Feature: Estate Planning & Taxation

By Mark Merric & Robert D. Gillen

Asset Protection for the Middle Class

Other than its effective use as an elder law planning tool, an irrevocable income only Medicaid trust may not be the way to go. Here's why

There's a new type of asset protection technique that's evolved from a well-established and highly effective elder law planning tool: the irrevocable income only Medicaid trust (IIOMT). We find the IIOMT to be an extremely effective tool in Medicaid planning. But the IIOMT is now being marketed outside the Medicaid arena as an asset protection tool for middle income families against all creditors. We question the use and effectiveness of the IIOMT as an asset protection tool, as against any creditor other than the government in the Medicaid context.

IIOMT's Original Purpose

For elder law purposes, when (1) property is given to a trust five years in advance; (2) the settlor holds only a mandatory income interest;[1] and (3) the settlor's income is below certain levels, then the trust is not considered as a countable resource in qualifying the settlor for Medicaid. By giving property to an IIOMT, the remainder interest may then pass to the settlor's beneficiaries free from any governmental claims for reimbursement of Medicaid expenses paid on behalf of the settlor. (See "The Medicaid Trust," p. 18, for details.)

Due to the retained income interest, an IIOMT is a self-settled trust. Absent the protection of a domestic[2] or offshore asset protection trust (APT) statute (that is, a self-settled trust that provides protection of the settlor/beneficiary's interest by statute or case law),[3] any creditor "may reach the maximum amount that can be distributed to or for the settlor's benefit."[4] This issue brings us to the main purpose of an IIOMT and why it works for Medicaid. The IIOMT allows the Medicaid recipient to supplement his income with the governmental benefits for so long as his income generally doesn't exceed a certain amount per month. At the same time, the IIOMT allows the settlor to pass his wealth to his spouse or descendants free from any Medicaid recovery for expenses paid on behalf of the settlor. An IIOMT works for elder law planning because the federal statute prevents the government from recovering against the settlor's income interest or the trust assets. This statutory protection doesn't extend to anyone other than the government, and even then, only in the Medicaid context.[5]

A New Use?

The IIOMT and its derivatives are now being marketed outside the Medicaid arena to middle income families as an APT variant. Some estate planners have referred to the IIOMT and its derivatives as one side of the asset protection planning coin. To these planners, the other side of the asset protection planning coin consists of the traditional asset protection planning tools such as tenancy-by-the-entirety, charging order protection, domestic APTs and offshore APTs.

Attorneys sometimes advise their clients that by transferring assets to an IIOMT, they have protected the principal of the trust. But this advice has little legal substance. Let's analogize to a simple gift to see why. When a client gives a share of stock to his daughter, she receives both the right to dividends (income) as well as the right to the sales proceeds of the stock. Comparing the gift of a share of stock to an IIOMT, assume a client's daughter is the sole remainder beneficiary of an IIOMT. If capital gains are allocated to principal,

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consistent with the general rule for fiduciary accounting, then the daughter will eventually receive only the capital gains. In the gift scenario, both the income and principal are protected, because the client gave away all interests in the property. In the IIOMT scenario, the client only gave away the principal or remainder interest, and therefore that is all that is protected from creditors.

So what, if anything, has been accomplished? If any creditor can reach the income, there is little, if any, asset protection for the income interest. Also, if the remainder interest has been given away, then the settlor no longer has the remainder interest, so how does the settlor benefit under this IIOMT arrangement?

"Nod, Nod, Wink, Wink"

In order for the settlor to benefit from the IIOMT, the settlor would have to, in some way, be able to get back part of the principal. This is the point where a drafting attorney explains to his client what we call the "nod, nod, wink, wink" part of the plan. Distributions may be made to the client/settlor's children, and then his children can give the property back to him. This important detail that is the foundation of the asset protection component behind this newly marketed trust is seldom publicized. Rather, it's communicated verbally at estate-planning seminars and likewise verbally communicated by estate-planning attorneys to their clients.

When hearing how the IIOMT works, a client may worry that his children won't give distributions back to him. To mitigate the chance that the children won't work in collusion with the settlor, most proponents draft the IIOMT so that the settlor retains a testamentary limited power of appointment. The settlor/parent then informs his children that should a child not follow the settlor/parent's wishes, the settlor/parent will exercise the testamentary limited power of appointment and disinherit the child.[6]

Serious Concerns

Up front, we suggest that you never advise your client to create an asset protection plan that is based on a "nod, nod, wink, wink." Here's why.

If there's no spouse/beneficiary who may receive distributions, the asset protection behind the IIOMT for middle income families is primarily based on a plan originated by the estate-planning attorney that when the client needs the principal, the client's children will make a distribution to the client. This distribution will be made back to the client at a later time, in a different amount. For example, let's say the trustee makes a trust distribution of $5,000 to his son in January, and in February his son gives $2,000 to his dad. In March,

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the son gives $2,500 to his dad. A total of $5,000 was distributed by the trust, with $4,500 subsequently gifted back to the settlor. Depending on how well the estate-planning attorney directs and orchestrates the "nod, nod, wink, wink" part of the plan, clients hope that some, if not most, of the creditors will not discover the collusive plan orchestrated by the attorney.

However, a creditor may subpoena the trust to track future distributions. A creditor may also subpoena a client's bank accounts to determine deposits as well as the source of these deposits. If there was a pattern of distributions from the trust, followed by gifts from the children receiving the distributions to the settlor of the trust, the creditor has a detailed map of a possibly heavily traveled road proving the existence of a "nod, nod, wink, wink." In addition to piercing the trust and reaching the underlying assets, the creditor may bring a claim against the client under a civil Racketeer Influenced and Corrupt Organizations (RICO) action.

The client is now in a real predicament. During depositions or interrogatories, can a client state he did not receive distributions of principal from the trust?

The implied collusion in an IIOMT is that the trustee will make distributions to the children, not for their use, but to be given back to the parent when and if needed.

How does a client answer interrogatories or depositions regarding money he received from his children? How does the client answer the question, "Did someone advise you that the trustee could make distributions to your children, and then your children could give the property back to you?"

At this point, the client's trial attorney would probably advise the client to cut a deal with the creditor. Part of this deal may be to disclose the mastermind who designed, implemented, and orchestrated the structure—the estate-planning attorney. The creditor will then have an ethical claim against the estate-planning attorney and may also have a civil claim, fraudulent conveyance claim and a civil RICO action against the attorney for damages.

Claims Against Attorneys

There are many examples of ethical disciplinary actions against attorneys who have engaged in unethical conduct representing clients in asset protection cases. For example, in *Florida Bar v. Edward Rood*[7] an attorney's son had a judgment entered against him in Michigan. The attorney/father prepared a deed conveying some real estate from the son to the father. The attorney was suspended for one year for a fraudulent conveyance in connection with the property transfer. In *In Re Bensen,*[8] an attorney helped a client protect assets by creating notes and mortgages secured with the client's property to protect it from forfeiture. The notes, however, weren't real and no loans had been made. The attorney was suspended for six months for assisting a client in conduct that the attorney knew was illegal or fraudulent.

An IIOMT, as an asset protection tool, is in many ways similar to the techniques used in the cases cited above, but in some respects, an IIOMT is quite different. It's similar to a fraudulent conveyance in that an IIOMT may be based on collusion between a client and his children to transfer property back to the parent when needed, with an attorney orchestrating the plan to remove assets from the reach of legitimate creditors. Remember, in *Rood*, the attorney/father would at some time in the future return the real estate to his son. The implied collusion in *Bensen* was that the notes would never be paid and there was no valid debtor. The implied collusion in an IIOMT is that the trustee will make distributions to the children, not for their use, but to be given back to the parent when and if needed. The special power of appointment held by the settlor/parent insures that the children will follow the parent's request to have the property given back to him and provides some evidence of the settlor's control over the beneficiaries and trust income.

Some may argue that an IIOMT is different from the above cases because an IIOMT should never be created to effect a fraudulent conveyance. Rather, an IIOMT should always be set up in advance of a legal crisis or debt in which creditors may be looming. For example, in the disciplinary case of *In Re Carl L. Kenyon and Robert P. Lusk*,[9] two attorneys assisted their clients by transferring estate assets into corporations controlled by the attorneys and financing the property with liens from other corporations controlled by the attorneys in an attempt to defeat creditor claims against the estate. The South Carolina Supreme Court found that helping clients cheat creditors is dishonest and in violation of the state's ethics code; conduct constituting an ethical violation doesn't have to be sufficient to state an action under fraudulent conveyance statutes.

In addition to being subject to disciplinary actions, an attorney may also face conspiracy claims by a creditor. In *Banco Popular North America v. Gandhi*,[10] a New Jersey lower court found that an attorney who advised his client that it was lawful to transfer his house to his wife prior to a loan default was subject to a civil conspiracy claim. The case was appealed to the N.J. Supreme Court[11] that considered two issues: First, whether a cause of action exists for creditor fraud that would encompass the attorney's conduct and second, whether the attorney violated any duty to the non-client bank, in connection with the fraudulent transfer or a subsequent loan. The N.J. Supreme Court held that no direct cause of action existed for creditor fraud but the attorney could be liable for conspiracy to violate the New Jersey Uniform Fraudulent Transfer Act for his participation in the transfer. The court also held that the attorney may be liable for the misrepresentations he made in connection with an opinion letter he issued on the subsequent loan. Likewise, in *Monastra v. Konica Business Machines, USA, Inc.*[12] an attorney was held liable for civil conspiracy to make a fraudulent conveyance. The California appeals court stated that a fraudulent conveyance that leaves a creditor unable to satisfy a judgment is a civil wrong under a civil conspiracy theory. Be aware that in some states, including Illinois[13] and California,[14] participation in a fraudulent conveyance constitutes a criminal act. Also, in the bankruptcy context, a fraudulent conveyance is a criminal act in New York.[15]

In all likelihood, many creditors will probably never uncover the trust, understand the plan, or discover how it was implemented with a gift-back strategy.

Moreover, there's a minority view that allows a creditor to bring a direct conspiracy action against the attorney, regardless of whether the creditor proved a fraudulent conveyance.[16] Arizona is not alone in its view that a direct action for a conspiracy claim may be brought against an attorney. The treatise *The Law of Torts* takes the same view, stating: "When a civil wrong occurs as the result of concerted action, the participants in the common plan are equally liable."[17]

Beyond ethical violations and concerns, fraudulent transfer claims and conspiracy claims, an orchestrating attorney may also be liable to a creditor for civil RICO damages. In *Cadle v. Schultz*,[18] a creditor claimed that an attorney assisted his client in transferring the client's assets out of the creditor's reach by partitioning community property; transferring the client's salary into a family limited partnership created by his wife; transferring various amounts of money to trusts for children; and making additional questionable transfers of real estate to various other defendants. These transfers were made shortly after a court entered a $41,000 judgment on a promissory note against the client. The Northern District Court of Texas found that if the alleged facts were viewed as most favorable to the creditor, the attorney as well as the client could be liable under a civil RICO claim.

In addition to a creditor bringing claims against an estate-planning attorney, a client himself may bring a malpractice claim against his own estate-planning attorney. In general, a malpractice claim against an attorney exists if the client proves the following:

1. A duty existed to use such skill, prudence and diligence as other members of the legal community would commonly have and utilize;
2. The attorney breached this duty;
3. A causal connection exists between the negligence and the injury claimed; and
4. Injury claimed caused actual damages to the client.[19]

When the asset protection of an IIOMT is dependent on the gift-back scheme, we think a client will have little problem proving the necessary elements for a malpractice action against the orchestrating attorney.

The Smoking Guns

Outside of the Medicaid context, noted tax specialist and author Peter Spero writes in his treatise that when a settlor creates a trust and reserves both an income interest and a special power of appointment, it's uncertain whether a creditor can reach the principal of the trust. Some proponents of using an IIOMT for middle income families take the opposite point of view. Occasionally, proponents of using the IIOMT for a middle income marketing plan will cite *Spetz v. New York State Department of Health*[20] and *Verdow, et. al. v. Onondaga County Department of Social Services*[21] as authority that a court will not impute a bad motive that distributions will be made to the children and then given back to the parents. The *Verdow* court specifically stated: "Absent evidence of bad faith or fraud, the decision of whether or not to provide Medicaid benefits should not be based upon the remote possibility of collusion."

First, note that *Spetz* and *Verdow* are Medicaid eligibility cases—very different scenarios from creditor cases against a middle income settlor. Second, we agree with the *Spetz* and *Verdow* outcomes; that is to say that if there are no distributions to the settlor's children followed by making gifts back to the settlor, there would be no evidence of fraud or collusion. Third, we agree with *Spero* that the law is uncertain in this area on special powers of appointment alone. But we are concerned with a special power of appointment combined with a pattern of a trustee making distributions to the children and the children subsequently giving the property back to the parents—that's what makes the plan fatal. It's the implementation of the conspiracy part of the plan, orchestrated by the designing attorney that is problematic.

> If a settlor's spouse pays for expenses that are only the settlor's responsibility, then there's a much greater chance that the creditor may be successful in reaching the trust assets under a "dominion and control theory."

In all likelihood, many creditors will probably never uncover the trust, understand the plan, or discover how it was implemented with a gift-back strategy. Some estate planners will say this means the IIOMT as an asset protection tool works.

But as creditors learn more about asset protection tools, there are smoking guns that would lead prudent creditors to the true nature of a plan.

The first smoking gun: An IIOMT is a grantor trust. Therefore, the income from the trust should appear on the grantor's income tax return. And a creditor may subpoena past income tax returns. The second smoking gun: Upon uncovering the trust and reading its contents, a creditor may see the trust contains an unusual provision for irrevocable trusts—that the settlor retained a testamentary power of appointment. Generally, retaining a testamentary power of appointment by a settlor only occurs in two types of trusts: an APT or an IIOMT when used for Medicaid purposes. If the trust is an IIOMT, a creditor should immediately attach the income interest, subpoena the trust records, depose the trustee and subpoena the client's bank accounts. Discovery may prove the existence of distributions to a child, followed by a trail of gifts from that beneficiary to the settlor. That's enough to establish the "nod, nod, wink, wink" part of the plan. And that can lead to a finding of collusion, perjury and fraud.

More Asset Protection Concerns

Additional asset protection concerns arise depending on the design of the IIOMT and the type of assets used to fund it. For example, in many of these structures the client transfers his residence into the IIOMT but is given the right to live in his house. Similar to an income interest, the right to live in a client's house for a client's life is a self-settled interest and absent the protection of an APT (or possibly a homestead exemption), any creditor should be able to reach it. For example, in *In re Frangus*,[22] the settlors transferred their house into a trust. The life interest in the house remained with the settlors, and the remainder interest went to their children. Because of the loose language in the trust document, the bankruptcy court held that creditors could reach the entire interest, not just the life interest.[23] But with a properly drawn IIOMT, creditors should be able to attach only the income interest or the right to live in the residence. Note also, however, that when a residence is transferred into an IIOMT, an estate planner may actually cause more damage than good. By transferring the residence into an IIOMT, the client may lose a state homestead exemption.[24]

There is another issue to consider: Ten states have held that a remainder interest is in whole or part marital property and eligible for division in a divorce.[25] That is to say, in these states, when a child/beneficiary goes through a divorce, the child's estranged spouse has marital rights in the trust property. With a divorce rate in the United States of over 50 percent, this leaves a settlor hoping and praying that one of his children doesn't move to or reside in one of those 10 states. Conversely, if the IIOMTs are designed as discretionary dynasty trusts, this issue should be mitigated.[26]

Now What?

So no asset protection exists as to an income interest since any creditor, except Medicaid, could attach a settlor's income interest. And to the extent a homestead is funded into the trust, it's an income interest, and any creditor may reach a settlor's right to live in the house (unless the trust is an APT or a homestead exemption exists to protect property in an irrevocable trust). Of course, your client may decide not to fund the IIOMT with his family homestead but the reality is, the homestead is probably one of your client's largest assets and likely the first asset he wants to protect. Now what?

You obviously want to mitigate and eliminate the potential of ethical, fraudulent conveyance, conspiracy and civil RICO claims. Assuming the IIOMT isn't a joint trust, one option is to add the settlor's spouse as a discretionary beneficiary of distributions of trust principal. Similar to a spousal access trust, distributions may be made to the spouse and then these funds used to pay for family expenses. This doesn't resolve creditor attachment issues with the mandatory income interest held by the settlor. But, assuming that no distributions were made to the children and then given back to the settlor, the use of discretionary distributions to a spouse should lessen and many times eliminate the chance of a successful creditor claim for unethical conduct, fraudulent conveyance, conspiracy and civil RICO. This last point is based on one very important caveat: The spouse does not use the distribution for expenses that are clearly the settlor's obligation (for example, a settlor's attorney's fees to defend an action by a creditor). If a settlor's spouse pays for expenses that are only the settlor's responsibility, then there's a much greater chance that the creditor may be successful in reaching the trust assets under a "dominion and control theory."

If the settlor has dominion and control over the trust, there's no asset protection. Will the following combined factors demonstrate dominion and control and thus result in no asset protection? (1) The settlor's spouse or child is a trustee; (2) the settlor retained or was granted an income interest; (3) the settlor has an unrestricted removal/replacement power over the trustee; (4) a special power of appointment was held by the settlor; and (5) distributions are only being made to the spouse and are used for family purposes. Fortunately, the case law on dominion and control has not developed too far. But three of the top trust jurisdictions[27] have enacted third-party trust statutes[28] to prevent these type of dominion and control arguments.

IIOMT vs. APT

Legitimate asset protection planning isn't based on concealment, hiding the ball, burying someone's assets, or misrepresentation to creditors. Rather, it refers to the protection of assets afforded by statute or case law against creditors. Some time before a creditor has obtained a judgment and almost for certain shortly thereafter, a debtor's assets and how they are held in a legitimate asset protection planning tool will be disclosed to the creditor. A creditor may decide to negotiate a settlement or challenge the asset protection planning tool.

When comparing an APT to an IIOMT used for the middle class, an independent corporate trustee[29] decides if, when, and how much a settlor will receive as a distribution. The asset protection behind a domestic APT is based on statutes for in-state residents and on conflict-of-law principles for out-of-state residents. The asset protection for an offshore APT is based on conflict-of-law principles and the ability of a creditor to enforce a judgment offshore. There's no concealment of assets from the creditor; rather, it's the application of statutory and case law that provides for the ultimate protection of the beneficial interest.

Less of a Concern?

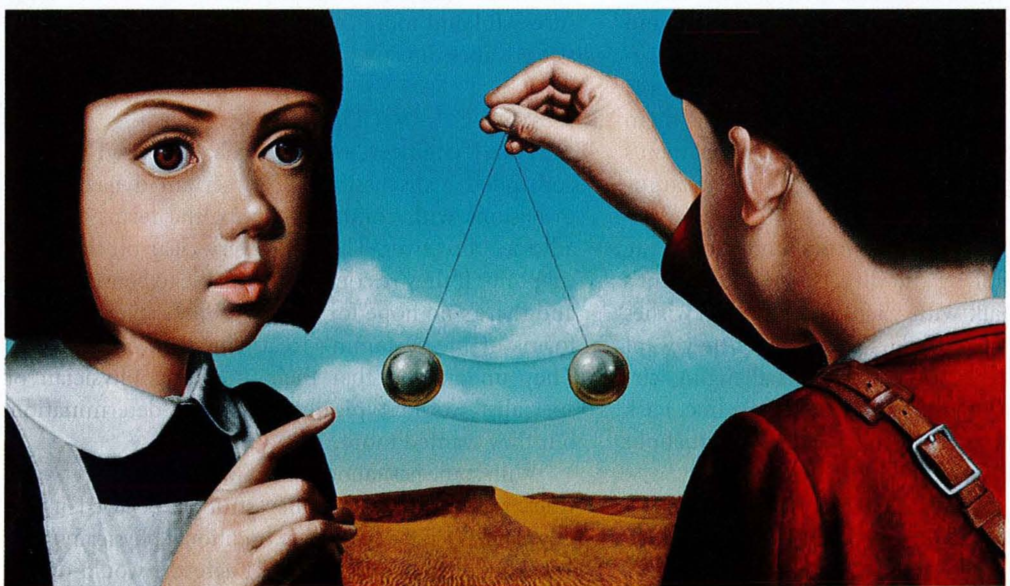
Why are dominion and control issues much less of a concern with APTs? The asset protection of a domestic APT is based on conflict-of-law principles. If a court follows the law of the domestic APT state,[29] then the statutory protection will preclude a dominion and control argument. Almost all 11 of the APT states provide that the only remedy a creditor may bring against the domestic APT or a beneficial interest is a fraudulent conveyance claim. Therefore, there's no such thing as a reverse veil pierce, constructive trust, resulting trust, alter ego, creditor's bill or dominion and control claims under these domestic APT statutes. With an offshore APT, there's the same conflict-of-law protection, plus the general inability of a creditor to enforce the judgment.

—The authors would like to thank estate planner Bruce Steiner for his comments and suggestions for this article.

Endnotes

1. For purposes of this article, a mandatory interest is defined to require all income to be distributed no less than annually.
2. Domestic asset protection trust (APT) statutes are frequently referred to as "qualified disposition statutes."
3. When offshore APTs were introduced into the United States, many practitioners questioned whether APTs would be effective. Although the Isle of Man, Guernsey, and Jersey upheld the validity of self-settled trusts, many commentators in the United States continue to debate the effectiveness of these trusts as well as domestic APTs for an out-of-state resident, against an out-of-state claim, or against a federal claim or a bankrupt.
4. *Restatement (Second) of Trusts,* Section 156(2); Uniform Trust Code Section 505(a)(2); *Restatement (Third) of Trusts,* Section 58(2) and cmt. E.
5. Except by statute, the government cannot reach the interest for Medicaid purposes.
6. Under Treasury Regulations Section 25.2511-2(c), the power to change beneficial interests granted by the testamentary limited power of appointment will prevent transfers to the irrevocable trust from becoming a completed gift. Also, this ability to change the beneficial interests in the trust will result in the trust being included in the settlor's estate under Internal Revenue Code Section 2036(a)(2).
7. *Florida Bar v. Edward Rood,* 632 So.2d 1028 (Fla. 1993).
8. *In re Bensen,* 854 P.2d 466 (Or. 1993).

9. *In Re Carl L. Kenyon and Robert P. Lusk*, 491 S.E.2d 252 (S.C. Sup. Ct. 1997).
10. *Banco Popular North America v. Gandhi*, 360 N.J. Super. 414; (N.J. Super. Ct. 2003).
11. *Banco Popular North America v. Gandhi*, 184 N.J. 161; (N.J. 2005).
12. *Monastra v. Konica Business Machines*, 43 Cal. App. 4th 1704 (Ct. App. 1996).
13. Illinois Statute, 720 ILCS 5/7-14.
14. California Penal Code Section 531.
15. New York Penal Law Chapter 40, Title K, Sec. 185.00(2)(A).
16. *McElhanon v. Hing*, 728 P.2d 256 (Ariz. App. 1985).
17. W. Prosser and W.P. Keeton, *The Law of Torts*, Sec. 46 at p. 323 (5th ed. 1984). The word "conspiracy" is generally used in connection with imposing vicarious liability for concerted action. *Ibid.* at p. 324.
18. *Cadle v. Schultz*, 779 F. Supp. 392 (N.D. Tex. 1991).
19. *Williams v. Ely*, 668 N.E.2d. 799 (Mass. 1996).
20. *Spetz v. New York State Department of Health*, 737 N.Y.S.2d 524 (Sup. Ct. Chautauqua Co. 2002).
21. *Verdow et. al. v. Onondaga County Department of Social Services*, 209 F.R.D. 309 (N.D.N.Y. 2002).
22. *In re Frangus*, 132 B.R. 723 (N.D. Ohio Bkrtcy 1991) and 132 B.R. 272 (N.D. Ohio Bkrtcy 1992).
23. In *In re Frangus, ibid.*, similar to the irrevocable income only Medicaid trust (IIOMT), the irrevocable trust was not a qualified personal residence trust (QPRT). It should be noted that the QPRT suffers from the same asset protection deficiencies.
24. By analogy, *In re Lyle*, 355 B.R. 161 (D. Ariz. Bkrtcy 2006) held that Arizona's homestead exemption was lost if the homestead was transferred into an entity (such as a limited liability company (LLC)). Conversely, *Nolte v. White*, 784 So.2d 493 (Fla. App. Dist. 2001) and *Robbins v. Welbaum*, 664 So.2d 1 (Fla. App. Dist. 1955) held the homestead exemption applicable to a homestead held in trust.
25. Alaska: *Burrell v Burrell*, 537 P.2d 1 (Alaska 1975); Colorado: *Balanson v. Balanson*, 25 P.3d 28 (Colo. 2001); Connecticut: *Carlisle v. Carlisle*, 1994 WL 592243 (Super. Ct. Conn. 1994); Indiana: *Moyars v. Moyars*, 717 N.E.2d 976 (Ct. App. Ind. 1999); Massachusetts: *Davidson v. Davidson*, 474 N.E.2d 1137 (Mass. 1985); Montana: *Buxbaum v. Buxbaum*, 692 P.2d 411 (Mont. 1984); New Hampshire: *Flaherty v. Flaherty*, 638 A.2d 1254 (N.H. 1994); North Dakota: *Van Osting v. Van Osting*, N.D. Sup. Ct. No. 940003 (1994); Oregon: *Benston v. Benston*, 656 P.2d 395 (Or. App. 1983); and Vermont: *Chikott v. Chikott*, 607 A.2d 883 (Vt. 1992).
26. Mark Merric, "Discretionary Dynasty Trusts—Parts I-III," *Estate Planning Magazine*, February March, April 2010.
27. Delaware, Nevada, and South Dakota have all adopted legislation preventing creditors from attacking third-party trusts with dominion and control arguments.
28. Third-party trust statutes need to be distinguished from first-party statutes, such as domestic APT statutes. A third-party trust is when someone other than the settlor creates the trust for the benefit of others. The three states are South Dakota, Delaware and Nevada.
29. The term "corporate trustee" is used generically in this article to include those who may be in LLC form. Domestic APT statutes usually do not require the use of a corporate trustee. However, as a practical matter, almost all of the time, settlors appoint an independent corporate trustee for these trusts.



SPOT LIGHT

Spring Into Action! Masaru Shichinohe's acrylic on canvas "Movement of the Pendulum," about 38 inches by 97 inches, painted in 2009, sold for U.S. $103,011 at Sotheby's "Contemporary Asian Art" auction in Hong Kong on April 5, 2010.