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Ohio House Bill — The Ohio Legacy Trust Act and Due Diligence Concerns

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The Bankers' Statement – Spring 2014

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Ohio House Bill 479, which became effective on March 20, 2013, enacted Sections 5816.01-14 of the Ohio Legacy Trust Act, allowing and enabling individuals who properly create a Legacy Trust under the provisions of the Act to shield assets conveyed to the Legacy Trust from creditors. What this means is that there must be sound processes and procedures in place in order to determine, among other things, if:

- You are dealing with a Legacy Trust
- If the Legacy Trust has been properly established
- What assets are subject to the Legacy Trust
- When assets were transferred to the Legacy Trust
- Does a subsequent transfer of collateral to a Legacy Trust by a borrower or guarantor cut off the bank's secured interest in the collateral?

1. What is a Legacy Trust under the Ohio Legacy Trust Act?

A Legacy Trust under the Ohio Legacy Trust Act must:

- (A) Be evidenced by a written instrument
- (B) Have at least one Qualified Trustee for, or in connection with, the property that is the subject of a qualified disposition
- (C) Be governed by Ohio law
- (D) Expressly state that it is irrevocable
- (E) Have a spendthrift provision

A "Qualified Trustee" under the Ohio Legacy Trust Act is defined as a person who is not the transferor, is an Ohio resident or regulated bank and maintains or arranges for custody in Ohio of some or all of the property that is subject to a qualified disposition, arranges for tax returns and materially participates in the administration of the Legacy Trust.

The transferor of the property has various rights relative to the Legacy Trust, including:

- (A) To receive income
- (B) To receive up to 5 percent of the corpus each year
- (C) To remove and appoint new trustees
- (D) To use a house transferred to the Legacy Trust for the transferor's residence

The transferor must sign a "qualified affidavit" at the time of the qualified disposition of assets. The "qualified affidavit" must state, among other things, that:

- (A) The transfer will not render the transferor insolvent
- (B) The transfer is not intended to defraud creditors
- (C) There are no pending or threatened actions, except as listed in the affidavit
- (D) The transferor does not contemplate filing for bankruptcy

2. What Due Diligence Issues do Legacy Trusts raise?

Legacy Trusts add another level to due diligence concerns related to collateral securing loans, the transfer of that collateral, and determining when the borrower or guarantor lists a trust or trusts on his or her financial statement if the trust is actually a Legacy Trust. Common due diligence issues and questions include: QUESTION LEGACY TRUST DUE DILIGENCE ISSUES(S) RESPONSES(S)

How will the bank know that an obligor (borrower or guarantor) has established a Legacy Trust and has transferred property into it in a "qualified disposition?"

Due diligence. There is no public filing requirement. The transferor (with one exception) must sign a qualified affidavit pursuant to Ohio Revised Code (ORC) Section 5816.06. The qualified affidavit will likely stay in a lawyer's file. However, there is no requirement that a lawyer or other professional such as an accountant must be used in establishing a Legacy Trust. An individual, in compliance with the statute, could establish a valid Legacy Trust.

Can there be more than one qualified disposition of property in the Legacy Trust?

Yes, but a qualified affidavit may be required in each instance. A subsequent qualified affidavit is not required in connection with any qualified disposition made after the execution of an earlier qualified affidavit, if that disposition is a part of, required by or the direct result of a prior qualified disposition made in connection with the earlier qualified affidavit.

What effect does a transfer of assets by a borrower have with respect to loan documentation? Should (or can) the bank insert provisions in loan documents to try to address possible issues arising with a Legacy Trust?

Are there change of ownership clauses in the loan documents? Review the underlying loan documentation for language in security agreements or mortgages such as:

- "The Grantor represents, warrants and covenants to _____ that... (c) except as herein provided, the Grantor will not hereafter without _____'s prior written consent sell, pledge, encumber, assign or otherwise dispose of any of the Collateral..." or a
- Due on Sale Clause, such as: "The Mortgagor shall not sell, convey or otherwise transfer any interest in the Property (whether voluntarily or by operation of law), or agree to do so, without the Mortgagee's prior written consent, including (a) any sale, conveyance, encumbrance, assignment, or other transfer of (including installment land sale contracts), or the grant of a security interest in, all or any part of the legal or equitable title to the Property, except as otherwise permitted hereunder; * * * * Any default under this Section shall cause an immediate acceleration of the Obligations without any demand by the Mortgagee."

What happens if a bank's obligor, who has given the bank a mortgage or other secured interest, then enters into a Legacy Trust?

Assuming that the lien given prior to entry into the Legacy Trust is valid, nothing happens to the secured interest. A valid lien and lien rights follow the collateral into the trust. ORC Section 5816.10 (G) provides, in part, that any valid lien attaching to property before a disposition of that property to a trustee of a Legacy Trust shall survive the disposition. The trustee shall take title to the property subject to the valid lien and subject to any agreements that created or perfected the valid lien. Nothing in this chapter shall be construed to authorize any disposition that is prohibited by the terms of any agreements, notes, guaranties, mortgages, indentures, instruments, undertakings or other documents.

Is the bank permitted to foreclose on a mortgage or exercise rights and remedies with respect to collateral even if the collateral is in a Legacy Trust?

Assuming the lien is valid and the lien predated the establishment of the Legacy Trust, nothing happens to the secured interest and the bank may exercise all of its rights and remedies as provided in any agreements, notes, guaranties, mortgages, indentures, instruments, undertakings or other documents.

What happens when a mortgagor (with an Ohio open end mortgage with a maximum amount of \$Y) enters into a Legacy Trust and later wants to increase that maximum open end amount to \$Y +? What if the mortgage is very specific to a particular note (as is often the case)? Will an amendment or restatement of the note create issues?

As to an increase in the open end amount, the mortgage can be amended. But real property assets (over and above those subject to a valid mortgage lien in favor of the creditor) in the Legacy Trust may not be subject to the mortgage. The language within the mortgage will need to be reviewed to see if it proactively addresses the particular facts of the case.

One can imagine factual disputes as to the value of property transferred into a Legacy Trust since the property actually subject to the open end mortgage remains the same; but the amount of value of that property available to satisfy the mortgage may be limited by the open end amount.

What happens when a guarantor (with a limited guaranty with a maximum amount of \$Y) enters into a Legacy Trust and later wants to increase the amount of the guaranty?

The guarantor can increase his or her obligations under the guaranty. The establishment of the Legacy Trust does not preclude doing so. However, the assets, if not subject to a prior valid lien, transferred into the Legacy Trust are not reachable by the creditor.

What happens when a guarantor (with a limited guaranty with a maximum amount of \$Y and who has granted to a bank a security interest to secure the guaranty) enters into a Legacy Trust and later wants to increase the amount of the guaranty?

The guarantor can increase his or her obligations under the guaranty. The establishment of the Legacy Trust does not preclude doing so. But assets (over and above those subject to a valid lien in favor of the creditor) in the Legacy Trust are not reachable by the creditor.

What happens with a grantor of a secured interest who grants a lien in specific collateral and then enters into a Legacy Trust and with the passage of time the secured creditor wants to maintain its lien in replacement collateral or accessions (or, for example, the grantor grants a lien in a motor vehicle and later gets a new car)?

Review the original loan documentation to see how the security agreement defines the collateral – is after acquired property or replacement property included?

Will this impact "bad boy" guaranties or "contingent" or "springing" guaranties where the liability may not arise until long after the guaranty is signed?

Once assets are in a valid Legacy Trust, those assets are not reachable by the creditor. These types of guaranties usually are truly unsecured except as to future income, paychecks, property, etc. which might arise after the establishment of a Legacy Trust.

Assuming the terms of the Legacy Trust permit or require distributions of income or principal, can the bank get at those distributions?

Once received by the Transferor of the Legacy Trust, the income is attachable by any creditor. However, routine exemptions may protect the income from attachment.

Can a creditor challenge a transfer of assets into a Legacy Trust?

There is a very heavy burden of proof and, unlike in other instances, attorney fees are to be awarded to the winner of any litigation. That means that if a bank challenged and lost, it might be responsible for paying for all the legal fees.

ORC Section 5816.07 provides that a creditor cannot bring action against a Legacy Trust, except that it may bring an action to avoid a qualified disposition with intent to defraud the specific creditor if:

(a) The creditor was a creditor before the qualified disposition and (i) action is brought within the later of 18 months after the disposition, or (ii) within six months after the qualified disposition reasonably could have been discovered by the creditor, the creditor makes a demand for payment, and an action is filed within three years after the qualified disposition.

(b) The creditor becomes a creditor after the disposition and action is brought within 18 months of the disposition.

(c) The creditor must prove its case by “clear and convincing evidence.”

(d) In the event of a conflict of Act with Chapter 1336 (Fraudulent Transfers) of the ORC, the Legacy Trust Act controls.

3. Practice Points

In summary, it is not enough just to obtain a personal financial statement. If a trust is described on the personal financial statement, further due diligence should be conducted to determine if the trust is a Legacy Trust and, if so, whether the Legacy Trust was properly established, what assets are subject to the Legacy Trust, and when the assets were transferred to the Legacy Trust. If subsequent financial reporting is required under the loan, the same due diligence must be conducted if additional trusts are listed within subsequent financial reporting.