Understanding "Estate Planning": Asset Protection or Fraudulent Conveyance

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I. Introduction

Estate planners occupy a unique position in today's highly segmented, high powered legal world. Traditionally viewed as family counselors to families, they are often the confidants to whom the most intimate details of people's lives are revealed. Many are viewed by such clients as the source of wisdom and guidance in human, as well as legal, affairs.

In this context, estate planners are often approached by one member of a married couple who discloses that he or she is contemplating a divorce. What measures, the unhappy client asks, are available to protect his or her assets if the marriage does not survive? The estate planner can suggest numerous measures, from outright gifts to irrevocable trusts, many of which look innocent enough but which are designed to produce the desired result with respect to a property settlement. The purpose of this article is to identify for the divorce lawyer some of the likely "techniques" that can be used to achieve these goals and to suggest ways to undo or counter the offending technique.

This entire discussion is set against a backdrop of trust law, tax law, the law of fraudulent conveyances and the rules of professional conduct. The article will first examine the most likely techniques and, with respect to each, suggest what explanation might be proffered to rationalize its use. The article will then examine whether, absent a fraudulent conveyance, the technique is effective and/or whether there are any lines of attack to under-

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cut the technique. After examining the various techniques, the article will review other, broad based attacks that may be used to "undo" irrevocable transfers by a spouse including the doctrine of fraudulent conveyances.

Finally, the article provides a brief review of the rules of ethics that apply to lawyers advising clients in the pre-divorce context.

II. Estate Planning Techniques

A. *In General*

A comprehensive discussion of estate planning is beyond the scope of this piece. However, to scrutinize the actions of a spouse who claims that he has given away property "for estate planning" reasons, one must have at least a basic understanding of the goals and techniques of the estate planning process.

To begin with, what are the goals? Or, to put a somewhat finer point on it, what estate planning reasons might motivate a spouse to give away property? Most of the time, the answer will fall into one of two categories: 1) to save taxes, or 2) to avoid probate.

1. *Save taxes*

Fundamentally, estate planning is a two-part process. First, one must ensure that one's property will pass to the "correct" beneficiaries in a manner that comports with the needs and capabilities of the beneficiary (*e.g.*, outright or via an appropriately drafted trust). Second, an estate plan should preserve as much of the decedent's assets as possible for benefit of the beneficiaries. The single biggest cost, of course, is the federal estate tax. Accordingly, much of estate planning deals with minimizing the estate tax.[1]

Although a gross generalization, it might be said that there are three basic strategies employed to reduce the estate tax. They are as follows:

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[1] It is actually more helpful to think of the estate tax as part of the federal wealth transfer tax system. The Internal Revenue Code imposes a tax on gratuitous transfers of wealth, whether during lifetime, when it is called a gift tax, or at death, when it is called an estate tax.

a. The applicable credit amount

Every citizen and resident of the United States may transfer, either during lifetime or at death, a specified amount of property to his/her family or friends without the imposition of tax. That amount, which is known as the "applicable credit amount," currently stands at $650,000.[2] This amount will increase slowly over the next seven years when, in 2006, it will reach $1,000,000.[3]

The first order of business in most estate plans is to ensure that every taxpayer takes full advantage of the applicable credit amount. The traditional estate plan in which each spouse leaves everything outright to the other, if living, and otherwise to the children in equal shares, offends this principle, since the credit amount of the first to die will be "wasted." This waste occurs because all of the assets of the first spouse to die will pass into the survivor's estate and will be subject to tax upon his or her subsequent death, unless consumed during the spouse's lifetime. The transfer to the spouse is tax free, since under § 2056 there is a 100% marital deduction.[4]

When the surviving spouse dies, the surviving spouse has only his or her own credit amount to protect against the imposition of estate tax on the couple's combined assets. A more sophisticated plan calls for the use of a trust to be established at the time of the death of the first spouse to die, which will hold the credit amount for the benefit of the surviving spouse but which insulates the trust property from estate tax when the surviving spouse dies. Such a trust is often referred to as a "credit shelter trust" and sometimes as a "by pass" trust, since the trust property "by passes" the taxable estate of the surviving spouse.[5]

It follows that the most common estate planning technique is to take full advantage of the applicable credit amount for both spouses. Implementation of this strategy normally requires that each spouse execute an estate plan which provides for credit

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2 *See* I.R.C. § 2010(c). All "§" references are to the indicated section of the Internal Revenue Code of 1986, as amended, unless otherwise noted.

3 The applicable credit amount, formerly called the unified credit, is available to shelter lifetime gifts as well as transfers at death. *See* § 2505.

4 But special rates apply if the spouse is not a U.S. citizen.

5 *See, e.g.,* Karin J. Barkhorn, *Drafting Considerations – Credit Shelter Trusts and Trusts for Spouses, Minors and Incapacitated Persons.* 278 PLI/Est. 7 (May 1999).

shelter trust to be established for the survivor's benefit. In addition, ownership of property is customarily reviewed when the plan is being executed and, if either spouse owns property worth less than the credit shelter amount, interspousal asset transfers are encouraged so that the less wealthy spouse will own assets with at least $650,000 in the event of the spouse's death.

A client contemplating a divorce would not want to set up a credit shelter trust for the benefit of his or her spouse. However, the client might contemplate an immediate transfer of the credit amount, either outright or in trust, to individuals other than his or her spouse as a gift (most likely, the client's children). Assuming no fraud is involved, this is a valid, indeed, valuable, estate planning technique. Not only would such a transfer ensure the proper use of the credit amount, it would also prevent the inclusion in the client's estate of any capital appreciation on the transferred property which occurs after the gift has occurred.

Thus, a client interested in estate planning might legitimately make a gift (either outright or in trust) in 1999 of $650,000 of assets to his or her children. Assuming a 55% marginal federal estate tax rate, such a transfer could save $360,000 of taxes on the death of the second spouse to die. Indeed, for every dollar of capital appreciation on the transferred property, there would be an additional tax savings of $0.55.

b. Annual exclusion gifts

A second strategy is to take advantage of so-called "annual exclusion gifts." Section 2503(b) provides a $10,000 per donee annual exclusion from the federal gift tax. Not only are such gifts exempt from the gift tax, the property which is given away is removed from the donor's taxable estate at death. An effective estate plan can/should/could include many such gifts. Again, assuming a marginal bracket of 55%, if a client could make five annual exclusion gifts a year for ten years, the client would have transferred $500,000 worth of property to his children, saving at least $275,000 in federal estate taxes, even before factoring in the capital appreciation on the gifted property. So, absent fraud, annual exclusion gifts are legitimate estate planning measures.

c. *Leveraging opportunities*

The third broad strategy to save estate taxes is to transfer property at a fraction of what the client believes to be the "true value" of the property. In this context, it could be that the property being transferred has the potential to appreciate dramatically in the future. For example, an entrepreneur who believes that his company will grow dramatically might transfer shares of the company today so that the capital appreciation will not be subject to tax in his or her estate. A variation of the theme would be the transfer of a life insurance policy, which has a low value in the early years and a big payoff at death.

Alternatively, a client might try to depress the "true" value of an asset that is given away by burdening it with restrictions. For example, an enterprising estate planning client who wishes to make aggressive transfers of an interest in an apartment building might convey title to the apartment building to a family limited partnership. This client could then transfer non-voting limited partnership interests to children or others and claim that the value of the limited partnership interests is substantially less than the value of the underlying assets by virtue of the fact that limited partners have no ability to participate in the management of the partnership, cannot alienate their interests without the permission of the other partners and are generally subject to the "whims" of the general partner. Again, absent fraud, this strategy can be a highly effective way of "leveraging" wealth transfers to others as part of one's estate plan.[6]

2. *Avoid probate*

A second objective which might explain (or excuse) a transfer of property is the avoidance of probate. Much has been written on the topic and, indeed, many make a living by publicizing the vagaries and perils of probate administration. However, in most states, these tales of doom are often overstated.

Nevertheless, avoiding probate offers some advantages. One such advantage is the reduction of legal fees. Where there is no probate, there is no need to pay a lawyer to submit the will to probate and ask the court to appoint executors. It will not be necessary to prepare an inventory for the court or to prepare ac-

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6 For a more detailed discussion of this technique, *see infra* Section C.

countings. If there is no probate, it may be unnecessary to spend lawyer's or accountant's time collecting estate assets. To the extent that professional fiduciaries charge for services on a percentage basis, avoiding probate could produce a significant cost savings, since many fiduciaries apply a 50% discount when the estate holds non-probate property.

A second advantage to avoiding probate is to avoid delays. In Massachusetts, it can take two to three months for a will to be allowed by the probate court. If it is necessary, during this period, for assets to be made available to beneficiaries or to deal with the affairs of the decedent, such delays can be quite detrimental. By contrast, if title to the decedent's assets is held in a funded revocable trust, probate, and the attendant delay, can be avoided altogether.

The probate process does not entail lengthy delays in many jurisdictions, such as Florida, that have adopted the Uniform Probate Code. Moreover, even in Massachusetts, delays can be mitigated if the fiduciary seeks temporary appointment as executor which will enable the estate administration to be commenced before the will has been allowed (although, admittedly, with added legal expense).

Third, avoiding probate can help preserve privacy. The probate docket and all court papers, including the will, inventory of property and accountings, are open for public inspection. Avoiding probate allows the client to preserve privacy for the benefit for the beneficiaries of the estate.

Accordingly, legitimate reasons exist to avoid probate. To this end, a client might transfer individually held assets into a trust of one sort or another. Alternatively, the client could avoid probate by entering into a joint tenancy with one of his or her beneficiaries.

B. *Specific Techniques for Asset Transfers*

The previous section of this article reviewed the general reasons why an individual might consider making asset transfers. The following discussion sets forth in greater detail a few of the specific techniques that might be employed.

1. *Outright gifts*

As stated above, an outright gift can be a legitimate estate planning measure. Indeed, the annual gift exclusion, noted above, is frequently used by clients with a variety of estate planning circumstances and objectives. Where gifts are made outright, they are usually made to adults rather than to minors. In a carefully drafted estate plan, annual exclusion gifts may be made to minor children via a so-called "Crummey" trust or to a § 2503(c) "minor's" trust.[7] If no such trust exists, the gift must be made to a custodian under the Uniform Transfers to Minors Act ("UTMA") or to the minor's duly appointed legal guardian. Both the UTMA custodianship and the legal guardianship lack the flexibility of a trust. Accordingly, a hastily made exclusion gift to a UTMA account might indicate something other than proper estate planning.

Gifts in excess of the annual exclusion amount can also serve legitimate estate planning ends. As noted above, a donor can make significant gifts that do not give rise to any out-of-pocket gift tax (as long as the donor has not exceeded his applicable credit amount).[8] Indeed, even gifts that generate a current gift tax can be legitimate where significant wealth is involved.

For example, the payment of gift tax may save significant estate tax if the donor survives for at least three years after the gift occurs. The savings result from the way the gift tax is calculated, compared to the estate tax. Whereas the estate tax is computed on the value of the decedent's taxable estate (i.e. total taxable assets less allowable deductions), the gift tax is computed only with respect to the amount of the "taxable gift."

Example: A makes a gift of $1,000,000 to a trust for his three children. A has previously used up his entire applicable credit amount. The gift tax, at a marginal rate of 50%, is $500,000. Thus, by making the $1,000,000 gift, A is reducing his total assets by $1,500,000 ($1,000,000 of gifted property plus $500,000 in gift tax). If A would have delayed the gift until death, the estate tax would be substantially greater. Assuming that the applicable marginal rate of the estate tax is also 50%, A would have to have $2,000,000 of assets for $1,000,000 to pass in trust for his children:

7 *See* I.R.C. § 2503(c).

8 *See supra* Section 1-b.

$1,000,000 for the estate tax (50% of $2,000,000) and $1,000,000 for the gift in trust. The difference is that the gift tax itself escapes transfer tax (the computation is described as "tax-exclusive") whereas the estate tax is included in the estate tax computation (described as "tax-inclusive"). The difference to A is a $500,000 savings – 50% of the estate tax liability – as a result of making the transfer as a gift.

Thus, a donor who wishes to take advantage of the tax-exclusive nature of the gift tax may be motivated to make a very large gift. If that is not the case, a donor will generally be motivated to make a significant gift only if he or she has employed one of the leveraging techniques noted above. If the gifted property is not likely to appreciate, the donor's motive may be suspect.

Most estate planners will counsel donors to make significant gifts in trust rather than outright. This is true for a variety of reasons, some of which are as follows. First, assets held in trust for the benefit of someone other than the grantor are protected from the claims of the beneficiary's creditors.[9]

Second, a gift in trust allows a grantor to take advantage of the $1,000,000 exemption from the generation skipping transfer ("GST") tax. For example, if a donor makes a gift of $1,000,000 to an appropriately drafted trust, the trust property, including future capital appreciation, can remain in trust for the benefit of successive generations of beneficiaries free of any transfer tax when a beneficiary dies. A gift that fails to take advantage of this possibility may be suspect from an estate planning perspective.

Third, a gift of cash and/or marketable securities usually benefits from the careful investment management afforded by the trust form. Proper investment management may be dispensed with for the donee(s) of an outright gift. Accordingly, a significant gift that is not made in trust bears scrutiny.

It should also be noted that most individuals consult with their spouses on the subject of making gifts, not only for reasons of domestic harmony, but also because it makes sense for tax reasons. Under § 2513, the non-donor spouse can, if he or she wishes, consent to the gift.[10] With such consent, the gift is con-

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9 *See infra* Section 3-a.

10 *See* I.R.C. § 2513.

sidered to have been made one-half by each spouse. Such "gift-splitting" has the result of doubling the capacity to make tax-free gifts (i.e., increasing the annual exclusion limit per donor from $10,000 to $20,000). In addition, both spouses' applicable credit amount can be utilized with respect to gifts which exceed the annual exclusion limits. Thus, a well-considered estate plan that involves a gift program would typically require consultation with the spouse. Where no such consultation occurs, there may be other objectives at work.

Thus, while outright gifts are often legitimate estate planning strategies, such gifts typically follow a pattern. An annual exclusion gift to a minor beneficiary typically will be made to a trust. Similarly, a significant gift usually will be made to a trust(s) for the benefit of the donee(s). And most gifts will involve consultation with the spouse to maximize the estate planning benefit that the opportunity for "gift-splitting" offers.

2. *Creation of joint tenancies*

As noted above, one might create a joint tenancy to avoid probate with respect to the joint property. At best, however, this is a clumsy technique that would rarely be recommended by an estate planner.

Consider an elderly parent with two children whom she wants to treat equally when she dies. The parent may believe that she can avoid probate and treat her children equally by creating two bank accounts of equal size, naming each child as the joint owner of one of the accounts. While this technique can theoretically work fairly, as the parent draws on the accounts to pay her bills, she must pay each bill with funds drawn equally from the two separate accounts to maintain parity between the two accounts. In practice, the parent may draw on one account for some items and the other account for other items, resulting in unequal balances and a distortion of the intended dispositive plan. A revocable trust is a far better vehicle for avoiding probate, since all the funds which remain at the time of the parent's death are subject to division and distribution as provided in the trust instrument.

The creation of a joint tenancy in property other than cash may also have an unintended result, i.e., a taxable gift. For example, if an individual creates a joint tenancy in securities or real estate with a child, the donor will be deemed to have made a gift for gift tax purposes of one-half of the value of the subject property.[11]

By contrast, the creation of a joint bank account does not give rise to a completed gift, at least for gift tax purposes.[12] The theory is that the donor, as a co-tenant, retains the power to withdraw funds from the account at any time for any reason, and thus the gift remains incomplete until the donor dies.

3. *Revocable trusts*

Revocable trusts are a favored estate planning vehicle. They serve a number of important purposes in the estate plan, including the following:

a. Estate planning trusts

Assets in a revocable trust can be managed effectively for the benefit of the donor. This is especially important with respect to an elderly donor.

Assets in a revocable trust avoid probate, not only at death but also during lifetime. If a donor becomes incapable of managing his own property, a guardianship or conservatorship can be avoided if a carefully crafted revocable trust is in place.

Revocable trusts serve, in effect, as substitutes for wills or other testamentary documents. Upon the death of the donor, the assets in the trust pass to the donor's beneficiaries in accordance with the terms set forth in the trust instrument. As noted above, the trust's provisions can achieve a number of dispositive objectives, including the avoidance and/or minimization of estate and/or income taxes, providing necessary management of trust investments, creditor protection for the beneficiaries, etc.

b. *Nominee/realty trusts*

In many cases, a donor who owns real estate will convey ownership of the real estate to a "nominee" or "realty" trust. This is a trust that does nothing more than hold title to the real estate. It is like a corporate shell. Legal title is held by the trustee, but all the beneficial enjoyment of the trust property resides

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11 *See* I.R.C. § 25.2511-1(h)(5).
12 *See id.* at § 25.2511-1(h)(4).

with the beneficiaries (who are set forth in a separate Schedule of Beneficiaries). Moreover, as a practical matter, control also resides with the beneficiaries, because the trustees of the realty trust can take no action with respect to the trust property without an express written direction from the beneficiaries.

The primary legitimate purpose of a nominee trust is to preserve the privacy of the beneficial owner. For purposes of the public record at the Registry of Deeds, title to a piece of property will be held by the trustees of the nominee trust. Thus, since it is not necessary to record the Schedule of Beneficiaries with the Registry of Deeds, the identity of the "true owner" of the property can remain private.

A second legitimate purpose of these trusts is to facilitate the donor's gift program. An owner of a beneficial interest in a nominee trust can assign some or all of his or her beneficial ownership to another person, who becomes a beneficial owner of the underlying property when the assignment is made. This is an effective means of making gifts of property that would otherwise be indivisible. For example, in this fashion, fractional shares of a house can be given to family members without the preparation of numerous deeds of fractional interests.

Because of its ability to conceal the real owner of a property, the nominee trust has been employed by many a donor who wants to keep his or her interest in a piece of property "private" with respect to his or her spouse in the divorce context. If the trustee of the property is someone other than the donor, then the donor's interest will not be revealed by a title search at the Registry of Deeds. Assuming the donor has retained his or her beneficial interest in the property, however, the donor has retained a valuable ownership right in property, a right that is different in form, but not substance, from outright ownership of the property. Thus, by employing the nominee trust, the donor may keep control of the property without his or her ownership interest being readily apparent to his or her spouse (or other creditors).

Notwithstanding the advantages discussed above, a donor who has an interest in a revocable trust, whether an estate planning trust or a nominee trust, should not gain any advantage in the context of a divorce. Although such trusts add an additional layer of complexity, they are in the end interests that can be reduced to direct ownership rights without too much difficulty. Indeed, with appropriately focused discovery, ownership of these assets does little more than present a smoke screen. Divorce lawyers can discern trust ownership during the course of discovery. The trust will not protect the donor from claims of a spouse.[13]

4. *Irrevocable trusts*

a. Where donor retains an interest

An irrevocable trust can take many forms, but for purposes of this article, the critical element is whether the donor has retained any beneficial interest in the trust property. To this end, a donor could retain an interest in the principal of the trust property or the income produced by the principal — or both. It could be that the donor has retained the *right* to enjoy the retained interest (*e.g.*, the right to withdraw the principal at the donor's discretion); or, alternatively, it could be that the donor's ability to enjoy the trust property is subject to the discretion of the trustee.

Generally speaking, a donor will not create and fund an irrevocable trust for his or her own benefit for tax reasons, since any significant retained interest will cause the donor to be treated as the owner of the trust property for both income and estate tax purposes. There are, however, many "legitimate" reasons why a donor might create such a trust. For example, a young adult might choose to create and fund such a trust to put the assets in the hands of an experienced and competent trustee to achieve consistent long-term investment management (and simultaneously remove such assets from temptation). However, the purpose of many an irrevocable trust in which the donor has retained an interest is to frustrate creditors. Whether this purpose will be successful will depend on whether the donor is in a majority or minority jurisdiction.

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[13] *See, e.g.,* Sullivan v. Burkin, 460 N.E.2d 572 (Mass. 1984). La Bow v. La Bow, 537 A.2d 157 (Conn. App. Ct. 1988). *See also* J.R. Kempler, Annotation, *Validity of Inter Vivos Trust Established by One Spouse Which Impairs the Other Spouse's Distributive Share or Other Statutory Rights in Property*, 39 A.L.R. 3d 14 (1971, 1999 Supp.).

(i) Majority rule

The majority rule is that, despite a "spendthrift" provision in the trust providing otherwise, creditors of a donor can reach trust property to the same extent as the trustee is permitted to distribute the property to the donor. Under this rule, trust property is reachable even if the trustee has discretion, rather than an obligation, to make distributions to the donor. For example, in *Ware v. Gulda*,[14] the court held that a trust which gave the trustee discretion to make or withhold payments of income or principal to the donor-beneficiary failed to protect the trust property from the donor's creditors. Thus, in the majority of jurisdictions the creation of a spendthrift trust for the donor's own benefit will not shelter assets from the donor's creditors.

The "flip side" of the majority rule is that trust property is protected from a donor's creditors to the extent that the trustee cannot distribute the trust property to the donor. Thus, where a trustee has the power to distribute trust income, but not principal, to the donor, the trust principal will remain beyond the reach of the donor's creditors.

(ii) Minority rule

The minority rule is that a spendthrift clause (a clause which forbids attachment of an interest by creditors) will shelter trust assets from a donor's creditors even though the donor has retained an interest in the trust. In an effort to increase the number of trusts established within their boundaries, a small number of states, including Alaska and Delaware, have recently enacted statutes to this effect.[15] Missouri has enacted a similar statute, but has not touted it as an asset-protection device. The Alaska and Delaware statutes enable donors to shelter trust assets from creditors by including a spendthrift clause providing that the donor's interest in the trust is inalienable and free from attachment. Under these statutes, the inclusion of a spendthrift clause in a

14 117 N.E.2d 137 (Mass. 1954).

15 *See* ALASKA STAT. § 13.36.105 - 13.36.220 (1997) (Alaska Trusts Act); DEL. CODE ANN. tit. 12, § 3570-76 (1997) (Delaware Qualified Dispositions in Trust Act); John E. Sullivan III, *Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes with Offshore Trusts*, 23 DEL. J. CORP. L. 423, 424 (1998); Elizabeth L. Mathieu, *States Now Use Favorable Laws to Lure Trusts*, NAT'L L.J. (December 15, 1997).

trust will shelter trust assets, regardless of whether the trustee has power to distribute the assets to the donor.

The statutes are subject to some limitations however. Under both the Alaska and Delaware statutes, if a trustee is required to make distributions to the donor, the trust assets will be subject to creditor claims.[16] More importantly, Delaware's statute contains an exception making the use of spendthrift clauses ineffective at sheltering assets from spouses, former spouses and children of the donor.[17] Alaska's statute protects trust assets from alimony and spousal support claims, but allows trust assets to be used to satisfy child support claims as long as the donor is over 30 days delinquent in payment at the time he or she transfers the assets into trust.[18] Both statutes are subject, of course, to the law against fraudulent conveyances.[19]

Both statutes contain several jurisdictional requirements. In the Alaska Trusts Act, there is a conclusive presumption that Alaska law controls the trust if the trust instrument so recites and if the following statutory conditions are met. First, some of the trust assets must be deposited in Alaska and be administered by a "qualified person." A "qualified person" is an Alaska domiciliary or an Alaska trust company or bank. Second, the Alaska trustee's duties must at least include maintaining records for the trust and preparing or arranging for the preparation of the trust's income tax returns. Third, part of the administration of the trust must occur in Alaska.[20]

Delaware's law contains jurisdictional requirements similar, but not identical to, Alaska's statute. In Delaware, *all* trustees must be Delaware individuals or entities. The trust instrument must contain a spendthrift clause and must state that the trust is irrevocable and that the trust's validity, construction and administration are governed by Delaware law. Finally, the following administrative activities must occur in Delaware: (i) custody of at least some of the trust assets; (ii) maintenance of trust records;

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16 *See* Alaska Stat. § 34.40.110 (1997); Del. Code Ann. tit. 12, § 3570 (1997).

17 *See* Del. Code Ann. tit. 12, § 3573 (1997).

18 *See* Alaska Stat. § 34.40.110(b)(4) (1997).

19 *See* Alaska Stat. § 34.40.110 (1997); Del. Code Ann. tit. 12, § 3572(a) (1997).

20 *See id.* at § 13.36.035.

(iii) preparation or arrangement for preparation of the trust's tax returns; and (iv) other material participation in administration of the trust.[21]

(iii) Off-shore trusts

Among the most effective asset-sheltering tools is the off-shore trust.[22] These trusts take advantage of the donor-debtor friendly laws of a foreign jurisdiction. The laws of these jurisdictions generally allow a donor to retain a financial interest in, and control over, trust assets without subjecting the assets to creditor claims. Moreover, such jurisdictions generally do not recognize U.S. judgments (including divorce decrees) or other legal processes such as asset freezes and forfeitures. Thus, by establishing a trust in an appropriate foreign jurisdiction, a donor may be able to retain greater interests in the trust assets without sacrificing protection from creditor claims. Among the more popular jurisdictions for establishing off-shore trusts are the Cook, Channel and Cayman Islands.

In addition to the opportunity to safeguard property from spouses and other creditors, the off-shore trust offers estate planning benefits in the form of probate avoidance and privacy. In the past, off-shore trusts were touted as a means of escaping estate and income taxes. Today, it is widely agreed that the use of off-shore trusts for this purpose is improper.[23]

As noted above, off-shore trusts are generally quite effective at defeating creditor claims. However, to the extent that an off-shore trust is subject to U.S. jurisdiction, its asset-sheltering effectiveness is considerably diminished. An off-shore trust may be subject to U.S. jurisdiction if it has a U.S.-affiliated trustee. Thus, creditors wishing to reach assets in an off-shore trust would be wise to examine the identity of the trustee.

A donor who transfers assets to an off-shore trust is, of course, subject to the laws of fraudulent conveyance. However,

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21 *See* DEL. CODE ANN. tit. 12, § 3570 (1997).

22 *See* Switzer, et al., *Asset Protection Trusts: Evaluating New Opportunities Under 1997 Legislation*, NATIONAL PUBLIC ACCOUNTANT (Nov. 1998); Howard D. Rosen, *The How's and Why's of Offshore Trusts in Asset Protection Planning*, 21 TAX MGMT. EST. ESTATES, GIFTS & TR. 115 (May 9, 1996).

23 *See, e.g.*, Michael W. Galligan, *Foreign Trusts and U.S. Estate Planning: A Client-Centered Analysis*, 12 INT'L L. PRACTICUM 19 (Spring 1999).

as noted above, repatriation of assets that were fraudulently conveyed may be quite difficult.

b. Where donor retains no interests

Let us turn now to an examination of irrevocable trusts in which the donor has *not* retained any interest.

In general, the assets of a trust will be beyond the reach of the donor's creditors if: (i) the trust is irrevocable; and (ii) the donor retains no beneficial or reversionary interest in the trust. Despite its general effectiveness as an asset-sheltering tool, a trust meeting all of these requirements may nevertheless be reachable by the donor's creditors if the trustee has agreed to follow the donor's directions in administering the trust. In addition, a trust meeting the requirements set forth above will be ineffective at protecting assets from creditor claims if it runs afoul of the law of fraudulent transfers.[24]

As discussed above, there are many legitimate reasons why a donor might create an irrevocable trust as part of an estate plan. Many such trusts are tax driven and extremely complicated. Examples of the sorts of trusts that one might encounter, with a brief explanation of each such trust, are as follows:

(i) Section 2503(c) trusts

As noted above, these are trusts for the benefit of minors and are used primarily to receive $10,000/20,000 annual exclusion gifts.[25] It should be noted that the annual exclusion is available only where the donee has a so-called "present interest" in the gifted property. A donee has a present interest in property if he or she can enjoy the fruits of the property immediately. Most gifts in trust, therefore, will not qualify. Congress recognized, however, that an exception should exist for a gift to a minor child since it is appropriate to make gifts to minors in trust. Section 2503(c) of the Internal Revenue Code sets forth the requisites for a trust to qualify for a present interest exclusion. Among other things, these trusts must be administered solely for the benefit of the donee; there must be no restrictions that prevent the trustee

[24] *See, e.g.*, Patricia E. Dilley, *Hidden in Plain View: The Pension Shield Against Creditors*, 74 IND. L.J. 355, 409 (1999).

[25] *See supra* text accompanying footnote 7.

from using the funds for the donee's benefit during the term of the trust, and the donee must be given rights of withdrawal at his or her 21st birthday.

(ii) Crummey trusts

These trusts are also designed to take advantage of the present interest exclusion. Crummey trusts are trusts which allow the donee/beneficiary of the trust to withdraw property transferred to the trust for a stated period following the date of the contribution, usually 30 or 60 days.[26] By granting the beneficiary the right to withdraw the property, the donor is considered to have conferred a "present interest" in the gifted property to the beneficiary. Once the withdrawal period has elapsed, the beneficiary's right to withdraw the contributed property lapses and the property remains in trust.

This type of trust can be used for minors but may also be used for adult beneficiaries. The concern with respect to Crummey trusts is that the beneficiary may actually exercise the withdrawal right so that the property passes outright rather than in trust. However, it is necessary to notify the beneficiary of the contribution and the withdrawal right each time a contribution is made; otherwise, the Internal Revenue Service may disallow the annual exclusion with respect to the contribution to the trust on the theory that the withdrawal rights are illusory.[27]

With respect to both § 2503(c) and Crummey trusts, the divorce lawyer may wish to examine how the trusts have been and are being administered. Have expenditures really been for the benefit of the beneficiary or have they benefited the donor, either directly or indirectly? If the latter, then perhaps a case can be made that these instances of mal-administration are evidence of fraud.

(iii) Life insurance trusts

A life insurance trust can be a valuable part of an individual's estate plan. Funds are contributed to such a trust which the trustees use to purchase a life insurance policy on the life of the

26 *See* Estate of Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).

27 *See generally* Marc A. Chorney, *Transfer Tax Issues Raised by Crummey Powers*, 33 Real Prop. Prob. & Tr. J. 755 (1999).

donor. Ownership of the policy is held by the trustees of the trust rather than in the name of the donor. When the insured dies, the insurance proceeds are collected by the trustees and held in trust for the beneficiaries named in the trust instrument. Moreover, since the donor has theoretically retained no incidents of ownership in the policy, the donor's estate pays no estate tax with respect to the life insurance proceeds.

Absent fraud, an insurance trust is a legitimate method of passing assets to one's beneficiaries. However, the divorce lawyer should examine whether the cash amounts transferred to the trust (to pay the premiums on the insurance policy) are proportionate to the donor's other assets. To the extent that they seem excessive, perhaps the purpose is to move assets beyond the reach of a spouse's marital claims. Likewise, the size of the death benefit should be examined in light of the donor's assets. Does the size of the policy seem excessive? Moreover, one should examine whether there are any insurance needs that are addressed by the policy. For example, is the estate largely illiquid such that the insurance would provide needed cash to pay debts, expenses and taxes? Is the insurance necessary to replace lost income for the beneficiaries of the trust?

It should be noted that many insurance trusts will provide for the spouse as an eligible beneficiary. Sometimes, the spouse's rights as a beneficiary automatically terminate in the event of a divorce. Is the spouse otherwise well provided for or does the exclusion of the spouse suggest something else?

(iv) Exemption trust

A donor may also establish what might be referred to as an "exemption trust" and convey to that trust a significant amount of property.[28] Typically, these trusts will receive gifts designed to take advantage of the donor's applicable credit amount (currently $650,000) and/or the generation skipping tax exemption amount (currently at $1,010,000). If the donor anticipates significant appreciation in the assets transferred to the trust and if the donor has taken advantage of one of the leveraging techniques noted above, this can be one of the most effective ways of minimizing estate tax on the intergenerational transmission of wealth.

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[28] *See supra* text accompanying footnotes 9 and 10.

Again, one must ask why the spouse was not consulted with respect to the gift. As noted, if the spouse "consents" to the gift for gift tax purposes, twice as much property can be transferred free of gift tax. Is there a legitimate reason for not consulting the spouse? Here, one should also examine the actual transactions of the trust to determine whether the transactions truly benefited the beneficiaries or are disguised distributions to the donor (e.g., tuition payments for dependent children).

(v) Charitable remainder trust

This is a so-called "split interest" trust that provides for both non-charitable and charitable beneficiaries. The non-charitable portion is paid out in the form of an annuity or a "unitrust amount" consisting of a fixed percentage of the trust property valued annually. This amount is paid over to one or more individuals for a term of years or for the life or lives of the individuals. Upon the termination of the trust, the remaining trust property is paid over to one or more charitable organizations. More often than not, the donor is a beneficiary of the trust, though he or she is not required to be.

These trusts provide a number of financial benefits to the donor, including the following: (i) The value of the charity's remainder interest in the trust will be deductible from the donor's income taxes in the year in which the contribution is made; (ii) the trust is tax-exempt. Accordingly, appreciated assets can be liquidated by the trustees without any capital gains tax being paid by the trust; (iii) the donor, as stated, can retain an interest in the trust; and (iv) assets passing to the charity at the termination of the trust will pass free of estate tax.

Taken together, these advantages can be quite attractive to the right donor. For example, assume a donor who has a holding of highly appreciated property that produces little or no income. If that donor contributes this property to the trust, he or she will qualify for an immediate income tax deduction based on the full fair market value of the appreciated property. He or she will also be in a position to liquidate those assets, through the trust, at no capital gains tax cost. Moreover, the proceeds can then be reinvested in income producing property. Thus, the donor will have succeeded in converting non-income producing property to income producing property and still qualify for an income tax deduction.[29]

If the donor has retained an interest in the trust, presumably a creditor can reach that interest even if the trust includes a spendthrift provision.[30] However, the charity's interest will presumably not be reachable, absent fraud.

One way of determining whether a charitable remainder trust serves a legitimate estate planning purpose is to examine the payout reserved to the non-charitable beneficiaries. With a so-called "charitable remainder unitrust", the payout is measured by a percentage of the trust assets, valued annually. The percentage must be at least 5% and cannot exceed a percentage which would result in the charity receiving less than 10% of the trust property, valued actuarially at the outset.[31] (This latter percentage will be a function of the annual payout taken together with the term of the trust.)

Obviously, the higher the payout, the less the charitable intent. Indeed, some aggressive donors view a charitable remainder trust as a way of "laundering" highly appreciated assets by selling the assets in the trust without any immediate capital gains tax cost. After taking gains, the proceeds are funneled back to the donor and/or his designated beneficiaries at as high a percentage as possible. Thus, it may be possible to argue that a charitable remainder trust with a high payout rate was merely a device to divert property from the spouse. If the donor is the beneficiary, the spouse should also be able to reach the annual distributions.

(vi) Charitable lead trust

This trust is similar to the charitable remainder trust, except that the charity takes the annuity or unitrust (referred to as the "lead") interest, with non-charitable beneficiaries taking the remainder interest. This trust typically does not produce a charitable income tax deduction. Likewise, it is not tax-exempt. Gains

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29 *See, e.g.*, Dan W. Llewellyn, *The Evolution of Sophisticated Tax Planning for Lifetime Gifts – What Planning Techniques Continue to be Effective?*, 30 Real Prop. Prob & Tr. J. 213 (1995).

30 *See supra* Section 4-a.

31 *See generally*, Paul D. Callister, *Charitable Remainder Trusts: An Overview*, 51 Tax Law. 549 (1998).

realized at the trust level are subject to income tax. However, the payments made to charity give rise to a charitable gift tax deduction and it is this attribute that *creates* the popularity of such trusts. Consider a trust that is created for a term of 20 years, with a 10% payout to charitable organizations. At the end of the 20 year term, the trust principal is paid over to the donor's children. Under these facts, the donor would be entitled to an 86% gift tax deduction (based on a discount rate of 5.4%). If the trustees can generate a return at or greater than 10%, then the trust property can be passed intact to the donor's family at the end of 20 years with relatively little transfer tax cost.

Again, this is a legitimate estate planning device, especially considering today's low interest rate environment. Generally, the lower the applicable discount rate, the more favorable the tax consequences which can be achieved from using a lead trust.

However, the trust could be employed by the donor as a ruse to move assets to family members other than the spouse. As with the other trusts discussed above, one must consider whether the lead trust makes sense within the context of a particular donor's estate plan, whether it is proportionate to his or her other assets, etc.

C. *Business Entities*

1. *Family limited partnership*

A family limited partnership can serve a legitimate purpose in the context of one's estate plan. Typically, the donor would be named as the general partner of the limited partnership. As general partner, he or she would retain a 1% interest in the partnership. The balance of the interests in the partnership would be owned by the limited partners, who would include the donor and at least one other individual (who could, theoretically, own a mere 1% interest). The partnership itself could own almost any type of asset, from commercial real estate to marketable securities. However, management of the underlying assets would reside exclusively with the general partner. The limited partners would derive only as much benefit from the partnership as the general partner determined, consistent with the terms of the partnership agreement.[32]

In this context, an individual who wished to defeat the claims of his or her spouse could transfer limited partnership shares to another family member. Since the gifted property would be an interest in a family partnership – as opposed to the underlying assets, such as marketable securities or commercial real estate – the value of the gift would be diminished. Moreover, since an interest in a family limited partnership has a limited market and is usually subject to numerous restrictions on alienation (as set forth in the partnership agreement), the value of the interest is further depressed. Indeed, estate planners routinely argue that discounts of 35% to 50% are justified, with even more aggressive valuations possible.

A donor seeking to protect assets in a divorce might avail himself of a family limited partnership for two reasons. First, by transferring assets to the family limited partnership, the client will convert marketable, valuable assets into assets that are not marketable and thus cannot be converted into cash. The owner of shares of stock can sell the stock; the owner of an interest in a piece of commercial real estate can seek partition in a court of proper jurisdiction and cause the eventual liquidation of his or her interest in the property. However, the ability of the owner of an interest in a family limited partnership to convert his partnership interest to cash is severely restricted. Second, the family limited partnership allows the donor with deep discounts to transfer significant amounts of property at a reduced transfer tax cost.[33]

2. *Limited liability company*

This is a relatively new form of business entity, created by statute in all 50 states. Generally speaking, it confers upon its owners the tax benefits of a partnership while providing the benefits of limited liability to its owners similar to those enjoyed by owners of corporations. From an estate planning perspective, the LLC has taken the place, to some degree, of the family limited

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[32] *See generally*, Lisa H. Jamieson, *Marital Property Issues in the Modern Estate Plan*, 49 BAYLOR L. REV. 391, 400-02 (1997).

[33] *See* Craig Stephanson, *How To Establish a Successful Family Limited Partnership*, 44 PRAC. LAW. 41 (Sept. 1998).

partnership. A member in a limited liability company, like an owner of a limited partnership share, can make a gift of his interest in the entity. The gifted interest is relatively unattractive to a creditor in view of the lack of marketability and other restrictions. For the same reason, a gift of a membership interest is desirable from an estate planning point of view, since it will be eligible for deep discounts.

As with all the other estate planning devices discussed, the use of a family limited partnership or a limited liability company as an instrument in estate planning must be examined in the context of the individual's overall estate plan. While any one or more of these devices may, by itself, be highly effective and desirable, they may, by contrast, seem disproportionate, out of context or otherwise inappropriate for a particular client's individual situation.[34]

III. Fraudulent Conveyances

Transfers of property made using the techniques previously discussed may be set aside if they constitute fraudulent conveyances. Most jurisdictions have enacted a version of the Uniform Fraudulent Conveyance Act ("UFCA") or the Uniform Fraudulent Transfer Act ("UFTA"). In a divorce scenario, the test used under either act will likely be an actual fraud test.[35]

A transfer is fraudulent when it is made with the intent to hinder, delay or defraud present or future creditors.[36] Because proving the intent of a transferor is often impossible, courts allow

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[34] For further information on family limited partnerships and limited liability companies, *see* Scott E. Friedman & James G. Sciarrino, *Estate Planning Vehicle of Choice for the 1990s: FLLC or FLP?,* 4 J. LIMITED LIABILITY COS. 91 (Winter 1997); Andrew J. Willms, *Family Limited Partnerships and Limited Liability Companies: New Estate Planning Tools for the 90s*, 67 WIS. LAW. 17 (Mar. 1994); Kathryn G. Henkel, *How Family Limited Partnerships Can Protect Assets*, 20 EST. PLAN. 3 (1993); Larry W. Gibbs, *A Family Limited Partnership as the Centerpiece of an Estate Plan*, 131 TR. & EST. 45, (Sept. 1992).

[35] Note that both the UFCA and the UFTA also provide a constructive fraud test which may be used when transfers are made by a debtor who is, or consequently becomes, insolvent.

[36] *See* UFCA § 7A; UFTA § 5(a)(1).

the finder of fact to infer fraud from the existence of one or more "badges of fraud."[37] These badges include, among others:

(i) actual or threatened litigation against the transferor;
(ii) the transfer of substantially all property owned by the transferor;
(iii) a special relationship between the transferor and the transferee; and
(iv) the concealment of the transfer.[38]

Moreover, absent "significantly clear" evidence of a legitimate supervening purpose, the presence of several badges of fraud can constitute a conclusive presumption of actual intent to defraud.[39]

Transferors have attempted to use estate planning as a legitimate supervening purpose. However, whether a transfer is purportedly made for estate planning purposes or for other reasons, the timing of the transfer is the crucial factor in determining whether the transfer will be held to be fraudulent. The closer in time that the transfer occurs to litigation involving creditors, the more likely it is to be set aside.

For example, in a case where a debtor, thirteen months prior to filing for bankruptcy, transferred assets to an irrevocable trust at the suggestion of an unrelated estate planning specialist, the court held that facts did not support a finding of actual intent to defraud.[40] Here, the debtor had only transferred about ten percent of his assets, was solvent after the transfer, and the circumstances surrounding his financial demise had not yet occurred at the time of the transfer.[41] When a debtor is already in the throws of litigation, the result is quite different. Thus, where a debtor transferred assets into trust for his children during litigation over federal tax deficiencies, the court granted a summary judgment motion setting aside the transfers as fraudulent despite the debtor's claim that a heart attack had spurred a sudden need for estate planning.[42]

37 Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248, 1254 (1st Cir. 1991).

38 *See id.* at 1254; *See also* In Re XYZ Options, Inc., 154 F.3d 1262, 1272 (11th Cir. 1998).

39 *Sugarman, supra* note 37 at 1254-55.

40 *See* In re: Mart, 88 B.R. 436 (Bankr. S.D. Fra. 1988).

41 *See id.*

42 *See* United States v. Bryant, 15 F.3d 756, 758 (8th Cir. 1994).

Timing is particularly important in a divorce context. Because nothing is wrong *per se* with one spouse transferring his or her assets without the consent of another, the first query to make when seeking to set aside a transfer is whether the complaining spouse qualifies as a creditor for the purposes of the statutes.[43] If the spouse does not, any transfers made, by definition, cannot be fraudulent as to him or her. For a spouse to qualify as a creditor, divorce must be imminent.[44] Thus, a wife did not qualify as a creditor and could not set aside her husband's transfer of real estate to his children, where the transfer occurred eight years prior to filing for divorce.[45] However, where a husband had transferred real property to his secretary after his wife had obtained a decree stating that she was living apart from him for just cause, but before a petition for divorce had been filed, divorce was held to be imminent.[46]

Where a transfer is made when divorce is imminent, it is likely to be set aside as fraudulent. The above-referenced transfer to the husband's secretary in *Jordan v. Ball* was deemed to be fraudulent, despite the husband's claim that it was payment for legal services.[47] Similarly, the court rejected a claim by a husband that a transfer into an irrevocable trust for his children, made one month after filing for divorce, was for estate planning purposes and held it was a fraudulent conveyance.[48] The court noted the timing of the transfer, that it was made without his wife's knowledge and that the husband held a potential retained interest under the terms of the trust.[49] It concluded that, based on the circumstances, there was ample evidence upon which to conclude that the transfer was made to deprive the wife of her right to claim the property.[50]

As shown above, the case law indicates that a common sense approach is used to determine if a conveyance is fraudulent. If a transfer looks like an attempt to remove property from imminent

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43 *See* Yacobian v. Yacobian, 508 N.E.2d 1389 (Mass. App. Ct. 1987).
44 *See id.* at 1390.
45 *See id.*
46 *See* Jorden v. Ball, 258 N.E.2d 736, 737-38 (Mass. 1970).
47 *See id.* at 738.
48 *See* Aronson v. Aronson, 516 N.E.2d 184 (Mass. App. Ct. 1987).
49 *See id.* at 186.
50 *See id.*

divorce proceedings, it probably is. Transfers carried out pursuant to a plausible estate plan that was in place long before divorce litigation commenced will generally be held non-fraudulent. Transfers made by persons who have last minute estate planning epiphanies while in the throws of divorce proceedings are likely to be set aside as fraudulent.

IV. Problems for the Lawyer

A. *Assisting Clients With Asset Transfers: Ethical Considerations*

When a lawyer assists a client with asset transfers to protect them from creditors, the lawyer must be cognizant of the fine line between zealous advocacy and assisting the client engage in fraudulent conduct. The ABA Model Rules of Professional Conduct ("Model Rules") state that a lawyer shall not "counsel a client to engage, or assist a client, in conduct that a lawyer knows is criminal or fraudulent."[51] The ABA Model Code of Professional Conduct ("the Code") states that a lawyer shall not "counsel or assist a client in conduct that the lawyer knows to be illegal or fraudulent."[52]

Both ethical rules beg the question: when is an asset transfer fraudulent conduct? The rules and cannons do not shed much light on the subject, but as seen before in the discussion regarding fraudulent conveyances, the issue often comes down to timing. The South Carolina Bar Ethics Advisory Committee, interpreting the Code's DR 7-102(a)(7), concluded that while an attorney may, with creditor protection as a goal, assist a client in transferring assets where there is no immediate prospect of a judgment against that client, an attorney may not assist clients to do the same where the sole purpose is to avoid the likely prospect of an adverse judgment.[53]

The Model Rules contain, and some jurisdictions have adopted, a "good faith" rule for examining the lawyer's conduct. The rule states that if the actions are warranted by existing law or can be supported by a good faith argument to modify the law, the

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51 Model Rules of Professional Conduct Rule 1.2(d) (1999).

52 Model Code of Professional Responsibility DR 7-102(A)(7) (1999).

53 *See* South Carolina Ethics Advisory Comm. Op. 84-02.

lawyer will not be subject to sanctions.[54] The lawyer should note, however, that, in order to take advantage of this exception, there must be some realistic possibility that the lawyer will prevail.[55]

Because sanctions imposed on attorneys assisting clients who commit fraud can be severe, including suspension, disbarment and money judgments in favor of the defrauded party, attorneys should exercise extreme caution when advising clients about, and assisting clients with, the irrevocable transfer of assets.[56] In a divorce context, it is particularly important for the lawyer to be aware that a client's spouse does become a creditor when divorce is imminent and transfers made during this time will be subjected to close scrutiny and are often set aside as fraudulent.

While, as is often the case with ethical considerations, it is hard to draw clear lines of right and wrong, the following general guidelines may prove helpful:

If a client wishes to transfer assets with the specific purpose of frustrating spousal claims in a divorce proceeding, the lawyer should counsel the client against such a course of action and refuse to participate in it.

If divorce proceedings are imminent, or ongoing, and the client wishes to make transfers that, under the various acts concerning fraudulent transfers, would likely be set aside, much caution is necessary. The client should be counseled on the law of fraudulent conveyances and the likelihood that the transfer will be set aside. If the client insists on proceeding, the lawyer should carefully consider the client's motives and whether, under the circumstances, there is any sound authority upon which to claim the transfer is other than a fraudulent conveyance. If the client's motives are not fraudulent and such authority exists, the lawyer may find sanctuary from discipline under the good faith rule, even if the transfers are ultimately deemed fraudulent.

Finally, if divorce proceedings (or any other proceeding involving potential creditors) are not imminent and the client sim-

54 *See* ABA Comm. On Ethics and Professional Responsibility, Formal Op. 85-352; State v. Baker, 539 S.W.2d 367, 373 (Tex. Civ. App. 1976).

55 *See* ABA Comm. On Ethics and Professional Responsibility, Formal Op. 85-352.

56 *See, e.g.*, In Re Mandell, 431 N.E.2d 382 (1982); McElkhanan v. Hing, 728 P.2d 256 (Ariz. Ct. App 1985).

ply wishes to transfer assets "just in case," the lawyer should not be in violation of the ethical rules by rendering advice and assistance toward that end.

B. *Representation of Husbands and Wives: Ethical Issues*

In a great majority of cases, husbands and wives will be jointly represented by the same estate planner. After all, most of the time husbands and wives will have shared goals that can be addressed most effectively and efficiently through joint representation. However, the interests of husbands and wives may diverge and that divergence may call continued joint representation into question. The subject is a difficult one inasmuch as the parties' circumstances will change over the years. And the interpretation of those facts may be difficult for the lawyer. Consider, for example, the situation where a husband or wife tells the lawyer in confidence that he or she is contemplating a divorce. Has the potential for a conflict ripened into an actual adverse situation? What are the rules that govern the lawyer's conduct?

The Model Rules of Professional Conduct of the American Bar Association (Model Rules) set forth detailed rules with respect to conflicts of interest. The applicable rules are as follows: Model Rule 1.7(a) states "[a] lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless: (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and (2) each client consents after consultation."[57]
Model Rule 1.7(b) states,

> [a] lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
> (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.[58]

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[57] MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(a) (1999).
[58] *Id.* at Rule 1.7(b).

Another point of reference for the lawyer is the Restatement (Third) of Law governing lawyers, which provides at Section 201 as follows:

> Unless all affected clients consent to the representation under the limitations and conditions provided in § 202, a lawyer may not represent a client if the representation would constitute a conflict of interest. A conflict of interest exists if there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to another current client, to a former client, or to a third person.[59]

Section 202 of the Restatement provides:

> (1) A lawyer may represent a client notwithstanding a conflict of interest prohibited by §201 if each affected client gives informed consent to the lawyer's representation. Informed consent requires that the client have adequate information about the risks and advantages of such representation to that client.
> (2)Notwithstanding each affected client's consent, a lawyer may not represent a client if: (a) The lawyer represents an opposing party in the same litigation; (b) One or more of the clients is legally incapable of giving consent; or (c) Special circumstances render it unlikely that the lawyer will be able to provide adequate representation to one or more of the clients.[60]

The dilemma for the practicing estate planner is to determine when the potential for conflict has evolved into an actual conflict. Certainly many situations where the clients' wishes may differ will not rise to the level of a conflict for purposes of the Model Rules. For example, the spouses may differ regarding how to provide for their children in their estate plans. One may feel that assets should be distributed outright to the children while the other believes that the assets should be held in further trust for their benefit. Or perhaps they disagree as to choice of fiduciary or whether it is an appropriate risk to create and fund an intentionally defective grantor trust. However, when spouses disagree in such a manner that only one can succeed, the threshold may be crossed. For example, if each spouse claims exclusive ownership of an asset, it may be impossible to reach a resolution satisfactory to both.

Accordingly, at some point during the course of the joint representation, Model Rule 1.7 may become applicable. If it

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59 Restatement (Third) of Law Governing Law, § 201 (1991).
60 Restatement (Third) of Law Governing Law, § 202 (1991).

does, the lawyer may not continue the representation without disclosure and consent.[61]

Once the lawyer learns of an actual adversity, the lawyer must decide whether it is appropriate to seek a waiver from the adversely affected spouse or to withdraw as counsel for both. In making this decision, the lawyer must balance the potential harm disclosure would cause to the confiding spouse with the potential harm caused by failing to disclose. The lawyer may conclude that disclosure but not withdrawal is appropriate, or that withdrawal but not disclosure is appropriate. As a practical matter, the decision will turn on whether the spouse who has confided in the lawyer is willing to disclose the confidence. If not, the lawyer may be forced to withdraw.

Interestingly, withdrawal may itself be problematic. This is because unexpected and unexplained withdrawal may cause disclosure of a confidence indirectly. If this is so, the lawyer must weigh the potential harm caused by the unintended disclosure with the harm caused by the failure to disclose. There are, it should be obvious, no bright lines in any of this.

A consequence of the joint representation that should be made clear to the estate planner is that, with a joint representation, the spouses are the joint holders of the attorney-client privilege. If the matter moves to litigation, either can compel the discovery of any information communicated to the lawyer.[62] So all "confidences" shared with a lawyer by one member of a couple will be shared during the course of discovery with the other spouse.

A full blown discussion of all the ethical intricacies in the joint representation of a husband and wife is well beyond the scope of this outline. However, this brief discussion should make it clear that the estate planner who learns that one spouse is contemplating a divorce must consider his or her obligations to the other spouse. If the confidence suggests that an actual adversity has developed between the spouses, the lawyer cannot continue representation of either until the conflict is resolved, either by full disclosure and consent or by withdrawal. The lawyer who

61 *See* Model Rules of Professional Conduct Rule 1.7 (1999).
62 *See e.g.*, Cal. Evid. Code § 962 (West 1999).

assists one spouse at the expense of the other does so in violation of the Model Rules.[63]

As an attorney representing one of the spouses in a divorce action, thought should be given to the question of whether, while the marriage was harmonious, both spouses were represented by one estate planner and, if so, whether property was transferred by either spouse "for estate planning purposes." In addition, if transfer did occur, inquiry should be made as to the disclosure made by the estate planner to each spouse and whether either spouse executed a waiver of any potential conflict. Some states, such as California[64], require that each spouse execute a written waiver for the estate planner to represent both spouses. Even in states where written waivers are not required, many estate planning practitioners are providing a written statement concerning the scope of the representation seeking to define the estate planner's duty with regard to the preservation of/disclosure of confidences. A sample of such disclosure statement can be found at Appendix A to this article.

In the absence of a written waiver or a clearly defined relationship between the spouses and their counsel, it is possible that, if the estate planner advised either spouse regarding asset transfers without disclosure of the advice to the other spouse, or if the estate planner has advised both spouses concerning an asset transfer without considering the possible financial impact that such transfer might have upon each spouse in the event of a future divorce, the aggrieved spouse may be able to assert claims against the estate planner for breach of duty as attorney for the client.[65]

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63 For a thoughtful and comprehensive discussion on the subject, *see* Report of the Special Study Committee on Professional Responsibility, *Comments and Recommendations on the Lawyer's Duties in Representing Husband and Wife*, 28 REAL PROP., PROB. & TR. J. 765 (Winter 1994).

64 *See* CALIFORNIA RULES OF PROFESSIONAL CONDUCT Rule 3-310(A) (West 2000).

65 *See, e.g.*, Hotz v. Minyard, 403 S.E.2d 634 (S.C. 1991).