

Did Bankruptcy Reform Act Close The 'Loophole' for the Wealthy?

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On March 16, 2005, the U.S. Senate passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (S. 256). The purpose of the act, according to the bill's sponsors, is to prevent abuse "where deadbeats can get out of paying their debt scott-free while honest Americans who play by the rules have to foot the bill."

After an article appeared in *The New York Times* in March criticizing Congress for leaving a "loophole" for the wealthy by allowing them to avoid their creditors by use of self-settled spendthrift trusts (SSSTs) (now available under the laws of eight states) Sen. Charles Schumer, D-N.Y., proposed an amendment that would severely limit the use of SSSTs by capping the exemption at \$125,000. Following Senate rejection of Schumer's proposed amendment, Sen. Jim Talent, R-Mo., submitted Amendment 121, which would add to 11 U.S.C. 548 ("Fraudulent Transfers") the following:

(e)(1) 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.

(2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by —

(A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or

(B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C.

781 and 780(d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f).

Sen. Talent's amendment was passed by a vote of 73 to 26 and included the support of senators from the SSST states.

The House passed the Senate's version of the bill on April 14 by a vote of 302 to 126 and the bill was signed into law by President Bush on April 20. Numerous commentators have indicated that there are significant flaws in the bill that will affect small-business owners, the elderly, families with children, and ironically even many creditors who pushed for the bill's passage. There are also ambiguities that, without a technical amendment, would likely lead to protracted litigation in our courts.

Focusing on Amendment 121, there are numerous issues that will have to be resolved. Based on the legislative history, it appears that Schumer's and Talent's concerns had their roots in the purported attempts by some corporate executives to avoid their creditors by availing themselves of various bankruptcy exemptions. Sen. Talent's press release said: "We should not allow wealthy people, including corporate criminals, to hide their assets and avoid paying their bills. Our amendment makes certain that dishonest people can't hide their assets, especially if they have caused others to lose their jobs, retirement pensions, health care benefits and, in some cases, their life savings."

Following is some of the colloquy on the Senate floor:

Mr. HATCH: Mr. President, one can have self-settled trusts. What the amendment of the distinguished Senator from New York does is do away with essentially all self-settled trusts. Frankly, Senator Schumer's amendment is so broad that it covers all settled trusts, not just fraud.

The amendment of the distinguished Senator from Missouri covers fraud, and he does it in the appropriate way, a legal way, the way it should be done.

Mr. TALENT: I thank the Senator from Utah.

Very briefly, we should not allow criminals to hide their assets and avoid paying their bills. This amendment makes certain that dishonest people can't hide their assets, especially if they have caused others to lose their jobs, retirement pensions, health care benefits and, in some cases, their life savings.

One of the reasons the economy plunged into a recession a few years back was because of corporate fraud. And those crimes caused companies to fail, eliminating thousands of jobs. It is fundamentally unfair to allow these crooks to abuse the trust laws of certain States to hide their wealth.

My amendment is simple. It closes the asset protection trust loophole by empowering bankruptcy courts to go back 10 years to take away fraudulent transfers that criminals have sheltered away in an attempt to avoid paying back their debts.

Here is a little background on the problem. Asset protection trusts are trusts that a person forms to shield assets for his or her own benefit.

Although the law has historically allowed property owners to create trusts for others, courts have historically refused to permit someone to tie up his or her own property in such a way that he or she can still enjoy it but prevent his or her creditors from ever reaching it.

My amendment states clearly that these trusts cannot be used in bankruptcy to allow a person to shelter their assets to avoid repaying their debts because of a judgment in criminal, civil, or bankruptcy court.

In addition, my amendment closes the loophole that *The New York Times* wrote a good article about. That article noted how difficult it is to determine how much money these crooks have sheltered into these asset protection trusts. Some estimate that criminals have stashed away billions of dollars in these types of trusts.

This amendment allows victims to go after any resource transferred into the trust by a corporate criminal over the previous 10 years. Current laws say that if a corporate executive is convicted of a crime, victims can only go after resources transferred into these trusts over the last year. The bankruptcy bill, without my amendment, would have made it only 2 years.

But, that is still not enough time to go after the criminals who set up these asset protection trusts. There is a gap of several years where criminals could have put billions in assets into these trusts and the Federal and State bankruptcy courts might not be able to touch them. My amendment closes the loophole for criminals.

I urge my colleagues to support this amendment — it simply cracks down on criminals.

As noted in the debate, the emphasis was on corporate criminals and intent to defraud. As estate planners are well aware, however, most domestic SSSTs are used for legitimate estate planning and asset protection purposes. Furthermore, most people creating those trusts are not crooks and are not avoiding any existing creditors. In fact, there has not been one reported decision that alleges that a person accused of corporate fraud created a self-settled trust. Given the stated purpose of the amendment, it is apparent that the Senate has thrown out the baby with the bathwater by drafting such a broad provision to encompass anyone who settles a self-settled trust within 10 years of filing a petition.

Some of the other concerns the courts will have to grapple with are the following: Were contributions to retirement plans intended to be subject to the 10-year lookback as there is no exception for such "self-settled" trusts? What is meant by a "similar device"? Will partnerships or limited liability companies fall prey to this provision? Was the use of the term "entity" intended to limit the application of the statute, or will "entity" be given the broad construction normally afforded the term under section 101 of the Bankruptcy Code? How will the courts determine whether a debtor had the requisite "intent to hinder, delay or defraud" his creditors? Will the mere existence of a self-settled trust be deemed

sufficient to prove that intent? After all, the argument goes, why else would a person create such a trust since there are no tax benefits thereto? Or will the courts limit the application to those situations in which the creditor was existing at the time or the claim could have reasonably been expected to be made at that time?

Was the 10-year limitation based on the fact that corporate executives who intend to commit fraudulent acts are often not found guilty until many years thereafter? Should it not therefore be applied only to those whose conduct is a violation of state or federal laws involving moral turpitude? Was section (e)(2) therefore intended to be limited to those involved in securities fraud?

Is there a reason why the homestead exemption provides for a 40-month period and that provision applies a 10-year lookback?

John E. Sullivan III, a bankruptcy and trusts attorney in Cleveland, notes that this is "still just an actual fraud statute and anything that can be done to defuse a claim of actual fraudulent intent under current law would still seem to be a valid defense under this provision. In many ways," he believes, "it simply restates existing law but extends the period that a transfer can be unraveled to 10 years. . . . This will expose debtors to abusive and extortionate litigation based on their conduct from up to a decade prior." That extraordinarily long limitations period will also inevitably cause serious evidence problems, such as key witnesses dying or relocating to points unknown, faded memories, loss or routine destruction of relevant documents, and other troubles normally associated with "stale" cases.

Further, Hofstra Law School Professor Mitchell Gans suggests that the legislation raises a federalism issue. Gans notes that "under current law in all of the self-settled states, creditors in existence at the time of the trust's inception are protected by the fraudulent conveyance doctrine. In altering the balance between creditors and debtors that these states have struck, the legislation trumps a state-law approach that adequately deals with the creditor problem."

In the end, this amendment, which was in response to a biased article in *The New York Times*, is another example of legislators acting without the benefit of knowing all the facts. In my experience, self-settled spendthrift trusts do not provide a loophole for the wealthy. There are safeguards that all domestic self-settled trusts statutes provide to creditors who have claims existing when those trusts are settled. What the Senate has done in passing this amendment is to cause those who are looking for more effective asset protection to move their assets offshore, thereby affecting the economies of those states that, until now, have been successful in attracting businesses to their home-based institutions. And in the end, creditors will be left without any remedy because those trusts are not subject to the U.S. courts' jurisdiction.

As for domestic self-settled spendthrift trusts there may even be a silver lining to this legislation. Planners will have more reason to recommend that clients settle those trusts as early as possible so that the clock can begin to run on the 10-year period. Also, the legislation seems to validate self-settled spendthrift trusts in cases in which there are no existing creditors.

In the end, although much uncertainty exists, at least one thing is certain — there will be more to be said on this in the future.