

FEATURE: ESTATE PLANNING & TAXATION

By **George D. Karibjanian**

The Uniform **Voidable** Transactions Act Will Affect Your Practice

It casts a wider net than you might think

To most estate planners, the July 2014 conversion by the National Conference of Commissioners on Uniform State Laws of the Uniform Fraudulent Transfer Act (UFTA) into the Uniform Voidable Transactions Act (UVTA) was an under-the-radar non-event. After all, according to the Uniform Law Committee (Committee) on the UVTA, the stated intention behind the UVTA was to tighten existing creditors' laws. Such a move was, and should be, applauded, because creditors need more ammunition when faced with unscrupulous debtors. On careful review, however, the UVTA isn't a perfect solution for all areas of the law. The UVTA casts a wide net, and it's within that net that unsuspecting estate planners and their clients may be caught.¹

The Law Behind the Law

As of the date of this article, eight states have adopted the UVTA—California, Georgia, Idaho, Kentucky, Minnesota, New Mexico, North Carolina and North Dakota.² Legislation has been introduced for 2016 passage in Indiana, Iowa and Massachusetts.³ With the exception of a jurisdictional venue statute and the introduction of certain burdens of proof, most of the changes from the UFTA to the UVTA are minor. So, if not much has changed with the actual uniform law, why worry about its enactment? It's not the technical statutory language that should worry estate planners, but the official interpretation of the UVTA and how courts will apply

that interpretation.

So, how is the UVTA to be applied? As with every statute, it begins with learning the legislative intent. Unlike the Internal Revenue Code, most state laws don't have secondary sources from which legislative intent can be derived. For such laws, the best guide to intent is a review of the analysis behind the particular legislative bill containing the law. In many instances, there may not be any such analysis, but if the particular statute is modeled from a Uniform Act, the applicable Committee will have enacted official comments (Comments) to the particular uniform law. How important are the Comments? They often become the primary source for legislative interpretation.⁴ This means that through the Comments, the particular Committee can directly affect how the legislature interprets a statute based on a uniform law. Consider the words of Professor Kenneth C. Kettering, the Committee's official reporter for the UVTA: "The Drafting Committee's mandate narrowly limited its authority to revise the [UFTA], but the committee had a free hand to revise and refresh the official comments as it thought best."⁵ With the UVTA, the Committee adopted several pages of new Comments, many of which will impact estate-planning techniques.

Wait, though—since Comments aren't adopted as law, how, then, can they shape the interpretation of the law? While there's an expansive body of debtor/creditor law, not every potential scenario has a judicial or administrative interpretation or explanation. For these particular scenarios, there's no current law on point, which means that courts are left to interpret the impact of that particular scenario. A court may look to official Comments for guidance, and thus the court may be swayed by a position advocated by the Comments regardless of whether the Comments substantiate that



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position (for example, the Comments may say that the color of something is “red” without providing any judicial or legislative proof for the conclusion). The new Comments, therefore, can actually have the effect of creating new law based on the mere thoughts of the Committee.

Four Planning Concerns

From an estate-planning perspective, the Comments take positions that directly affect four commonly used estate-planning techniques. These are: (1) asset substitution; (2) entity formation and conversion; (3) domestic asset protection trusts (DAPTs); and

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(4) homestead laws.

1. Asset substitution. This is the exchange of an asset that’s more reachable by a creditor for one that’s less reachable.

The analysis begins with a review of (arguably) the most prominent section within the UVTA, which is Section 4(a)(1).⁶ This section states, in part:

SECTION 4. TRANSFER OR OBLIGATION VOIDABLE AS TO PRESENT OR FUTURE CREDITOR.

(a) A transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor’s claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the

obligation:

(1) with actual intent to hinder, delay, or defraud any creditor of the debtor ...

It’s important to emphasize the basic premise of Section 4—it applies not only to present creditors, but also to future ones. Although the UVTA didn’t modify much within Section 4, it added several pages of new Comments. The third paragraph of new Comment (8) to Section 4 (Paragraph 3) focuses squarely on asset substitution. Paragraph 3 provides:

A transaction that does not place an asset entirely beyond the reach of creditors may nevertheless ‘hinder, delay or defraud’ creditors if it makes the asset more difficult for creditors to reach. Simple exchange by a debtor of an asset for a less liquid asset, or disposition of liquid assets while retaining illiquid assets, may be voidable for that reason.

It’s important to note that Paragraph 3 omits one key word from Section 4(a)(1)—“intent.” The Committee doesn’t inadvertently omit words, so we must presume that this omission is intentional. Will this omission be interpreted to mean that the Committee is stating that “intent” is always present unless proven otherwise? If so, this interpretation is the equivalent of shifting the burden so that, even as to a future creditor, an asset substitution is de facto voidable unless proven otherwise by the debtor. Isn’t this backwards—in the absence of clear intent, shouldn’t the burden be on the creditor to prove that the debtor intended to hinder, delay or defraud future creditors?

While the Committee apparently intended that this paragraph apply to a debtor attempting to avoid a current debt by trying to insert “space” between the debtor and the creditor, the issue for estate planners is that they’ve recommended that their clients engage in this exact technique without even considering creditor avoidance. Consider the estate freezing technique, in which a settlor creates an irrevocable trust, taints the trust for income tax purposes so that he’s the income tax owner of the trust and then sells assets to the trust in exchange for a promissory note. The sale has the effect of “freezing” the value of the estate at the then-value of the transferred assets via the note. The customary provision to attain grantor trust status is the retention



by the settlor of the unilateral right to transfer assets into the trust in exchange for other assets of equal value (the IRC Section 675(4)(C) substitution power). The substitution power is usually exercised by transferring cash or high basis assets to a trust in exchange for low basis assets. If, subsequently, the settlor were to unexpectedly die, the low basis assets would receive the step-up in cost basis under IRC Section 1014(b)(9).

Suppose that this technique is implemented, and the settlor transfers cash into the trust in exchange for low basis membership interests in a limited liability company (LLC). Assuming that the company is a Delaware LLC, solely because 6 Del. C. Section 18-703 provides charging order protection for LLC interests (that is, a creditor can't receive the interest in satisfaction of a judgment, but rather can only obtain the right to receive any future distributions), the settlor has exchanged reachable assets (cash) for non-reachable assets (the LLC membership interest with charging order protection). Although the swap was undertaken solely for federal income tax purposes, the transaction fits squarely within Paragraph 3, so query whether a future unknown creditor can seek to reverse the transaction and thereby retroactively undo the settlor's tax planning.

2. Entity formation and conversion. There are plenty of reasons why individuals form a closely held entity (such as a family limited partnership (FLP) or an LLC) to conduct business, such as tax advantages and ease of transferability. For example, an LLC may afford the membership owners the ability to pay lower overall income taxes than if the entity were formed as a corporation. For the same reasons, individuals owning a corporation may wish to convert the entity into an LLC. One additional reason for the use of an FLP or an LLC may be the charging order protection described above. The key to the charging order protection is that the partner/member retains full ownership and control over the interest; the creditor only receives the distribution rights.

In the sixth paragraph to new Comment (8) to Section 4 (Paragraph 6), the Committee acknowledges the use of a particular state's entity laws, but continues:

By contrast, if owners of an existing business were to reorganize it as an LLC under such a statute when the clouds of personal liability or financial distress have gathered over some of them, and with the intention of gaining the benefit of

that creditor-thwarting feature, the transfer effecting the reorganization should be voidable under Section 4(a)(1), at least absent a clear indication that the legislature truly intended the LLC form, with its creditor thwarting feature, to be available even in such circumstances.

In attempting to define situations in which asset protection shouldn't be available to a particular member, Paragraph (6) penalizes all of the members regardless of their knowledge of the problems of the particular member and, apparently, without regard to the size of the particular member's interest. For example, if

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10 individuals form an LLC, with nine of them owning 99 percent of the membership interests and one of them owning a 1 percent membership interest, and it's later discovered that the 1 percent member had "clouds of personal liability" over her at the time of the entity formation, what should happen? Logically, given the size of the 1 percent owner's interest, the interest—and only that interest—should either be made available for attachment or subject to forced liquidation; the other owners should be unaffected. This, however, isn't what Paragraph 6 provides. Instead, Paragraph 6 states that so long as some of the owners have creditor issues, then all of them suffer the consequences, that is, the entire transfer is voidable. This is an overly harsh result that could cause havoc for unsuspecting entity owners.

3. DAPTs. The Committee wasn't so subtle in its intentions regarding the third technique, which involves the DAPT.⁷ A DAPT is an irrevocable trust created by a settlor whereby the trustee has full discretion to pay trust income or principal back to, among others, the settlor, and applicable state law prohibits the settlor's creditors from attaching judgments against the trust. As of



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Jan. 1, 2016, 15 states have enacted full DAPT legislation.⁸ Through the Comments, the Committee expresses a desire to eradicate DAPTs. For example, in his explanation of the UVTA, Prof. Kettering states,

The avoidance laws of some jurisdictions are substantially debased by comparison with the UVTA ... Section 10 reflects the committee's conclusion, which was to include no escape hatch in the statutory text. It addresses asset tourism through a comment stating that a debtor's 'principal residence,' 'place of business,' or 'chief executive office'

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should be determined on the basis of genuine and sustained activity, not on the basis of artificial manipulations.⁹

DAPT states will market themselves to residents of non-DAPT states seeking certain protections from creditors. Until the UVTA, the uncertainty of which state law applies to a transfer to a DAPT allowed a DAPT state to disregard any judgment seeking attachment against one of its trusts for the return of certain assets. That is, the DAPT state wasn't bound to grant the domiciliary state's judgment full faith and credit (FF&C) under the U.S. Constitution. For example, suppose that, prior to California's enactment of the UVTA, a California resident created a South Dakota DAPT. If the California courts had awarded a creditor a judgment against the trust settlor, it was unlikely that the creditor could force the return of the assets from South Dakota, as the South Dakota courts would likely say that

South Dakota law governed the transfer. Fast forward to 2016—with California having adopted the UVTA and, in particular, Section 10¹⁰—does this impose any pressure on the South Dakota courts to grant FF&C to the judgment? After all, unlike pre-UVTA laws, the California legislature has officially determined that California law should apply to the transfer. What if both states had adopted the UVTA? In this instance, attachment would be veritably assured as, under these facts, South Dakota would have recognized under Section 10 that California law—the state where the transaction originated—governs the transaction.

4. Homestead laws. Section 10 not only affects DAPTs, but also may affect a particular state's homestead laws. In general, homestead laws provide the surviving spouse and descendants with certain protections from creditor attachments (other than those direct obligations, such as secured mortgages). Florida is known for its staunch homestead creditor protection, most notably from the 2001 Florida Supreme Court decision in *Havoco of America, Ltd. v. Hill*,¹¹ which provided that Florida constitutional homestead protection is superior to a violation of the statutory fraudulent conveyance laws.

Under the UVTA, however, it might be possible for one state to determine the effect of another state's homestead laws. In *Havoco*, a Tennessee resident, after a judgment was rendered against him, purchased real property in Florida and declared himself to be a Florida resident, thereby taking advantage of Florida homestead protection and avoiding any attachment against the homestead. Suppose that the facts in *Havoco* occur in 2016 and that the defendant was initially a resident of California. By applying Section 10, California has the jurisdiction to determine the voidability of the transaction and, in doing so, may actually render an opinion on Florida's homestead laws. If Florida also adopted the UVTA and if the California court determined that the transfer was voidable, would Florida be forced under FF&C to accept the judgment? If so, would this mean that the California court—and not the Florida court—will have created an exception to *Havoco*?

Steps for Estate Planners

The UVTA is noteworthy for its attempt to strengthen creditor's rights, for which no one should take any umbrage. However, in formulating its analysis of the



UVTA, the Committee intentionally set forth overly broad mechanics for its interpretation, which can have serious repercussions for estate-planning attorneys.

Estate-planning attorneys must become educated on the UVTA and learn of its ramifications. The estate-planning bars in jurisdictions that haven't passed the UVTA should press for a "non-acquiescence" of the UVTA-added Comments. In UVTA states, the estate-planning bars should alert their membership as to the potential pitfalls when engaging in some commonly used planning techniques. 

Endnotes

1. Portions of this article are based on George D. Karibjanian, J.J. Wehle, Robert Lancaster and Michael Sneringer, "The Uniform Voidable Transactions Act and its Effect on the Estate Planning Community, Parts One and Two," *Leimberg Asset Protection Planning Newsletters* #316 and #317 (March 14 and 15, 2016). The author expresses his gratitude to J.J. Wehle, Robert Lancaster, Michael Sneringer and Keith S. Kromash for their assistance with the preparation of this article.
2. See Uniform Law Commission, Enactment Status Map & Legislative Tracking, www.uniformlaws.org/Act.aspx?title=Trust%20Code.
3. *Ibid.*
4. See, for example, *In re Nocita*, 914 S.W.2d 358, 359 (Mo. 1996): "When construing uniform and model acts enacted by the General Assembly, we must assume it did so with the intention of adopting the accompanying interpretations placed thereon by the drafters of the model or uniform act ... Generally, comments accompanying a uniform code when adopted have great weight in construing the code;" *Jeld-Wen, Inc. v. PacifiCorp et al.*, 245 P.3d 685, 687 (Ore. Ct. App. 2010): "Commentary to a uniform law adopted in Oregon serves as legislative history;" *Havens v. Portfolio Investment Exchange Inc.*, 983 F. Supp. 2d 1007, 1011 (N.D. Ind. 2013): "Indiana law is quite clear that model or uniform commentary is persuasive when construing an ambiguous statute;" *Yale University v. Blumenthal*, 624 A.2d 1304 (Conn. 1993): "A court can 'properly consider the official comments as well as the published comments of the drafters as a source for determining the meaning of an ambiguous provision [of a uniform act];'" *Coker v. Abell-Howe Company et al.*, 491 N.W.2d 143, 148 (Iowa 1992): "The official comments to the Uniform Act have some persuasive influence in determining what our legislature intended by the language in our comparative fault act."
5. Kenneth C. Kettering, "The Uniform Voidable Transactions Act; or, the 2014 Amendments to the Uniform Fraudulent Transfer Act," 70 *The Business Lawyer* 778 (Summer 2015), at p. 794.
6. Unless otherwise stated, all section references shall be to sections of the Uniform Voidable Transactions Act.
7. A full analysis of domestic asset protection trusts is beyond the scope of this article.
8. Alaska Stat. Section 34.40.110; 12 Del. C. Sections 3536(c)(1), 3570-3576; Haw. Rev. Stat. Sections 554G-1-554G-12; Miss. Code Sections 91-9-701 et seq.; R.S. Mo. Section 456.5-505(3); Nev. Rev. Stat. Sections 166.010-166.180; N.H. Rev. Stat. Ann. Sections 564-B:5-505(c), 564-D:1-564-D:18; Ohio Rev. Code Ann. Sections 5816.01-5816.14; Okla. Stat. tit. 31, Sections 10-18; R.I. Gen. Laws Sections 18-9.2-1-18-9.2-7; S.D. Codified Laws Sections 55-1-36, 55-16-1-55-16-17, 55-3-39, 55-3-41, 55-3-47; Tenn. Code Ann. Sections 35-16-101-35-16-112; Utah Code Ann. Section 25-6-14; Va. Code Ann. Sections 64.2-745.1, 64.2-745.2, 64.2-747(A)(2); Wyo. Stat. Ann. Sections 4-10-103, 4-10-506(b), 4-10-510-4-10-523.
9. Kettering, *supra* note 5, at pp. 800-801.
10. See Cal. Civil Code Section 3439.10.
11. *Havoco of America, Ltd. v. Hill*, 790 So.2d 1018 (Fla. 2001).



SPOTLIGHT

All That Glitters Is Not Gold

"Untitled (Nude and Projection), 1949," by Arthur Siegel, sold for \$5,000 at Phillips' Photographs auction in New York City on April 4, 2016. Siegel had a longstanding career as a photojournalist, working for publications such as *Life*, *Fortune* and *Colliers*. He introduced innovative methods of using color to express emotional states. He's also known for his contributions to photographic education.