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# Developments

## IN ASSET PROTECTION AND WEALTH PRESERVATION

*This issue focuses on how asset protection is becoming a mainstream planning area, which is evidenced by the proliferation of accounts receivable financing programs that are backed by major finance and insurance companies. We also discuss some of the confusion generated by last year's bankruptcy reform act, as*

*well as summarize several recent cases that may impact asset protection planning. Finally, this edition's Report from Quatloosia focuses on the latest abusive tax schemes – just in time for April 15.*

*~ Jay and Chris*

### Upcoming:

- **March 30, 2006 – Oklahoma City – Jay Adkisson** will present "Asset Protection for Physicians" (free seminar) – Call 888-359-8851 for more information.
- **May 5, 2006 – San Diego – Jay Adkisson** will be a speaker at the presentation "Ethical Issues in Asset Protection Planning" at the AMERICAN BAR ASSOCIATION'S REAL PROPERTY, PROBATE AND TRUST LAW SPRING SYMPOSIUM. [http://www.abanet.org/rppt/meetings\\_cle/2006/spring/home.html](http://www.abanet.org/rppt/meetings_cle/2006/spring/home.html)
- **May 8, 2006 – Washington D.C. – Jay Adkisson** will present "Asset Protection for the OBY/GYN" at the Annual Clinical Meeting of the AMERICAN COLLEGE OF OBSTETRICIANS AND GYNECOLOGISTS. <http://www.acog.org/acm/pgcourse.cfm?courseId=CMP14>
- **May 12, 2006 – Miami – Jay Adkisson** will present "Good Lessons from Bad Cases" at the FLORIDA BAR ASSOCIATION'S Annual Wealth Protection 2006: The Hot Topics in Asset Protection Planning. <http://www3.flabar.org/FBWEB/CLEReg.nsf/WCESearchResults?OpenForm>
- **May 16, 2006 – Charleston, SC – Jay Adkisson** will present "Abusive Tax Schemes" at the Southeast Regional Meeting of INTERNAL REVENUE SERVICE CRIMINAL INVESTIGATION
- **October 19-21, 2006 -- San Diego -- Jay Adkisson** will present "Understanding Charging Orders" at the SOUTHERN CALIFORNIA TAX AND ESTATE PLANNING FORUM. <http://www.clenet.com>

## ASSET PROTECTION GOES MAINSTREAM

*by Jay D. Adkisson*

Once upon a time, asset protection was a seedy little niche practice area whereby money was moved offshore and then hidden in foreign trusts, bearer share corporations, and secret Swiss bank accounts. There were relatively few planners who held themselves

out as asset protection planners, maybe less than a couple of dozen nationwide.

Today, things are dramatically different. Asset protection has become a mainstream planning area. Many attorneys, CPAs, and financial planners hold themselves out to clients as being asset protection planners. Even insurance companies are getting into the business, by actively promoting "Accounts Receivable Financing" programs for the specific purpose of asset protection (and, of course, to gener-

ate additional annuity and life insurance sales). Very simply, asset protection has become the sexy hot topic of the otherwise bland estate and financial planning world.

Are clients really being served? The answer, sadly is "No". Even before asset protection became all the rage, it suffered from "productization", which means that promoters were selling one-size-fits-all cookie-cutter structures to the public with the promise that these structures afforded

everyone asset protection regardless of their circumstances.

The problem with standardized asset protection products is simple: If one creditor can figure out how to de-fuse the product, then it is likely that every creditor that follows will use the same technique as the first creditor and also defuse the product. This was the case with the supposedly impregnable foreign asset protection trust (FAPT) – after the Anderson decision in 1999 showed creditors that they could seek a contempt remedy to cast offshore trust settlors into jail until the money came back, creditors have routinely and successfully employed what has become known as “Anderson relief” to defuse these types of trusts.

By far the biggest problem is that most alleged asset protection planners simply do not have anything like a sound understanding of creditor-debtor law or what happens in collections litigation. Most planners have been to a few continuing education seminars and heard whatever guru regurgitate his thoughts about his pet asset protection structure *du jour*, and then these planners have set out to try to sell the structures on their own. You would be amazed at how many planners have never even read the Uniform Fraudulent Transfers Act – much less have anything like a working knowledge of it – nor do they fundamentally understand such basic concepts as what a charging order really does. They have no clue about what questions a creditor’s attorney will ask at a debtor’s exam. But that doesn’t keep these planners from selling the asset protection structure *du jour* to their clients.

Take domestic asset protection trusts (DAPTs), for example. They are sold like crazy, being promoted by several trust companies that preach their benefits without suggesting any possible weaknesses. Actually, some planners have started repeating the trust companies’ mantra and themselves are now chanting that DAPTs are currently the greatest and most undefeatable asset protection tool that one can buy.

But how many court opinions validate the benefits of DAPTs? None. There is not a single case that demonstrates that DAPTs

work to protect assets from creditors, though to hear the trust companies tell it you would think that they have 100 years of solid precedential opinion showing that DAPTs work. To the contrary, there is 100 years of case law showing that self-settled trusts do not work, at least in the solid majority of states that do not recognize DAPTs.

Admittedly, DAPTs might work for people who actually live and keep their assets in the few states that have adopted DAPT legislation, but there is little chance that DAPTs will work for somebody living in another state. Oh, and if all that weren’t bad enough, last year’s bankruptcy act created a 10-year clawback for transfers to spendthrift trusts that were meant to defeat the rights of creditors. Although the defects of DAPTs are numerous and their benefits are highly doubtful outside of the few DAPT states, they are still being marketed like crazy by the trust companies and without any warning of the DAPTs numerous potential defects.

My point is this: The mere fact that something is being marketed doesn’t mean that it will work, either at all or in a particular client’s circumstances. There is a lot of junk being marketed for asset protection – junk that has little chance of protecting assets in hotly contested litigation. There are also a lot of planners out there who are peddling asset protection even though they don’t have much of a clue as to what they are doing.

This situation is not unique; indeed, it is the precise same growing pains that “estate planning” went through in the early 1990s when that became all the rage. There were crazy people with crazy ideas about estate planning then, just as there are crazy people with crazy ideas about asset protection planning now. Just as then, some of these crazy people will actually sell their crazy ideas to the banks, life insurance companies, and trust companies who will then see that they are mass-marketed to the general public. And just as then, these ideas will blow up and litigation will result.

Do not think that mere complexity makes something work from an asset protection perspective. The recent opinion of the bankruptcy court in the case of *In re*

*Turner*, 335 B.R. 140 (Bankr. N.D. Cal. 2005) is instructive. In *Turner*, the debtor and his wife went to a seminar on asset protection, and thereafter embarked upon a series of sophisticated transfers for the purpose of asset protection. They transferred their home (exactly as some “gurus” suggest) to a Nevada LLC that they had set up that was owned 99% by their Bahamas trust and 1% by another Nevada corporation that they formed.

Good planning? Hardly. The federal bankruptcy judge set aside the conveyances of the home as a fraudulent transfer, and then held that the entire structure was simply the alter ego of the debtor:

“Asset protection’ is not illegal and is honored if done for a legitimate purpose. For example, an individual may do business through a corporation or limited liability company and will not be held personally liable for the debts of the entity. The assets of the corporation or limited liability company will not be considered the assets of the individual interest holder. However, an entity or series of entities may not be created with no business purpose and personal assets transferred to them with no relationship to any business purpose, simply as a means of shielding them from creditors. Under such circumstances, the law views the entity as the alter ego of the individual debtor and will disregard it to prevent injustice.”

What the debtor, and undoubtedly his planner, thought was rock-solid asset protection turned out to be something that was easily sliced through by the courts. As sophisticated as the structure might have seemed, it failed for the very reason that it was concocted for the specific purpose of asset protection and lacked any significant other business purpose. If the planner had understood the basics of creditor-debtor law, this type of planning would never have taken place. As it was, the debtor paid for a complex structure only to find out that it wasn’t worth the mound of paper that it took to implement it.

There are many similar asset protection structures out there. People may think that they have implemented a bulletproof plan, but in fact they are surrounded by tissue paper that will dissolve at the first sign of rain. Most planners do not even know whether the stuff they are selling even

works or not, but ignorance seems to be bliss so long as their clients don't get sued. Unfortunately, their clients will not figure this out until it is way too late.

Asset protection is the latest rage in planning for the affluent. It is one of the best attractors of wealthy individuals and their money. But just as estate planning before it, the sector of asset protection planning will keep going through growing pains and goofy schemes until once again sanity reigns. Let's just hope that not too many people get hurt in the meantime.

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**Part II of a Series**

**ECONOMICS OF ACCOUNTS RECEIVABLE FINANCING**

*By Ronald J. Adkisson*

In the Aug/Sep Edition of *Developments* I mentioned that accounts receivable financing plans for retirement have the chance to create significantly more money for a business owner than if he did nothing. I stand behind that statement with emphasis on the operative word "chance". Mathematically, the arbitrage of compound interest over simple interest should produce substantial gains over time. However, there are "ifs" and "buts" within that statement which must be considered.

Aside from other reasons for entering into a plan to use your accounts receivable to help finance your retirement, the key components to make the program work economically are the interest rate on the loan, the achievable gains within the investment vehicle and timing. These components have to be in sync. For example, you can't have a 10% loan interest and a 3% gain in the investment vehicle to make the plan work even if the vehicle provides compounded interest and tax-deferred gains. Similarly, you can't count on the arbitrage to work over a short period of time (i.e. less than 10 years). Be leery of a proposal that projects unreasonably low loan rates and/or very high net gains from your investment vehicle.

On a long term loan, you can expect the lending rate to be an adjustable interest rate supported by a published index such as the prime rate, LIFOR, etc. If you look at what is happening to interest rates in today's economy, which way do you think the future adjustments are going to move in the next five years? How about the next 20 years? Importantly, the possibility that the lending interest rate will move upwards to a point the cost of supporting the loan will become untenable is real and you should be prepared for that potential situation in your plan. Similarly, you should understand any early pay-off provisions or surrender charges if that situation occurs and have a plan to repay the loan.

You have choices in selecting the investment vehicle to provide the needed arbitrage. Obviously, in selecting the appropriate vehicle, two important components to consider are compounded interest and tax-deferred gains. This pretty much limits you to an insurance product such as an annuity or life insurance policy. With adjustable interest rates on the loan, the gains earned on the investment side must be able to keep-up with increases. Clearly, fixed products offered by the insurance companies will not provide you with any guarantees in that regard as they generally offer a very low minimum guaranteed rate and a higher year-by-year rate that varies in accordance with the investment successes of the company. While that rate may increase in some years, it is not tied to a specific index and there are no guarantees the company will invest successfully each year.

With accounts receivable retirement plans, the obvious choice for an investment vehicle is an equity indexed program, either an equity indexed annuity or an equity indexed life insurance program. With 100% participation rates and no-caps on the indices growth, these programs have the better chance of keeping up with the adjustable interest rates on the loans. Equity indexed life insurance products offer the advantage of tax-free loans which the annuities cannot offer. Generally, equity indexed universal life insurance products are used because of the ability to adjust both the premiums and

the death benefits to suit your changing needs over the years.

Timing is also an important component in accounts receivable financing for retirement. Again, the economic success of the plan is based on the arbitrage between the simple interest-only loan and the compounded tax-deferred gains within the investment vehicle. The arbitrage must have some time for it to work and the more time available the better the arbitrage. Clearly, any plan under 10 years would not realize much of an arbitrage.

Following are a couple of tables which demonstrate the results with varying interest rates. The first table shows a loan of \$1,000,000 for a 20 year period with both a 7% interest-only loan and a 7% compounded growth rate in the investment product.

<u>Loan Side</u>	
Simple Interest Cost	\$1.4M
Repay Loan	\$1.0M
Tax on Loan Repay	\$0.4M
	=====
Total Amount Paid	\$2.8M
<u>Growth Side</u>	
Loan Distribution	\$1.0M
Investment Growth	\$3.2M
	=====
Investment Total	\$4.0M
Total Amount Paid	<\$2.8M>
	=====
Net Gain*	<b>\$1.2M</b>

*\*Does not include set up or maintenance costs.*

In the above table, using a \$1 million loan on the accounts receivable, the borrowed funds have been converted into an investment vehicle valued at \$4 million and, after providing for the loan payments and repaying the loan, realizing a \$1.2 million gain. The \$400,000 tax on the loan repayment results from the tax incurred by collecting the final receivables to repay the loan without corresponding expenses to offset the income.

But, what happens if the investment product only earns an average rate of 3% over the period?

### Loan Side

Simple Interest Cost	\$1.4M
Repay Loan	\$1.0M
Tax on Loan Repay	\$0.4M
	=====
Total Amount Paid	\$2.8M

### Growth Side

Loan Distribution	\$1.0M
Investment Growth	\$1.8M
	=====
Investment Total	\$2.8M
Total Amount Paid	<\$2.8M>
	=====
Net Gain*	\$0

\*Does not include set up or maintenance costs.

In this scenario, we have spent the same \$2.8 million dollars and we end-up with \$2.8 million in our investment vehicle for a wash. However, these numbers do not account for the commissions and other costs associated with setting-up the loan and purchasing and maintaining the investment vehicle which can be substantial.

The economics can work out. However, prior to jumping into a program you should consider the fact that you are committing substantial dollars as interest on the loan for a long period of time. Are there other opportunity costs for those funds? For example, if you consider the \$1.4 million loan payments in the above scenarios with payments made at the rate of \$70,000 per year over the 20 year period, that \$70,000/year would be worth \$2.8 million if you could earn 7% interest over the period. Even if you assume after tax dollars at the 38% tax bracket, the after-tax \$43,400 would be worth \$1.8 million for your retirement. Are there other in-company investment opportunities which would yield a higher return?

Deductibility of the loan payments is also an issue, and a very delicate one. Since I am not a tax person, going into the details of this tax issue is not something I am comfortable with other than to say that it is incumbent upon anyone proposing to enter into a program where they believe the interest rates are deductible to obtain professional guidance before making a commitment. Tax issues vary from program to program and from participant to participant, so my advice to you is to seek your own separate tax advice.

Probably the most advantageous way to capitalize on the merits of financing accounts receivable for retirement is to contain it within your organization.

*Ronald J. Adkisson is the author of "Financing Accounts Receivable for Retirement and Asset Protection" available through his website at farbook.com*

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## ACCOUNTS RECEIVABLE FINANCING: INTRODUCING EQUISTRIP™

by Jay D. Adkisson

One of the most difficult business assets to protect is the accounts receivable. For many businesses, however, accounts receivable constitute the single largest business asset. Where there is a reasonable chance that the business will generate liabilities in excess of its insurance coverage, it becomes critically important that the accounts receivable be protected from creditors. It also makes sense to reduce the book value of the accounts receivable for unforeseen contingencies, and to deter creditors generally.

Some methods have been developed to protect the accounts receivable. Over the last several years, the most popular method has been to borrow against the value of the receivables, distribute the loan proceeds to the business owner, and then put the loan proceeds into either annuity or life insurance products as additional collateral for the loan. Fueled by the availability of cheap credit, more than a dozen such programs have been created which offer accounts receivable financing.

Although these A/R financing programs purport to provide asset protection, they all have one thing in common: None of them have been designed by anybody with any significant experience in creditor-debtor litigation, or who has attempted collection against receivables. It is, simply, the blind leading the blind.

### Protecting the Financial Product

None of the existing programs have a method for protecting the annuity or life insurance policy that is purchased as col-

lateral for the loan. If you live in a state where the cash value of the annuity or life insurance policy is exempt, that is one thing. But if you live in a state where such products are not protected from creditors, then from an asset protection perspective you have not accomplished much.

### The Double Variable

One of the problems with these programs is that they have two variables: First, there is a variable with the loan interest rate. Second, there is a variable how the annuity or life insurance product performs. In a rising interest rate environment, such as we have had for the last year and may continue to have into the foreseeable future, there is a risk created that financially the program might actually go backwards if the financial product cannot outperform the interest being charged on the loan.

### Cash Flow Problems

Many business owners would like to take advantage of A/R financing, but currently do not have the cash flow. For these business owners, the existing programs offer no solutions.

### No Self-Financing Option

Many business owners have the cash available to self-finance their A/Rs, which would save them the interest cost. However, none of the existing programs offer any option to self-finance the receivables.

### Confusing Tax Consequences

Many of the existing accounts receivable programs have all sorts of hidden tax consequences that negatively skew the numbers. Not surprisingly, the promoters of these programs do not point out these shortcomings and blandly refer prospective clients to contact their own tax advisor for guidance (as if the average tax advisor would even begin to understand these programs in a short period of time). Most of these programs make no attempt to get the value of the annuity or life insurance policy out of the business owner's estate, either.

### And The Biggest Problem

The biggest problem facing most A/R financing programs is that they simply will not work properly when a judgment

occurs! These programs are defectively designed from a creditor-debtor perspective such that the most likely thing to happen is that the creditor will take the A/Rs anyway. How could such programs fail so miserably in the very thing that they are designed to do? It is because they are primarily designed by financial advisors who do not have the first clue about creditor-debtor law and couldn't find the courthouse if they wanted to.

### Enter EquiStrip™

In response to all of these concerns, EquiStrip™ was created as a system for protecting accounts receivable that is solid from both a financial and creditor-debtor viewpoint. EquiStrip™ is the only second-generation A/R financing program that offers all of these benefits:

- Unique five-year fixed financing (available in California only) to eliminate the “double variable” risks of adjustable-rate loans
- Flexible financing that can accommodate a business that does not presently have sufficient cash flow to make current interest payments
- A self-financing option (available nationwide) that allows a business owner with sufficient liquidity to provide their own financing for their A/R program and thus avoid the interest payments
- Straightforward tax treatment and no hidden tax traps.
- Designed first and foremost from a creditor-debtor perspective, with unique components built in to the program in anticipation of litigation challenges.
- Ability to “rescue” existing, inefficient and variable-rate A/R financing arrangements.
- Ability to utilize most fixed annuity or life insurance products.
- Works equally well with most other business assets, such as equipment, inventory, and even intellectual property, as well as with accounts receivable – allows for protection of all valuable business assets and not just A/Rs.

The EquiStrip™ program is currently being financed by commercial lenders in California, and thus is presently limited to California, but additional states should be added by the end of the year. More information about this program is available at <http://www.equistrip.com>

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## CONFUSION WITH THE NEW BANKRUPTCY ACT: IRAS, ROLLOVER IRAS, AND HOMESTEAD

by Jay D. Adkisson

### Exemption for IRAs

Many financial planners – and even some alleged asset protection planners – have been giving advice that IRAs are now inherently asset protected. Their advice is based on last year's bankruptcy act, which we covered extensively in our May 2005 *Developments*. But are IRAs really protected from creditors?

The new bankruptcy act added a new paragraph (n) to section 522, which deals with exemptions. This new paragraph (n) provides in relevant part that “[f]or assets in individual retirement accounts . . . the aggregate value of such assets exempted under this section . . . shall not exceed \$1,000,000 in a case filed by a debtor who is an individual . . .” Thus, it is clear that in bankruptcy an IRA is protected up to \$1,000,000.

The problem is the two operative words “in bankruptcy”. Paragraph 522(n) solely, only, and exclusively provides protections to IRAs in a federal bankruptcy proceeding. However, this provision has absolutely no application at all to proceedings outside of bankruptcy. It does not, for example, override state law relating to IRAs in either state court proceedings or in non-bankruptcy federal proceedings. In other words, for the protections of Paragraph 522(n) to apply at all, the debtor who seeks to protect his IRA must actually be in a bankruptcy proceeding.

Many states give very little protection to IRAs. This means that if a debtor has a lot

of money in their IRA, they will have to file for bankruptcy to protect it. However, there may be reasons that the debtor may not want to file for bankruptcy.

One reason is that by filing for bankruptcy, other favorable state exemptions could be superseded by the bankruptcy act. For example, somebody living in a state with favorable homestead protection who has not yet met the 40 month requirement might face a difficult choice as to whether to file for bankruptcy and protect their IRA but lose their home, or to not file for bankruptcy and protect their home but lose their IRA.

Another example of somebody who probably will not want to take bankruptcy is a wage earner, since under the new changes to the bankruptcy laws they may be required to work off their debts over a long period of time in order to obtain a discharge.

The upshot is that even though an IRA is protected in bankruptcy, one should not rely on that protection unless they live in a state that substantially protects IRAs. Are IRAs inherently asset protected? Yes and no, but mostly no.

### Rollover IRAs

Many advisors are now stating that although IRAs are subject to a \$1 million limitation, there is no limitation for “Rollover IRAs”. This position is taken section 522(n) refers to “the aggregate value of such assets exempted under this section, *without regard to amounts attributable to rollover contributions . . . and earnings thereon*” (emphasis added). The claim, which is not yet supported by any case law, is that this language creates an unlimited exemption for Rollover IRAs. In other words, the exemption for a normal IRA may be limited to \$1 million, but a Rollover IRA could theoretically be \$5 million and still exempt.

Some advisors believe in this position so strongly that they are actively telling their clients to liquidate other assets and put them into an IRA, and then roll the IRA into another IRA so that as a Rollover IRA it gains this unlimited exemption.

But is the exemption for a Rollover IRA really unlimited? I do not believe that it is. First, there is scant evidence that Congress specifically intended to create such a huge exemption. Second, the mere fact that such a large exemption is created runs contrary to the very anti-debtor/pro-creditor tenor of the act. Third, there is simply no intelligent reason whatsoever why Rollover IRAs should have such a large exemption, but non-Rollover IRAs do not.

What you have here is a typical case of sloppy drafting. What I am pretty sure that Congress meant to say (and believe that a court will rule) is that the exemption for IRAs is \$1 million, and it doesn't matter how much of that \$1 million came from Rollover IRAs. In other words, the total exemption is \$1 million for IRAs and Rollover IRAs in the aggregate, and there is no special exemption for Rollover IRAs. While it is possible that a court could interpret the language to create such an exemption, I doubt that will happen because of the overall anti-debtor/pro-creditor tenor of the act.

So, mark me down as one who does not believe that Rollover IRAs have an unlimited exemption in bankruptcy. But even if an advisor believed that this is the case, they should not be advising clients to contribute money to Rollover IRAs until the issue is settled by the courts. If an advisor tells a client with more \$1 million in a Rollover IRA that the money is exempted, and the courts ultimately rule the other way, the advisor could very well be liable for malpractice (especially if the advisor is a non-attorney advisor who shouldn't even be giving such advice in the first place). In the absence of case law validating the exemption, advisors who affirmatively tell their client that there is an unlimited exemption for Rollover IRAs are basically playing Russian Roulette with their clients' accounts.

Further, even if the courts ultimately rule that Rollover IRAs are exempted, keep in mind that as with normal IRAs this exemption only applies in bankruptcy proceedings, and not in ordinary state or federal cases. So, whether or not a greater than \$1 million exemption exists, it is probably bad advice to tell clients to load

up their IRAs for asset protection, since that will later force them to take bankruptcy to try to protect the IRA.

One should keep in mind that the very purpose of bankruptcy is to marshal the debtor's assets to satisfy creditors, and not to protect the debtor's wealth. The presumption is always that an asset of the debtor is an asset that is available to creditors, in the absence of clear state or congressional intent that the asset should be exempt. Especially with the latest changes to the bankruptcy laws, debtors should normally avoid bankruptcy whenever possible, and certainly not anticipate taking bankruptcy as part of their asset protection plan. Yet, by telling their clients to load up their IRAs, that is implicitly what many advisors are doing.

### Homestead Confusion

If one wants to see that there is great confusion in how the provisions of the new bankruptcy act are being interpreted, they need only to look at how the changes to homestead exemption are being interpreted. The new act basically created a 40-month grandfather period for homestead exemption: If the property had been owned for less than 40 months, then the \$125,000 cap on homestead of section 522(p) applies regardless of contrary state law. But if the property has been owned for more than 40 months, then the state homestead law applies.

While that part is clear enough, questions then arise as to increases in equity within the 40-month period. For example, let's say that you live in a state with unlimited homestead, you initially put \$250,000 into your home, and now you have owned the home for over 40 months. There is no doubt that your \$250,000 initial equity is protected. But what about your house payments, and the increase in value to the house within the last 40 months: Is that protected too?

Let's further assume that within the 40 months before you filed for bankruptcy, you made \$100,000 in principal payments on your loan. Can you claim that since your home was bought more than 40 months before you filed for bankruptcy, the additional \$100,000 in principal pay-

ments that you made should be protected to?

Currently, it depends on where you filed for bankruptcy, since the courts are split on whether principal payments within the 40-month period are exempted, with most courts holding that the \$125,000 cap does apply. *In re Virissimo and In re Heisel*, Chapter 7, Case Nos. BK-S-13605-LBR and BK-S-05-15667-LBR (Bankr. D. Nev. 2005) (\$125,000 cap on exemption applies); *In re McNabb*, 326 B.R. 785 (Bankr. D. Ariz. 2005) (\$125,000 cap on exemption applies); *In re Kaplan*, Chapter 7, Case No. 05-14491-BKC-RAM 331 BR 483 (Bankr. S.D. Fla. 2005) (\$125,000 cap on exemption applies). *But see In re Wayrynen*, Chapter 7, Case No. 05-32144-BKC-SHF (Bankr. S.D. Fla. 2005) (\$125,000 cap on exemption does not apply). In other words, there is no solid answer. The bottom line is that you shouldn't count on principal payments or appreciation in value within the 40-month limitation being protected in bankruptcy.

There are ways to protect the owner's value in personal residences. These methods include contributions to certain types of trusts that have asset protection features, and debt-financed methods of stripping equity from property. Where property has significant equity, these methods should be employed now to get the applicable Statutes of Limitation running, and if the owner gets into financial trouble later, bankruptcy should be avoided if at all possible.

As with IRAs discussed above, what this illustrates is that nobody knows how many of the issues created by the new bankruptcy act will shake out. It will likely be some years before there will be opinions decided by the U.S. Court of Appeals such as can reasonably be relied upon by planners and litigants. In the meantime, planners should presume the worst and not rely on wishful pro-debtor interpretations of the act.

## OLD-AND-COLD DOESN'T MEAN SAFE FOR 20-YEAR OLD OFFSHORE TRUSTS

**U.S. v. Grant, U.S. Dist. Ct. So. Fla. No. 00-CV-89-86 (9/2/05 aff'd 12/22/05).**

A U.S. District Court ordered the repatriation of assets in two Bahamas trusts that had existed for over 20 years in order to satisfy the beneficiaries' federal income tax liabilities, ruling that the beneficiaries' ability to replace trustees means that they also have the ability to change the trustees to a U.S. trustee who will then satisfy creditors.

Husband and Wife self-settled and funded two foreign trusts – one in Bermuda and the other in Jersey off the coast of England – in 1983 and 1984. Husband was the settlor of one of the trusts for Wife's benefit, and Wife was the settlor of the other trust for Husband's benefit.

As settlors of the respective trusts, Husband and Wife were given powers in the trust documents to replace trustees. In the event that one of them died, the other spouse would gain the power to replace trustees "anywhere in the world" for both trusts. The trusts were also drafted so that if one spouse died, the other spouse would become the beneficiary of both trusts.

Two decades later, in 2003, Husband and Wife were hit with a \$36 million final judgment for unpaid federal income tax liabilities for tax years 1991 and 1993. As part of its collection efforts, the DOJ moved the court to order the repatriation of the offshore trust assets to satisfy the judgment. Husband died in early 2005, and Wife thus became the beneficiary of both trusts and obtained the ability to replace trustees. Wife argued that the repatriation order violated the laws of the jurisdiction where the trusts were located, and that she did not wish to either repatriate the funds or order the replacement of the foreign trustees.

The court noted that:

"The only issue here is whether for purposes of repatriation, the corpus of a trust is any different than funds held in an ordinary offshore bank account, or for that matter, any offshore asset of a taxpayer. Therefore the query must be: is this a trust

over which the beneficiary lacks any control, such that the beneficiary is simply that and nothing more, and regardless of what she does or says, she lacks the power to repatriate these assets to the United States? -- or, does the beneficiary retain such control that she has the power vested in her in some way by the terms of the trust to repatriate the corpus? If she has such power, then this asset is no different than any other asset. \* \* \* Once the power of the person who is either the owner or the beneficiary of the asset to repatriate is established, the court can require that person to repatriate the funds."

The court then looked to the trust document, which gave Wife the "unreviewable discretion" to replace trustees, and rejected Wife's contention that because she had the complete discretion to replace trustees, she could simply refuse to replace the trustee:

"The owner of an asset cannot avoid the impact of a lawful court order requiring repatriation by saying, 'I choose not to do so,' any more than any person can avoid the impact of any court order acting directly against his person by saying, 'I choose not to do so.' The fact that such a person may decide to exercise his will to not make such a choice does not insulate him from the court's power and authority to lawfully order such a choice against the person's desire not to do so. That is the nature and essence of the court's power to act upon the person. The consequences of disobeying such an order are clear. Likewise, if the Defendant here has the power to change trustees or to repatriate assets, she cannot avoid the obligation by saying, 'I choose not to do so,' without incurring the dire consequence of such an avowed choice. The only question at issue is whether [Wife] has the power to effect a repatriation of the trust assets; if so, the court can order her to perform such acts which will in fact result in repatriation, to the same extent it can order any person owning or controlling an offshore account to repatriate the assets to the United States."

The court also ruled that it was totally irrelevant that the trusts were funded a decade before the tax liability even arose:

"[Wife] argues that the trusts were funded prior to any assessment of tax liability . . . and that therefore the court cannot order their repatriation because they are not fraudulent transfers. Such a position has no legal support. While it is true that several of the cases relied upon by the Government involve the repatriation of funds which were transferred within the period in which they would be considered fraudulent transfers, others do not. Moreover, [Wife] has failed to cite any law which holds that funds which are not fraudulently trans-

ferred are immune from repatriation. Nor does the law or logic compel such a result."

The court held that since Wife clearly had the power to replace trustees, the court could order her to replace the foreign trustees with a court-appointed U.S. trustee who could marshal assets to satisfy creditors. The court additionally held that despite the language of the trust documents giving her only discretionary distributions, her requests for distributions had never been denied and so therefore it appeared that she had apparent authority – backed up by her power to replace trustees – to require that distributions be made to her.

### Analysis

In some ways, this decision is just another in what has become a long and relatively consistent line of offshore trust failures – a line that has grown so long that cases such as these have started to become unremarkable. Could the trusts have been better structured? Probably. Would it have made a difference? Who knows? What we do know is that there are some important points that can and should be gleaned from this latest asset protection trust trainwreck.

The first point is that the mere fact that a trust is "old and cold" does not mean that it is immune from repatriation orders. The trusts in this case were formed more than 20 years before judgment was finally entered, and that fact barely merited a passing comment by the court. In other words, the amount of time that has passed since an asset protection trust is created is hardly relevant to the larger question of whether the trust assets should be available to satisfy creditors. The concept of "old and cold" as a defense to repatriation is a farce, as this case explicitly demonstrates.

Don't start thinking that simply because a trust has been around a long time that it is no longer subject to challenge. In fact, older trusts are possibly more dangerous than recently-funded trusts because they probably have not been updated to reflect changes in creditor-debtor law. Which is another way of saying that asset protection planning is not susceptible to "fire

and forget" planning where the documents are forgotten soon after the ink dries, and the client may never be seen after the initial representation is done. Because of changes in creditor-debtor law, it is critically important that key documents be regularly updated, and that the planner should maintain an ongoing relationship with the client with, hopefully, at least annual reviews.

The second point is that one should not start thinking that an asset protection trust is no longer subject to challenge after the limitations period for fraudulent transfers runs after the initial funding. In entering repatriation orders, courts have not given more than passing thoughts to whether the funding was a fraudulent transfer under either U.S. or foreign law – it just doesn't matter. What the court wants to know is whether the creator or beneficiary of the trust has a current ability to bring trust assets back now, not what happened when the trust was formed. This should especially be true with the 10-year clawback provision for self-settled trusts (both foreign and domestic) in the recent bankruptcy act.

The third point is that if somebody wants to have even a chance of an asset protection trust working, they must actually give up all control of the trust and the assets. A common theme in all of the asset protection trust disasters is that of hidden control, meaning that the settlor has attempted to retain some sort of strings over the assets supposedly given away. No matter how creatively planners have tried to paint these strings, labeling them as "negative powers" or whatever, when the court finds them the arrangement usually comes to grief. Remember: The mere fact that you can articulate an argument doesn't mean that it is a winning argument.

Finally, we are back to the entire concept of the self-settled spendthrift trusts. There is a long line of cases that demonstrate that self-settled trusts don't work, and very few decisions that even suggest that they might work even in ideal circumstances. Although Husband and Wife attempted to cross-settle trusts for each other, it seems like the court treated Husband and Wife as effectively one unit (certainly this was the case after Husband

died) and essentially presumed from the outset that logically the assets should be returned to satisfy the creditor. This does not bode well for the new, and totally untested, domestic asset protection trusts either.

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## REPATRIATION AND CONTEMPT

Every wonder how long a court could hold you in contempt for failing to repatriate offshore assets? You might try asking attorney H. Beatty Chadwick. According to a recent Associated Press report, Chadwick was jailed in 1995 for refusing to bring back to the U.S. some \$2.5 million in assets that he sent overseas so that his ex-wife couldn't get them in their divorce proceeding. He is still in jail. A three-judge panel in Philadelphia has now refused to let him out of jail, basically holding that the court could hold him indefinitely until the money comes back. The 68-year old Chadwick is believed to hold the record for time served for contempt.

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## INTERESTING OPINION ROUNDUP

Malpractice judgment of \$412,000 entered against law firm that formed family limited partnership for debtors, and then acted as counsel for the Chapter 11 debtor-in-possession while assisting the debtors into making transfers to the FLP in fraud of creditors. *In re R&R Assoc.* (1st Cir. No. 04-1610, March 31, 2005)

[http://www.assetprotectionbook.com/  
NH\\_R&R\\_Assoc\\_2005.htm](http://www.assetprotectionbook.com/NH_R&R_Assoc_2005.htm)

Myriad complex transactions made by debtor company under instruction of promoter operating under the name "Institute for Asset & Lawsuit Protection" deemed to be fraudulent transfers and avoided in a bankruptcy proceeding. The court rejected the debtors' contention that the fraudulent transfer action could not be successful because the creditors did not challenge the

initial transfers: "Nothing in the language of Section 550 requires a plaintiff in a fraudulent transfer adversary proceeding to avoid the transfer received by the initial transferee before continuing with avoidance actions down the line of transfers. Certainly, the plaintiff can pursue the initial transferee, but the plaintiff is not obligated to do so. The plaintiff is free to pursue any of the immediate or mediate transferees, and nothing in the statute requires a different result." *In re Int'l Admin. Services Inc.*, No. 04-11829 (11th Cir. 05/03/2005)

[http://www.assetprotectionbook.com/  
FL\\_Intl\\_Admin\\_2005.htm](http://www.assetprotectionbook.com/FL_Intl_Admin_2005.htm)

Finally, it appears that the *Ehmann* case (sometimes referred to as "Fiesta Investments") has settled, with the parties agreeing that the opinion in the case should be withdrawn so that it does not have any precedential effect. The opinion caused much heartburn to planners since it held that a non-executory LLC membership interest may effectively be pierced by a bankruptcy trustee of the debtor member. Although the Opinion was withdrawn, the executory/non-executory problem is still unresolved. Original opinion at *In re Ehmann*, 2005 WL 78921 (Bankr.D.Ariz. 01/13/2005)

[http://www.assetprotectionbook.com/  
AZ\\_Ehmann\\_2005.htm](http://www.assetprotectionbook.com/AZ_Ehmann_2005.htm)

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## REPORT FROM QUATLOOSIA

QUATLOOS.COM

by *Tony-the-Wonder-Llama*

'Tis the season to pay taxes.

In this Report from Quatloosia, we focus on a couple of transactions that are being marketed to affluent individuals that have drawn the attention of Los Federales.

### The Bogus Insurance Premiums Transaction

A new tax scam is going around which is roping in business owners and professionals around the country. This scam is marketed by a financial company out of the

Bahamas, but has been roping in insurance brokers, banks, and sometimes even estate planners to sell the scam for them.

The scam promises that a business can make a payment to an insurance company located in the Caribbean. The payments are ostensibly for business insurance premiums, though there is little evidence that any real insurance is being provided. The business owner takes a deduction for the insurance premiums paid.

At the same time, the business owner sets up an offshore trust, and the offshore trust essentially purchases an interest in the insurance company. The insurance company then takes the premium and makes a “distribution” of profits to the offshore trust.

At the end of the day, the business owner has taken a deduction for his “insurance payment” and yet regained control of his money in the offshore trust. Sounds too good to be true? It is.

Although the scam is made to sound like a sophisticated and legal tax strategy, there is so much of it that is just plain hokey. For instance, the promoters put a “Attorney-Client Privileged Communication” header across the front page of their agreement letter for clients, yet further back in the letter they specifically disclaim that they are a law firm or are giving legal advice and state that they are a financial firm instead. Good luck in getting that privilege to stand up in court.

But aren't clients entitled to rely on the promoter's letter and opinion? No, for a variety of reasons. First, as just related, the promoters expressly disclaim that they are a law firm or are giving legal advice. Second, the letter that they provide to clients is what is known as a “promoter's letter” that can not be relied on after the recent Jobs Act. Finally, the letter will not even qualify as an opinion letter since it does not reasonably set forth the legal basis upon which the client can rely.

What does this mean? It means that clients are totally naked to fines, penalties, and criminal prosecution when this scheme blows up. In other words, if you are somebody who got caught up in this scheme, you are totally on your own.

Despite the promoter's assurances, this is big-time tax evasion which is also known as criminal tax fraud. The IRS will have no difficulty in setting aside this scheme under a variety of theories, such that the original insurance was bogus, the entire arrangement was a sham, and the step-transaction doctrine. But this scheme is so brazen that there is little doubt that criminal prosecutions will follow.

**Tony's Inside Scoop:** Law enforcement has been tracking this scam for some months and considers it to be extremely abusive.

So what is likely to happen? If past DOJ actions are any indication, expect the DOJ to first get an injunction against the promoters to stop them from further marketing the program, and also requiring them to provide their client and prospective client lists to the DOJ (who will of course turn them over to the IRS and IRS-Criminal Investigations). That the promoters are out of the Bahamas might slow down obtaining this information, but under a recent agreement with the Bahamas, the DOJ will ultimately be able to obtain their client lists as well as banking information in the Bahamas and Nevis (which now has a similar agreement).

Next, the DOJ will start criminal investigations of all those who paid premiums to the offshore insurance company, and will prosecute those who don't voluntarily come forward before they are contacted, plus a few high-profile defendants just to set an example for others. This is basically how the prosecutions of those who used offshore credit cards tied to unreported foreign bank accounts went.

So if you got caught up in this scheme, what should you do?

First, contact a tax attorney who practices in the area of controversy litigation or who is known for handling the defense of criminal tax cases. You will need him or her. If they can get to the IRS and DOJ before a criminal investigation against you is commenced, they may be able just get you to pay the taxes owed without any other ramifications, or going on the IRS's audit-list-from-hell for the next decade.

Second, absolutely do not take the deduction for the premiums you paid! Once you do this, you have committed criminal tax fraud. If you have already taken a deduction for premiums paid, talk to your tax attorney about immediately amending your returns and paying the back tax. Any action that you take now to remediate the situation and show that you were a victim of the scam, and not somebody intent on committing tax evasion, may help you later.

Third, have your tax attorney demand your money back. Even if the money has already been distributed to your offshore trust, demand that the promoters reverse the transaction so that your offshore trust refunds the dividend to the insurance company, and the insurance company refunds the premiums you paid. If you are successful in getting the transaction reversed, you may be able to claim later that the transaction ever occurred at all. At worst, it will support your later claim that you were a victim and doing everything you could to remediate the situation and comply with the law.

Fourth, be sure that your tax attorney reports everything that you are required to report, such as the existence of the offshore trust, any foreign bank accounts, and anything else that you could arguably be required to report relating to the transaction. Even if the transaction is reversed, consider filing returns that at least disclose the existence of the involved entities and transactions so that you can later show that you made full disclosure, and also get the Statute of Limitations for any tax liability running now.

Do not go back to the original advisor who got you into this scheme and expect that they will help you out. They exercised terrible judgment in getting you into the scam in the first place, and probably will not promote your best interests in getting you out of it. Because of referral fees and other consideration that they would have to repay, the odds are low that they will give you the best advice. Instead, find an independent tax attorney to assist you, and consider making a demand on the advisor who got you into the scam to make a full disclosure to you for all compensation that they received because

of the transaction, and any other relationship that they had with the promoters.

### The OPPLI-PA Transaction

Another sophisticated transaction that the IRS is starting to attack is the transaction which blends an offshore private placement life insurance policy (or sometimes a "Swiss Annuity" product) and a private annuity. This is a complex transaction which involves several steps:

Step #1: A business owner purchases and funds an offshore private placement life insurance policy (known as a "FVUL") with some amount of money;

Step #2: About the same time, the business owner funds an irrevocable trust for his children, and has the irrevocable trust create a wholly-owned limited liability company as a subsidiary.

Step #3: The business owner next sells a large part of his operating business to the LLC owned by the trust, in exchange for a private annuity agreement for the business owner's benefit.

Step #4: Although the LLC now owns a large portion of the business owner's operating business, it also owes the private annuity obligation back to the business owner. Therefore, at this point in time, the value of the LLC is theoretically zero.

Step #5: The trust now sells its interest in the LLC to the offshore private placement life insurance policy, so that the private placement life insurance effectively owns a part of the business owner's operating business.

Step #6: The business owner now makes distributions of profits and taxes to the interests in his operating business that are now owned by the offshore private placement life insurance policy. Because the insurance company is offshore, it pays no U.S. taxes (and usually no taxes at all) on these distributions. The distributions are used to increase the cash value of the life insurance policy, thus allowing the business owner to borrow tax-free from the policy.

Step #7: At death, the life insurance proceeds now pay out to the business owner's children through the policy by making

"like kind" distributions of the LLC interests to the children.

Voila! The business owner has just converted a large and taxable part of his business income into tax free loans from his offshore insurance policy!

This transaction has been around since at least 2000, and probably hundreds of business owners have implemented it in one form or another. Because of its complexity, the transaction has not been widely marketed, but instead has been quietly employed by a number of tax attorneys. And for many years, the transaction escaped scrutiny.

Not anymore. As with all aggressive tax transactions, this transaction eventually drew scrutiny from Treasury, and the IRS is now starting to contest this transaction and investigate promoters and their clients. The IRS has vowed a "no settlement" policy with this transaction, and the rumors are that it will be the next listed transaction.

Among the many problems with the transaction is that lacks any economic basis other than to save taxes. It also probably fails the "step transaction" doctrine quite miserably. There are a number of other technical reasons why the transaction probably doesn't work, but you get the picture: This is a strategy that worked primarily by stealth, but it is now firmly onto Treasury's radar screen.

### Tax Protestors Headed For The Pokey

Since our last Report from Quatloosia, the following tax protestors will not have to worry about paying taxes since they will be free guests of our good friends at the Federal Bureau of Prisons.

#### Sentenced

Irwin Schiff, 151 months  
Cindy Neun, 68 months  
Larry Cohen, 33 months  
Bill Ledford, 24 months  
Larken Rose, 15 months

#### Awaiting Sentencing

John David Van Hove  
a/k/a "Johnny Liberty"  
Tessa Rose

Dr. Ward Dean  
Daniel Anderson  
Lorenzo LaMantia

### Recently Extradited to U.S.

Dave Struckman

The number of tax protestor successes against the IRS during this same period? None. There is a good reason that the number of tax protestors roughly tracks the societal incidence of insanity.

### IRS Outsources Collections

A much criticized program to allow the IRS to outsource some collections activity has started. The concern is not that taxes are being collected more efficiently, but that private information is being shared with tax collectors. Over these objections, the IRS has awarded its first contracts:

#### IRS NEWS RELEASE: IR-2006-42

#### IRS Selects Three Firms to Take Part in Delinquent Tax Collection Effort

WASHINGTON — The Internal Revenue Service today awarded contracts to three firms to participate in the first phase of its private debt collection initiative.

The firms are:

- The CBE Group Inc., Waterloo, Iowa.
- Linebarger Goggan Blair & Sampson, LLP, Austin, Texas.
- Pioneer Credit Recovery, Inc., Arcade, N.Y.

A total of 33 firms took part in the competitive bidding process that resulted in today's contract awards.

"The vast majority of states use private firms to help collect delinquent taxes. The new authority that Congress gave to the federal government allows us to use private firms as well," said IRS Commissioner Mark W. Everson. "We have carefully considered all of the concerns expressed about this project, which involves work traditionally done by the government. As a result, we are putting tough safeguards in place to protect taxpayer rights and privacy. We will be closely monitoring contractor performance to make sure they're following the law as well as our own internal standards."

To assist the IRS in its collection of back taxes, the 2004 American Jobs Creation Act authorizes the IRS to hire private firms to collect federal tax debts. This particular

portion of the law was carefully crafted and includes several limitations to ensure the private firms will be subject to the same stringent taxpayer protection and privacy rules that IRS employees work under. In addition, private firms cannot subcontract the work. The IRS expects to assign uncollected liabilities to the firms beginning this summer.

The IRS has also developed its own guidelines for the private firms, including background checks on all private firm personnel associated with the project as well as a mandatory, IRS-directed training program for company personnel.

Private firms will not be authorized to take enforcement actions such as liens, levies or seizures. In addition, private firms will not be authorized to work on technical issues such as offers in compromise, bankruptcies, hardship issues or litigation. Rather, the IRS will assign to the private firms cases in which the taxpayer has not disputed the liability. The private firms will contact taxpayers to make payment arrangements.

"Redirecting relatively simple cases to private firms will permit the IRS to focus its existing collection and enforcement personnel on more complex tax issues," Everson said.

In the second phase of the private debt collection project, scheduled for 2008, the IRS intends to contract with up to 10 firms. Over the course of 10 years, the IRS expects the private firms to help it collect an additional \$1.4 billion in outstanding taxes.

### **Notes from the "I Told You So" Department #1: New York Goes After Pre-Arranged Life Settlements**

In our June-July 2005 Report from Quatloosia, we warned about pre-arranged life settlements, which are deals where people take loans to buy life insurance policies with the expectation that they will sell them for a big profit as soon as the contestability period ends (usually two years). We warned that these policies might be contested by the insurance companies for lack of "insurable interest", on the basis that the real purchasers of the life insurance policies are the investors who extend the loans and then later buy the policies up – and they have no personal interest in the life of the person upon whom the policy is made.

Sure enough, the New York Insurance Commissioner had agreed, and in a landmark ruling has determined that there is no "insurable interests" in such policies.

The Department has been presented in the past with proposals similar to the one herein. Although it is not expressly stated in the inquirer's description, based on our review of the transaction it appears that the arrangement is intended to facilitate the procurement of policies solely for resale. It is our view that a plan of this nature does not conform to the requirements of the New York Insurance Law. First, the policies obtained by the Clients herein are arguably not obtained 'on [their] own initiative' as required by N.Y. Ins. Law § 3205(b)(1). Secondly, the potential transferees do not appear to have a legitimate 'insurable interest' in the lives of the Clients.

While it is true that N.Y. Ins. Law § 3205(b)(1) expressly allows an individual to procure and immediately transfer or assign to another a policy on his own life, irrespective of the existence of an insurable interest in the assignee . . . it is the Department's view that the transaction presented involves the procurement of insurance solely as a speculative investment for the ultimate benefit of a disinterested third party. Such activity . . . is contrary to the long established public policy against 'gaming' through life insurance purchases.

In addition, there may exist other potential problems, such as rebating violations, with the proposed transaction. \* \* \* Upon the sale of the Policy by a Client (following the exercise of the Put Option) it is conceivable that the policy premiums would be effectively rebated since the Client may well recoup from the proceeds of the Policy sale the amounts it borrowed and paid as policy premiums. Such a Client would thus receive cost free coverage for the two-year incontestability period, arguably an inducement to enter into the transaction.

In light of the above, the Department does not view the transaction as permissible.

*Opinion of the New York State Insurance Department, December 19, 2005.*

What does this mean? At least in New York, it means that many of the life insurance policies that were sold specifically for purposes of later resale are probably invalid. It is likely that most of the other states will follow this ruling as well. Wherever you live, if you have been defrauded into entering into one of these "we'll buy the insurance for you and you can sell it in two years" programs, you should immediately contact an attorney to see what your rights are against the promoter and whatever advisor was dumb enough to let you participate in this arrangement.

### **Notes from the "I Told You So" Department #2: Promoters of "Mortgage Elimination" Programs Indicted**

In our May 2005 Report from Quatloosia we discussed the so-called "mortgage elimination" scam, whereby promoters would have homeowners file false documents with the county clerk's office showing that their original mortgage was discharged, and then make applications for new loans the proceeds of which the homeowners would split with the promoters as profit. As stupid as this scheme sounds, unfortunately hundreds of homeowners fell for it – and the promoters were of course indicted for conspiracy to commit loan fraud and other offenses:

**U.S. DEPARTMENT OF JUSTICE**  
United States Attorney's Office  
Northern District of California

February 17, 2006

#### **FOUNDERS OF NATIONWIDE DEBT ELIMINATION SCHEME AND FOUR "BROKERS" CHARGED IN SIXTY- EIGHT COUNT SUPERSEDING INDICT- MENT**

*Indictment Adds Charges Against Four  
"Brokers"*

*Alleged Scheme Caused Home Mortgages  
to Falsely Appear Paid*

OAKLAND – United States Attorney Kevin V. Ryan announced that a federal grand jury in Oakland indicted Dale Scott Heine-man, 45, Kurt F. Johnson, 42, the Dorean Group, and four Dorean Group "brokers" in a 68-count superseding indictment charging mail fraud, bank fraud, conspiracy to commit mail fraud, wire fraud and bank fraud, and contempt of court. The superseding indictment, returned late yesterday, has added charges of mail fraud, bank fraud, and conspiracy to commit mail fraud, wire fraud and bank fraud against the following four Dorean Group "brokers":

- William Julian, 42, Cayce, South Carolina,
- Farrel J. LeCompte, Jr., 35, Kingwood, Texas,
- Sara J. Magoon, 29, Hamilton, Montana, and
- Charles Dewey Tobias, 58, of Longwood, Florida.

These charges are the result of an investigation by the FBI.

The principals of the Dorean Group are Dale Scott Heineman of Union City, California, and Kurt F. Johnson, of Sunnyvale, California. They, along with the Dorean Group and four of its brokers, are charged with operating a debt elimination scheme whereby fraudulent documents are recorded as part of their clients' titles to allegedly transfer lenders' secured interests in the properties when the corresponding mortgage and home equity loans had not been paid. With this fraudulently-generated free and clear title, some clients, at the direction of the Dorean Group, obtained hundreds of thousands of dollars in home equity loans from independent lenders.

Heineman and Johnson also face contempt of court charges for violating a restraining order and preliminary injunction which prohibited the Dorean Group from engaging in any activities related to its mortgage elimination scheme.

The charges in the superseding indictment relate to 24 properties in California, Colorado, Florida, Idaho, Montana, Nevada, North Carolina, South Carolina, Texas, Utah and Washington with a value of over \$6 million. The FBI continues to investigate more than 550 properties throughout 35 states with a potential value of greater than \$88 million in loans that may have been affected by this alleged scheme. The FBI is also investigating properties in 19 California counties affected by this alleged scheme.

U.S. Attorney Kevin V. Ryan stated, "Homeowners should be cautious of offers that sound too good to be true. This alleged scheme violates mortgage agreements between the lender and borrower and taints property titles by recording false documents on the title of a home. Manipulating property titles and interfering with mortgage loans with the intent to defraud is illegal and will result in prosecution."

Joseph Ford, Special Agent in Charge of the FBI in San Francisco, stated, "Mr. Heineman and Mr. Johnson are accused of being con artists in a sophisticated telemarketing scheme. They are alleged to have incorporated the internet to further their criminal enterprise, which is nationwide in scope and has significant impact on the housing market in the U.S. Because cyberspace has no borders, the FBI is working with its law enforcement partners from around the world to address these growing crimes."

According to the indictment, the Dorean Group is an unlicensed and unincorporated entity that has been operating a purported debt elimination program since at least January 2004. The Dorean Group uses brokers to promote its program. On various websites, the Dorean Group and its brokers publicly advertise that they have a "PROVEN, legal and moral way of elimi-

nating your mortgage while adding \$32K to your pocket (\*based on a \$200,000 mortgage)."

According to the superseding indictment, the Dorean Group's scheme to defraud operated as follows:

(1) Fee: The client pays an up-front fee of approximately \$1,000 to \$3,000 per loan to be eliminated and promises to make a "free-will offering of 50% of the RE-DEEMED mortgage." The redeemed mortgage (dubbed a refinance loan in websites promoting this scheme) refers to a subsequent equity loan obtained from a separate lender based upon the Dorean Group's fraudulent recordation representing that the initial mortgage loan secured by the property had been fully satisfied.

(2) Transfer of Title: Once the initial fee is paid, the Dorean Group forms a trust with its client, the trustees of which are Heineman and Johnson. The client records a quitclaim deed with the local county recorder's office, which allegedly transfers the borrower's title interests to this trust. However, typical mortgage agreements between a borrower and a lender require the lender's consent before the borrower may transfer his/her title interests. According to the superseding indictment, no lender granted Heineman, Johnson, or the Dorean Group permission to act on behalf of the borrower under the applicable mortgage agreements.

(3) Self-Executing Presentment Packet: The Dorean Group subsequently mails a "self-executing presentment packet" to the lender of its client's loan. In this packet, the Dorean Group claims to act on behalf of the borrower, demanding proof of the validity of the lender's loan "to the unilateral satisfaction of the Dorean Group" within 10 days. If this burden is not met, documents in the packet allege that, due to the lender's "tacit assent" and "default," Heineman and/or Johnson of the Dorean Group will act as the lender's agent and attorney-in-fact as to the loan and the secured property. In addition, if the lender elects to attempt to prove the validity of its loan, but fails to do so "to the unilateral satisfaction of the Dorean Group," the lender, according to the packet, is liable to the Dorean Group for damages twenty times the amount of the loan.

(4) Substitution of Trustee: After 10 days has elapsed, Heineman, Johnson and the Dorean Group prepare a "Substitution of Trustee," or, depending on jurisdiction, a "Specific Power of Attorney" or "Power of Attorney," that is recorded as part of the title to its client's property. This recordation claims that Heineman and/or Johnson is acting as agent and attorney-in-fact on behalf of the lender. According to the indictment, no lender has authorized Heineman,

Johnson, or the Dorean Group to act either as its agent or attorney-in-fact.

(5) Full Reconveyance: Under this false representation, Heineman, Johnson and the Dorean Group prepare a "Full Reconveyance" or, depending on jurisdiction, "Discharge of Mortgage" or "Satisfaction of Mortgage," that is recorded as part of the title to its client's property. In this document, Heineman and/or Johnson of the Dorean Group – allegedly acting on behalf of the lender – represents that the loan secured by the property has been fully satisfied, when the loan had not been repaid. In this recordation, Heineman and/or Johnson purportedly transfers the lender's secured interests in the client's property to the client's trust established by the Dorean Group, causing the property title to falsely appear unencumbered.

(6) Subsequent Home Equity Loan: With what appears to be free and clear title, and pursuant to its standard client service agreement, the Dorean Group directs its clients to seek a subsequent "refinance loan," or home equity loan, from a separate lender with the apparently-unencumbered property serving as the security for the loan. When the loan disbursement is obtained, the Dorean Group receives 50% of its proceeds, the Dorean Group broker (who solicited the client) receives 10-25% of the funds, and the client keeps the remaining 25-40% of the loan. The refinance loan is subject to the Dorean Group's debt elimination program and is not repaid.

Mr. Heineman and Mr. Johnson are also each charged in the superseding indictment with contempt of court. On July 6, 2005, the Civil Division of the United States Attorney's Office filed a complaint for injunctive relief, and a motion for a temporary restraining order directing that Messrs. Heineman and Johnson, doing business as the Dorean Group, to cease engaging in their mortgage elimination scheme. On July 6, 2005, Judge William H. Alsup granted the government's motion for a temporary restraining order. On August 1, 2005, Judge Alsup converted the temporary restraining order to a preliminary injunction, prohibiting the Dorean Group from engaging in any activities related to its mortgage elimination scheme, pending final judgment in the civil action. According to the superseding indictment, after they were served with the temporary restraining order and the preliminary injunction, respectively, Heineman and Johnson executed an "appointment of successor trustee" to allegedly transfer their interests as trustees of the Dorean Group's clients' trusts to a Dorean Group employee.

Mr. Heineman and Mr. Johnson were previously arraigned on the initial indictment before Judge Wayne D. Brazil in Oakland on February 13, 2006. Mr. Heineman and Mr. Johnson appeared before Magistrate

Judge Brazil for arraignment on the superseding indictment on February 17, 2006, at 10:00 a.m. They are also set to make an initial appearance before Judge D. Lowell Jensen in Oakland on February 17, 2006, at 11:00 a.m. No bail arrest warrants were issued for Mr. Julian, Mr. LeCompte, Ms. Magoon, and Mr. Tobias.

The maximum statutory penalty for each count of mail fraud in violation of 18 U.S.C. § 1341 and affecting a financial institution is 30 years imprisonment and a fine of \$1,000,000, plus restitution. The maximum statutory penalty for each count of bank fraud in violation of 18 U.S.C. § 1344 is 30 years imprisonment and a fine of \$1,000,000, plus restitution. The maximum statutory penalty for each count of conspiracy to commit mail fraud, wire fraud and bank fraud in violation of 18 U.S.C. § 1349 is 30 years imprisonment and a fine of \$1,000,000, plus restitution. However, any sentence following conviction would be imposed by the court after consideration of the U.S. Sentencing Guidelines and the federal statute governing the imposition of a sentence, 18 U.S.C. § 3553.

An indictment contains only allegations against an individual and, as with all defendants, Mr. Heineman, Mr. Johnson, Mr. Julian, Mr. LeCompte, Ms. Magoon, Mr. Tobias, and the Dorean Group must be presumed innocent unless and until proven guilty.

James Keller is the Assistant U.S. Attorney who is prosecuting the case. The prosecu-

tion is the result of a fourteen-month investigation by the Federal Bureau of Investigation. Several law enforcement entities, including the Alameda County District Attorney's Office, the California Attorney General's Office among many others, provided valuable assistance and information about this alleged scheme to the United States Attorney's Office.

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