

IIR 16th Annual Family Office Forum

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DOMESTIC ASSET PROTECTION TRUSTS

I. Overview/Anatomy of Domestic Asset Protection Trusts (“DAPTs”)

A. Demand for DAPTs and International Protection Trusts

Asset protection has always been an integral part of estate planning, but not necessarily a primary goal. Asset protection has become increasingly important in this era of ubiquitous litigation, exploding monetary awards, increased divorce rates, regulatory liability (such as environmental contamination) and the current economic crisis. In some circles it is believed that if an estate planning attorney is not specifically discussing asset protection with his clients, he/she is committing malpractice.

Traditional methods of asset protection have already been discussed. Historically, trusts are accepted mechanisms for an individual to make assets available to a third person beneficiary, yet preclude involuntary or voluntary alienation of the beneficial trust interests, thus protecting those assets from the beneficiary’s creditors or a spouse of a beneficiary in the event of divorce (the latter of which varies from jurisdiction to jurisdiction). See *Nichols v. Eaton*, 91 U.S. 716 (1875). Generally, the terms of the trust limits a beneficiary’s property rights (the extent

of the beneficiary's dominion and control over the property), which are what can be attached by a creditor.

An exception to the acceptance of spendthrift trusts is where the trustee is the beneficiary, as in a self-settled trust. Where a person creates a trust for his own benefit, creditors can still reach "the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit", even if the trust is discretionary or limited to specific benefits. *Restatement (Second) of Trusts*, Section 156 (1959). Public policy exists in favor of seeing that a claimant's claim is paid, over spendthrift trust provisions.

B. Self-Settled Spendthrift Trusts

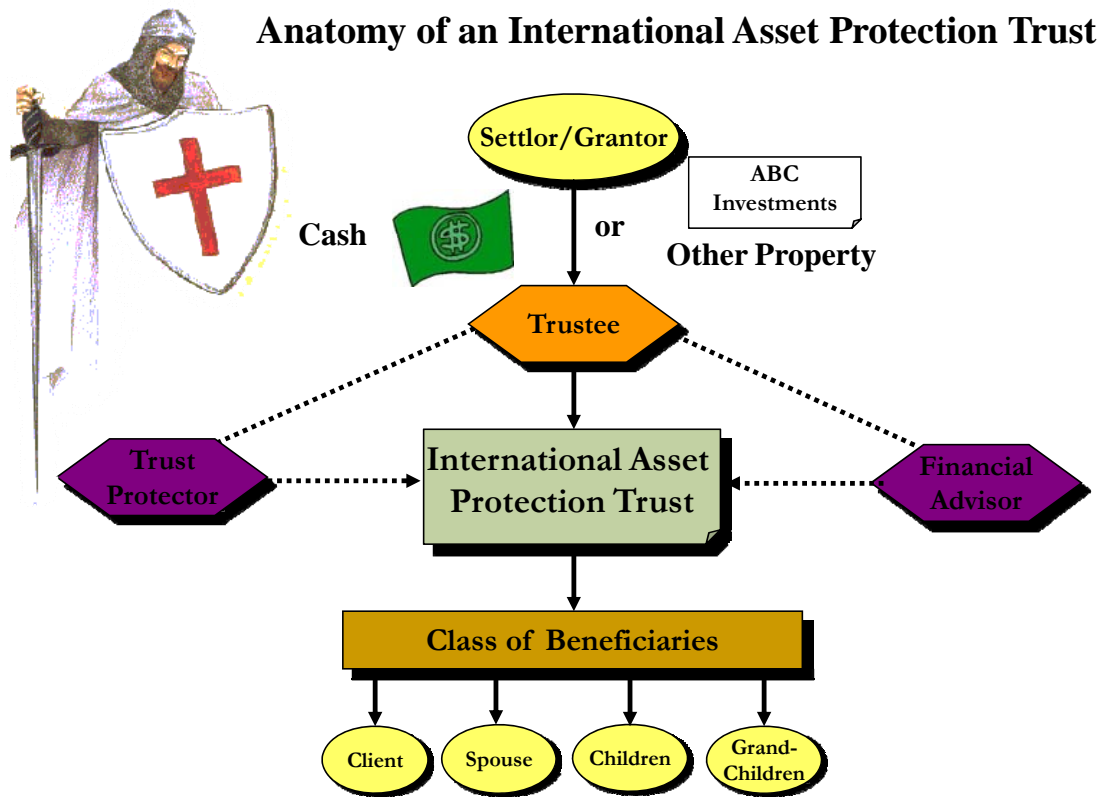
In the early 1980's, a few foreign jurisdictions permitted a settlor to create a spendthrift trust for his/her own benefit. Many of these jurisdictions do not recognize foreign judgments, requiring a creditor to pursue a claim in a foreign jurisdiction, which can be extremely expensive and have little likelihood of success. These off-shore trusts became very popular with the very wealthy.

In 1997, Alaska (followed quickly by Delaware, and later by 10 other states) enacted protective trust legislation designed to permit a settlor to create a trust and receive discretionary distributions without exposing the trust to claims against the settlor (with some exceptions). An added benefit was that the settlor could

transfer assets out of his estate (for estate and gift tax purposes) into the trust, even though the settlor remained a discretionary beneficiary of the trust.

This interesting change to public policy places these 12 states in some opposition to the remaining states, which brings into play various constitutional issues, such as the full faith and credit clause, which are not covered in this presentation.

C. Anatomy of an Asset Protection Trust



II. Summary of States with DAPT Statutes: Typical Scheme

A. The 12 States that currently have Domestic Asset Protection Statutes are the following.

Alaska
Colorado
Delaware
Missouri

Nevada
New Hampshire (as of 1/2/2009)
Oklahoma
Rhode Island
South Dakota
Tennessee
Utah
Wyoming

B. The Typical Scheme of Domestic Asset Protection Trust Statutes

1. Almost all DAPTs must include the following:

- Irrevocability
- Spendthrift Provision
- No Mandatory Distributions/Discretionary Trust or, in some cases allow distributions pursuant to an ascertainable standard
- The settlor must not be the sole trustee and the trustee must be either a resident of the state or qualified to act as a trustee in the state
- Identify the law of the state that governs the trust

2. Some provisions common to most statutes:

- All or part of the trust assets must be located and administered in the state
- Settlor must attest that he/she is solvent and knows of no impending claims or potential claims against him/her; the intent of the transfers is not to defraud creditors; and the settlor will not be insolvent as a result of the transfers
- Trustee should maintain records and prepare income tax returns
- Many of the states having DAPT Statutes have also effectively or specifically abolished the rule against perpetuities
- Some of the interests that the settlor may retain and still protect trust assets varies from state to state, but may include:

Current income

Up to 5% interest in a total return trust

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GRAT or GRUT

Ability to have debts, expenses and taxes of the settlor's estate paid from the trust

Ability to be reimbursed from the trust for income taxes attributable to the trust

- The settlor may retain some powers, such as:

The power to veto distributions

Non-general testamentary power of appointment

Right to appoint a trust protector or trustee advisor

- Some states allow the settlor

Power to replace trustee/advisor with non-subordinate party

Ability to serve as investment advisor

3. Protections from claims for child support, alimony, property division on divorce and tort claims differ from state to state:

- a) Child Support: Most states do not protect trust assets from claims for child support; only Colorado and Nevada protect assets from child support claims entirely; Alaska and Rhode Island do not protect assets from child support claims if the settlor was in arrears at the time of the transfer/court order for child support existed at the time of the transfer (respectively).
- b) Alimony: Five states do not protect trust assets from claims for alimony (Alaska, Colorado, Nevada, Oklahoma, Wyoming); five states do not

protect trust assets from claims for alimony if the ex-spouse was married to the settlor on or before the date assets were transferred to the trust (Delaware, New Hampshire, Rhode Island, South Dakota, Tennessee); and two states provide protection from claims of alimony (Missouri, Utah).

- c) Property Division on Divorce: Five states protect trust assets from property division on divorce (Colorado, Missouri, Nevada, Oklahoma, Wyoming); six states do not protect assets from property division on divorce if the ex-spouse was married to the settlor on or before the date of transfer, otherwise the assets are protected (Delaware, New Hampshire, Rhode Island, South Dakota, Tennessee, Utah); Alaska does not protect property in property division only if the assets were transferred into the trust during or less than 30 days prior to marriage.
- d) Tort Claims: Seven states protect trust property from tort claims (Arkansas, Colorado, Missouri Nevada, Oklahoma, Tennessee, Wyoming); four states protect property from tort claims unless the claims arise before or the date of transfer (Delaware, New Hampshire, Rhode Island, South Dakota); Utah provides several exemptions from asset protection for tort claims.
- e) Oklahoma limits asset protection to \$1,000,000 of contributed property.

III. Issues and Challenges

A. Lack of Case Law

Domestic Asset Protection Trusts are just over 11 years old. Currently, there is insufficient case law to determine how the 38 states that do not provide asset protection for self-settled trusts will recognize the change in public policy now accepted by the other 12.

Those cases that have been litigated usually have extremely bad facts.

B. 2005 Bankruptcy Code Amendment

Section 548(e) of the Act says that a bankruptcy trustee “may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the filing of the bankruptcy petition if:”

The transfer was made to a self-settled trust or similar device;

The transfer was made by the debtor;

The debtor is the beneficiary of the trust;

The transfer was made with the fraudulent intent as to an entity to which the debtor was indebted.

“It appears that the trustee would be required to show that there was an intent to defraud actual creditors and not potential future creditors for Section 548(e) to apply.” *See* Nelson, Barry, “Asset Protection Planning: The Ethical Considerations in Advising Clients on Asset Protection Techniques”, 34th Annual Notre Dame Tax and Estate Planning Institute, September 25-26, 2008

This legislation, which only applies in bankruptcy situations, will most likely be litigated, particularly whether the transferor had actual intent to defraud and whether the creditor was actual or potential.

The ten year look-back period should encourage those clients interested in establishing DAPTs to do so sooner rather than later. In operation, it has strongly encouraged clients to consider and implement International Asset Protection Trusts.

C. Fraudulent Transfers

Fraudulent transfers were previously addressed, but in brief, the Uniform Fraudulent Transfer Act applies in most states and sets aside transfers made with the intent to hinder, delay or defraud and transfers made with constructive fraudulent intent. Most states' statutes provide for protection against existing and future creditors beginning four years after the transfer. Some states allow a shorter look back period of one or two years after the transfer if the claim was or could reasonably have been discovered during that time and if the transfer was based on the intent to hinder delay or defraud the claimant. A clear and convincing evidence standard is required.

IV. Current Developments

A. New Statute in New Hampshire

The New Hampshire statute, N.H. Rev. Stat. Ann, Section 564-D: 1-18, was passed in 2008 and became effective on January 2, 2009. It is very similar to the Delaware and Rhode Island statutes.

Interestingly, the legislature gave several reasons for enacting the statute: the rapidly growing national market for trusts and fiduciary services; New Hampshire's unique position to provide the most attractive legal and financial environment for trusts and investment assets, and attracting good paying jobs to New Hampshire.

B. Ethical Issues

Generally, protecting assets from potential future creditors is permissible, but conveying assets to avoid existing and identifiable creditors is an ethical violation. *ABA Lawyer's Manual on Professional Conduct* 1001:1801.

The ABA Model Rules of Professional Conduct state that if an attorney knows that the client is or will commit a crime, the attorney must disclose the material facts necessary to avoid assisting the client in committing the crime or fraud and the attorney should withdraw from representation of the client. Rules 1.2 and 1.4.

C. Potential Liability

Claim of Malpractice for aiding and abetting fraudulent conveyance or any other unlawful act

Solution: Due Diligence

Attempt to determine the client's motivation

Identify the client's assets and liabilities and potential claimants

Check pre and post marital agreements

Claim of Malpractice for failure to advise client about asset protection planning

Solution: Discuss asset protection alternatives

Civil liability for a client's fraudulent conveyance is based on whether: the attorney acted in good faith; there was a presence of collusion; the attorney acted within the scope of his duty as an advisor. There is a potential for co-conspiracy if there is an agreement to participate in an unlawful act.

Criminal and civil RICO Actions could apply if the attorney acts as a principal in pre-bankruptcy transfers of property

V. Advanced Planning Applications

Traditional asset protection methods were previously incidental to estate and tax planning. It is becoming clear that asset protection planning is an integral part of such planning. Even core estate plans have asset protection goals, using such means as GST Trusts and Dynasty Trusts.

Advanced Planning can make use of and incorporate the public policy of encouraging enterprise, business and trade. Creditor protection has long been available to businesses

in the form of corporations and, more recently, limited liability companies. The business person can determine the value of the assets he is placing at risk in entering a business enterprise, without endangering his or her other assets. Utilizing these entities in an estate plan provide added layers of creditor protection.

Domestic Asset Protection Trusts should be discussed with clients, particularly those in high risk situations, such as those who practice the medical arts. A combination of LLCs, corporations and DAPTs should be considered as Advanced Planning options for clients of high net worth.

Helpful references:

Shaftel, David G., "Comparison of the Domestic Asset Protection Statutes", ACTEC, 2008.
Rothschild, Gideon, ACTEC Asset Protection Committee Fall 2008 Annual Meeting.
Fox IV, Charles D., "Asset Protection Planning: Fundamentals and Current Developments", 34th Annual Notre Dame Tax and Estate Planning Institute, September 25-26, 2009.



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