

Fraudulent Transfer Defenses

F. Bentley Mooney, Jr.

Introduction. Since the evangelical fervor of Jay Mitton first spawned an army of asset protection planners, this pursuit has taken on an “in your face” quality that poorly serves the client. Frequently, a client with a claim unfiled but coming down the pipeline will be advised:

— to transfer all fungible assets to a classic asset protection trust, with or without an underlying family limited partnership,

— and to rely on having acted before the lawsuit is *actually* filed in defending against the fraudulent transfer action sure to follow a judgment on the underlying claim. In short, constructing a legally sufficient defense to the fraudulent transfer claim gets short shrift in the process, and weak tools like the duress clause and partnership dissolution trigger arrangements are employed as the principal protective tools. Those who follow that pattern live in a fool’s paradise.

The Duress Clause. The purpose of a duress clause is, for *public* consumption, a tool to be used by ransom negotiators if the prominent, wealthy client becomes a kidnap victim. The *real* purpose, as is freely admitted by most, is to provide a means by which the client may foreclose one of the three *prima facie* elements required for a contempt of court citation. It comes up after the underlying lawsuit is lost, and after the judgment creditor conducts supplemental proceedings, learning that the most desirable assets were placed beyond his reach just in time, and after the client is found guilty in a subsequent action of committing a fraudulent transfer. Here is a typical duress clause:

“ 10. **Duress.** Notwithstanding any provision herein to the contrary, if Trustee perceives that Settlor provides any direction under duress from any source, Trustee may follow such direction, or refuse to follow it, or take any other action with respect to it or the Trust Estate, which it, in its sole and absolute discretion, believes to be in the best interest of Settlor under the circumstances.”

If the asset protection clients of others bear any reasonable resemblance to mine, *something* has scared them into calling me. If the lawsuit is not already filed, it will not be long. Without going into detail on fraudulent transfer law, there is a good chance that any asset transfers will be seen as fraudulent unless undertaken with care and foresight. Of course, if the plan is established well in advance, almost anything works. But it is rare for anyone to be so far-sighted. After all, bold planning is not for the faint of heart, and transferring money thousands of miles away, entrusting it to strangers, is a huge leap of faith. So let us accept the fact that in many cases, there is a

serious prospect of a fraudulent transfer action in the near future.

Having, state-by-state, now eliminated debtors prisons as violations of constitutional due process and equal protection, the only remaining vehicle for incarcerating debtors is by first holding them liable for a fraudulent transfer. The court issues a mandatory injunction: “Bring back the money or sit in jail ‘til you change your mind!” The *prima facie* elements the judgment creditor (as plaintiff in the fraudulent transfer action) must plead and prove are (a) a *lawful court order* (the injunction), (b) *known to the contemnor*, and (c) *willfully disobeyed*.

The client does not deny the lawfulness of the court order, or that he was aware of its existence. But by means of the duress clause, he aims to render it impossible to obtain the result desired by the court – repatriation of the transferred assets. Often mischaracterized as the “impossibility” defense, it will work in most cases if established far enough in advance of the underlying claim to “season”; *i.e.*, the more time that passes between the transfer to an offshore trust, the more credible becomes the clients story about why the transfer was made in the first instance. As noted, few are so far-sighted.

More often, the court makes its order, the client replies, “Write the letter, judge, and I’ll sign it.” The letter is posted, then the client calls the trustee to report the events of the day. In due course, a reply letter is received from the trustee, stating that it perceives the instruction as given under duress, and it chooses not to comply. The client dutifully reports back to the court, the judge shouts in exasperation, “You goin’ to jail, boy!” The client responds, “You can’t do that, judge. Contempt of court requires a lawful court order, known to the contemnor, and willfully violated. I didn’t disobey your order, judge. I just can’t get the result you want.” Well, the client may be technically correct, but go to jail anyway. The result turns on all the facts and circumstances. Illustrative of the point is *FTC vs Affordable Media, LLC*.¹

Mr. and Mrs. Anderson owned a telemarketing venture in which they sold infomercial “media units” for \$5,000. Each unit entitled the investor to participate in the sale of products. The projected return on investment was 50% within 60 to 90 days, *after* the Andersons received a 45% commission on each unit. This came to the attention of the Federal Trade Commission (FTC), which filed suit against the Andersons and their company. The charges included various violations of the Federal Trade Commission Act and the Telemarketing Sales Rule. The FTC claimed that the Andersons received more than \$6 million in commissions, and that the enterprise was a Ponzi scheme.

While this was going on, the Andersons transferred most of their assets to a Cook Islands trust. But like most Americans, they suffered from the *Fortress America* fiction; *i.e.*, the check is at risk as soon as it is 20 feet off the beach. That led them – foolishly – to write themselves in as co-trustees and as protectors of the trust. The FTC learned of it and obtained temporary restraining orders and preliminary injunctions, requiring the Andersons to repatriate the assets. They dutifully transmitted a memorandum to the trustee to that effect, receiving in reply a

notification: that the instructions were perceived to arise from “duress”; that their positions as co-trustees was thereby terminated; and that the assets would not be returned.

The Andersons were found in contempt of the court’s orders and jailed, where they remained for six months. They remained in contempt, even after their release in mid-December 1998. They appealed both the contempt order and the denial of their “impossibility defense.” Unfortunately, the Ninth Circuit Court of Appeals affirmed the trial court. The courts comments are instructive.

Noting the burden of proof and the evidentiary standard (“clear and convincing”) was carried by the FTC, the burden shifted to the Andersons to demonstrate why then are they unable to comply with the court order. Although viewed as *dicta* (not necessary to the ultimate decision), the perception of the court was well-expressed in these few pithy words:

“We are not certain that the Anderson’ inability to comply in this case would be a defense to a finding of contempt. It is readily apparent that the Andersons’ inability to comply with the district court’s repatriation order is the intended result of their own conduct – their inability to comply and the foreign trustee’s refusal to comply appears to be the precise goal of the Anderson trust.”

Thus, even though the court based its decision on the conclusion that the Andersons failed to show that the trial court decision was “clearly erroneous,” its review of published articles on asset protection planning demonstrated that it was fully aware of the duress clause and its function. The implication is that if no more commonly-accepted legal basis for affirming could be found, the court is perfectly willing to consider basing it on the notion of self-created impossibility. To that point, the court noted that the Andersons’ burden of proof is “particularly high” because of the likelihood that any supposed attempted compliance is a charade.

Practitioners overstating the value of the duress clause are leaning on a bent reed.... bent reed number 1. Let us now turn our attention to bent reed number 2.

The FLP Dissolution Trigger. Because of two California cases and a supporting provision in the next version of the *Uniform Partnership Act*,² a number of practitioners now include in their family limited partnerships (FLPs) a provision enabling the limited partner – a foreign trustee holding a 99% capital interest in the FLP – to compel the general partner (who is also the judgment debtor) to dissolve the FLP and distribute the assets. The debtor-general partner sees the whites of the judgment creditor’s eyes, tips off the foreign trustee-limited partner, in comes the dissolution order, the partnership is dissolved and the assets are gone before the judgment creditor can levy. The debtor then stands before the court, lower lip quivering, and asks in substance, “What could I do? Under the terms of the FLP agreement I *had* to comply.”

Well, really now. Although the “impossibility defense” is an imperfect fit, the “spring gun” cases come to mind.³ As general partner, the debtor is in control of the FLP assets because the general partner holds 100% of the *management* rights. The spring gun cases comprise a long line of court opinions holding that it is premeditated murder or assault with intent to kill if someone rigs a weapon to discharge when a thief attempts to enter the private property. The usual fact situation is a farmer rigging the rifle to fire down a fence line when the thief climbs over to steal from the farmer's crop.

Think about the logic involved: the person who placed the mechanism in place, intending the probable result, is held responsible for the harm that follows. In this case, the debtor-general partner included the special clause (certainly "special," because such powers are ordinarily *withheld* from limited partners) by which the partnership assets were yanked away from the approaching creditor. Do you really believe the judge will not treat that act as the act of the debtor? Given the comments of the Ninth Circuit Court of Appeals in *Anderson* (above), it has fraudulent transfer liability written all over it.

Weigh the Value of the Available Tools. This view of the protective steps available to litigation-plagued clients has served as my mantra since 1984, when I spent nights and weekends for 11 months, consuming seven thousand-plus pages of reference material in preparing to write *The Artful Use of Offshore Tax Havens*. You cannot win playing to your weak suit. Nothing *really* bad happens unless you are found guilty of making a fraudulent transfer, so the planning focus must be on eliminating that prospect. To instead rely on a purported inability to control the foreign trustee, or on a self-created obstacle to enforcement of judgment, is to invite disaster – perhaps a malpractice action. There are many opportunities for defensive planning around fraudulent transfer exposure if you really know the territory, and *that* is where the planning focus belongs.

Endnotes

1 (9th Cir, June 15, 1999, Number 98-16378) 99 Daily Journal DAR 5991, 99 Recorder CDOS 4689.

2 *Centurion Corporation vs Crocker National Bank* (1989) 208 CA3d 1, 255 CR 794; *Hellman vs Anderson* (1991) 233 CA3d 840, 284 CR 830. The courts have the power to order the execution sale of the partnership interest if the creditor is unable to recover under a charging order.

3 Actually, there is an exception if the victim is actually a burglar shot inside the home. But you are hung out to dry if the victim is instead a child, or a fireman entering to extinguish a blaze, a police officer making a property check of the building or a trespasser entering without burglarious intent. (*Commonwealth vs Keith*, 46 Berks 137 (Pa.Co.1954); *Pierce vs Commonwealth*, 135 Va 635, 115 S.E. 686; *State vs Green*, 118 S.C. 279, 110 S.E. 145 (1921); *Simpson vs State*, 59 Ala 1 (1877); *State vs Plumlee*, 177 La 687, 149 So. 425 (1933); *United States vs Gilliam*, 25 Fd.Cas. 1319, #15,205a (CCDC 1882)). Some states have forbidden the use of mechanical devices intended or likely to cause death or great bodily injury. (*Oregon Revised Statutes* §166.320 (1953); *Schmidt vs State*, 159 Wis. 15, 149 N.W. 388 (1914))