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Asset Protection Planning

Asset protection planning—planning to avoid liabilities, lawsuits and claims—has become a major field in wealth planning. In many respects, it is as important or more important than estate planning and income tax planning. It is especially important for high-profile figures who are an easy target for lawsuits and claims. There is no asset protection "silver bullet," i.e. a technique that will protect against all risks in all circumstances. There are, however, a number of recognized techniques that can provide varying degrees of protection in different contexts. These techniques are best viewed as "defenses" that can surround a client's assets. No one strategy is entirely fool-proof and a perfect defense against all claims of future creditors and litigants. For clients who have significant concerns in this area, we always recommend that they take a multi-strategy approach, rather than relying on a single strategy.

Asset Protection Planning Through Trusts

In most common law jurisdictions, it has long been recognized that one can create a trust for a third party (a spouse, a child, a family member, etc.) that will not be subject to the claims of creditors. Such trusts, often referred to as “*third party asset protection trusts*” or "*spendthrift trusts*," are a standard feature of the estate plans of most wealthy Americans. As concerns about liability protection have increased, the use of third party asset protection trust has also increased to a point that significant inheritances are often routinely planned through such structures.

For example, we routinely see parents, rather than leaving asset to a child outright, instead create a discretionary trust for the benefit of the child. Such a trust can be structured in different ways, but the Trustee or Trustees are generally given discretion to distribute income or principal to the child for broad purposes, or for any reason. By providing in the trust instrument that the trust is not subject to claims of creditors, and prohibiting the child from selling or assigning his or her interest in the trust, the assets of the trust can generally be sheltered from claims against the child. Parents often choose to create such a trust rather than provide for an outright inheritance, since the trust will protect the child if he or she is in a high liability profession, is in a difficult marriage, etc.

Thanks to the modernization of the trust laws in the U.S. in the past two decades, it is often possible to provide a child with a high degree of asset protection through a properly-constructed trust, while at the same time giving the child almost the same level of control over the inherited property as if he or she had received the property directly. Some states permit a trust beneficiary to participate in various decisions involving the trust, such as investments, without treating the trust assets as belonging to the trust beneficiary.

First Party Asset Protection Trusts: The Domestic Asset Protection Trust

Although third party asset protection trusts are very standard in U.S. estate planning, is it possible to create such a trust for your own benefit? In other words, is it possible to create a first party asset protection trust, where the person creating the trust is also one of the beneficiaries? Traditionally in the U.S. it was <u>not</u> possible to create such a trust. Public policies prevented a person from creating and funding a trust for his own benefit that would be beyond the reach of his creditors.

In recent decades, however, a number of states in the U.S. have passed laws authorizing the establishment of self-settled spendthrift trusts.[1] The Delaware statute, entitled the Delaware Qualified Dispositions in Trust Act,[2] first enacted in 1997, authorized the creation of first party asset protection trusts. Under the Delaware statute, an asset protection trust is an irrevocable trust that contains certain required language, is governed and administered in Delaware, and has at least one Delaware resident Trustee. The creator of the trust (referred to in Delaware as the "Trustor") can have the right to receive income from the trust and can receive principal in the discretion of the Trustee. The Trustor can also have the power to direct who is to inherit the trust upon his or her death. In spite of the Trustor being a beneficiary of the trust, the Delaware statute bars actions (including actions to enforce judgments entered elsewhere) against a trust that meets the requirements of the statute. In general, a creditor seeking to make a claim against a Delaware APT must bring suit within a certain period of time (referred to as a "tail period"[3]) of the trust's creation or prove the trust was created with an intent to defraud. In other words, a properly-created Delaware APT puts the burden on the creditor to prove that an exception to the protection afforded by the trust applies. And even an exception applies with respect to a particular creditor, the trust is only defeated to the extent necessary to satisfy that claim—it still may be effective against other creditors.

Typical Terms of a Delaware APT

As noted above, a Delaware APT is an irrevocable trust.

During the lifetime of the Trustor, income and principal can be distributed from the trust in the Trustee's discretion to the Trustor, to the Trustor's spouse, or to any children of the Trustor. Income that is not paid out is accumulated and added to principal each year.

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[1] Currently, fifteen states in the U.S. have some form of stature authorizing self-settled asset protection trusts.
[2] Del. Code Ann. Tit. 12, Section 3570 to 3576.
[3] Four years in the Delaware statute.

Upon the Trustor's death, the remaining assets of the trust will be distributed however the Trustor directs by his Will. Thus the Trustor retains control of how the trust assets are to be distributed at his death. If the Trustor does not exercise his "power of appointment" at death, the trust will contain further provisions, such as providing for a continuing trust for the surviving spouse and children.

A Delaware APT is usually established as a grantor trust for income tax purposes, and the grantor's transfer of asset to the trust is an "incomplete gift" that is not recognized for gift tax purposes. This is the typical arrangement for a client who is only seeking liability protection from his or her Delaware APT. In some circumstances, however, it may be desirable to set up the trust as a "nongrantor trust" (i.e. a trust that pays its own income taxes) or as a trust to which the grantor can make a taxable gift.

Governance of a Delaware APT

In most Delaware trusts, there are three governance roles that are performed in connection with the management of the trust:

- The *Trustee* is responsible for carrying out the provisions of the trust, making distributions (discretionary and otherwise) to beneficiaries, custody and safekeeping of trust assets, filing tax returns, etc.
- The *Direction Investment Advisor* is responsible for making all investment decisions for the trust.
- The *Trust Protector* has the power to remove any Trustee and any Direction Investment Advisor and appoint successors (as long as the successor appointed is considered to be "independent").

In a Delaware APT, the Trustor is not permitted to act as a Trustee. The Trustor may, however, act as Direction Investment Advisor of the trust and as Trust Protector (with power to remove and replace the Trustee). Depending upon the facts and state income tax considerations, it may be beneficial to have an independent third party act as Direction Investment Advisor of the trust.

Limits on the Effectiveness of the Delaware APT

As noted previously, the Delaware statute that authorizes the creation of Delaware APTs itself contains exceptions to the protections they afford. A Delaware APT may be defeated by:

- A creditor's claim that arose before the trust was created, if the creditor brings suit within four years of the trust's creation or, if later, within one year of learning of the trust;
- A creditor's claim that arose after the trust was created, if the creditor bring suit within four years of the trust's creation and proves by clear and convincing evidence that the trust was created with an intent to defraud the creditor;

- A transfer made with an “actual intent” to defraud a creditor; or
- Certain child support claims and claims in divorce.

The four-year period from the creation/funding of the Delaware APT is referred to as the “tail period”—it is the period in which the protections afforded by the trust are most in doubt. This is not to say, however, that a Trustor is not better off even during the tail period than he would have been if the Delaware APT had not been created.

Another limit on the Delaware APT is that, as a fundamental matter, the transfer to the trust cannot constitute a “fraudulent transfer” under state fraudulent transfer laws. In general, this means that, as a result of the transfer to the Delaware APT, the person creating the trust cannot be or become insolvent. For this reason, at the time a Delaware APT is created, the Trustor usually provides some form of “Affidavit of Solvency,” indicating that he is solvent before and after creation of the trust.

In addition to these statutory limits, some legal commentators have more generally questioned the effect of the Delaware statute on constitutional grounds. Since the several states of the U.S. are required to give effect to judgments of courts of other states, some commentators have argued that these statutes will ultimately be found to be unconstitutional. It has been argued that the principle of “comity”—giving equal force to the judgments of the courts of different states—is violated by these statutes.

Our experienced team of wealth planning advisors at HPM Partners is available to assist with any questions you may have about this or other wealth planning techniques.

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