-35767, 2006 WL 1345248 (9th Cir. May 17, 2006).
2. Note that even within Washington State, the Ninth Circuit determined the *Townley* decision to be "not appropriate for publication" and that it "may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3."
3. 162 B.R. 619 (Bankr. S.D. Fla.), *aff'd sub nom*, 168 B.R. 434 (S.D. Fla. 1994), *aff'd*, 58 F.3d 1573 (11th Cir. 1995). 4. *Ibid.*, at 439.
5. 560 So.2d 1276 (Fla. Ct. App. 1990).
6. *Ibid.*, at 1279.
7. *Ibid.*, at 1279-1280.
8. *Ibid.*, at 1280.
9. 195 Neb. 829, 832, 241 N.W.2d 127, 129 (1976).
10. *Ibid.*, at 832; *Accord*, *Jayne v. Hymer*, 66 Neb. 785, 789, 92 N.W.2d 1019,

1020 (1902), wherein the Supreme Court of Nebraska held that "[i]n order to maintain a creditors' suit against a wife to set aside a conveyance of property made by a third person to her, the relation of debtor and creditor must have existed between the plaintiff and her husband at the time such conveyance was executed; or it must have been executed fraudulently, with the expectation on the part of the husband that he would become indebted to the plaintiff at a future time, and for the purpose of preventing, hindering and delaying the collection of the debt when it should finally be contracted."

11. 112 N.Y.S.2d 546 (N.Y. Sup. Ct. 1952).
12. *Ibid.*, at 547.
13. *Ibid.*, at 548.
14. 207 Misc.474 (N.Y. Sup. Ct. 1955).
15. *Palumbo v. Palumbo*, 284 N.Y.S.2d 884 (N.Y. Sup. Ct. 1967).
16. 161 Misc. 2d 369, 613 N.Y.S.2d 809 (New York County Surrogate's Court 1994).
17. *Ibid.*, at 810-811.
18. Orlando Bump, *Fraudulent Conveyances*, (Beard Books, reprint 2000) (originally published in 1872).
19. "Assuming arguendo, that this Court had jurisdiction over the corpus of the Riechers Family Trust, which it does not, a cause of action would not lie to set aside the trust since the trust was established for the legitimate purpose of protecting family assets for the benefit of the Riechers family members." *Riechers v. Riechers*, 679 N.Y.S.2d 233 (1998).
20. *In re Miami General Hosp., Inc.*, 124 B.R. 383, 392 (Bankr. S.D. Fla. 1991) (emphasis in original), *quoting Bay View Estates Corp. v. Sutherland*, 154 So. 894, 900 (Fla. 1934) (overruled on other grounds).
21. Rev. Code Wash. Section 19.40.041.
22. Rev. Code Wash. Section 19.40.041(a).
23. *Leopold v. Tuttle*, 549 A.2d 151 (Pa. Sup. Ct. 1988).
24. *Ibid.*, at 154.
25. Pub. L. No. 109-8, 119 Stat. 23 (April 20, 2005).
26. 11 U.S.C. Section 548(e)(1).
27. *Ibid.*
28. See Gideon Rothschild and Daniel S. Rubin, "Asset Protection Planning: Ethical? Legal? Obligatory?" *Trusts & Estates*, September 2003, at p. 42.
29. 1984 WL 272915 (S.C. Bar. Eth. Adv. Comm.). South Carolina's DR 7-102(A)(7) is the equivalent of the American Bar Association's Model Code of Professional Conduct R. 41 (1983).