

The Land Trust for Asset Protection

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The land trust is more useful in holding title to second homes and investment real estate than for your primary residence. You name a trustee to hold record title to the property subject to your direction (as beneficiary) on all matters affecting title. Because of the limited function and purpose of the trust, the trustee does not attract as much fiduciary liability (including liability for the costs of toxic waste contamination) as would ordinarily be the case. For those reasons, the fees are extraordinarily low.

This vehicle has some utility in transferring beneficial ownership to a foreign trust, whether Delaware or Bermuda. A lack of reciprocity between 46 states and all other jurisdictions of the world prevents out-of-state corporate trustees from holding direct title to local real property. Use of the land trust converts the real property interest to a personal property interest. That way, the corporate trustee may hold the beneficial interest in out-of-state real property. Just keep your focus: there is no protection if the aggressive judgment creditor figures out that you are the beneficial owner; *i.e.*, you are the settlor-beneficiary of a revocable domestic or foreign trust that owns the land trust interest. I use it when, for whatever reason, you cannot or chose not to sell the property and redeploy the proceeds to the foreign trust.

Land trusts were first established decades ago as "Illinois Land Trusts." Almost all commercial and industrial real estate in the northern part of Illinois is held this way. Transfers on sale are accomplished by means of an assignment of beneficial interest under the land trust, rather than by deed. This form of trust was later recognized by statute in several states, by case law in others,¹ but never gained widespread use. You might not find it available in your home state.

A basic consideration is that most states deny full reciprocity to the corporate trustees of any other state or country. That means, while non-trustee corporations and individual trustees may hold direct interests in out-of-state real property, corporate trustees may not.² Stated another way, individual trustees may hold direct title to real property throughout the United States, and *all* trustees (individual and corporate alike) may hold *personal* property (stocks, bonds, bank accounts, etc.) wherever located. Two states have laws denying recognition to any corporate trustee not *domiciled* there. One such law was challenged (Florida) and found unconstitutional as an unlawful interference with the commerce clause.³

The U.S. Supreme Court reversed that ruling on the ground that the constitutional issue was not adequately raised at the trial court level. The issue was remanded for further proceedings, leaving the possibility that such a statutory restriction may be ultimately held invalid. Interestingly, that case was cited with approval in two other cases, underscoring the probable direction of things.⁴

In order to place the selected real property in the family trust (whether domestic or foreign), you first convert it from a *real* property interest to a *personal* property interest. We may do that by conveying it to a corporation, partnership or LLC, but for purposes of this discussion, we do it by transferring the property to a land trust. One feature of the trust agreement is that the beneficial interest is personal property. *That* is the interest we deliver to the family trust. In the trust agreement, the beneficial interest is characterized as *personal* property. State law must recognize this change in character, so if land trusts are a rare commodity in your state, this point must be examined.⁵

By holding title through a land trust domiciled in the state where the property is located, your foreign trust or domestic family trust holds the beneficial interest as *personal* property, and record title is held by the domestic trustee. Thus, there is no out-of-state trustee of *any* stripe holding record title to the real property, and therefore no concern about state recognition.

Your home is an obvious target for the creditor (or prospective creditor) doing an asset search. A reasonable creditor will assume that you are a homeowner, so you should concede the point by placing the home in the family trust with your other semi-public holdings. After all, if you are a target defendant, you are probably a prominent and successful business or professional person, so no creditor or judge will believe that you rent your home. Attempting to hide it in a land trust serves no useful purpose, and may well lead the creditor to other assets. The land trust should be used for *other* real property, especially if the plan contemplates the use of a foreign trust as its central feature.

You may transfer partnership property to a land trust, continuing to use the partnership agreement as the basis for instructing the trustee on all matters affecting title. The trustee signs all leases, notes, deeds of trust, and other records pertaining to the property; it is the legal owner. However, you must do all the work (leasing, evicting, insuring, maintaining, etc.) and prepare those papers for the trustee to sign. You also hold the trustee harmless from all liability.

Your name does not appear on the deed; rather title is held in this manner:

[Name] Trust Company, Trustee, Trust Number [1234]

The trust agreement is not recorded. In the event a judgment is taken against you and the creditor learns of the trust, that creditor may subpoena the production of trust records. It is at that point that the evidence will lead to a court order authorizing a charging order or lien foreclosure against the beneficial interest.

As a matter of historical practice, the trust agreement ordinarily contains no right to amend or revoke. That requires you to look to state law, although the tax consequences are determined by federal tax law.⁶ The common law rule adopted in most states is that a trust in which no power to revoke is expressly reserved is irrevocable, and that no right to revoke is implied from the grantor's silence.⁷ A few states have reversed the common law rule, treating a trust as revocable unless expressly made irrevocable.⁸ Under local law, an irrevocable trust may be reformed, usually by petition to the probate court. In most states, the basis may be that it was made irrevocable by fraud, duress, undue influence, or mistake.⁹ Drafting error or a simple misunderstanding of its import may serve in some jurisdictions.¹⁰ In California, reformation is available with the consent of all beneficiaries and court approval,¹¹ by the settlor and all beneficiaries *without* court approval,¹² and based on changed circumstances.¹³ The following footnote lists the points to be researched in ascertaining if, or the extent to which, the land trust is recognized in your state.¹⁴

The trust agreement usually establishes a specific term, at the end of which it either expires or is extended. It also provides for who will receive the beneficial interest of a beneficiary who dies during the term of the trust.

The fees of the trustee are usually modest, and – as above – you remain in full control: you may change or cancel the trust, you may put property in and take it out, and as beneficiary you direct the trustee in all matters affecting title. If you rent out the trust property, you prepare the lease for signature by the trustee; same thing for refinancing or sale. You hold the trustee harmless for your actions, of course.

Title records are structured as a grantor-grantee index, so computer database searches first seek all properties vested in your name as grantee. The careful investigator, however, will conduct a second search for those in which you are the grantor. That will disclose your conveyance of real property to the land trust trustee. This exposure is slightly reduced by conveying the property first to a straw

man, who concurrently conveys it to the trustee.

The land trust provides imperfect protection because the judgment creditor who discovers it may obtain a charging order lien for trust distributions, and may (in most states) foreclose on that lien. This makes it all the more important to either sell the properties and transfer the proceeds to the foreign trust, or render the properties unattractive to the creditor by the use of loans.

For practical reasons, the trustee is usually a corporate fiduciary. Corporations don't die, lose interest in the job or move away, and mistakes can be rectified by means of a collectible judgment.

Following are some of the benefits commonly attributed to the land trust:

- Often, the beneficiary has a legitimate need to avoid disclosure of the property interests. This is particularly true in the acquisition of large parcels of land by developers. Otherwise, sellers realize what is taking place and collude to raise prices. Just as often, persons of means prefer not to attract the attention of those prospecting for wealthy individuals, and so seek to avoid record ownership. Privacy of this nature is not without criticism: Slumlords sometimes hide their ownership so as to make it difficult for public agencies to enforce municipal codes. On balance, however, the legitimate interests of those seeking privacy by this means outweigh the prospect of any such abuse.

- Probate administration of a decedent's estate takes place in the county in which that decedent resided at the time of death. The probate estate includes real property in the state of domicile and personal property everywhere. Real estate, though, is governed by the law of the state (or country) in which it is located. That means the home-state probate court orders have no effect on out-of-state real property. To pass the out-of-state real property to the devisees, an *ancillary* probate administration proceeding is required, in the county in which the real estate is located. By converting the interest of a land trust beneficiary from real property to personal property, that ancillary probate proceeding is avoided, perhaps along with estate or inheritance taxes in that state.

- The property of the decedent passes to whoever is going to receive it in one of three ways: by *title* (typically joint tenancy), by *contract* (typically life insurance, trusts, pay-on-death accounts, pre-retirement death benefits of a pension plan) and by *probate administration* (whatever is left). The inclusion in the

probate estate of a deceased beneficiary's interest in the land trust may be avoided by at least two means: one is to issue the certificate to the beneficiary's personal trust, and the other is to provide in the land trust agreement for who is to receive that beneficial interest upon death of the beneficiary.

□ Where several people are beneficiaries of a land trust, there is continuing risk that one or more may encounter difficulties resulting in a personal judgment. The judgment will not impair the interests of the other beneficiaries because it will not constitute a lien on the real property itself, only on the beneficial interest of that beneficiary-judgment debtor. As a consequence, the other beneficiaries (perhaps with the judgment creditor now included) may continue to deal freely with the development, rent, refinancing and sale of trust property without a cloud on title from any such judgment.

□ The real property held in the land trust is not, in and of itself, subject to the dower, community property or other marital rights of the beneficiary. Consequently, instruments dealing with title to the property need not be executed by a spouse, only by the trustee. That permits continued trust property operations notwithstanding marital strife among multiple beneficiaries. Such strife will involve only entitlement to the certificate of beneficial interest in the trust estate, not the trust property itself.

□ In addition to death and marital disputes noted above, the incompetence or bankruptcy of a beneficiary need not interfere with the conduct of trust business. Under other methods of holding and developing real property, the death or incompetence of an owner will invariably produce delays as an executor or conservator is appointed by the court and authorization is sought to continue with the project.

□ By converting the interest from one in real property to one in personal property, that interest may be transferred with a simple written assignment. This permits its sale or gift without a public record of the transaction and without the related expense and delay of procuring title policies.

□ While it may strain the imagination, given normal banking practice, it is at least theoretically possible to make a collateral assignment of the beneficial interest as security for a loan. Any such transaction is separate from any loans secured by a charge on the trust's real property, and will not impair trust operations.

□ Partition is a legal proceeding by which one or more owners of real property (but fewer than all) may force division or sale of the property in order to liquidate their interest. The property in the land trust, being owned by the trustee and not the beneficiaries, is not subject to a partition proceeding, thus sparing the trust and other beneficiaries this risk.

□ By providing in the trust agreement for distribution on death of a beneficiary, the land trust may be fully integrated with personal estate planning needs.

□ The land trust lends itself nicely to protecting the beneficiary in the acquisition, development and operation of smaller apartment developments, condominium apartments or cooperatives. Anonymous purchase of the land means sellers are less likely to inflate property prices. Unit owners do not know the owners, thus do not bother them with complaints.

□ An especially attractive feature of the land trust is its utility in holding property for partnerships, both general and limited. By this means, property operations may be protected from interference arising from liabilities of the partnership or disputes between the partners. The governing provisions of the partnership agreement also serve as an effective substitute for the management agreement otherwise used in instructing the trustee as to matters affecting title where there are multiple beneficiaries.

□ Using a corporation as beneficiary creates liability protection for the shareholders and, by means of the officers appointed by its board, also serves as a substitute for the management agreement noted above. Tax issues related to corporate ownership are discussed elsewhere.

□ The land trust is in wide use for holding title to agricultural land. It is of special interest to farming families wishing to pass the property through succeeding generations without risk of partition by dissident heirs.

In order to understand the uses of land trusts, you must clearly distinguish the roles of trustee and beneficiary. The trustee owns the property, subject to your right as beneficiary to instruct on all matters affecting title. You hold *only* that right and the right to enjoy the net distributable income of the trust.

Under common law, the trustee is not your agent. A superficial analysis of the

relationship between trustee and beneficiary *suggests* an agency relationship. However, the courts uniformly hold that reserving or granting a power of direction does not create an agency. As a result, the trustee always acts as *principal*, never as *agent*.¹⁵ As principal, and subject to statutory exceptions, the trustee is always liable for acts taken and responsibilities assumed in its representative capacity.¹⁶ For this reason, you may expect the trustee to protect itself with release and indemnification provisions in the trust agreement. A second legal consequence is that the trustee may not create a liability enforceable against the beneficiaries without their consent.

As beneficiary, you are not the agent of the trustee, either. In managing the property and giving instructions to the trustee, you act strictly on your own behalf; any obligations incurred are enforceable against you alone, not the trust or the trust property. You may not sign anything on behalf of the trustee. Rather, you make the deals but prepare the documents for signature by the trustee alone. That gives the trustee a chance to decide *before* the fact whether it is adequately protected from liability in the proposed transaction.

In the absence of a trust agreement provision to the contrary, multiple beneficiaries are likely to be viewed as partners or joint venturers in conducting the trust-owned real property operations.¹⁷ The usual rules apply: unlimited personal liability for partnership obligations and the acts of other partners taken within the course and scope of partnership operations; and a fiduciary duty to each other requiring full disclosure and fair dealing.

Third parties dealing with the trustee may assume trustee powers greater than actually exist. They may, for instance, rely on the powers and restrictions found in the deed under which the trustee holds title. Those powers and restrictions provide that the trustee has full powers affecting title, and third parties need not examine the trust agreement to ascertain whether the trustee is acting consistently with its duties and obligations. Such deed provisions are neither contrary to law nor to public policy, and are given effect as a means of enabling third parties to deal with real estate in reliance upon the record title of the land trustee.¹⁸

Any beneficiary may, of course, act alone with respect to dealing with beneficial interests in the trust (sale, gift, etc.) It is personal property and, unless restricted by agreement, may be transferred or encumbered just like stock in a corporation.

If used as a syndication vehicle, the land trust may present the same securities law issues as a corporation, partnership or LLC. Federal securities law is found in *The*

Securities Act of 1933 and *The Securities Exchange Act of 1934*. (The "'33 Act" and "the '34 Act, respectively) There, Congress defines the term "security" in a way that includes not only stock, bonds and notes, but "investment contracts, certificates of interest or participation in any profit-sharing agreement" as well as any related warrants or subscription rights.

The regulatory purpose is to protect the public from fraud. The Securities Exchange Commission (SEC) will look to substance, rather than form, in determining whether a given investment constitutes a security. The principal tests are: (a) the investment of funds in a common enterprise; (b) where the investment returns are to be earned from the efforts of others. The states generally apply the same two tests.

For our purposes, this suggests that securities issues arise only where:

- two or more people or entities "invest" by contributing cash or property to a land trust; and
- one or more of them will rely on others to manage the trust property.

On those facts, beneficial interests in the land trust may well be a security. If so, an exemption must be found relieving you from the duty to register the offering with the SEC, or to qualify such interests as an intrastate public offering with your state regulatory agency.

Without an exemption, the purchasers of unregistered or unqualified securities have an absolute right to rescind the transaction and recover their investment with interest. There is no need to prove fraud, material misstatement or material omission. The statute of limitations on enforcement of that right is three years following issuance.¹⁹

Because this use of the land trust is rare, there is no value in discussing the details of establishing exemptions under state and federal law. Suffice it to say that if this is the intended use, seek assistance from competent securities law counsel.

The land trust is classified as a grantor trust. As a consequence, all income, deductions and credits of the trust appear on the personal tax returns of the settlor.

Related to tax classification, established practice is to leave the trust agreement silent on the question of a power to amend or revoke, probably more a result of old habits than considered legal analysis. As a general proposition, leaving this point unaddressed leads to a presumption that the trust may be amended or revoked, or not, depending on local law.²¹

The land trust is a flexible legal entity, capable of more than generally assumed. It is one with important utility in real property acquisition, syndication, development, operation and sale. In addition, it now delivers important features for estate plans, from the most simple to today's elegant litigation-sensitive estate plan.