

## **ASSET PROTECTION TRUSTS: A NECESSITY IN TODAY'S WORLD?**

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### ***Introduction***

Who's suing whom in America? EVERYBODY! It is estimated that one lawsuit is filed every thirty seconds in the United States. Additionally, about one in every ten adults is sued each year. Liability issues have expanded and greater exposure to risk of loss has occurred through higher jury awards, unprecedented theories of liability and volatile judges. More alarmingly, liability can be imposed on those who do no wrong. One can be liable for damages caused by someone for whom one is responsible or damages caused by accidents that occur on one's property in which no fault arises. As such, many law abiding citizens look for legitimate ways to protect their assets from future judgments that, in one swoop, can deplete the assets they have worked hard to accumulate over their lifetime. Accordingly, the concept of asset protection planning is prevalent in the minds of people today.

Asset protection planning involves organizing one's affairs in advance to protect against risks that would otherwise threaten those assets. The goal of asset protection planning is not only to protect against the ramifications of an adverse judgment, but also to serve as a deterrent to litigation. The ultimate goal is not to hide assets, but to protect them.

There are many common forms of asset protection, such as outright gifts of assets or owning property jointly with another. However, more complex asset protection techniques, such as offshore and domestic asset protection trusts, have become extremely popular in recent years. Such complex techniques permit a person to protect their assets while, at the same time, retaining some control over those assets.

### ***Basics of Asset Protection Trusts***

An asset protection trust or APT, whether offshore or domestic, has a couple of major requirements to be effective. First, an APT must be irrevocable or unchangeable. Second, an APT should appoint a trustee with the discretion to administer the trust. The appointed trustee must be a corporate or individual resident of the jurisdiction in which the trust is formed. Third, an APT must contain a spendthrift clause, which restricts the transferability of a beneficiary's interests in the trust property, whether voluntary or involuntary, before the trustee actually distributes the property to the beneficiary.

In exchange for restricting the use of their assets, those who establish APTs or grantors may receive several benefits. First, because the assets placed in the APT may be viewed as the property of the trust, the grantor may protect those assets against claims made by future creditors of the grantor. Additionally, unlike jurisdictions without asset protection statutes, a grantor may create a self-settled trust, which permits a grantor to retain a beneficial interest in the trust while protecting the assets from future creditors.

Although APTs generally do not provide a grantor with either U.S. federal income tax or U.S. estate tax benefits, in Delaware, grantors can benefit from the state income tax benefits of asset protection trusts.

In establishing APTs, one should be careful to avoid a fraudulent conveyance. A fraudulent conveyance is a transfer of assets made with the intent to delay, hinder or defraud creditors. As such, a thorough investigation of a grantor's financial situation should be completed. Primarily, one should undertake due diligence procedures to ensure that the intention of the asset protection planning is lawful. In the due diligence process, one should obtain the financial statements for the grantor and all affiliated entities and perform searches for judgments, liens and pending litigation. Additionally, one should obtain an affidavit of solvency from the grantor. No jurisdiction, whether offshore or domestic, will protect transfers made by an insolvent grantor. Thus, in order to ensure the effectiveness of the asset protection planning, the grantor should be as open as possible regarding his or her financial situation.

### ***Offshore vs. Domestic Asset Protection Trusts***

Prior to the late 1990s, asset protection planning through trusts could only be accomplished in offshore jurisdictions, such as Gibraltar and the Isle of Man. However, in 1997, Alaska became the first state in the U.S. to pass a statute permitting self-settled asset protection trusts. Thereafter, several states, including Delaware and Nevada, enacted similar statutes. Since the enactment of domestic asset protection trust statutes, proponents of offshore and domestic APTs continue to debate over which technique is most advantageous. Both offshore and domestic APTs, however, have advantages and disadvantages.

#### ***Offshore Asset Protection Trusts***

For several decades, offshore asset protection trusts or OAPT have been considered an effective form of protecting assets from claims of future creditors. An OAPT is a trust established under foreign laws that lawfully remove assets from a grantor's balance sheet without adverse federal transfer tax consequences and allows for some or all of the assets to be distributed back to the grantor.

There are two methods of establishing an OAPT. First, one can establish an OAPT by importing the law of the foreign jurisdiction. Under the "import the law" method, a grantor creates a domestic entity to hold the assets. Thereafter, the grantor conveys some or all of the entity's interests to a foreign trustee. Although the assets remain in the entity in the United States, the trust itself is under the jurisdiction of a foreign country. However, the "import the law" method may be risky. Because the assets continue to be located in the U.S., they may be vulnerable to being frozen by an U.S. court. The second method one can use to establish an OAPT is to export the assets to a foreign jurisdiction. In the "export the assets" method, a grantor sends the real assets to a foreign jurisdiction and creates a trust governed by foreign law with a foreign trustee to hold the assets. In utilizing the "export the assets" method, a grantor receives maximum protection of the assets because a creditor would have to travel to the foreign

jurisdiction to attempt to enforce an U.S. judgment. Additionally, some jurisdictions will refuse to enforce a foreign judgment, or will only do so if the case is retried under local law.

There are several advantages of an OAPT. The primary advantage of an OAPT is that offshore jurisdictions will not recognize judgments of foreign courts in determining whether trust assets are subject to claims of the grantor's creditors. OAPTs provide procedural, substantive and psychological barriers to creditors by making assets beyond practical reach of most creditors. Thus, due to the onerous undertaking of litigating in a foreign jurisdiction, a creditor may be deterred from going after the assets of an OAPT..

Additionally, there are several disadvantages of an OAPT. The most prevalent disadvantage of an OAPT is the loss of control of a grantor over the assets. As stated previously, for maximum protection from U.S. judgments, assets should be located physically outside the U.S. In most cases, grantors may be unwilling to transfer assets to a foreign jurisdiction where political difficulties and unrest may arise or where foreign trustees may be unreliable. Although most foreign jurisdictions known for OAPTs, including the Cayman and Cook Islands, have well structured governments, grantors may feel uncomfortable in the knowledge that they are several hours away from their assets and that the U.S. government may not be able to assist with prosecution of foreign trustees. Furthermore, OAPTs may have negative tax consequences. OAPTs actually or potentially risk being classified as foreign trusts for U.S. income tax purposes, which will subject such trusts to special U.S. tax rules and reporting requirements. Moreover, OAPTs may be costly to establish and administer.

### ***Domestic Asset Protection Trusts***

Although domestic asset protection trusts or DAPTs are relatively new to the asset protection arena, many grantors have realized the utility of DAPTs. Prior to the enactment of asset protection trust statutes in the U.S., self-settled spend thrift trusts (trusts established for the benefit of the grantor that also provide protection from creditors) were not permitted in the U.S. However, Delaware and other states, through enactment of asset protection trust statutes, provide U.S. citizens with access to protections once only offered by foreign jurisdictions.

There are several requirements that must be satisfied to establish an effective DAPT. For example, under Delaware law, in addition to the basic asset protection trust requirements (i.e. irrevocability, appointment of trustee and a spendthrift clause), the trust document must state that Delaware law governs the validity, construction, and administration of the trust. Additionally, the Delaware asset protection statute applies to "qualified dispositions." A "qualified disposition" is a disposition by or from a grantor to a trustee who is a Delaware resident or corporation authorized by Delaware law to act as trustee and maintains custody of the trust assets in Delaware.

DAPTs have several advantages. First and foremost, grantors are more comfortable knowing that the trust assets and its trustees are located in the U.S. and

subject to the jurisdiction of U.S. courts. Furthermore, besides protection from future creditors for non-fraudulent transfers, DAPTs do not have complex reporting requirements and can be a cost effective way to protect assets.

Moreover, some states offer additional advantages. For instance, Delaware law permits grantors to retain a right to income or annuity payments without losing spendthrift protection. Delaware law also permits non-residents of Delaware to act as trust advisors or trust protectors with the authority to remove and appoint qualified trustees and discretion over distributions from the trust. Delaware asset protection trusts may have multiple trustees located in different jurisdiction so long as at least one of the co-trustees is an individual resident of Delaware or a corporation authorized by Delaware law to act as a trustee. Also, Delaware law grants extensive liability protection to trustees and advisors of grantors thereby absolving such advisors and persons involved in the creation of a Delaware DAPT from any personal liability to a grantor's creditors. Additionally, under Delaware law, even where a transfer is found fraudulent, the transfer may be held void only to the extent necessary to satisfy a creditor's judgment.

DAPTs, however, have a few disadvantages. Unlike OAPTs, the validity of DAPTs is less certain since no reportable cases exist construing the effectiveness of DAPTs. Additionally, the validity of DAPTs may be vulnerable to the Full Faith and Credit Clause of the U.S. Constitution. In brief, this clause requires each state to respect the acts of other states. Thus, an argument can be made that a creditor could obtain a judgment against a grantor in a non-asset protection state such as Florida that must be recognized by an asset protection state such as Delaware. However, a rebutting argument could be made that the trust is the property of the trustee, not the grantor, and, therefore, claims against the grantor are ineffective against the trust. Also, the federal bankruptcy laws, which give Bankruptcy courts jurisdiction over a grantor or trustee located in the U.S., may threaten the validity of DAPTs. Nevertheless, if an individual is sufficiently solvent, the federal bankruptcy laws may not be applicable.

Due to the lack of reportable case law regarding DAPTs, it is unclear whether the Full Faith and Credit Clause or the federal bankruptcy laws actually decrease the effectiveness of DAPTs. Accordingly, states such as Delaware continually modify their asset protection statutes to combat the uncertainty found in the present law.

### ***Conclusion***

In today's litigious society, asset protection planning may be a necessity. Individuals, whether or not involved in liability producing activities, are justified in seeking to protect their assets from unforeseen liability in order to preserve those assets for themselves and future generations. However, the particular asset protection technique used by an individual is a personal decision. As previously noted, both offshore and domestic asset protection trusts have advantages and disadvantages. Depending on one's goals, expectations and mental state, an offshore or domestic asset protection trust may be preferable. If an individual is comfortable with less control over exported assets and foreign trustees, an offshore asset protection trust may be the way to go. However, if one

desires more control over the trust assets and domestic trustees and can handle the uncertainty of developing law, then a domestic asset protection trust may be the answer.