Price & Farrington's Estate and Tax Planning *Fast* Faxts September, 2002

Estate, Tax, and Wealth Planning For Advisors and Clients

Price & Farrington
Attorneys and Counselors at Law
12501 Bel-Red Road, Suite 215
Bellevue, Washington 98005
425-451-3583
Email: pricefarr@aol.com

Asset Protection Trusts: Rarotonga or Your Own Backyard?

Ask any serious asset protection attorney where he would put his own money for the strongest creditor protection and he'll tell you "offshore" — and usually as far offshore as possible. Even the die-hard advocates of domestic asset protection trusts (DAPT), when pressed, will admit that offshore is best. But does "best" mean *onshore* protective trusts are a bust? Not by a long shot. Are offshore trusts tainted because of their location? Is it necessary to go so far? A Brooklyn debtor who claims he can't pay his debt because his funds are in an irrevocable trust managed in Rarotonga (capital of the Cook Islands) might be motivated by something other than the trustee's outstanding management performance. In two recent cases judges have scoffed on the record at a person who would send his money "to a stranger on the other side of the world" for any other reason than to "hide the money" and "thwart" the court's jurisdiction.

Relativity. There are degrees of asset protection. If the protection provided by a domestic asset protection trust suits a client's needs and risk tolerance, the DAPT could be "best" for that client.

Like reward or punishment, asset protection is relative. A simple transfer to a spouse – or other straightforward retitling – might provide the desired level of asset protection. Or it might take layers of limited liability entities owned by a Lichtenstein foundation operated for the benefit of a Cook Islands trust to achieve the desired results. The DAPT is somewhere in between.

The past. For two hundred years U. S. laws have provided that you cannot establish a trust for your own benefit while at the same time enjoying the benefit and use of the assets. This is the "spendthrift trust" rule, which basically says that where a trust is self-settled, the settlor's creditors can reach the maximum amount that could be paid or distributed to the settlor under the terms of the trust.

The future: Easy to A-DAPT. Four states — Alaska, Delaware, Nevada and Rhode Island — have recently abrogated the spendthrift trust rule by enacting DAPT laws specifically designed to allow a person to establish a trust for his own benefit (a "self-settled spendthrift trust"), the assets of which are protected from creditors by law, even though the settlor of the trust is also a discretionary beneficiary! —something disallowed as against public policy by the other 40+ states. And, say the promoters, this makes it unnecessary to go to Rarotonga or to Douglas (capital of the Isle if Man).

The protective trust laws of these four states are similar. If the trust (1) is irrevocable, (2) provides for discretionary distributions, (3) has some of its assets managed in the state by a trustee residing there, and (4) is not subject to a lifetime power of appointment, then the trust assets will not be reachable by a creditor of the settlor even though the settlor is a beneficiary of the trust.

"My only crime, Denise, was loving you too much. That and embezzling your trust fund."

The trust would provide for discretionary income and principal payments to the settlor and possibly to his spouse and children. The trust assets will presumably be impervious to run-of-the-mill malpractice, business or negligence claims arising *after* their transfer to the trust as long as it wasn't a fraudulent conveyance.

Cutting through the marketing whoopla, what you have are state laws that allow: (1) self-settled spendthrift trusts; (2) with shorter statutes of limitations (a shorter time period for a creditor to challenge a transfer to one of these trusts); and (3) standards making it more difficult for a creditor to prove that a transfer to the trust was fraudulent.

So what's a fraudulent conveyance? A fraudulent conveyance is a transfer of property where the object is to hinder, delay, defraud or put property beyond the reach of a known creditor with the intent to avoid some duty or debt .

So, it would appear on its face that a creditor of the settlor/beneficiary simply could not reach the assets in a DAPT because the laws of the state governing the DAPT disallow it. It appears to be a great concept, but…

It ain't necessarily so. There are at least five glaring defects to the DAPT

Quotables…

"He who knows others is clever; he who knows himself is enlightened."
-Lao-Tzu

"Age is not important unless you're a cheese." -Helen Hayes

"A good plan executed right now is far better than a perfect plan executed next week."
-George S. Patton

that could make it a weak asset protection technique.

Glaring defect #1: The trustee is subject to U.S. jurisdiction. While an offshore trustee could ignore a U.S. court order, a U.S. trustee can be compelled with threat of contempt to honor a court order. The U.S. trustee is also vulnerable to a civil lawsuit and available to law enforcement authorities. This basically guts the alleged protection of a DAPT.

Glaring defect #2: Full faith and credit. Since an offshore trustee wouldn't recognize a U.S. judgment, a creditor would have to start all over in the offshore jurisdiction — incredibly expensive and time-consuming. Not so for a DAPT. No matter where the trust is formed, that state is required by the "full faith and credit" clause of the U.S. Constitution to recognize a judgment registered in any other state. It's a simple process done everyday by collection firms.

Glaring defect #3: Choice of law. Think you can get a Washington judge to apply Alaska law in favor of a Washington resident-debtor against a Washington judgment held by a Washington creditor involving Washington Property? Ain't happening. If the judge rules against you, you're fighting an uphill battle to get the decision reversed on appeal. In the meantime the creditor gets your assets and even if you win the appeal you might not get them back.

Glaring defect #4: Federal courts will ignore. Because of the Supremacy Clause of the U.S. Constitution, federal courts aren't necessarily bound by state law. This can be really ugly considering that the nightmare cases are often cases, or defenses, against federal administrative agencies.

Glaring defect #5: No chance of secrecy. Because the trustee is in the U.S., the trustee will be subject to discovery orders and subpoenas. As each state applies its own procedure (as opposed to substantive law) without regard to the other states' procedure, and the federal courts follow their own procedure, it means that any secrecy protections of the laws of the state where the trust is formed will be totally irrelevant and ineffective.

Where DAPTs might work. As lame an asset protection tool as the DAPT is believed to be by some commentators, it probably has a fair-to-middlin' chance of prevailing if you actually live in Alaska, Delaware, Nevada or a state that has adopted a similar law, have all of your assets there, fund the trust well in advance, follow all formalities and avoid federal court actions.

The mere existence of the DAPT is proof that there are serious questions about the foreign version (FAPT). Many planners who used to crow about how foolproof the FAPT was supposed to be have now fallen off the offshore trust bandwagon in favor of domestic trusts. But don't be fooled by the imitator. While the FAPT has been blown up a few times and the DAPT hasn't, the offshore trust is still a far superior asset protection vehicle than its domestic variant. In general, the consensus of the leading commentators is that at the "end of the day" the Constitution will ultimately prevail and the DAPT might be busted by a creditor of the settlor.

So why bother? Because the "end of the day" means after the constitutional issues have been decided by a federal court, and possibly the U.S. Supreme Court. This can happen only after the creditor has plodded and paid his long, expensive way through at least one state court, then perhaps two federal courts, and then possibly the U.S. Supreme Court. That's gotta be a long day and a creditor has to be pretty determined — not to mention owed a ton of money — before he'll take on this costly, uphill project. Viewed in this light, the protection offered to a settlor by a DAPT might be much more than is actually the case, largely because of the huge, practical barriers a creditor will face before he can get to the money.

But here's a great concern for settlors of DAPTs: it might take only one case to bring down the whole pile of them, and it won't matter whose case it is or the state in which suit was brought. If, for example, a federal appeals court ruled that Delaware's DAPT law is unconstitutional, every settlor of every other DAPT in all the four states would start to lose serious sleep. After such a decision, how could any advisor in their right mind thereafter recommend a DAPT? There is, of course, also the possibility that the DAPT would withstand a "constitutional attack," and such a result would undoubtedly make them more popular than ever. So, a great deal is at risk and it's just a matter of time before the issue is tested in the courts.
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"Your Honor, my client would like to be tried offshore."

Asset protection planning is increasingly important to your clients. It means different things to different clients and can be implemented using many different strategies. Contact us if you think we can be of assistance.

More Quotables…

"...skate to wear the puck is going to be, not where it has been."
-Wayne Gretzky

"Never ruin an apology with an excuse." ***-Kimberly Johnson***

"One thought driven home is better than three left on base."
-James Liter