

# Planning to Avoid Pitfalls

## Asset Protection Trusts Thirteen Years After Enactment

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**T**he Delaware Qualified Dispositions In Trust Act, 12 Del. C. §§ 3570 et seq. (the “Act”), enables a trust settlor to establish a so-called Delaware asset protection trust (“DAPT”). A DAPT is basically a trust with a spendthrift clause that applies to the settlor. In other words, it is a trust in which the settlor is a beneficiary and the assets of the trust are protected from the settlor’s creditors. The Act was adopted by the Delaware legislature in 1997, and many developments have occurred in the thirteen years since its enactment.

### Changes To The Landscape

Eleven other states have enacted domestic asset protection trust statutes. With over twenty percent (20%) of the states in the country having some form of a domestic asset protection trust statute, and many thousands of asset protection trusts having been created over the years, asset protection trusts have become more commonplace and well-accepted than they were at the time of the Act’s infancy. Moreover, Congress enacted Section 548(e) of the Bankruptcy Code in 2005, which specifically addresses self-settled asset protection trusts in the bankruptcy context. The Act has been amended every year since 1997 to provide improvements, additional clarity and utility for trust settlors.

Despite the growing popularity and numbers of asset protection trusts, there have been no published court decisions in any state

in which the validity of a domestic asset protection trust has been challenged. In the recent Delaware Chancery Court case, *In The Matter of the Juan Carlos Fischberg Family Trust*, C.A. No. 2527-VCN, Del. Ch., the subject of the case was a DAPT but the substantive issues pertaining to the DAPT were not ultimately decided because the other issues in the case were resolved in another jurisdiction. However, in a bench ruling dated February 22, 2007, the Court did recognize the significance of the issues to Delaware and the implications for DAPTs, and notably stated that the Court has exclusive jurisdiction over challenges to the propriety of transfers to asset protection trusts formed under Delaware law.

### Bankruptcy Code Section 548(e)

The circumstances surrounding the enactment of Bankruptcy Code Section 548(e) are both interesting and relevant to the discussion of the acceptability of domestic asset protection trusts. Reportedly in response to a New York Times article criticizing domestic asset protection trusts as a loophole for the rich to walk away from their credit card and other debts, Senator Charles Schumer of New York proposed an amendment to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to pull all assets over \$125,000 that were transferred to a self-settled trust into the debtor’s bankruptcy estate. This amendment would have had a significantly deleterious affect on self-settled asset protection trusts in the bankruptcy context, as almost all asset protection trusts would have been pulled into the settlor-beneficiary’s bankruptcy estate. The proposed amendment never made it out of the Senate and was defeated by

a vote of 56-39. Subsequently, Senator Jim Talent of Missouri proposed an amendment which provided that assets transferred to a self-settled asset protection trust by the bankruptcy debtor will only be pulled into the bankruptcy estate to the extent there was a fraudulent transfer within ten (10) years prior to filing the bankruptcy petition. That amendment was passed by the Senate with a vote of 73-26 and is currently found in the Bankruptcy Code as Section 548(e). Thus, given the debate and consideration of the efficacy of asset protection trusts, Congress has specifically approved their use, subject to certain limitations.

Section 548(e) provides that a trustee in bankruptcy “may avoid any transfer of an interest of the debtor in property that was made on or within ten 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.” Section 548(e) has little effect on properly structured DAPTs because the settlor of such a trust should never make a fraudulent transfer of assets to the trust. It effectively validates a properly structured DAPT if there was no fraudulent transfer made at the time of the creation of the trust. Since its enactment, there have been only two reported bankruptcy court cases analyzing Section 548(e). However, those cases did not involve asset protection trusts and the decisions did not ultimately address the Section 548(e) issues. Bankruptcy Code Section 541(c)(2)

The other Bankruptcy Code section that potentially addresses DAPTs is Section 541(c)(2). Under that section, a debtor-beneficiary’s interest in a trust which is subject to a valid spendthrift provision under applicable state law shall not become a part of the bankruptcy estate. Under the Act, a spendthrift clause that applies to the settlor in a DAPT agreement is expressly enforceable under applicable non-bankruptcy laws within the meaning of Section 541(c)(2). Although bankruptcy courts have applied Section 541(c)(2) in many cases involving third party spendthrift trusts, there have been no reported opinions in which that section has been applied to self-settled asset protection trusts. In theory, a bankruptcy court should find that a spendthrift clause in an asset protection trust agreement is enforceable under applicable non-bankruptcy Delaware law, because the Act provides that it is enforceable. However, with an absence of case law, it is not entirely clear how a bankruptcy court would decide such a case.

## Areas of Uncertainty

With the lack of case law surrounding DAPTs, and the myriad of fact scenarios that may surround the creation of a DAPT, some issues and concerns about structuring a DAPT remain unclear. There are a number of arguments that creditors of the settlor of a DAPT might make to get access to the assets of the trust. These arguments can be broken down into three sets of issues and concerns: (1) drafting issues; (2) bad facts; and (3) fraudulent transfers.

### Drafting Issues

Attorneys who attempt to draft a DAPT agreement, but are not familiar with the Act, may make inadvertent mistakes by drafting provisions into the agreement that do not technically satisfy the

requirements of the Act. Strict compliance with the statute is required in order to create a valid DAPT because if the governing instrument does not qualify under the statute, that will surely be one of the first arguments a creditor would make when trying to defeat the DAPT. They could argue that the assets of the trust are subject to the claims of the creditors under default common law rules because the trust, in failing to satisfy the technical requirements of the Act, is not a valid DAPT. Under Delaware common law, if a settlor-beneficiary has the right to receive distributions of income or principal in the sole discretion of the trustee, and the trust is not a DAPT, the trust fund will be subject to the claims of the settlor’s creditors. See, e.g., *Security Trust Co. v. Sharp*, 77 A.2d 543 (Del. Ch. 1950).

The Act is written in a somewhat complicated, if not arcane, way. Section 3570(11)b lists rights and interests that the settlor may be permitted to retain in the trust. They are couched in terms of a general requirement that the trust be irrevocable, along with a specific list of powers held by the settlor or others that will not cause the trust to be revocable (even though those rights and interests have nothing to do with revocability). The proper approach when drafting a DAPT agreement is to not give the settlor any powers beyond those specifically enumerated as permissible under the Act. Examples of common errors made by drafters include an improper choice of law provision that does not comply with Section 3570(11)a of the Act, improper duties held by the “qualified trustee”, the settlor’s retention of a reversion, an improper power of appointment held by the settlor, the termination of the trust after a period of time with a reversion of the assets to the settlor, a spendthrift clause that does not mirror the provisions in Section 3570(11)(c), the settlor’s retention of powers beyond those which may be properly possessed by an investment adviser, a pour-over to the settlor’s estate or revocable trust, and many other issues.

### Bad Facts

Although the settlor and attorney may have drafted a DAPT that technically satisfies the requirements of the Act, the facts surrounding its creation or administration could raise other concerns. Facts at the time of trust creation may not seem to present an issue, but when creditor claims arise, those same facts could look like bad facts in hindsight. In such a case, a creditor could argue that there was a prearranged plan or side arrangement between the settlor and the trustee, or that the trust should be overturned as a sham or on grounds of substance over form (although Section 3571 of the Act attempts to curtail such arguments).

### Funding

One possible area where bad facts can impact the structure of a DAPT is funding issues. The most common of which is the question of what amount of the settlor’s assets should be used to fund the trust. Planners typically suggest that the settlor of a DAPT only place that amount of assets in the trust that the settlor reasonably views as a nest egg or for which the settlor merely views himself as a caretaker for the next generation. Some planners suggest one-third of the settlor’s assets. There really is no rule of thumb, as an appropriate amount of funding for a DAPT may depend upon such factors as: (1) the purpose of the

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DAPT (e.g. a prenuptial arrangement could warrant putting most of the settlor's assets in the DAPT), (2) the structure of the DAPT (the answer could be different depending upon whether the settlor will receive only income, ascertainable standard distributions, a unitrust amount, or pure discretionary distributions), (3) the total amount of the settlor's assets, (4) the settlor's cash flow needs and lifestyle, and (5) other solvency issues.

### Choice of Assets

Many settlors wish to place a personal residence and/or personal use items in a DAPT and these types of assets present unique issues. Such assets should be placed in a limited liability company or other entity to avoid liability issues and also to help avoid conflict of laws issues surrounding real and tangible property held in a trust but located in another jurisdiction. In addition, if the settlor lives in the personal residence and then transfers it to a DAPT and continues to reside there, there may be greater potential for a court to raise questions about the DAPT structure. The settlor of a DAPT is permitted to "use" assets held in the trust and such use may include a personal residence. Many trusts are structured so that such use of falls either under a discretionary distribution provision, income distribution provision or a right to use the property.

### Timing

The timing of the contribution of assets to a DAPT could present issues for the planner if the DAPT is being structured for tax planning purposes. For example, if a capital gain recognition event occurs immediately following the funding of the trust, a state taxing authority of another jurisdiction may attack the funding and the tax position taken by the trustee as a sham or step transaction. Of course, the timing of the contribution of assets to the trust may also become an issue if creditor claims arise and fraudulent transfer analysis is necessary or relevant statutes of limitation potentially apply to the transfer.

### Trustee and Trust Administration

Ideally, a DAPT would have a single Delaware "qualified trustee" with no other co-trustees outside of Delaware. Co-trustees outside of Delaware may raise jurisdiction and choice of law issues. From a creditor's perspective, the use of a Delaware qualified trustee that is directed by individual co-trustees or advisers who are close confidants, friends, spouse or other family members of the settlor could raise the specter of bad facts involving indirect retained control by the settlor. Other factors surrounding the administration of the trust may also raise questions, such as a suspicious pattern of distributions, automatic compliance with every distribution request of the settlor or failure to respect the formalities of the DAPT.

### Choice of Law

The Delaware trustee needs to perform more than the minimum administrative requirements described in the Act within the State of Delaware. The Act describes a very short list of ministerial functions in Section 3570(8)b which, while satisfying the Act's requirements, do not satisfy the well-established Delaware conflict of laws rules regarding the required nexus with Delaware in order to successfully select Delaware law to govern the trust.

### Fraudulent Transfers

The third argument that creditors of the settlor of a DAPT might make

to get access to the assets of the trust involves fraudulent transfer analysis. If the settlor of a DAPT makes a fraudulent transfer to the trust, then the transfer can be defeated by a creditor under the Act or the Bankruptcy Code. A fraudulent transfer is defined in Title 6 of the Delaware Code as a transfer made, or an obligation incurred with actual intent to hinder, delay or defraud a known or knowable creditor. A properly created DAPT will not involve a fraudulent transfer and the trustee and lawyers involved in structuring the trust should take care to avoid the possibility of assisting with a fraudulent transfer.

Most attorneys and trustees require a settlor to sign a solvency affidavit or solvency letter that establishes the facts necessary to conclude that there will not be a fraudulent transfer when the assets are transferred to the trustee. Planners may also want to perform some due diligence to get assurance that a fraudulent transfer is not taking place, particularly if there are red flags such as solvency or liquidity issues or known creditors. An additional consideration may be to require the settlor to sign the solvency affidavit under penalties of perjury, pursuant to 28 USC § 1746. This provision is used in bankruptcy proceedings and may add weight to the affiant's assertions. Although a solvency letter or affidavit may appear somewhat self-serving, it is usually done to protect the settlor, the lawyer and the trustee from creditor arguments that a fraudulent transfer occurred.

### Conclusion

To some extent, the clarity and detail that has been gradually built into the Act through amendments over the last thirteen years, the growing number of states that have enacted similar statutes and the established framework under the Bankruptcy Code should reassure settlors, planners and trustees that asset protection trusts are becoming an increasingly accepted creditor protection planning technique. The absence of case law challenging domestic asset protection trusts presents some uncertainty, and the creation of a DAPT will inevitably involve any number of factual scenarios. Consequently, there are many questions that planners and their clients must consider when structuring such trusts. Just as Title 12 of the Delaware Code has gradually developed over the years to provide clear rules and an enviable statutory framework for the creation and administration of Delaware trusts, future amendments to the Act will no doubt work to eliminate some of the gray areas that arise concerning DAPTs.



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