

Offshore Trusts Flop Again	1
Client Confidentiality Compromised	1
Continuing Concealment Doctrine	3
Single Member LLCs	4
Circular Transactions	5
Advice for the Crashing Client	7
Stop Tax Haven Abuse Act	9
Captive News	9
KYC Conference	10
Firm News	11
Upcoming Appearances	11

# Developments

## IN ASSET PROTECTION AND WEALTH PRESERVATION

Jay Adkisson has released his latest book, *Adkisson's Captive Insurance Companies: An Introduction to Captives, Closely-Held Insurance Companies and Risk Retention Groups*, which is available from Amazon.com and through Barnes & Noble and other booksellers.

Congratulations to Chris Riser, who has been selected as the Chair of the American Bar Association's Asset Protection Planning Committee.

For offshore practitioners, the OffshoreAlert 6th Annual Conference in Fort Lauderdale on April 13-15 is the premiere event regarding the offshore tax and debtor havens. More information on page 10

### OFFSHORE TRUSTS FLOP AGAIN

*Morris v. Morris*, Case Nos. 4D04-3812, 4D04-4621, 4D04-4763, *aff'd* Appeal No. SC05-1166 (Fla.S.Ct. April 13, 2006); *Morris v. Wroble*, Case No. CIV-06-80479 (S.D. Fla.) *aff'd* Appeal No. 06-80452-CV-DTKH (11th Cir. Nov. 16, 2006).

In January, Merry Morris finally turned herself in to the Sheriff's office in Palm Beach County, Florida, and was immediately sent to jail. Why? No more or no less than she had conveyed assets to a Cook Islands trust and had refused to bring the assets back.

Once again, a court has refused to believe the claims of a settlor of an offshore trust that they really have no power to bring the trust assets back to the U.S. to satisfy creditors -- a ruling that was once called "impossible" by some offshore trust pundits, who once upon a time ridiculed the mere suggestion that a U.S. court could make such a ruling. That was the theory, but the metal bars keeping Merry Morris in her cell are all too real.

Lee and Merry Morris had been married for nearly 11 years when they executed a post-nuptial agreement in 1998. Among other things, in the event of a divorce, the post-nuptial agreement provided for joint custody of the couple's children and for a \$1.35 million payment from Leland to Merry.

The agreement also contained an incontestability clause. If Merry contested the terms of the agreement, she would forfeit the \$1.35 million payment. In 2001, the agreement was modified to provide for a \$1.5 million payment under the same terms. In August 2001 the couple parted ways and filed for divorce.

Two years later, in June 2003, Merry brought an action to enforce the post-nuptial and to clarify certain unresolved issues such as the custody of their children during holidays. The pleadings filed by Merry made clear that she was attempting to enforce the post-nuptial agreement, not challenging it. For some unknown reason, Merry represented herself in these proceedings.

*Continued on next page*

### CLIENT-CONFIDENTIALITY MAY BE COMPROMISED WHEN TRAVELING IN U.S.

Businessmen in offshore financial centers and elsewhere who value client-confidentiality ought to think long and hard before taking laptop computers and other data-storage devices with them on trips to the United States, says Washington, DC-based technology consultant Mark D. Rasch.

There has been a growing number of incidents of travelers having electronic devices seized at U. S. airports by Government agents wanting to access the information stored on them, even if it is password-protected, according to Rasch, who is a former head of the U.S. Justice Department's computer crime unit, and now specializes in computer crime, computer security, incident response, forensics and privacy matters as Managing Director of Technology for FTI Consulting, Inc.

*Continued on page 9*

Although the court noted that Merry had "some legitimate gripes," the court denied her claims. It also held that her action amounted to a challenge of the post-nuptial agreement such that she forfeited the \$1.5 million paid to her from Lee. The court also awarded Lee his attorney fees in the amount of \$264,000 plus costs, so that the total judgment, with interest, came to just over \$1.8 million.

While Merry appealed, Lee pursued collection and discovered that Merry had transferred the bulk of her liquid assets, nearly \$3 million, to a Cook Islands asset protection trust. When Lee went after the \$500,000 home that he had purchased for Merry in Boca Raton, Merry drew down a home equity line of credit secured by the home and sent the proceeds to her Cook Islands trust too.

In an interview with the Palm Beach Post, Merry characterized her Cook Islands trust as an uncle who cares for her and pays her bills, stating "I'm not real good with money and I'm not real smart with investments." The terms of the trust agreement made Merry only a beneficiary, with no powers to demand distributions or control trust assets.

The Florida court ordered Merry to bring back to Florida the money that she had sent to her Cook Islands trust, and enjoined her from making any further asset transfers. Rather than complying, Merry apparently fled from Florida.

Three times the Florida court ordered Merry to appear in person, and three times she failed to appear. Finally, the court held her in criminal contempt of court, and issued three arrest warrants, each of which required a \$100,000 bond. Lee's attorney registered the criminal contempt citations with the national Sheriff's registry, so that if she was ever stopped anywhere in the country for anything, even a minor traffic violation, she would have been arrested and returned to Florida to face the charges.

It got worse for Merry. Because she was a fugitive, the Florida Court of Appeals dismissed her appeals, though the court did give her 15 days to voluntarily appear before dismissing her appeal. The Florida

Supreme Court refused to hear Merry's Writ of Mandamus.

Thus foreclosed from relief in Florida, Merry's current attempt is to have the U.S. District Court in the Southern District of Florida hear her Writ of Habeas Corpus to relieve her from the commitment orders of the Florida court. However, a habeas writ is relief that is meant for persons being held in government custody. Merry is not in custody.

Finally, so that she would not be totally cut off from her children Merry finally turned herself in to the authorities and is now in jail in Palm Beach County, Florida. A hearing is scheduled in the case for April to determine her status, meaning: Will she finally cause the Cook Islands trustee to bring her assets back or will she continue to sit in jail?

I will warn you in advance that the following analysis is mine only, and probably will not be generally shared within the asset protection community, which continues to view the foreign asset protection trust as a sacrosanct planning structure that should be immune to all criticisms if for no other reason than that so many planners continue to use them.

Offshore trusts do make sense in some very limited circumstances, such as to facilitate international estate planning for families having members spread over the globe. But they do not make any sense at all in their common usage, which is for a U.S. person having no significant international business to set up a trust for themselves and then try to hide behind that trust when creditors come a'calling.

I'm here to tell you (again) that this King has no clothes. Sure, this will be viewed as another "bad facts" case, and it is. No sane planner should have even considered setting up this structure, and the results are entirely predictable. Yet, the planning was done, and this case now adds to the ever-longer line of cases that say "offshore trusts don't work".

Some offshore trust proponents likely will declare Merry's use of her foreign asset protection trust to be a success, since the \$3.5 million in trust assets have not been touched by the Florida court or by her ex-

husband. Most of the rest of us will see this case for what it is – another in a long and consistent line of courtroom failures of offshore trusts to protect assets while allowing the settlors of those trusts both their beneficial use of the trust assets and their corporeal freedom in the U.S.

There has yet to be a reported court case where a foreign asset protection trust has worked as a practical matter. Not only have these trusts routinely failed in the courtroom, but courts and legal academics have branded the use of foreign asset protection trusts as a gutter tactic. Remarkably, they continue to be standard planning fare for many planners.

This case is particularly egregious, since not only did Merry's use of the Cook Islands trust force her into hiding to avoid jail, but it also cost her the ability make what may well have been a successful appeal on the issue of whether her action to enforce and interpret the post-nuptial agreement was a challenge that caused her to forfeit the \$1.5 million payment from her ex-husband.

Furthermore, as a fugitive, Merry has not seen her children for several years, and had to turn herself in just for some brief time with them on Saturday mornings. Merry has lost her right to appeal, she has lost custody of her children, and she can't even go out for a cheeseburger like any other Joe Blow.

In other words, not only did Merry's Cook Islands trust fail to serve its purposes, but it actually put her in a much worse position than if she had done nothing at all.

If Merry tries to get the money from the trust, but can't, how long might she be held in jail in contempt of court? Stephen Jay Lawrence was recently released by the U.S. District Court for the Southern District of Florida after over six years of imprisonment for contempt of court for failing to repatriate assets from an offshore asset protection trust. *In re Stephen J. Lawrence*, 279 F.3d 1294 (11th Cir. 2002).

I want to see the disclosure letters given to clients that warns them that they might spend some years in jail if they do not agree to repatriate their trust assets. Who

would be crazy enough to go forward with planning with such a letter? Yet, without such a letter, clients are arguably being defrauded into entering into a transaction lacking adequate disclosure of the actual risks based upon existing case law.

Will it be worth saving the \$3.5 million to spend an undeterminable amount of time in jail seeing her children for a few hours a month – assuming they visit?

Using offshore asset protection trusts to protect the bulk of a person's assets must end. In the 2005 bankruptcy law changes, Congress sent a strong message that insolvent debtors would not be allowed to stash assets in self-settled spendthrift trusts. The courts have shown little inclination to recognize such trusts, and the entry of repatriation orders against those with such trusts is now routine.

The case law involving offshore trusts is getting worse, not better. The much-talked about but never seen "good case" that validates the benefits of the foreign asset protection trust has simply not materialized.

That asset protection trusts continue to be commonly used, or that planners want them to work, does not overcome the fact that when challenged in U.S. courts they have routinely and nearly consistently failed. It is time to put down the Cook Islands Kool-Aid and move on.

## CONTINUING CONCEALMENT DOCTRINE AND RETAINED INTERESTS

Wilferd v. Wardle, 2007 WL 391583 (D.Utah, Feb. 1, 2007)

Wardle bought two businesses from the Wilferds, giving them a promissory note for \$1.2 million. Wardle later defaulted on the note and the Wilferds sued him. While this case was pending, Wardle sold his residence for \$10 to his wife by quit claim deed claiming "asset protection" reasons for the transfer.

More than a year later, Wardle filed for bankruptcy but omitted that he had owned the residence which he had transferred to his wife. The bankruptcy court denied

Wardle's discharge, applying what is known as the Continuing Concealment Doctrine.

A bankruptcy court is required to discharge the debts of a debtor under section 727(a)(2) unless the debtor has engaged in certain misconduct, such as fraudulently transferring or concealing property within one year before the filing of the bankruptcy petition.

Wardle claimed that because he transferred his residence to his wife more than one year before he filed for bankruptcy, that section 727(a)(2) would not apply.

The court rejected Wardle's argument by application of the Continuing Concealment Doctrine, which allows the application of section 727 to deny a discharge so long as property continues to be concealed within the one year period.

Wardle claimed that the Continuing Concealment Doctrine should not apply to his case because he lacked any intention to hinder, delay or defraud creditors.

The court rejected this argument on the grounds that the Continuing Concealment Doctrine can be satisfied by a transfer or title coupled with retention of the benefits of ownership. Importantly, the court also noted that there was evidence of Wardle's purpose to defeat anticipated creditors as found in Wardle's own deposition:

Q. You had indicated that you assigned your title in the home to [your wife.]

A. Yes.

Q. What consideration did you get for that?

A. What do you mean by consideration?

Q. Did you get any money from her?

A. A \$10 transaction.

Q. All right. And so why did you do that?

A. Just asset protection.

Q. You wanted to protect the home from the Wilferds?

A. From the Wilferds, from anybody.

Wardle's contention that he had no actual intent to defraud creditors was belied by a number of factors, most importantly that "retention of the use of the transferred property very strongly indicates a fraudulent motive underlying the transfer."

Our analysis:

Bankruptcy is an arena to be avoided for those who have attempted to engage in asset protection planning. The primary purpose is not to protect the debtor, but instead is to marshal the debtor's assets for the benefit of creditors. The bankruptcy laws create many traps for debtors and many avenues for creditors to circumvent debtors' schemes.

This is another case where the admission by the debtor that he engaged in asset protection planning tended to indicate an actual intent by the debtor to engage in planning meant to hinder, delay or defraud creditors. One cannot testify that "asset protection" was a substantial reason for planning, and expect that the planning will survive a fraudulent transfer analysis.

Because of the Continuing Concealment Doctrine, a debtor may be denied a discharge for attempting to hide his interest in a personal residence even if the residence was transferred some time before the debtor files for bankruptcy, if there was any evidence (including an admission that the debtor engaged in asset protection planning) that the debtor meant the transfer to remove assets from the reach of creditors.

Although Wardle claimed that he had sold his residence to his wife, in fact he continued to benefit from the residence. Absent evidence of a transaction for reasonably equivalent value, which a gift or transfer for nominal consideration will never satisfy, the transfer of a residence in which one continues to live may be ineffective for asset protection purposes.

For estate planners, this point is particularly relevant in the case of a transfer to a Qualified Personal Resident Trust (QPRT) in which the transferor retains the right to live in the residence for a period of years. During the fraudulent transfer limitations period, the residence will be subject to claims of creditors of the trans-

feror. This period lasts for four years from the date of the transfer in most states.

In California, for example, the four-year limitations period in some circumstances does not begin to run until a creditor has obtained a judgment. Therefore, the transfer of a California residence to a QPRT may be subject to a fraudulent transfer claim for seven years from the date of the transfer, the period of unique "extinguishment" statute of limitation under the California UFTA. That's an awfully long period of time to wait to see if a transfer might survive a fraudulent transfer challenge.

Even after the limitations period expires, although the residence might not be available to the creditors of the transferor, the transferor's retained interest in the QPRT will be available to her creditors. If a creditor were able to force the sale of the residence within the QPRT, the creditor would be able to attach the income stream of the grantor retained annuity trust (GRAT) to which the QPRT would convert for the remainder of the QPRT term. There are other potential flaws with a QPRT as an asset protection tool, but you get the picture.

Asset protection is not a game, and those who attempt to game the system will find that judges may use obscure rules such as the Continuing Concealment Doctrine to get around a ploy by the debtor that might otherwise technically avoid being a fraudulent transfer. Admitting that a transfer was done for asset protection reasons sends up a bright red flag and, as here, makes the judge both suspicious and willing to thwart the debtor's intent.

Retaining interests is particularly dangerous in asset protection planning, since retained interests can by themselves support a finding that an arrangement was a fraudulent transfer. It is skating on thin ice to keep strings over an asset or maintaining the beneficial use of an asset that was purportedly transferred away. That you might be able to do it for tax purposes will be of absolutely no relevance at all when creditors come a'calling.

Saying that a debtor did something for asset protection reasons can be, in some circumstances, tantamount to an admission of the debtor's intention to engage in a fraudulent transfer. Since there is never a need to make such an admission, just don't put your clients in a position where they might have to do that.

## SINGLE-MEMBER LLCs AND CHARGING ORDERS

In re Ashley Albright, No. 01-11367 (Bkrptc.D.Col. 04/04/2003) was the first opinion to consider the case of the so-called single-member LLC. There, the sole member had filed for personal bankruptcy, and the court held that charging order protection would not prevent the Trustee from marshalling the assets of the entity to satisfy creditors, explaining:

"A charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a single member limited liability company, because there are no other parties' interests affected. \* \* \* Because the Trustee became the sole member of Western Blue Sky LLC upon the Debtor's bankruptcy filing, the Trustee now controls, directly or indirectly, all governance of that entity, including decisions regarding liquidation of the entity's assets."

Two recent cases have further considered single-member LLCs in the creditor-debtor context. In one case, a single-member LLC was once again deemed to be part of the debtor's bankruptcy estate without regard to charging order protection. In another case, a single-member LLC was deemed to be the alter ego of its parent. Neither case bodes well for the use of single-member LLCs for asset protection planning.

### **Case #1: In re A-Z Electronics, LLC, 350 B.R. 886 (Bkpr.D.Id 2006)**

Husband and Wife jointly filed for Chapter 7 claiming a 100% ownership in A-Z Electronics LLC.

Two years later, A-Z Electronics LLC itself filed a voluntary Chapter 11 petition seeking reorganization. Husband and Wife signed the Chapter 11 petition on behalf of A-Z Electronics LLC, and Husband signed the list as one of the 20 largest unsecured creditors. The statement of financial affairs for A-Z Electronics LLC said that it was 100% owned by Husband.

The bankruptcy Trustee moved to dismiss A-Z Electronics LLC's Chapter 11 case.

Since under Idaho law a membership interest in an LLC is personal property, it becomes property of the bankruptcy estate when the member's bankruptcy petition is filed.

The court quoted the Albright opinion for the proposition that where "there are no other members in the LLC, . . . the Debtor's bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate, and the Trustee obtained all her rights, including the right to control the management of the LLC. \* \* \* Because the Trustee became the sole member of the LLC upon the Debtor's bankruptcy filing, the Trustee now controls, directly or indirectly, all governance of that entity, including decisions regarding liquidation of the entity's assets"

The court determined that the initial bankruptcy filing by Husband and Wife caused their interests in A-Z Electronics to become the sole property of the Trustee, and thus the Trustee became the only party with the right to manage A-Z Electronics LLC or choose whether it should file a bankruptcy petition. Because it was Husband and Wife who filed the bankruptcy petition for A-Z Electronics LLC and not the Trustee, the bankruptcy petition was not properly authorized or executed, and thus the petition would be dismissed.

### **Case #2: Cognex Corp. v. VCode Holdings, Inc., 2006 WL 3043129 (D.Minn., Oct. 24, 2006)**

Cognex Corporation filed a suit for declaratory judgment against Acacia Research Corporation and its wholly-owned subsidiary VData LLC and other subsidiaries, relating to disputed intellectual property rights.

Cognex argued that VData was the alter ego of Acacia, while the latter argued that the traditional multi-pronged alter ego analysis did not support a finding that VData was an alter ego of Acacia. This analysis requires a corporate analysis that has not changed much from the 19<sup>th</sup> Century, and includes such factors as whether corporate formalities were observed, corporate records were kept, or funds were commingled, etc. The court rejected this form of analysis because VData was an LLC, not a corporation.

“[T]his test is premised on the assumption that the subsidiary is a corporation that is subject to certain corporate formalities. At the time that the test was developed, the law of business organizations had yet to recognize statutory limited liability companies. \* \* \* And unlike a corporation, an Illinois limited liability company does not issue stock, does not appoint officers, and is not required to issue annual reports. \* \* \* Though the proposed multi-factor test is germane to the extent it examines control by a parent entity, the underlying focus is whether the parent exercises such control that the parent and subsidiary are indistinguishable.”

The court instead focused on the fact that the officers/managers of the parent corporation and the LLC subsidiary were effectively the same. Noting that there was “no reasonable way” to distinguish when the officers/managers of the parent were operating for its benefit instead of the subsidiary, the court allowed plaintiff Cognex to proceed in its lawsuit against VData LLC as the alter ego of Acacia Research Corporation.

These two cases further illustrate the dangers of using a single-member LLC (SMLLC) for asset protection.

In the bankruptcy context, the courts seem inclined to simply treat the entity as another asset that the Trustee can take possession of and liquidate to satisfy creditors.

This effectively circumvents the so-called “charging order protection” whereby a creditor of a debtor/member of an LLC is usually restricted to what amounts to a lien against the debtor/member’s eco-

nomie rights to distributions (but theoretically has no way to access the assets of the entity).

Some practitioners, including myself, would argue that charging order protection makes little sense in the single-member context anyway, since the purpose of restricting the creditor’s remedy to a charging order is meant to protect the non-debtor members of the LLC. This is of course nonsensical in the single-member context where there are no other interests to protect.

An aggressive creditor facing a single-member LLC may try to force the debtor into bankruptcy so as to circumvent the charging order protection and allow the Trustee to liquidate the entity for the creditor’s benefit.

Ironically, as in the A-Z Electronics LLC case, a Trustee may try to use the LLC’s single member status to keep it out of bankruptcy so that the Trustee’s ability to liquidate the LLC remains unhindered by the LLC’s own reorganization.

The other problem with single-member LLCs is that it is comparatively easy to successfully claim that the LLC is the alter ego of its owner. The courts are now starting to recognize the absurdity of apply formality tests against an entity that is intended by the legislature to be informal in its structure and management. Yet, this leaves planners guessing at just what the courts might look at to determine alter ego.

Probably a lot more litigation on this issue is coming, which actually will be good in a way since then we will have some indication where the courts are going. Until then, the situation for single-member LLCs will be dangerous as the courts discard the traditional alter ego tests and make up new and unique ones on the spot.

Yes, single-member LLCs are cool and useful for many tax and business planning purposes. But they are not very cool for asset protection planning. To the contrary, single-member LLCs are a very dangerous tool for asset protection planning because there are too many unknowns and the cases are falling in favor of creditors.

Best just to avoid single-member LLCs until the law shakes out.

We would also be cautious of using obvious subterfuges to try to avoid single-member status, such as having a small membership percentage owned by the member’s living trust. It would be an easy step for a court to impute that interest to the debtor member, and then deem the entity to be a single-member LLC.

Caution should also be advised in community property states where both husband and wife own all the shares in the LLC, since it might be deemed to be the property of the community and thus a single-member LLC.

Finally, at least a couple of states -- Wyoming and Texas come to mind -- have passed legislation to make clear that charging order protection should still apply in the single-member context. There is not enough aspirin or Scotch in the world to allow us to consider the possible effect of such legislation in a federal bankruptcy proceeding just yet.

### **CIRCULAR TRANSACTION BITES CLIENT ON BOTH ENDS**

*Bermant v. Broadbent*, 2006 WL 3692661 (D.Utah, Slip Copy Dec. 12, 2006)

Merrill Scott & Associates, Ltd., was a Salt Lake City law firm that had established a variety of entities to help their clients with their tax planning, asset protection, and investment needs. These entities included Gibraltar Permanente Assurance, Ltd., an offshore insurance company, Legacy Capital, and Fidelity Funding, Inc.

Self-proclaimed "Advisors to the Affluent", the Merrill Scott aggressively marketed their services to high net worth individuals through high-profile advertisements in the Robb Report and similar media. Merrill Scott promised their clients significant tax reduction and asset protection, along with the potential for tremendous investment gains.

Like most schemes that sound too good to be true, Merrill Scott’s schemes were neither good nor true. The SEC concluded

that their investment deals were actually pyramid schemes where the funds of later investors were used to pay off earlier investors, and that Merrill Scott and its principals had been embezzling client funds. The assets of Merrill Scott and its associated entities were frozen, and a receiver was appointed to marshal the assets for the benefit of creditors and investors.

Jeffrey C. Bermant made the unfortunate decision to contact Merrill Scott after reading their advertisement in the Robb Report. Thereafter, Merrill Scott prepared an impressive-looking Master Financial Plan for Mr. Bermant, and Mr. Bermant paid Merrill Scott \$113,000 for initial planning and certain fees for arranging certain loans.

One of the strategies advocated by Merrill Scott was that Mr. Bermant purchase Loss of Income Insurance ("LOI") Policies from Gibraltar Permanente, Ltd., an offshore insurance company owned and controlled by Merrill Scott. Mr. Bermant would pay \$2 million in supposedly deductible premiums for policies to protect his business from a loss of income. Merrill Scott guaranteed that his premiums paid to Gibraltar Permanente would be segregated away from the company's other assets and held in a special account that would earn no less than 5% annually. The promise was that Mr. Bermant eventually would receive premium refunds and earnings on those premiums amounting to a total of \$4.4 million after twenty years, and that he would save over \$1 million in income taxes over a ten-year period.

As the day approached for Mr. Bermant to start writing checks, he became apprehensive. To encourage him to go ahead with the transaction, Merrill Scott told Mr. Bermant that (contrary to their earlier advice) he could borrow from other Merrill Scott entities using the LOI account as collateral, i.e., Mr. Bermant would pay his premiums to Gibraltar Permanente, take his deductions, and then his money would be immediately loaned back to him. Merrill Scott promised that they would lower the interest rates on the loans and that Mr. Bermant would incur only nominal tax-deductible interest expenses until Merrill Scott returned the LOI premiums. When Merrill Scott re-

turned the LOI premiums to Mr. Bermant, then Mr. Bermant could use those funds to reduce his loan balance.

Merrill Scott also told Mr. Bermant that he could cancel the LOI insurance at any time, with a full refund of premiums less a 5% surrender charge and less any outstanding loans secured by the policy account. Merrill Scott gave a "cancellation letter" to Mr. Bermant that purported to modify the terms of the LOI policies issued by Gibraltar Permanente.

Satisfied that his LOI premiums would be safe with Merrill Scott, Mr. Bermant set up two new LLCs to facilitate the arrangement, with one LLC paying a \$350,000 premium and the other LLC paying a \$1,650,000 premium. Mr. Bermant was named as the insured on both policies. Mr. Bermant later claimed that he had the LLCs purchase the LOI policies "as a matter of convenience and tax return presentation."

After having the LLCs pay the \$2 million in premiums to Gibraltar Permanente, Mr. Bermant then requested and received a \$1.5 million loan from Legacy Capital, another Merrill Scott entity. Legacy Capital transferred the \$1.5 million directly to Mr. Bermant, and Mr. Bermant gave a promissory note for \$1.5 million to Legacy Capital.

Later, when things fell apart, Mr. Bermant claimed that Merrill Scott really just loaned him \$1.5 million of his own money back, but of course that was not the representation made to the IRS at the time of the transactions.

A year after engaging in this transaction, Mr. Bermant told Merrill Scott that he wanted to unwind it. Merrill Scott advised him that it would be unwise to do this so soon because it would draw IRS scrutiny. So, Mr. Bermant did nothing. In the meantime, Merrill Scott collapsed and a receiver was appointed.

Shortly after the SEC had filed its action against Merrill Scott, the IRS informed Mr. Bermant that it would disallow the deductions that he had taken for the LOI premium payments. The IRS has also taken the position that Mr. Bermant owes

\$1.2 million in back taxes, penalties and interest.

After Merrill Scott was placed into receivership, Mr. Bermant attempted to exercise his letter agreement to cancel the LOI transaction and get his \$2 million back. Not only did the receiver refuse to cancel the \$2 million transaction, but the receiver also demanded that Mr. Bermant repay the \$1.5 million that he received from Legacy Capital, pursuant to the promissory note that he gave to it.

Mr. Bermant also submitted a claim to the receiver demanding the complete cancellation of his \$1.5 million promissory note to Legacy Capital, plus an additional \$613,000 which apparently represents the remaining \$500,000 of the \$2 million in LOI "premiums" paid, plus the \$113,000 planning fee.

This case thus pitted the claims of Mr. Bermant versus Merrill Scott against the claims of the Receiver versus Mr. Bermant. Mr. Bermant argued that the Receiver merely stepped into the shoes of Merrill Scott and thus is subject to all of his claims and defenses against Merrill Scott. Conversely, the Receiver argued that Mr. Bermant was simply another claimant who should not be treated specially, and that Mr. Bermant's claims for cancellation, set-off, and recoupment would "unadvisedly undercut the broader equitable purposes the receivership is designed to serve". The Receiver also argued that Mr. Bermant's claims failed on their merits.

Mr. Bermant essentially asked the court to disregard the paperwork that evidenced the LOI policies and the loan to him from Legacy Capital, and simply treat all the transactions as having been between him and Merrill Scott. But the court chose to hold Mr. Bermant's feet to the fire by forcing him to recognize the transactions that he himself entered into, stating:

*"Mr. Bermant must prevail upon the court to ignore the manner in which he actually chose to structure his relationship with Merrill Scott and instead enforce the parties' 'understanding' of what their association truly entailed. Mr. Bermant has failed to provide any persuasive authority that*

would support disregarding the chosen structure of the various agreements involving Merrill Scott."

The court rejected Mr. Bermant's assertion that the letter from Merrill Scott allowed him to terminate the LOI policies at any time and get his money back.

*"Far from an enforceable contractual right, the letter from Mr. Landis is simply further evidence that Merrill Scott and its clients frequently attempted to retain the benefits that flowed from structuring transactions in a certain way while never intending to honor the commitments or recognize the limitations attendant to utilizing such a structure. Mr. Landis's letter may be an alteration to the 'understanding' between Merrill Scott and Mr. Bermant, but the parties' understanding of a relationship does not necessarily control over the manner in which the parties finally structure their association. This is especially the case here, where the record indicates that the parties' understanding of their association was purposefully inconsistent with the mechanisms used to effect that association."*

And furthermore,

*"Mr. Bermant is asking the court to characterize the form of and parties to his various transactions with Merrill Scott as mere formalities although he fully recognized that those same formalities were necessary to maximize the financial benefit he would gain by making use of Merrill Scott's services."*

Accordingly, the court ordered Mr. Bermant to pay the receiver the \$1.5 million that he received from Legacy Capital. The court denied Mr. Bermant's claim for recoupment of the other \$500,000 and the \$113,000 fee, and denied his claim to set off the \$1.5 million against the \$2 million that Gibraltar Permanente allegedly owes him. However, the court declined to enter judgment for the Receiver for a precise amount until the Receiver's claims for attorney fees and interest were resolved.

The lesson here is one that is often forgotten in asset protection planning: There is a near total disconnect between tax law and debtor-creditor law. How a structure or transaction is treated for tax law purposes

does not dictate how it will be treated for debtor-creditor law purposes.

Here, the IRS (correctly) disregarded this series of transactions, disallowed Mr. Bermant's deductions, and imposed penalties, while the Receiver was able to enforce the same transactions for debtor-creditor purposes.

There simply is no rule that transactions must be treated consistently for tax and debtor-creditor purposes.

Note, however, that there is a peculiar one-way street involving tax filings. If you attempt to offer your own tax filings in court as evidence of the characterization of a transaction or entity, they may be inadmissible hearsay. However, if your opponent offers your tax filings against you, they may be allowed as your admissions. In other words, you should presume that your tax filings will be used against you, not for you.

This case was more a matter of tax fraud than asset protection. However, the lesson is the same from both perspectives: if you engage in "wink and a nod" transactions, don't be surprised if someone not a party to the winking and nodding enforces them according to their terms.

## ASSET PROTECTION FOR THE CRASHING CLIENT

*In re Middendorf*, \_\_\_ B.R. \_\_\_, 2008 WL 331095 (Bkrcty.D.Kan., No. 05-21748, Feb. 1, 2008); see also *Wittman v. Weir* ( *In re Weir* ), 1990 WL 63072 (Bankr.D.Kan.1990)

A recent bankruptcy court opinion rejected the contention by the bankruptcy trustee that the debtors' pre-payment of taxes to the IRS was either a preferential transfer or a fraudulent transfer. FN1

Only a couple of weeks before filing for Chapter 7 relief, debtors liquidated \$112,000 of their stocks, resulting in a \$70,000 capital gain. The week before their Chapter 7 petition was filed, the debtors pre-paid \$22,250 of their anticipated federal capital gains tax liability. The bankruptcy trustee challenged their tax payment on both preferential transfer and fraudulent transfer grounds, and de-

manded that the IRS return the \$22,250, which would have left the debtors with a non-dischargeable tax debt.

The court first rejected the trustee's claim that the transfer was preferential. One of the elements of a preferential transfer under Bankruptcy Code § 547 is that the payment be made "for an antecedent debt owed before the date of the transfer". Since the tax liability did not technically arise until December 31 of the year when the pre-payment was made, and the estimated tax payment was made on April 11 of that year, this element of a preferential transfer was not met.

The court also threw out the fraudulent transfer claim under Bankruptcy Code § 548 on the basis that:

"debtors receive reasonably equivalent value for tax pre-payments where they face significant tax liability and obtain a dollar for dollar credit against that potential liability and the right to a refund if the tax debt is ultimately less. The Trustee may no more recover the tax pre-payment as a fraudulent transfer than he could recover pre-petition wage withholdings under the same theory. There is nothing nefarious about paying estimated tax liability out of the very income to be taxed."

When a client gets into financial difficulty, there are some things that can and should be done immediately.

## Tax Liability

The first one, as indicated by the referenced case, is to calculate the client's tax liabilities and pay those immediately. This should be done for the previous tax year if returns have not been filed yet, and for the current year with pre-payments being made as quickly as possible. Clients will often go into a funk as things go down and neglect their tax issues ("What's the point? I'm not making any money anyway!") as they struggle to stay afloat financially. However, liability for taxes related to the most recent few years is difficult or impossible to discharge. Therefore, consideration should be given to paying otherwise non-dischargeable tax liabilities, including, e.g., the trust fund

portion of payroll tax liabilities, before paying other creditors.

### **Inheritances**

Clients may go bust, but that doesn't mean that their parents and other relatives have gone bust too. Even if creditors cannot get anything out of your client, a creditor may linger around and wait for somebody to die so that the creditor can then reach the debtor's inheritance.

You should ask your client about inheritances likely to be received, including how the client expects to receive it – outright, in trust, etc. If the client will receive an inheritance outright, you should suggest that the relative instead provide that the gift is made to a discretionary spend-thrift trust so that it will be protected from the client's creditors.

This is a sound plan for most clients anyway, even for those not headed south financially. We are often surprised to review asset protection plans only to discover that a significant inheritance will be received outright.

### **Cleaning Up**

Just as a person with a terminal illness needs to get their affairs in order, so does a failing business need to get its affairs in order. You may not be able to do prospective planning for a failing client without involving yourself in a civil conspiracy, but you can clean up the existing planning by making sure that corporate annual meetings are held and properly documented and that other necessary paperwork is put in order.

The client's current plan may not be the best, but you probably can make it better by tying up loose ends. Prepare documents as if they will be presented tomorrow at a debtor's examination. Ensure that the state filing fees for the client's business entities fees are paid up, and don't allow entities to lapse their registration.

### **Subtle Changes**

Slight changes to a client's planning structures may have substantial benefits. For instance, adding one or more additional members to a client's single-member

LLCs may significantly bolster the protection afforded to the assets in the LLCs in and out of bankruptcy. A new member will need to pay reasonable value for the interest, but better to have a friendly co-member buy in to the LLC than to risk losing all the assets in the LLC.

### **Reorganize S-Corporations**

If a corporation, partnership or non-resident alien ends up the owner of S corporation stock as the result of the seizure and/or sale of S corporation stock, negative tax consequences may arise for the debtor and for other shareholders. Consider reorganizing the corporation into an LLC which elects S corporation status so that a creditor will be limited to a charging order against the debtor-member's economic rights to distributions (but will not own the membership interest itself).

### **Face the Reality**

Clients often do not want to confront the reality that they will crash financially. They hope beyond hope that something will save them, whether a fantastic new business deal, a miraculous rebound in the real estate market, or a winning lottery ticket. With this hope, they keep their employees on board a lot longer than they probably should, and continue to run businesses that are losing money.

It is part of the planner's job to help clients see that they have gone bust or are headed there, and to help them plan accordingly. If severe choices must be made, they should be made quickly, otherwise they may make no difference. The sooner that a client collapses their empire, often the better chance he or she has at saving something and recovering more quickly.

### **Eliminate Credit**

Clients may have built up a great deal of credit in good times, but this credit can be a noose in bad times. Credit encourages clients to throw good money after bad. If creditors find out about the debtor's remaining borrowing capacity, they likely will take a hard line and try to require the debtor to borrow from another creditor to pay them. The IRS does this routinely in collection cases.

So, as tough as it will seem to the client, open credit lines may need to be eliminated. The less the client borrows in what is likely a hopeless situation, the less deep the hole he can dig for himself.

### **Control the Crash**

When a client has a financial crash, assets may be liquidated to satisfy debts. If these sales result from sheriff's levies and execution sales, expect bottom dollar. Most clients can and should liquidate their own assets. They will get better prices, with lower costs of sale, and liquidation will be more orderly.

Many creditors do not like to incur the costs of liquidating assets, particularly knowing that they will get bottom dollar, so they often will be receptive to deals where the client liquidates the asset but keeps some percentage of the liquidation price. For a client, it is better to get this piece than to get nothing, and to get better prices for the assets, resulting in less debt in the end.

In the last real estate bust, some attorneys became very good at "non-judicial workouts", orderly liquidation of the assets and other payment arrangements agreed by debtors and creditors outside the courts. Often, a non-judicial workout can result in a debtor left with more remaining assets, with the benefit of avoiding the stigma of bankruptcy. Creditors usually end up with more assets too, which is why they often go along with such plans. It is worth trying, and there is rarely a downside even if the deal can't be pulled off.

### **Prepare for Full Disclosure**

Trying to keep as many of their assets as possible, many debtors will not want to disclose their true financial status. However, most creditors will refuse to cut deals unless a debtor is completely honest about assets and income. If your debtor client wants to cut a deal, prepare now for full disclosure to the creditor and prepare answers to such questions as "Where are you getting money now to live on?" and "Where did that asset go?"

## Summary

A client's impending financial failure does not signal the end of the relationship for the business or estate planner. It just signals that the relationship and type of planning have changed. Troubled clients usually have as much need for quality planning – often more - than clients whose businesses are doing well. Don't let the fact that a client is financially troubled keep you from doing good work for him or her.

### **STOP TAX HAVEN ABUSE ACT**

Senators Levin and Obama have introduced Senate Bill 681 to address what they perceive as some of the worst abuses involving the offshore havens. According to Senator Levin's press release, the key features S.681 are:

**ESTABLISH PRESUMPTIONS TO COMBAT OFFSHORE SECRECY** by allowing U.S. tax and securities law enforcement to presume that non-publicly traded, offshore corporations and trusts are controlled by the U.S. taxpayers who formed them or sent them assets, unless the taxpayer proves otherwise;

**IMPOSE TOUGHER REQUIREMENTS ON U.S. TAXPAYERS USING OFFSHORE SECRECY JURISDICTIONS** by listing 34 jurisdictions which have already been named in IRS court filings as probable locations for U.S. tax evasion;

**AUTHORIZE SPECIAL MEASURES TO STOP OFFSHORE TAX ABUSES** by giving Treasury authority to take special measures against foreign jurisdictions and financial institutions that impede U.S. tax enforcement;

**STRENGTHEN DETECTION OF OFFSHORE ACTIVITIES** by requiring U.S. financial institutions that open accounts for foreign entities controlled by U.S. clients, open accounts in offshore secrecy jurisdictions for U.S. clients, or establish entities in offshore secrecy jurisdictions for U.S. clients, to report such actions to the IRS;

**CLOSE OFFSHORE TRUST LOOP-HOLES** by taxing offshore trust income used to buy real estate, artwork and jewelry for U.S. persons, and treating as trust beneficiaries those persons who actually receive offshore trust assets;

**STRENGTHEN PENALTIES** on tax shelter promoters by increasing the maximum fine to 150% of their ill-gotten gains, and on corporate insiders who hide offshore stock holdings by increasing the maximum fine on them to \$1 million per violation of U.S. securities laws;

**STOP TAX SHELTER PATENTS** by prohibiting the U.S. Patent and Trademark Office from issuing patents for "inventions designed to minimize, avoid, defer, or otherwise affect liability for Federal, State, local, or foreign tax"; and

**REQUIRE HEDGE FUNDS AND COMPANY FORMATION AGENTS TO KNOW THEIR OFFSHORE CLIENTS** by requiring them to establish anti-money laundering programs like other U.S. financial institutions, under regulations to be issued by the Treasury Department.

Mr. Bob Roach, the Senior Investigator for the Senate Permanent Subcommittee on Investigations was a guest of Jay Adkisson on a panel at the Southern California Tax & Estate Planning Forum in San Diego last October. Mr. Roach spoke at great length on S.681 and their ramifications for offshore planning.

The "must listen" audiotape from the panel, which included several other great speakers on asset protection related topics, is available by contacting Mr. Lonnie McGee at (619) 696-6773.

### **CAPTIVE NEWS**

A great wealth of free information, IRS rulings and regulations, and collection of pertinent case law regarding captives is available on our website's captive insurance section.

#### **Treasury Abandons New Challenges to Captives**

On February 19, the IRS formally abandoned its most recent challenge to captive

insurance arrangements, which sought to deny the ability of captives to deduct their contributions to their reserves.

The IRS wanted to take the position that a captive insurance company was just an artifice to get around the rules that prevent an ordinary business from deducting its reserves against future claims -- something that an insurance company can do.

The IRS backed away from this position, however, after intense lobbying by a number of industry groups, which is not surprising when one considers that most of the Fortune 500 companies already have captives.

#### **IRS Issues Guidance on Segregated Cell Captives**

In Revenue Ruling 2008-8, the IRS ruled that so called Segregated Portfolio Companies (SPCs) and Protected Cell Companies (PCCs) must meet the risk-shifting and risk-distribution requirements for each cell as if each cell were a stand-alone insurance company.

Various promoters have attempted to make captives cheaper and easier for smaller businesses that otherwise could not qualify for a captive insurance arrangement by lumping them together into various rent-a-captive and risk pool deals. The new guidance from the IRS effectively puts the kabosh on most of these arrangements.

Jay Adkisson has released his latest book, *Adkisson's Captive Insurance Companies: An Introduction to Captives, Closely-Held Insurance Companies and Risk Retention Groups*, which is available from Amazon.com and through Barnes & Noble and other booksellers.

#### **CLIENT-CONFIDENTIALITY MAY BE COMPROMISED WHEN TRAVELING IN U.S.**

*Continued from page 1*

"People, money and information all travel across borders. Internet and computer technologies help facilitate the transfer of both information and money," he told OffshoreAlert. "However, despite the

"borderless" nature of the Internet, real nations maintain real borders. In the United States and other countries, border patrol, customs and immigration officials have long maintained the right to inspect luggage coming into and out of the country.

"However, business travelers have recently learned that not only luggage is subject to inspection, but the contents of laptop computers, BlackBerrys, MP3 players, or other digital media are available for inspection.

"Customs agents have been pulling aside travelers, sometimes based upon some "profile," sometimes based upon "suspicion" and sometimes randomly, and inspecting computers for child pornography or other contraband. In addition, government officials reserve the right to copy the entire contents of hard drives, and to use the contents of these hard drives in any way they wish.

"Tax records, financial records, attorney client privileged information, or other personal data may be subject to inspection and use by the government, without any probable cause, warrant, or even suspicion."

Legally, it seems that Government agents "can do whatever they want" when it comes to snooping through your belongings at airports, says Rasch. "The computer is no different from any other "closed container" that the agent may search," he says. "Just as the agent needs no probable cause to search your underwear, they need no probable cause to rummage through your laptop. And besides, they are doing it to protect the country and enforce the laws and prevent terrorist attacks. You don't have any privacy rights at the border."

Rasch's advice is simple. "If you don't want your laptop or BlackBerry searched, don't bring it with you."

His comments come after an article headlined 'Clarity Sought on Electronics Searches, U.S. Agents Seize Travelers' Devices' was published by the Washington Post newspaper on February 7, 2008. In the article, the newspaper documented several examples of travelers having their

laptops and other devices seized at U. S. airports and of Government agents asking for passwords to access information.

"The seizure of electronics at U.S. borders has prompted protests from travelers who say they now weigh the risk of traveling with sensitive or personal information on their laptops, cameras or cellphones," reported the newspaper. "In some cases, companies have altered their policies to require employees to safeguard corporate secrets by clearing laptop hard drives before international travel."

Recent data-leaking scandals such as client-account records of Julius Baer (Cayman) being uploaded to the whistleblower's web-site Wikileaks, apparently by a former Chief Operating Officer, and the purchase by various tax authorities of stolen client data belonging to LGT Bank in Liechtenstein have thrust the issue of protecting client-confidentiality in the modern world to the forefront of business considerations, says Rasch.

Rasch will be discussing the legal and technological issues raised by laptop seizures at U. S. airports and the Wikileaks and Liechtenstein incidents during a presentation on 'Client Confidentiality' that he will give at the 6th OffshoreAlert Financial Due Diligence Conference, that will be held in Fort Lauderdale, Florida on April 13-15, 2008.

This session will address the following issues:

- \* How secure are offshore banking records?
- \* What are the current legal, regulatory, practical and other issues concerning client confidentiality?
- \* What precautions should international businesses take to protect their records?

The full details on OffshoreAlert VI are described below.

## KYC CONFERENCE

On April 13-15, 2008, some of the most influential and significant players in the world of offshore banking, finance, &

insurance will be in Fort Lauderdale, Florida to explain their highly complex and lucrative industry.

They are from the world's third largest reinsurance market, Bermuda; the world's fifth largest financial center, the Cayman Islands; and from other top offshore domiciles such as the Bahamas, the British Virgin Islands, and Barbados.

The 6th Annual OffshoreAlert Financial Due Diligence Conference offers you a rare opportunity to learn everything you wanted to know about Offshore Financial Centers (OFCs), but didn't know where to start or who to ask.

### What You'll Learn

- How client secrecy has been affected by data scandals in Liechtenstein & Cayman.
- Which offshore products work, which do not.
- What is legal, what is not.
- What is acceptable & unacceptable to the US tax authorities.
- How to maximum the efficiency of your capital.
- How to reduce bureaucracy.
- And a lot more!

Seldom before, if ever, has such a distinguished group of knowledgeable and accomplished businessmen who are on the cutting-edge of offshore banking, finance & insurance gathered together for a single event in the USA.

### Speakers include:

- Dan Mitchell, the Cato Institute
- Christopher L. Culp, Adjunct Professor of Finance, University of Chicago's Graduate School of Business
- The legendary Jack Blum, former US Senate Counsel
- Timothy Ridley, Chairman, Cayman Islands Monetary Authority

- Bob Roach, Senior Attorney for the U.S. Senate Permanent Subcommittee on Investigations
- Richard Hay, Co-Chairman of STEP
- Martin Kenney, one of the world's best-known asset recovery attorneys
- Eduardo D'Angelo P. Silva, Chairman, Cayman Islands Financial Services Association
- Graeme McDowell Smith, Director, British Virgin Islands Financial Investigation Agency
- Jacqueline Somersall-Berry, Director, St. Kitts & Nevis Financial Intelligence Unit.

Altogether OffshoreAlert VI features more than 50 industry experts representing the unbiased, unfettered collective wisdom, experience and expertise of over 500 years.

Simply put, if you are a compliance officer or general counsel, a senior manager or director, a financial institution involved with offshore transactions, a big business or a high net worth individual interested in getting the preservation of your capital,

then you should strongly consider attending OffshoreAlert VI.

Sunday, April 13 - Tuesday, April 15, 2008, in Fort Lauderdale, Florida, more information visit:  
<http://www.OffshoreAlertConference.com>

### FIRM NEWS

Last year, Jay Adkisson was admitted to practice law in California, and the firm opened its West Coast office at 100 Bayview Circle, Suite 210, Newport Beach, CA 92660.

### UPCOMING APPEARANCES

**April 4 -- San Diego --** Jay Adkisson to present "Captive Insurance Companies" at the BGA Sales Summit 2008 of the Underwriting Services of America

**May 3-7 -- New Orleans --** Jay Adkisson to present "Asset Protection for the OB/GYN" at the annual meeting of the American College of Obstetricians and Gynecologists

**June 12-13 -- San Antonio, TX --**Chris Riser to present "Asset Protection for High Risk Professionals" at the 11th An-

nual Wealth Counsel National Estate Planning Conference

**August 15 -- Galveston --** Jay Adkisson will present "Practical Asset Protection Planning in the Real World" at the University of Texas CLE 2008 Estate Planning, Guardianship & Elder Law Conference

**November 1 -- Las Vegas --** Jay Adkisson to present "Asset Protection for the Financial Services Professional" at the Annual Meeting of the Society of Financial Services Professionals

**November 2 -- Chicago --** Jay Adkisson to present "Asset Protection for the Plastic Surgeon" at the Annual Meeting of the American Society of Plastic Surgeons

### WANT MORE?

Lots of new information on asset protection, wealth preservation, and related topics on our website at:

<http://www.assetprotectionbook.com>

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