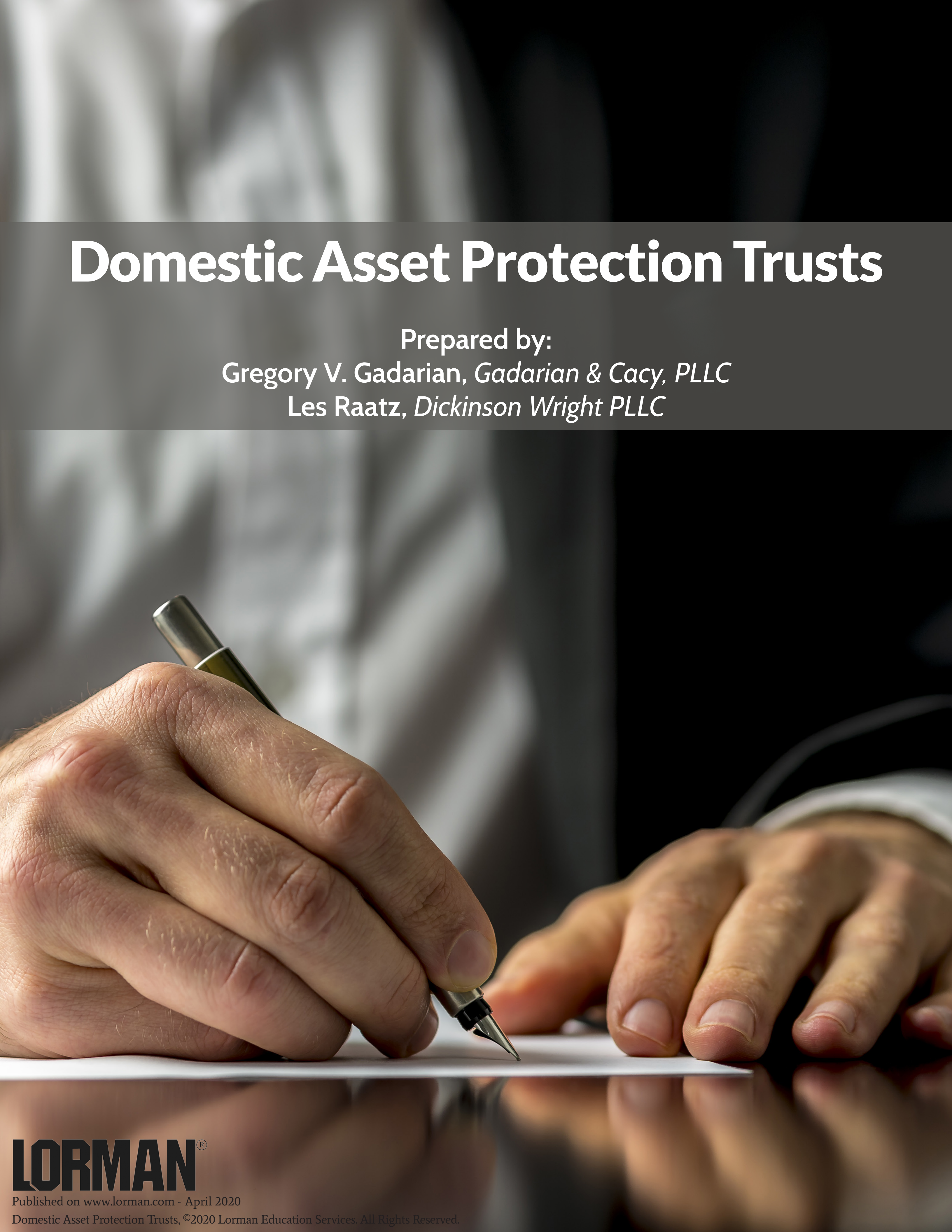

Domestic Asset Protection Trusts

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DOMESTIC ASSET PROTECTION TRUSTS (DAPTs) DISCUSSION:

There have been law changes made in the last few years in many states to codify the trust law and to provide more certainty of the protection that is given to beneficiaries of trusts. In some instances, the law follows the rules applicable to the majority of states. But in other instances, the protections legislated are greater than those of most other states. There is an important exception – more and more states specifically authorize individuals to fund or settle trust for their benefits, yet prevent creditors from reaching the trust assets. Such trusts are often referred to as "self-settled trusts," and the legislation authorizing them is referred to as Domestic Asset Protection Trust state statutes, or "DAPTs." However, those statutes are subject to the supremacy of relatively new federal bankruptcy legislation specifically designed to make much of those statutes of questionable value. This bankruptcy legislation is discussed further below.

Here is a summary of some of the laws of states, many universal, but some unique, regarding the rights of trust beneficiary creditors. The practitioner should know of the rules applicable to the state of which law is selected for the trust. It may be possible to borrow another state's law, if there is sufficient nexus, and the particular law is not contrary to a strong public policy of the forum state:

1. A revocable trust can be reached by the settlor's creditors.
2. Creditors of the settlor can reach the maximum amount the trustee of an irrevocable trust can pay to or for his benefit, without taking into account the exercise of a power of appointment held by someone other than the settlor or the trustee.[1]
3. Creditors of a decedent and decedent's estate can reach the decedent-settlor's revocable trust.
4. A holder of a power to withdraw under a trust is the deemed settlor of a revocable trust holding the property subject to the power during the time it is exercisable.

[1] Restatement (Third) of Trusts Section 58(2) and cmt. e (Tentative Draft No. 2, approved 1999), and Restatement (Second) of Trusts Section 156 (1959). UTC comment to Section 505(a)(2).

5. Creditors cannot reach amounts the trust determines to pay to reimburse the settlor for income taxes attributable to income of the trust.
6. Creditors of the settlor cannot reach amounts paid directly to taxing authorities.
7. A trust settled by a business entity, government or charity is not settled by its owners, fiduciaries or employees, unless the trust that has no valid business purpose and that has as its principal purpose the evasion of the claims of the creditors of the owners, fiduciaries, employees or the entity.
8. A settlor of a trust for his spouse is not a settlor if he reacquires rights in the trust after the spouse dies.
9. A person is not the settlor of a trust created by his spouse, and that result is not affected due to the person creating an irrevocable trust for the spouse.[2]
10. The settlor of a trust is not the settlor to the extent another has had a general power of appointment over the trust.
11. A person is not a settlor of a trust in excess of the person's share of contributions to the trust.

The above descriptions are rough statements of the statutes. The first four rules confirm the rights of creditors, and follow the common law of trusts. The remainder of them are specifically protective of beneficiaries. Many other states provide for some of these exceptions in one manner or the other.

IRAs, Qualified Plans, Insurance, Annuities, 529 Plan Exemptions. Some states now provide for protection of Section 529 Fund assets, as well as Individual retirement accounts, qualified plans rights, insurance and annuities in certain circumstances. The scope of some of these exemptions is not at all clear. For example, in Arizona, there is no authority whether a disability contract written by an insurance company is an annuity and protected if it is not in pay.

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[2] In other words, apparently a beneficiary of a trust funded by his spouse cannot be deemed to fund the trust under the common law. See Restatement (Second) of Trusts, Section 156, Comment f.; Restatement (Third) of Trusts, Section 58, Comment Illustration 9.

RECENT CASES AND OTHER LAW CHANGES.

Bankruptcy 10 Year Look Back Rule for Self-Settled Trusts: 11 U.S.C. Section 548(e).

In 2005, powerful federal pro-creditor legislation was enacted. Bankruptcy Code Section 548(e) became effective, enacted with the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA")(Public Law 109-8):

11 U.S.C. § 548(e) provides:

(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or **within 10 years** before the date of the filing of the petition, if—

(A) such transfer was made to a self-settled trust or similar device;

(B) such transfer was by the debtor;

(C) the debtor is a beneficiary of such trust or similar device; and

(D) the debtor made such transfer with **actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted**.

(2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by—

(A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c (a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or

(B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or

> 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78l and 78o (d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f).

Most recent cases involving Section 548(e) and asset protection planning noted by commentators have been adverse to debtors.

In re Mortensen.

Battley v. Mortensen, Adv. D.Alaska, No. A09-90036-DMD, May 26, 2011 (Original Memorandum) and July 18, 2011 (Memorandum Denying Motion For Reconsideration). In this nearly famous Alaska bankruptcy case, the debtor creates a trust for his benefit in 2005. The trust instrument states that it is for asset protection purposes. The court found that Debtor was solvent when the trust was funded. He then ran up over $25,000 in credit card debt. In 2009 the debtor filed for bankruptcy. The bankruptcy trustee asserted, among other things, that the transfer to the trust was reachable under 11 U.S.C. § 548(e)(1), the text of which is provided above.

The court ordered trust assets turned over to the bankruptcy trustee:

> "[W]hen property is transferred to a self-settled trust with the intention of protecting it from creditors, and the trust's express purpose is to protect that asset from creditors, both the trust and the transfer manifest the same intent. In this case, I found that the trust's express purpose could provide evidence of fraudulent intent. However, it was not the only evidence upon which I based my decision."

It is interesting that his mother gave him the funds that he contributed to his self-settled trust. The transaction could have been structured by her settling a trust for him. Then the assets, in all likelihood, would have been protected from his creditors.

In re Porco, Inc.

This is a plain vanilla bankruptcy court denial of a motion to dismiss regarding when the one year statute of limitations begins running on an alleged concealed transfer. However, there was a second count that the debtor sought to dismiss that resulted in the court interpreting whether a transfer to a single member limited liability company of the debtor could be a "similar device" to a self-settled trust to apply the 10-year look back rule of 11 U.S.C. Section 548(e). The court grant that motion, concluding that the 10 year look back can only be applied only to *express trusts,* and could not be applied to resulting trusts or constructive trusts theories to reach assets in a wholly owned single member LLC. *In re Porco, Inc.,* 447 B.R. 590 (Bkrtcy. DC Ill. 2011). This case was not well pleaded by the parties, leaving the authoritative legacy of this ruling in doubt.

In re Yerushalmi.

Although most cases involving Section 548(e) are favorable to the creditors, there is at least one outlier: *In re Yerushalmi*, 2012 WL 5839938 (E.D.N.Y., slip copy 11/19/2012). A QPRT Trust was found to be a legitimate structure. The court found that the trust was formed for estate planning purposes and not for a fraudulent purpose. Even though the settlor controlled the trust, it was not his alter ego. The actions were consistent with the QPRT structure. The court stated that even if the debtor said he was the owner, that announcement did not establish that the trust was his "alter ego." Merely having complete domination of the trust does not make it the controlling party's alter ego. It is also necessary to show that he used the domination power wrongfully or fraudulently.

Interstate Trust Issues: Choice of Law and Public Policy**.**

There is much discussion of the use of the law of trust friendly jurisdictions in settling trusts in other states. Some assert the sanctity of the contract clause and full faith and credit guarantees of the U.S. Constitution if declaratory judgments are handed down in the trust friendly jurisdictions. Regardless of the talk, court decisions dealing with these issues are where the rubber meets the road. The creditors do very well in all cases where the settlor, trustee, and beneficiary do not have a real presence in the jurisdiction selected in the trust agreement. Some split hairs over the nuances and theories that the courts follow. Forum state public policy and basic analysis of conflict of laws often are the basis for the court to ignore the trust law selected by the settlor. Jay Adkisson, Esq., a national speaker on cutting edge asset protection cases, has written extensively about recent cases in this area. He wrote at length about *In re Zuckerhorn*, 484 BR 182, 192 (9th Cir.BAP, 2012); and *Waldron v. Huber (In re Huber),* 2013 WL 2154218 (Bk.W.D.Wa., Slip Copy, May 17, 2013). *Huber* cites *Zuckerkorn*. The cases are likely templates for the reasoning many courts would use to analyze to apply or reject the protections granted under the trust law of Domestic Asset Protection Trust ("DAPT") states, such as Alaska (applicable in the Washington case cited) as to whether the DAPT states' laws violate the public policy in the respective forum states. The courts also throw in a conflict of law analysis. The Court in *Zuckerhorn* looked to the American Law Institute's Restatement (Second) of Conflict of Laws. Its decision, in quoting from the Restatement is useful:

> (From Restatement (Second) of Conflict of Laws, Introductory Note to Chapter 10):
>
> The creation of a trust is a method by which the owner of property makes a disposition of it. The chief purpose in making decisions as to the applicable law is to carry out the intention of the creator of the trust in the disposal of the trust property. It is important that his intention, to the extent to which it can be ascertained, should not be defeated, unless this is required by the policy of a state which has such an interest in defeating his intention, as to the particular issue involved, that its local law should be applied . . .

(From Restatement (Second) of Conflict of Laws, Sec. 270, Comment b):

> Law designated by the settlor to govern validity of the trust. Effect will be given to a provision in the trust instrument that the validity of the trust shall be governed by the local law of a particular state, provided that this state has a substantial relation to the trust and that the application of its local law does not violate a strong public policy of the state with which as to the matter at issue the trust has its most significant relationship.
>
> A state has a substantial relation to a trust when it is the state, if any, which the settlor designated as that in which the trust is to be administered, or that of the place of business or domicile of the trustee at the time of the creation of the trust, or that of the location of the trust assets at that time, or that of the domicile of the settlor, at that time, or that of the domicile of the beneficiaries. There may be other contacts or groupings of contacts which will likewise suffice.

The *Zuckerhorn* court held for the debtor primarily because the trust was established long ago by a Hawaii resident, and the debtor was just a beneficiary. Since the law in California would also have protected the debtor of such a trust, the Hawaii law did not violate the public policy of California. In analyzing conflict of laws principles, the court found that the law of Hawaii applied to the applicable legal issue because of its greater contacts. *Huber* involved people and property almost entirely situated in Washington. It found that Alaska's self-settled trust law violated the public policy of Washington. In addition it held that, applying conflict of laws principles, Washington had more significant contacts. Restatement (Second) of Conflict of Laws, Sec. 270.

Downside to Being Too Cute.

Sometimes it turns out better if someone just takes his licking, instead of getting proactive. If the court perceives the debtor's shenanigans are too far afield, it can deny a discharge. *In re Portnoy*, 201 B.R. 685 (S.D.N.Y. 1996).

Or if the court thinks it can compel a return of assets but the debtor is just stubborn, it can jail the debtor for contempt. *In re Stephan Jay Lawrence*, 227 B.R. 907 (S.D. Fla. 1998) and *FTC v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999).

Lessons.

One of the lessons to take away from this is to consider carefully where any disputes are likely to be resolved. Also consider the type of assets (real or personal property and locations of same), personal and subject matter jurisdiction, and entity creation and operations that own and control the assets at stake. Finally, consider who are the participants and the likely creditors and their location and the choice of law and venue selected in relevant agreements.

Source of limit of Constitution's Full Faith and Credit Clause mandate to apply other states' law protecting beneficiaries from creditors.

The Supreme Court has recognized a "public policy exception" to the Full Faith and Credit Clause of the Constitution in applying laws of another state:

"[T]here are some limitations upon the extent to which a state may be required by the full faith and credit clause to enforce even the judgment of another state in contravention of its own statutes or policy. …And in the case of statutes...the full faith and credit clause does not require one state to substitute for its own statute, applicable to persons and events within it, the conflicting statute of another state, even though that statute is of controlling force in the courts of the state of its enactment with respect to the same persons and events." [*Pacific Employers Insurance Co. v. Industrial Accident Comm'n.* (306 US 493 (1939).]

Full faith and credit will be given for foreign state judgments.