

DOMESTIC ASSET PROTECTION TRUSTS

By: R. James Young*

It has been said many times: we live in a litigious society. For better or worse, the threat of a lawsuit has many individuals, especially professionals and small business owners, concerned about the safety of their hard-earned nest egg. If faced with a large judgment against them, many individuals would be personally liable if such judgment exceeded their liability insurance limits. It is unsettling to think that an honest, hard-working professional or business owner could be reduced to a pauper because of one lawsuit against such individual or his or her business. When discussing ways to keep assets from judgment creditors, people may imagine nefarious defendants living in huge mansions, jet-setting around the globe, and hiding assets in Swiss bank accounts to avoid paying taxes or to avoid paying off a debt for which they are liable. Certainly this does happen, as now infamous names like Bernie Ebbers, Rod Blagojevich, Bernie Madoff and Allen Stanford come to mind. This article is geared towards the men and women “who contribute to society by their productivity and with their generosity, who pay their bills and their taxes, and who are not deadbeats, cheats, frauds, or criminals.”¹ Some of these people have accumulated significant wealth by their own industry, and are concerned that the American litigation system sometimes looks closer to a jackpot lottery as opposed to a reliable forum for the settlement of legitimate disputes.²

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¹ Duncan E. Osborne & John A Terrill, II, Asset Protection Without Asset Protection Trusts 2 (2003) (presented at The American College of Trust and Estate Counsel 2005 Fall Meeting).

² *Id.*

For some time, individuals have transferred assets to offshore trusts to take advantage of tax savings and insulate their assets from potential claims of creditors.³ Domestic Asset Protection Trusts (DAPTs) were designed to allow an individual to set up a self-settled spendthrift trust, and allow the individual to keep their assets in the U.S. and enjoy the benefits of the assets while being immune to most creditors' claims.⁴ This is a change to the traditional American legal view which disfavored self-settled spendthrift trusts.⁵

Roughly sixty nations have Foreign Asset Protection Trust (FAPT) statutes, which make it nearly impossible for U.S. creditors to reach the assets in the trusts through the U.S. judicial system because the FAPTs are not subject to the jurisdiction of the United States.⁶ This means that a creditor has to retain counsel in the foreign country, file suit in the foreign country, travel there to try the case, and understand the applicable foreign law in order to gain an enforceable judgment against the assets held in the trust.⁷ This is usually an expensive and difficult task for a United States creditor.⁸ In recent years, asset protection statutes have been enacted in many states in the U.S.⁹ For individuals that are reluctant to move assets offshore, DAPTs provide a useful alternative to offshore trusts.¹⁰ A DAPT is an irrevocable trust with an independent trustee in the same state where it is situated, who has absolute discretion to make distributions to

³ Michael A. Passananti, *Domestic Asset Protection Trusts: The Risks and Roadblocks Which May Hinder Their Effectiveness* (2006).

⁴ *Id.* For extensive articles on this subject see, Charles D. Fox IV, *Domestic Asset Protection Trusts* (2008); Richard W. Nenno, *Planning With Domestic Asset Protection Trusts: Part I*, 40 REAL PROP. PROB. & TR. J. 263 (2005); Richard W. Nenno, *Planning With Domestic Asset Protection Trusts: Part II*, 40 REAL PROP. PROB. & TR. J. 477 (2005).

⁵ *Id.* The DAPT statutes contradict the Restatement (Second) of Trusts, which says, "where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum among which the trustee under the terms of the trust could pay to him or apply for his benefit." Restatement (Second) of Trusts § 156 (1959).

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ Richard G. Bacon & John A. Terrill, *Domestic Asset Protection Trusts Work-Should They?* 26 TAX MGMT. ESTATES GIFTS & TRUSTS J. 123, 137(2001).

a class of beneficiaries which includes the settlor.¹¹ In 1997, Alaska became the first state to enact a DAPT statute, with Delaware following several months later.¹² Eleven states allow the formation of DAPTs (twelve if Colorado is included).¹³

Each state that has passed DAPT statutes has its own variation, but most of the laws share common characteristics, and none are complete shields from creditors.¹⁴ Spouse and child creditors can penetrate the DAPT, as can existing tort claimants.¹⁵ If a creditor can prove that the individual made a fraudulent transfer to the DAPT, the creditor may be able to enforce its judgment under the Uniform Fraudulent Transfer Act (UFTA).¹⁶ The UFTA is followed by most jurisdictions and includes certain scenarios that courts will use to determine if the transfer was fraudulent. These “badges of fraud” include whether the settlor has been sued, threatened with suit, or incurred a debt shortly before transferring assets to the DAPT.¹⁷ Most DAPTs have a period of time in which existing creditors must sue, or they will waive their right to argue that the transfer was fraudulent.¹⁸

There is an on-going legal policy debate as to whether DAPTs are good or bad for society. Some contend that DAPTs are helpful to entrepreneurs and business owners that do not have an opportunity to protect their assets like they would if they worked at a large business.¹⁹ Individuals at some large corporations may be able to put assets in “creditor proof” retirement

¹¹ David G. Shaftel, *Comparison of the Twelve Domestic Asset Protection Statutes*, 34 ACTEC JOURNAL 293 (2009).

¹² *Id.*

¹³ *Id.* The following states have passed DAPT statutes: Alaska, Delaware, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. *Id.* at 294-311. Colorado has passed a statute, but it is unclear whether it qualifies as a DAPT statute. *Id.* at 294. *Compare* *In Re Baum*, 22 F.3d 1014, 1017 (10th Cir. 1994), *with* *In the Matter of Cohen*, 8 P.3d 429 (Colo. 1999).

¹⁴ Passananti, *supra* note 3.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ UFTA § 4(a) (1984).

¹⁸ Passananti, *supra* note 3.

¹⁹ *Id.*

accounts.²⁰ Other people may use life insurance policies, annuities, and transfers to family members to protect themselves.²¹ Proponents argue that small business owners should have DAPTs as another option to protect their assets.²² DAPTs can also protect people whose profession exposes them to many frivolous lawsuits.²³ DAPTs can be a better alternative than their foreign counterparts because the assets stay in the United States and the trust is governed by U.S. law, which will limit abuse.²⁴ DAPTs also help the U.S. economy because they stop the outflow of assets from the U.S. to foreign countries, which has been significant in recent years, as more people have set up offshore trust accounts in an attempt to protect their assets.²⁵ Others argue that DAPTs impair people's moral duty to pay their debts, and could increase lending costs if banks are worried that borrowers will not pay their legal obligations.²⁶ DAPTs may also be expensive to set up.²⁷ Some scholars argue that DAPTs will promote hazardous conduct, because people may be less cautious if they believe they are protected from law suits.²⁸

DAPTs have been largely unproved, because there have not been any reported court cases to test their viability.²⁹ There are some weaknesses that should be considered.³⁰ One consideration is the Full Faith and Credit Clause of the U.S. Constitution, which says that each state must respect the judgments of other state courts.³¹ Consequently, if a person is successfully sued in Mississippi, but has his or her DAPT set up in Delaware, the judgment creditor must go

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ Passananti, *supra* note 3.

²⁵ *Id.* See generally, Henry J. Lischer, Jr., *Domestic Asset Protection Trusts: Pallbearers To Liability?* 35 REAL PROP. PROB. & TR. J. 479 (2000).

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ Passananti, *supra* note 3.

³¹ *Id.*

to Delaware state court to enforce the Mississippi judgment.³² The Delaware court will decide whether to enforce or deny the Mississippi judgment.³³

In order to enforce a judgment in a non-DAPT state, the judgment creditor must establish jurisdiction within the non-DAPT state.³⁴ The creditor can establish jurisdiction over the settlor, trust property, or the trustee.³⁵ Since the settlor does not own property in the trust, the creditor might not be able to establish jurisdiction over the settlor.³⁶ To gain jurisdiction over the trustee as owner, the creditor would have to establish that the trustee had minimum contacts with the forum state, and that the assertion of personal jurisdiction did not offend traditional notions of fair play and substantial justice.³⁷ If the trustee is an individual, it would be difficult to establish jurisdiction unless the trustee has a residence in the forum state.³⁸ However, if the DAPT is managed by a corporate trustee, there is a greater chance that jurisdiction could be established.³⁹ Corporate trustees that pursue estate and trust business throughout the nation and that have marketing campaigns directed at specific states or specific individuals may have sufficient contacts in many states.⁴⁰ This puts them at risk for being brought into many foreign jurisdictions.⁴¹

To prevent the plaintiff from enforcing a judgment in a non-DAPT state, where a court might hold that DAPTs violate that state's public policy, the trustee must hold all of the assets of the trust in the state where the trust was created.⁴² If the individual's trust contains real property

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ Passananti, *supra* note 3.

³⁷ *Id.* See *Int'l Shoe Co. v. Washington*, 326 U.S. 310 (1945).

³⁸ *Id.*

³⁹ *Id.* See *Hanson v. Denckla*, 357 U.S. 235 (1958).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² Passananti, *supra* note 3.

or tangible personal property in states that do not allow DAPTs, such as a small business in Mississippi and rental property in Nebraska, the creditor would be able to obtain in rem jurisdiction over the DAPT's real estate holdings in those states.⁴³ As the underlying assets of the trust are diversified throughout many states, the individual becomes more vulnerable to being dragged into court somewhere against his or her will.⁴⁴ The enforcement of a judgment from a non-DAPT state would probably be rejected in a DAPT state's court, because the DAPT statutes have a choice of law provision which allows the court to apply its own law.⁴⁵ It is unlikely that a court in a DAPT state would allow a foreign creditor to enforce the judgment against DAPT assets, unless the creditor proves that the DAPT statute violates public policy.⁴⁶ A non-DAPT forum state would probably apply its own law and refuse to enforce the spendthrift provision of the DAPT.⁴⁷ The non-DAPT states might also conclude that DAPTs violate the public policy of their state and ignore the governing law and substitute their own state laws.⁴⁸

Federal bankruptcy laws allow creditors to access funds held in the DAPT if the creditor can prove that within ten years of filing bankruptcy, the debtor transferred assets to the DAPT with the intent to defraud a creditor.⁴⁹ So, although state law may only have a four year reach-back period if a fraudulent transfer occurred, the federal law extends this time period to ten years for bankruptcy matters.⁵⁰ This virtually eliminates the DAPT as a useful bankruptcy protection.⁵¹

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Passananti, *supra* note 3.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

If the creditor can establish jurisdiction in federal court, federal courts may use their contempt power to make sure the settlor or trustee produces assets.⁵² Federal courts have already established that they have the power to reach assets in FAPTs even though they are located in other countries.⁵³ Since the DAPT is in the U.S., it would be much easier for federal courts to reach the assets.⁵⁴

DAPTs provide an important chance for individuals to add another layer of protection to their net worth. Although the long term effects of DAPTs are yet to be seen, they are currently being used throughout the United States by having the situs of the trust in a DAPT state. Having a DAPT in place could be the one important step that protects an individual's accumulated wealth if they are subjected to a large judgment. The protections of a DAPT might be compared to a bulletproof vest: an attorney can not guarantee that it will never be pierced; it is simply the best armor available to cloak ones assets.

⁵² *Id.* See Lawrence v. Goldberg, 279 F.3d 1294 (11th Cir. 2002); Fed. Trade Comm. v. Affordable Media, 179 F.3d 1228 (9th Cir. 1999); U.S. v Bank of Nova Scotia, 740 F.2d 817 (11th Cir. 1984).

⁵³ *Id.*

⁵⁴ *Id.*