DAVIS & WILLMS, PLLC
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
(281) 786-4500
Fax (281) 742-2600

# *BASICS**

## Planning to Preserve Assets

*Synopsis*

*Estate planning in its broadest sense has always provided assistance in the accumulation, management, and disposition of wealth. Although the focus has often been on asset disposition and minimization of death taxes, the focus has recently broadened to include providing advice concerning preservation of assets, including the isolation of assets from third party claimants. The "liability revolution" has become a principal concern for many of our clients. Estate planning can offer a number of strategies designed to protect assets from third party claims. This outline focuses upon asset protection techniques available to individuals.*

Many clients, faced with the prospect of paying dramatically increased insurance costs, "self-insuring," or restricting their activities in areas involving the highest degree of risk, seek the assistance of estate planning professionals to structure their affairs to provide legitimate protections from liability. Several factors are relevant in determining the proper planning techniques to implement for any client. These factors include the form of ownership in which assets are held, the nature of property owned by individuals under Texas marital property and exemption laws, the nature of the claim being made against property, and the extent of any transfers that a client may wish to consider.

### I. Marital Property Issues.

#### A. Community and Separate Property.

Texas is a "community property" state, and a marriage is treated somewhat like a partnership with respect to the characterization of marital property. Texas law presumes that all income and assets of a married couple are community property, to be used for the benefit of, and to be applied against the debts of, both spouses. In order to prevent the assets of a married couple from being subject to the debts of both spouses, the party asserting protection must establish that the assets qualify for special treatment. Assuming that a spouse asserting protection can establish the character of property, marital property may be broadly categorized into three types:

##### 1. Separate Property.

Separate property includes all property acquired before the marriage, all property acquired during the marriage by gift or inheritance, and all property which the spouses agree in writing constitutes separate property.

##### 2. Sole Management Community Property.

Sole management community property includes a spouse's personal earnings, revenues from separate property, and recoveries for personal injury.

##### 3. Joint Management Community Property.

If the sole management community property of one spouse is mixed or combined with the sole management community property of another spouse, the resulting property is subject to the joint management and control of the spouses. Again, Texas law presumes that all assets are joint management community property.

*Davis & Willms, PLLC has compiled the *Basics* series to provide plain-English, summary explanations of fundamental estate planning techniques and concepts. As a result, our discussions may gloss over some of the more complex topics and even ignore a few issues. The *Basics* memoranda are *not* legal advice. Instead, they are generalized, educational tools designed to help our clients and potential clients develop an understanding of the estate planning process. Before engaging in any estate planning, you should consult a qualified estate planning attorney.

### B. Marital Property Liabilities.

The liability of marital property for a particular claim depends upon the timing and character of the claim in question. Different rules apply to claims arising before or after marriage. In addition, different rules apply to claims arising by contract than to those arising by "tort" (injury) to the claimant. As a general rule, one spouse's separate property is not subject to the liabilities of the other spouse. In addition, a spouse's sole management community property is not subject to liabilities incurred by the other spouse before marriage, or nontortious liabilities incurred by the other spouse during marriage. All community property, however, is subject to tortious liability of either spouse incurred during marriage. These rules may be summarized by the following table:

| **HUSBAND'S LIABILITIES** | | | | |
|---|---|---|---|---|
| | Pre-Marriage | | Post-Marriage | |
| Assets | Tort | Contract | Tort | Contract |
| Husband's Separate Property | *** *** | *** *** | *** *** | *** *** |
| Husband's Sole Management Community Property | *** *** | *** *** | *** *** | *** *** |
| Joint Management Community Property | *** *** | *** *** | *** *** | *** *** |
| Wife's Sole Management Community Property | | | *** *** | |
| Wife's Separate Property | | | | |

## II. Exempt Property.

Under Texas law, individuals are entitled to hold certain property exempt from the claims of most creditors (other than certain taxing authorities and creditors who have loaned money for the purchase or construction of the exempt property). Exempt property includes a person's homestead, regardless of its value; eligible personal property having an aggregate fair market value of not more than $100,000 ($50,000 for a single person); pension and profit sharing plans, IRAs and other similar qualified employee benefit accounts; Education IRAs and Section 529 accounts; and the cash value and proceeds of life insurance and annuity contracts.

### A. The Homestead Exemption.

The homestead consists of one or more parcels of real estate, including improvements, totaling not more than one acre within in a city, town, or village, and not more than 200 acres if located in a rural area.

### B. Exempt Personal Property.

Eligible personal property includes furnishings; automobiles; tools, equipment and books used in a trade or profession; pets; certain livestock; and the cash surrender value of a life insurance policy in force for two years for the benefit of a person's family or dependents. The debtor is entitled to designate which eligible property he chose to be exempt, subject to the dollar value limits described above.

### C. Retirement Savings.

Qualified tax-deferred pension, profit-sharing, and similar plans, as well as deductible contributions to IRAs and IRA roll-overs (as well as the earnings thereon), are exempt from creditors by statute in Texas. No dollar limit applies to the assets in these plans. As noted below, however, in the bankruptcy context, the exemption for traditional and Roth IRAs is limited to $1,283,025 (adjusted every three years for inflation).

### D. Life Insurance and Annuities.

Texas law provides that insurance and annuity benefits, including the cash value and proceeds of an insurance policy, are exempt from attachment by the creditors of the insured or beneficiary of the policy. The statute exempts annuities and life insurance policies issued by a life, health or accident insurance company, including a mutual company or a fraternal benefit society. Also exempt are annuities and life insurance benefits under an annuity or benefit plan used by an individual or an employer. This statute means that both cash values and benefits paid under these contracts are exempt from the creditors of the insured and the beneficiary, without regard to any dollar limits. This statute presents a significant opportunity to shelter assets through the purchase of insurance and annuities. The exemption does not apply to child support obligations, or to debts validly secured by a pledge of the policy or its proceeds. In addition, as more fully discussed below, a court may set aside certain premium payments made with an intent to delay, hinder or defraud a creditor. As a result, the timing of the investment in and insurance policy or an annuity is critical. If an event which is likely to give rise to liability occurs before the investment, a subsequent conversion of non-exempt assets into a life insurance or annuity contract may be set aside under Texas law and the Bankruptcy Code. If the investment had been planned before the liability event, it probably would not be considered a transfer with an intent to "delay, hinder or defraud" a creditor.

## III. Types of Claimants.

Certain claimants are accorded special treatment under the law, and are entitled to reach assets unavailable to other creditors. For that reason, the character of the claimant must be determined.

### A. Contract Claimants.

The law assumes that if you enter into a contract with a third party, that party will have an opportunity to question you about your nonexempt assets, and negotiate suitable security for any amount advanced or credit extended. If a lender, for example, is dissatisfied with a borrower's separate property, and sole and joint management community property, the lender may ask the borrower's spouse to co-sign or guaranty the loan. If the creditor fails or chooses not to obtain the spouse's agreement to pay the loan, the creditor has foregone the opportunity to attach the spouse's separate and sole management community property.

### B. Tort Claimants.

As indicated above, the law provides special protection to tort claimants. The theory for this protection is that unlike a contractual creditor, a tort plaintiff has no choice as to the property ownership attributes of the person by whom he is injured. Accordingly, he is an "innocent" victim who should be provided greater protection. As a result, a tort victim has access to the nonexempt separate property of the debtor, and if the debtor is married, to *all* nonexempt community property of the debtor and the debtor's spouse.

### C. Internal Revenue Service.

Because of the supremacy clause of the United States Constitution, the protections discussed above provided by Texas law do not apply to claims made by the federal government. In particular, the Internal Revenue Service is not obliged to recognize the exempt property provisions set forth above. Note, however, that if a spouse is able to establish the defense of "innocence" with respect to certain Internal Revenue Service claims, that spouse may protect his or her separate property, and can seek reimbursement for his or her share of the homestead levied upon and sold by the IRS.

### D. Providers of Necessities.

In the marital property area, an exception to the general contract rule is provided for persons who provide goods and services considered "necessary for support." The law imposes upon each spouse a legal duty to support the other. Accordingly, all property owned by either spouse is subject to liabilities incurred for health care, food, lodging, and other items necessary for support of either spouse.

## IV. Transfers of Property.

Many asset protection techniques involve an evaluation of the ownership of property available to satisfy claims. In some circumstances, a debtor's assets available to creditors will include not only assets owned by the debtor at the date of the claim, but also assets that have been previously owned by the debtor. As a

general matter, the law prohibits transfers in fraud of creditors. Examples of these laws include the following:

**A. Bankruptcy.**

If a party declares bankruptcy, the court may revoke certain transfer made within 90 days of the filing of the bankruptcy (or within two years of the filing of the bankruptcy for transfers made to related parties).[1] Thus, a party contemplating a transfer of assets must determine whether bankruptcy is likely in the near future and whether the transfers contemplated might be set aside by a bankruptcy court.

**B. Transfers Resulting in Insolvency.**

Transfers made (or obligations incurred) by a debtor can be set aside by a court, for creditors' claims arising prior to the transfer, if the debtor was insolvent at the time of or as a result of the transaction. "Insolvent" means that the debtor's obligations exceed the fair market value of nonexempt assets retained by the debtor. A debtor who is generally unable to pay his debts as they come due is presumed to be insolvent. In order to set aside such a transfer, a creditor must show either that the debtor failed to receive a "reasonably equivalent value" for the transfer; or that the transfer was to an "insider" of the debtor, made to pay off a pre-existing debt.

**C. Intent to Defraud Creditors.**

Generally, Texas law provides that a court can undo any transfer made (or obligation incurred) by a debtor with "the actual intent to hinder, delay or defraud" any creditor. Thus, even a transfer that does not render a debtor insolvent can be set aside by a creditor whose claim arises a reasonable time before *or after* the transfer, if the creditor can establish "intent" to defraud. Since a transferor's "intent" is difficult to prove, Texas law has established eleven factors which courts may consider in establishing the actual intent of a debtor. The eleven factors set forth by statute are:

1. Whether the transfer is to an "insider" (family member, partner or affiliated business)
2. Whether the debtor retains possession or control of the transferred property
3. Whether the transfer is concealed
4. Whether the debtor has been sued or threatened with suit prior to the transfer
5. Whether the transfer is of substantially all of the debtor's assets
6. Whether the debtor leaves the jurisdiction of the court
7. Whether the debtor conceals assets or removes them from the jurisdiction of the court
8. Whether the value received by the debtor in exchange for transferred assets is reasonably equivalent to the value of the transferred assets
9. Whether the debtor is insolvent as a result of, or shortly after, the transfer
10. Whether the transfer occurs shortly before or shortly after a substantial debt is incurred
11. Whether the debtor transfers essential business assets to a creditor, who then re-transfers the assets to an insider of the debtor

Note that the list of factors is not intended as exclusive. On the other hand, the existence of one or more factors does not create a presumption that a transfer is fraudulent. Rather, the court is to determine the existence of intent based upon all facts and circumstances of a particular case, with the cited factors to be

[1]For bankruptcy cases filed before October 18, 2006, the look-back period for transfers to related parties was one year.

used as guidance. Texas courts have generally required a high degree of proof to establish an "intent" to defraud.

**D. Constructive Fraud.**

Texas law provides that a transfer of property for which the debtor does not receive "reasonably equivalent value" is deemed to be constructive fraud. In such a circumstance, a creditor whose claim arises a reasonable time before *or after* the transfer need not show an actual intent to defraud, if the creditor can establish that the debtor either intended to incur, or believed he would incur, more debts than he would be able to pay after giving effect to the transfer; *or* that the debtor was left with an unreasonably small amount of assets with respect to the risks associated with the transactions or business activities in which the debtor is engaged, or about to become engaged.

**E. Time Limits for Challenging Transfers.**

In order to set aside a transfer, a creditor must bring an action within the time allowed by statute. Texas law provides that the statute of limitations for challenging a transfer of assets is as follows:

1. For transfers with the "intent" to defraud, within four years of the transfer or, if later, within one year after the creditor could reasonably have discovered the transfer.

2. For most transfers resulting in insolvency, or "constructive" fraud, within four years of the transfer.

3. For transfers to insiders in exchange for pre-existing debts, within one year of the transfer.

4. For transfers to a spouse, minor, or disabled person, within two years of the transfer or, if later, within one year after the creditor could reasonable have discovered the transfer (but note that time limits do not run against a minor or incapacitated person until adulthood or recovery from incapacity).

## V. Specific Planning Techniques.

The foregoing discussion suggests certain types of techniques that may be utilized to preserve assets. These techniques generally involve modifying the form in which assets are held, investing in exempt assets, transferring assets within the limits afforded by law to place them beyond the reach of creditors, and acquiring new assets in a form exempt from creditors. An alternative approach involves restructuring asset holdings to leave them available to creditors, but to make them unattractive as sources of funds for satisfaction of a successful claim.

**A. Modifying the Form of Asset Ownership.**

**1. Corporations and LLCs.**

As a general rule, a business creditor of a corporation may reach only the assets placed in or held in the business. Parties contemplating a risky business undertaking would be well advised to place assets in the corporation, withholding any nonbusiness assets to protect them from the claims of business creditors. Limited liability companies provide the same sort of protections to their members as a corporation does for its shareholders.

**2. Professional Associations and Corporations.**

Texas law provides an exception to the general rule that owners of a corporation are not liable for its debts. In general, a licensed professional who forms a professional corporation or association cannot interpose the corporation to avoid liability for his or her professional misconduct. Thus, a malpractice claimant can reach the assets of the professional corporation or association, and also reach the personal assets of the business owner that committed the malpractice. In the context of a general partnership, a claimant could reach not only the personal assets of the negligent business owner, but *also the personal assets of his or her partners*. Therefore, whenever two or more professionals are engaged in business together, it may be advisable to form a professional association, professional corporation, or limited liability partnership for the conduct of their business. These entities effectively shield each partner from personal liability for the alleged malpractice of his or her partners.

**3. Limited Partnerships.**

Limited partners are afforded protections similar to shareholders in isolating themselves from liability for the conduct of partnership business. Since rules relating to the relative rights and duties of limited partners are established by agreement and not by statute, limited partnerships provide considerable flexibility in the manner in which potential obligations of the limited partnership may be discharged. Limited liability companies can also afford similar flexibility.

**B. Investment in Exempt Property.**

Subject to the fraudulent conveyance notions discussed above, a debtor may convert nonexempt property into exempt property to avoid reach by creditors. In particular, highly liquid clients may consider a number of strategies to protect non-exempt assets. For example:

**1. Buying a Home or Reducing a Mortgage.**

Purchasing a homestead or paying off the mortgage on a homestead enables a person to maximize the value of this exemption. Although courts may look to these sorts of arrangements as an indication of bad motives on the part of the debtor, courts have been reluctant to abrogate the constitutional homestead exemption in Texas in favor of creditors. Note that conversion of nonexempt personal property into exempt personal property is expressly disallowed by statute in Texas, if done with the intent to defraud, delay, or hinder a creditor, so long as the creditor brings a claim within four years of the transfer. Much has been made of the impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 on the use of the homestead exemption. Its impact on bankruptcy reform is outlined below.

**2. Investing in Retirement Accounts.**

In addition to offering significant income tax advantages, employer-sponsored retirement plans are exempt from attachment by creditors. Therefore, maximizing one's contributions to these plans may facilitate building a substantial safety net if creditors mount a successful attack. IRAs, SEPs and Roth IRAs offer a similar exemption, as do funds placed in an Educational IRA or Section 529 plan. These latter savings vehicles are subject to certain limits and restrictions under the current bankruptcy law, as discussed below.

**3. Investing in Insurance and Annuity Contracts.**

The liquidation of marketable securities and investment of the proceeds into a policy of life insurance or an annuity will generally make these assets beyond the reach of creditors unless the investment is accompanied by an intent to hinder, delay or defraud a creditor. As noted above, the standard of proof required to establish an actual intent to hinder, delay or defraud had been held to be quite strict.

**C. Transfers of Property.**

One way to protect assets from the reach of creditors is to part with the ownership of the assets. As indicated above, solvency, intent and timing are critical factors that must be evaluated with respect to any transfer of assets. As a general rule, however, subject to the limitations on insolvency and fraudulent conveyances, creditors cannot reach assets that the debtor has effectively transferred.

**1. Transfers to Trusts.**

Generally, a person may establish a trust to own property, and transfer ownership of the property into the trust. From a legal standpoint, then, the trust and not the grantor owns the property.

a. Revocable and "Grantor" Trusts. As a general rule, if the grantor retains a power of appointment over the property or is otherwise able to revoke the trust, the transfer is ineffective as against creditors of the grantor. In fact, the Texas "spendthrift" statute (which generally permits the person who creates a trust to provide that a beneficiary's creditors cannot reach trust assets) expressly provides that a provision that purports to keep away the creditors of someone who puts money into the trust is not effective against those creditors.

b. Irrevocable Trust. A trust may be established, however, for the benefit of persons other than the grantor. The theory here is that the grantor has truly and irrevocably parted with the assets (presumably transferring them to someone that the grantor loves more than his creditors). Generally, to be effective, the trust must be irrevocable, must provide for no retained interests by the grantor (although,

presumably, the grantor's spouse and dependents may be beneficiaries), and must not run afoul of the fraudulent transfer rules discussed above. Note that if the spouse is a beneficiary of the trust, and the spouse transfers a community property interest into the trust, that spouse's creditors may reach the trust assets because with respect to that property, the beneficiary-spouse is the grantor.

**2. Foreign Trusts.**

Several foreign countries and a few states have enacted statutes that enable an individual to transfer assets to a trust for the benefit of his family, retaining the right to have the assets returned to him. These laws provide that, so long as the grantor is solvent after the transfer, no creditor may attach his interest in the trust. Such trusts typically provide that the trustee (usually a foreign bank) has the right to refuse to return assets to the grantor if the grantor is "under attack" at the time the assets are sought. For trusts formed under Texas law, however, such a provision is ineffective against the grantor's creditors, and the transferor may be compelled, under threat of contempt of court, to obtain a return of the assets. Cases have tested the efficacy of foreign trusts and for the most part endorsed their effectiveness, so long as the grantor is not insolvent at the time that the trust is created, or rendered insolvent as a result of the trust's creation. The effectiveness of the exemptions provided by other states may be subject to attack under the U.S. Constitution. Few court cases have yet tested whether these trusts will act to protect Texans. Note that foreign trusts are not tax shelters (and in fact, if properly designed, are ignored for federal income and estate tax purposes), nor are they a mechanism to "conceal" assets, especially after the events of September 11, 2001. A properly structured foreign trust is fully disclosed on the grantor's income tax return. The benefit of a foreign trust depends not upon its secrecy, but upon the application of the laws of the state or foreign jurisdiction in protecting assets from an involuntary transfer to the creditors of the grantor.

**3. Transfers to a Spouse or Another Party.**

The separate property of a debtor's spouse is not liable for claims against the debtor unless that spouse has agreed contractually to assume liability for them. Thus, married couples can agree to partition assets, so as to establish certain property as the separate property of each spouse. It is incumbent upon the spouse asserting protection to establish the separate property character of the assets to be protected. Accordingly, separate record keeping and segregation of funds is imperative to maintaining the effectiveness of this technique. Alternatively, property may be transferred outright to others (children, parents, etc.), so long as the fraudulent transfer rules described above are not violated. Of course, the reason that creditors are prevented from reaching these assets is that they are beyond the debtor's reach. If the debtor divorces his or her spouse, the divorce courts are prevented from awarding one spouse's separate property to the other, even if the property was derived as a gift from the former spouse.

**4. Transfers to Charity.**

Transfers to charity often provide attractive income and estate tax benefits as well as a sense of satisfaction to the transferor. Often, for tax and personal planning purposes, transfers to charities are made through the use of a trust, with the grantor or his family retaining an interest in the assets of the trust, either before they are given to charity, or after the charity has used them for a specified period. While such transfers are subject to the fraudulent conveyance rules described above, many practitioners feel that the benefits provided to charity, as well as the tax and estate planning benefits of the transfer, tend to negate claims of an "intent" to defraud creditors.

**D. Future Property Acquisitions.**

Many clients have a unique opportunity to protect assets that they have not yet acquired but expect to acquire in the future.

**1. Inheritance.**

A client who expects a significant inheritance can, depending upon his family situation, request that the inheritance be made to him through the use of a "spendthrift" trust as opposed to transferring property to him directly. He can serve as the trustee of his own trust, deciding when to make distributions to himself and his family. Because he is not the creator of the trust, the creditor protection provisions of the trust should be effective to prevent his creditors from claiming his inheritance. For similar reasons, many clients choose to establish wills that pass property to each other, and ultimately to their children, in lifetime trusts. Children can be allowed to become a co-trustee or sole trustee at an age designated by the parents.

Assets inherited in trust are protected from divorce and creditors, and may also afford substantial estate tax saving opportunities.

**2. Marital Property Agreements.**

As indicated above, spouses may agree in writing to segregate assets, establishing them as the separate property of either spouse. This agreement may be made both with respect to existing assets and with respect to assets acquired in the future. Spouses who undertake this sort of planning should ensure that their wills establish trusts for one another, so that in the event one spouse dies, the separate property of that spouse will not then pass to the other spouse, but will instead pass into trust for the other spouse in a manner that is exempt from the surviving spouse's creditors.

**E. Nature of Ownership.**

In addition to parting with ownership of assets, asset ownership may be restructured to make a person's particular holdings less attractive to creditors in enforcing any judgment.

**1. Professional Associations and Corporations.**

As indicated above, a professional may not avoid liability for his own misconduct by the formation of a professional corporation, professional association, or limited liability partnership. Note, however, that creditors are much more reluctant to foreclose against a debtor's interest in a closely held professional corporation or association than against the assets of a proprietorship. This reluctance follows from the fact that only licensed professionals may be owners of this type of business, and that the value of one's ownership interest in the company is thus tied to his ability to liquidate the company, or to transfer that ownership to another licensed professional.

**2. Split Interest Acquisitions.**

Creditors generally avoid levying upon assets that the debtor co-owns with another party (such as a sibling). Accordingly, a debtor may wish to consider acquisition of property in conjunction with another person. A creditor who acquires such property will be forced to co-own the property with the non-debtor third party, with the attendant costs, duties and responsibilities owed to the co-owner.

**3. Family Limited Partnerships.**

A "family limited partnership," i.e., a limited partnership in which all of the partners are family members, is a technique used by estate planners to achieve a variety of objectives. These objective include providing centralized management of family investments; allocating income among family members in an income tax advantaged manner (subject to certain limitations imposed by Congress); reducing estate values for older generation partners; and simplifying annual gifting and other transfer techniques. Limited partnership interests may deter creditors from attaching property, due to their inability to reach partnership assets or compel distributions. The source of this deterrence is that a creditor who attaches a partner's interest in a partnership is not thereby made a partner. Rather, the creditor becomes an "assignee" of the interest under state law. An assignee does not have the right to withdraw from the partnership, or terminate the partnership prior to its stated term. An assignee's only right is to receive distributions from the partnership at such times and in such amounts as the general partner may determine. On the other hand, an assignee must pay tax on his share of the partnership's income, whether or not such income is distributed to him. As a consequence, a creditor may find himself in a situation where he must pay tax on income that he cannot reach. This exposure often deters creditors from seeking to attach partnership interests. An entity structured as a limited liability company can provide similar benefits.

## VI. The Impact of Bankruptcy Reform.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made some dramatic changes to the rules relating to asset preservation. Prior to the adoption of the new law, the Bankruptcy Code permitted a debtor in bankruptcy to opt for federal exemptions or the exemption rules available under state law. Most Texans opted for our generous state law exemptions. In fact, there were reports of debtors moving to Texas (or Florida) just prior to filing bankruptcy simply to take advantage of favorable state law exemptions. While the changes brought about by the new Act are significant, it must be remembered that they apply only for debtors who have sought the protection of the Bankruptcy Court. Unless the debtor is in bankruptcy, the state law exemptions and statutes of limitations outlined above continue to apply without restriction. Bankruptcy reform limits the availability of state law exemptions in a number of ways for debtors who are

subject to the jurisdiction of the bankruptcy court. If a debtor is in bankruptcy, the statute of limitations, exempt property rules and exemptions for IRAs, SEPs and Section 529 plans are all impacted.

**A. Extended Look-back Rules.**

The Bankruptcy Act now provides that the look-back period during which a trustee in bankruptcy may recover a fraudulent transfer is two years instead of one year (for all cases filed after October 17, 2006). If the transfer is to a trust of which the grantor is a beneficiary, the look-back period is extended to ten years if the trustee can prove an actual intent to defraud creditors. While this look-back period is extreme, asset protection counsel note that the burden of proof to establish an actual intent to defraud is quite high. Perhaps more importantly, the statute seems to implicitly sanction the use of self-settled "foreign" trusts for asset protection if there is no actual intent to defraud, or if more than ten years have passed.

**B. Limitations on Homestead Exemptions.**

The Bankruptcy Act provides a much-publicized limitation on the homestead exemption.

**1. "New" Equity.**

A debtor may not exempt more than $160,375 under the homestead exemption if the interest was "acquired" within 1215 days (40 months) of the filing date. Therefore, if more than $160,375 is paid down on a mortgage within about 40 months of filing bankruptcy, the excess would not be exempt. In addition to the $160,375 exemption, however, any equity rolled over from a previous homestead *located in Texas* that was owned for at least 1215 days is also exempt. It appears that equity rolled over from a homestead in another state, even if that state has an unlimited homestead exemption, is not allowed.

**2. Appreciation as Equity.**

The new Bankruptcy Act left open the question of whether the $160,375 limitation applied only to payments made for the home or against a mortgage, of if the value includes appreciation in the value of the property. A recent court ruling held that a debtor does not "acquire" an increase in value in the same way that one acquires title or a reduction in debt by virtue of payment. Therefore, it appears that appreciation is not considered in applying the $160,375 limitation. In the same case, the court noted that the purpose of the provision was to prevent out-of-state debtors from moving to states to take advantage of more advantageous homestead exemptions.

**3. Family Farmers.**

Family farms are not subject to the limitation on homestead equity. As a result, family farmers in Texas still have an unlimited homestead exemption (up to 200 acres), even in the context of bankruptcy. A "family farmer" is an individual engaged in farming operations with debts less than $4,153,150, at least half of which arise from farming operations, and at least one half of the debtor's gross income arises from farming.

**4. "Criminal" Conduct.**

If the debtor has engaged in certain criminal conduct, the homestead limitation is limited to $160,375, regardless of jurisdiction, length of stay, "rollover" of equity, or any other exception, unless the debtor can demonstrate that the homestead is reasonably necessary to support the debtor or the debtor's dependents. The conduct to which this limitation applies is rather loosely described. It includes: (i) a debtor owing a debt arising from a violation of federal securities laws; (ii) a debtor owing a debt arising from a criminal act, intentional tort, or willful or reckless misconduct, causing serious physical injury or death to an individual, or a penalty relating to a violation of federal RICO statutes in the five year period prior to the filing of the bankruptcy; (iii) or conviction of a felony, which under the circumstances demonstrate that the filing would constitute an abuse.

**5. Conversion of Non-Exempt Property.**

As mentioned above, a common strategy for Texans is to convert non-exempt property into exempt property. While Texas law has prohibited such a conversion if done with the actual intent to delay, hinder or defraud a creditor, the federal bankruptcy courts have often held that such a conversion is not necessarily fraudulent to creditors. Under the new statute, however, *in addition to the 1215 day limitation*, a state homestead exemption will be reduced by the amount of the value of the homestead attributable to any property disposed of by the debtor during the preceding **ten** years, if it can be established that the property

disposed of or converted was not exempt at the time of the disposition, and that the disposition was done with the actual *intent to hinder, delay or defraud a creditor*.

**C. Cap on IRA and SEP Investments.**

The new Bankruptcy Act limits any exemption for IRAs and SEPs to an aggregate of $1,283,025. However, the exemption does not apply to amounts held in qualified retirement plans or to amounts rolled over from a qualified plan to an IRA or SEP. The new Act does not address how mixed IRAs (or appreciation in a rollover IRA) is to be addressed. Until additional clarification is provided, clients rolling retirement account assets into an IRA may be well advised to maintain segregated accounts for the rollover funds.

**D. Education IRAs and Section 529 Plans.**

If contributions are made by a debtor to an Education IRA or to a Section 529 account within 365 days of filing bankruptcy, those contributions may be set aside and added to the bankruptcy estate as a transfer to an "insider." If more than 365 days have elapsed, but less than 720 days have passed, the transfers are exempt up to $6,425 per beneficiary. Amounts contributed more than 720 days prior to filing bankruptcy are exempt from the creditors of the debtor.

## VII. The Lawyer's Role.

Canon 7 of the Texas Code of Professional Responsibility provides that an attorney must "represent his client zealously within the bounds of law." Disciplinary Rule 7-102, which interprets this Canon, provides that an attorney must not "counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent." While the foregoing material suggests several planning techniques that may be suitable to implement in proper circumstances, it also describes conduct that might, in extreme cases, constitute fraudulent conduct. No reputable attorney will knowingly assist a client in undertaking actions that constitute fraud. Clients should neither suggest that their counsel assist them in committing actual fraud, nor be surprised if their counsel refuses to assist them to engage in such conduct.

## VIII. Conclusion.

The foregoing discussion provides a sampling of the factors to consider and the techniques available in planning to preserve assets. The considerations set forth must, of course, be tailored to each individual case to determine which techniques, if any, are appropriate for any given individual. One must weigh the cost and inconvenience associated with engaging in one of these techniques against the likelihood of attack by a creditor. Many potential debtors choose to defer action until creditors are "knocking on the door." As indicated above, however, timing, motive and forethought are critical elements in the effectiveness of any asset preservation planning. Transfers of assets to place them beyond the reach of known creditors with fixed claims are simply ineffective. Accordingly, individuals with the most foresight will reap the most benefits from these techniques.