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Unbreakable Trusts, Invincible Estates

The Trend in Domestic Asset Protection Trusts

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Keep a knockin' but you can't come in
Keep a knockin' but you can't come in
Keep a knockin' but you can't come in
Come back tomorrow night
and try it again.

—Perry Bradford (Early 1930s); Little Richard (Richard Wayne

Which has the better defense, an armadillo or a turtle? Which discourages predators more, a skunk or a porcupine? Which has a greater intimidation factor, an octopus or a stingray?

These defenses don't translate exactly for humans in the financial arena, but there are lessons to be learned. And now, after 400 years refining the relations regarding the law of fraudulent transfers, there is a new animal, a Domestic Asset Protection Trust (DAPT) with a hard shell, offensive attributes, and a frightening demeanor.

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A new trend involving DAPTs is evolving, and the epicenter of change appears to be Nevada. Let's see how the rules of creditors and debtors may evolve based on the new DAPT rules that are arriving.

A Beachhead for DAPTs

For more than 400 years, creditors have tried to limit fraudulent transfers by debtors, while debtors have tried to protect their personal assets from business deals gone bad, litigious persons, disgruntled employees, and other collection efforts.

Assets can be moved to trust, shifted to family members, wired to offshore bank accounts, and squirreled away in mattresses. For those who anticipate potential creditors and litigants just over the horizon, there have always been several asset protection options; however, they've come with undesirable side effects, such as losing control of assets.

Some of these strategies work, and others are frowned upon. In fact, a brilliant asset protection strategy in one state may be considered a fraudulent transfer in another state.

Two competing trends in the law have been vying for supremacy for centuries. The laws protecting creditors have historically dominated. But in the last generation, bankruptcy rules have provided another level of refuge for debtors.

However, in the past decade, DAPTs, also known as self-settled trusts, have been catching on in several jurisdictions. Add a couple of LLCs, comply with simple rules, and any moderate estate can be fortified comfortably against the most determined of creditors.

Creditors vs. Debtors

The rules of the game have evolved for millennia. Those who owe money try to shift the funds to trusts, family members, surrogates, fronts, Swiss banks, and mattresses. Laws to define when such transfers are fraudulent are widespread and varied.

Naturally, there have been attempts to bring order to the law of fraudulent transfers. Federal bankruptcy laws have accomplished this to some extent. Outside of bankruptcy, most transactions are addressed by the Uniform Fraudulent Transfer Act of 1984, which has been widely adopted at the state level. As of June 2005, it had been adopted in 43 states and the District of Columbia. Of course, there is not actual uniformity in the adopted laws, and the actual concepts precede 1984. The Uniform Fraudulent Conveyance Act (UFCA) was promulgated in 1918, adopted by 26 states, and helped shape Federal bankruptcy law.

As always seems to be the case with Anglo-American law, if you dig deeply enough, you'll end up back in England with some ancient law or a quaint case before the Star Chamber involving farmers and sheep. Sure enough, the UFCA was based on laws that almost every state had adopted from the statute of 13 Elizabeth, which in 1571 addressed transactions that were intended to defraud creditors by making them void.

Of course, it would have lacked historical formality to simply declare a fraudulent conveyance to be void. The original statute's language lays this out with the grandeur that we have come to expect of legalese. Here is about one third of the statute:

> "Be it therefore declared, ordained and enacted, that all and every feoffment, gift, grant, alienation, bargain and conveyance of lands, tenements, hereditaments, goods and chattels, or any of them, by writing or otherwise, and all and every bond, suit, judgment and execution at any time had or made to or for any intent or purpose before declared and expressed, shall be from henceforth deemed and taken, only as against that person or persons, his or their heirs, successors, executors, administrators and signs of every of them, whose actions, suits, debts, etc; by such guileful, covinous or fraudulent devices and practices, as is aforesaid, are, shall or might be in anywise disturbed, hindered, delayed or defrauded, to be clearly and utterly void, frustrate, and of none effect, any pretence, color feigned consideration, expressing of use or any other matter or thing to the contrary notwithstanding."

In other words, fraudulent transfers are void. But what makes a transfer fraudulent?
For the answer we look to a notorious transfer of sheep that was scrutinized by the Star Chamber in 1601.

Counting Twyne's Sheep

Putting the 1571 Statute of Fraudulent Conveyances from 13 Elizabeth into proper context was *Twyne's Case* from 1601. Farmer Pierce owed 200 pounds to a creditor. Before the Sheriff arrived to seize his belongings, Farmer Pierce transferred all his worldly possessions, including his herd of sheep, to his friend and neighbor, Farmer Twyne. Yet Farmer Pierce retained possession of the sheep and continued to put his mark upon them. When the Sheriff arrived, Farmer Twyne organized forceful resistance.

Six indicia (or badges) of fraud were identified by the Star Chamber and remain pertinent to this day:

1) A transfer of all assets, even including clothes and necessities, is highly irregular.

2) Donor or transferor retained full possession of the goods allegedly transferred.

3) The transfer was done in secret.

4) The transfer was made when litigation and enforcement of the creditor's remedies was imminent.

5) The property was held by Twyne in trust for Pierce, and "fraud is always appareled and clad with a trust."

6) There was neither consideration for the transfer nor any reason for a gift, making the transfer suspicious.

The transfers to Twyne were treated as fraudulent, and those aiding Twyne against the Sheriff were punished for rioting. More impressive still is the fact that the badges of fraud doctrine of *Twyne* is still cited as a common law precedent in modern American jurisprudence. [See, *Twyne's Case Retold*, by Stephen P. Harbeck, Mountbatten Journal of Legal Studies (2000).]

Modern Twynes

Creditors and debtors have upped the ante of transfers, and shifting ownership rights for your herb of sheep to a next-door neighbor isn't your typical modern scenario. Frankly, the sudden gift of your entire herd of sheep (and the clothes off your back) to a neighbor without any quid pro quo or explanation is about as blatant a fraud as it gets.

In the modern world, more subtle and sophisticated approaches have evolved. Several ultimate destinations for asset protection have developed reputations. Swiss bank accounts have an allure of armadillo-like impenetrability; exotic locales, such as the Cayman Islands, seem to shroud assets in inky mystery that would make an octopus proud. Foreign trusts and corporate entities are also useful.

But all such approaches have drawbacks. What good is a strategy to protect a portion of assets abroad if there are still domestic assets that are exposed to creditors? Why shift assets in a manner that prevents them from being invested successfully or that deprives the owner of adequate control? And if the potential for creditor efforts is merely speculative, then the shift may be less compelling when seen against the reality of expatriate tax penalties and the expenses and risks that apply for designing and maintaining these foreign asset protection devices.

There is now a growing trend in a number of domestic jurisdictions, such as Alaska, Delaware, Hawaii, and Nevada, that are vying to attract assets from other jurisdictions and are therefore permitting self-settled trusts. These trusts may be simple and effective enough to make foreign-based transfers as old-fashioned as transferring one's sheep herd. And the number of jurisdictions permitting DAPTs has jumped from 4 in 2003 to 13 in 2010.

Why Protect Assets?

If there is no immediate threat from creditors or litigants, why should someone consider a DAPT? The answer may depend on the potential for trouble and how much is being placed at risk. In a household with few assets, one spouse may transfer the family home to the other spouse. Elderly persons who may need expensive long-term nursing or assisted living care may transfer assets to the next generation as part of a plan to make their estate "Medicaid-ready" during the 60-month look-back period prior to application for Medicaid. A household with few assets may be aware that bankruptcy provides a failsafe option that is less expensive than certain planning options.

For persons who have substantial wealth and who have some exposure to risk from lawsuits, due to known conflicts in their business or their line of work, the likelihood of having litigation and creditors may be significant. In that case, having an impenetrable defense in place may be an excellent deterrent to potential litigants. And for those who are determined to press forward with an attack, an iron-clad defense, once tested, may prompt adversaries to give up or settle claims on reasonable terms.

For a moderate-size or large estate, there can be a false sense of security, in that many households will never face a significant lawsuit or other creditor. Yet consider the amount spent on other types of insurance compared with the risk involved. People pay homeowner's insurance, fire insurance, flood insurance, disability insurance, and so forth, even though they may never be burglarized, in a fire, in a flood, or unable to work. People spend a significant portion of their annual income insuring against events that never happen or which would only produce limited economic harm.

By comparison, many business owners, directors, officers, physicians, investment managers, etc., face a more significant threat of litigation. Such exposure could be devastating to an entire estate and not merely one particular home. The one-time cost of setting up a permanent defense against such critical threats makes the case for a DAPT rather powerful and the ongoing costs of trustee fees compare favorably with other protective measures such as insurance.

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The DAPT Solution

Everyone wants to have things both ways: full protection yet full control over assets as one of the trustees; keeping creditors at bay yet being able to enjoy the assets as one of the beneficiaries. A self-settled trust makes this possible—within reason.

There are rules that apply in each of the jurisdictions that permit such trusts. Generally, you can't set up a DAPT and expect it to be effective against known creditors. Some jurisdictions have exceptions for certain types of claims, such as child support, alimony, or pre-existing torts. There are waiting periods for certain protections to become effective. And the grantor is generally not permitted to be the sole trustee.

Nevertheless, self-settled trusts are a reality. And as more people take advantage of them in the jurisdictions that permit them, the other 37 jurisdictions will come under increasing pressure to remain competitive in keeping assets from migrating away. Where might assets be heading?

Nevada is the most likely destination for those seeking asset protection. If you are trying to deter creditors and litigants, you want the jurisdiction with the least loopholes and the most protection. In Nevada, the statute of limitations for a creditor is only two years after assets have been transferred for purposes of a non-preexisting creditor or six months after they knew or should have known of the transfer, if longer, for purposes of a preexisting creditor. This is the shortest statute of limitations period in the United States. South Dakota and Utah have three-year statutes of limitations. Alaska, Colorado, Delaware, and other DAPT jurisdiction have four-year statutes of limitations. [**Note:** A chart prepared by nationally known Nevada estate planning and asset protection attorney Steve Oshins comparing the rules of DAPT jurisdiction can be found at www.oshins.com.]

It would be a cruel and unwanted result if someone from a non-DAPT state chose to set up a DAPT in Alaska or Delaware and had a creditor reach the DAPT assets more than two years after the transfer. So an attorney advising a client on where to set up a DAPT may be risking a malpractice claim by not making a client aware of the Nevada advantage.

The Nevada DAPT or "NAPT" has its own requirements. The trust must have some minimal connection with Nevada. This can be easily satisfied but must not be overlooked. For example, the trust should have at least one Nevada-based trustee, whether an individual, a trust company or a bank. Having Nevada assets as the primary asset of the trust or having the primary administrative functions of the trust handled by a Nevada-based trustee would also meet the Nevada connection requirement.

There are three types of trustees with the NAPT, at least one of which must be based in Nevada. In addition to the Settlor and the Nevada-based trustee, there is a "distribution trustee" who authorizes distributions to the Settlor. The Nevada-based trustee can also be the distribution trustee.

Managing a Siege

Suppose a DAPT were besieged by lengthy litigation. What would the ultimate long-term defense look like? An increasingly popular design is to have a trust own one or more LLCs or FLPs. Having a trust own a pair of LLCs is one of the simplest and most effective ways to set up a resilient defense.

To begin with, a total transfer of all assets to a single trust would look very much like one of the original badges of fraud from *Twyne's Case* in 1601. But more significantly, having assets divided between two LLCs that are owned by an asset protection trust creates multiple obstacles to any creditor. As opposed to a judgment creditor of a shareholder for a conventional "C" corporation, where assets can be reached directly and liquidation of such assets can be compelled, judgment creditors of someone who owns shares in an LLC may be limited under state law to charging orders that only provide the creditor with access to distributions from the LLC.

Knowing how charging orders will work makes it possible to set up two separate LLCs, one that will be used to finance the debtor for a few years when and if there is a creditor trying to collect assets. The LLC that continues to make distributions will have an asset protection trust as its 99% owner, with the debtor owning 1%. This will limit the creditor to a charging order against only 1% of distributions.

Meanwhile, the LLC that holds most of the assets will not be making any distributions—or as few as possible. If the majority of assets are held in one LLC that does not make any distributions for five or six years, the creditor may have to be reconciled to a settlement on more favorable terms to the debtor.

A Caveat

Could non-Nevada creditors utilize the full faith and credit clause of the Constitution to attack a Nevada Asset Protection Trust? That question has not yet been answered by the courts, and that is one area where offshore trusts have an advantage. However, by combining the NAPT with one or more charging order-protected LLCs or FLPs and creating this additional wall that looks insurmountable to a creditor, the NAPT structure almost forces a potential litigant to settle the dispute for pennies on the dollar.