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## What is Asset Protection Anyway?

by Jonathan S. Frank

With an uncertain economy, high net worth individuals are reconsidering “preventative” measures that protect assets from potential creditors. An adviser to high net worth clients will need to consider both traditional and non-traditional asset protection strategies. These strategies include the use of traditional business and estate planning tools, such as family limited liability companies, family limited partnerships and domestic trusts as well as non-traditional methods of asset protection such as US compliant offshore business structures and asset protection trusts.

**T**his article will briefly explore the benefits and features of both traditional and non-traditional asset protection strategies to determine which approach may find favor with the client. (Discussion of detailed tax consequences and state-by-state fraudulent transfer laws is beyond the scope of this article.) There, of course, is no strategy that is ideal for every client. Instead, an adviser must consider customizing the approach to each client situation. Creditors and plaintiff’s attorneys have become increasingly successful in piercing traditional strategies to access assets. Therefore, to ignore offshore strategies in light of an intelligent and tenacious plaintiff bar is to accept a higher level of risk that can be minimized by using offshore vehicles, especially asset protection trusts.

Asset protection planning, when done correctly, must be legal and ethical. Any effort to conceal assets with the intent to evade US taxes is contradictory to sound asset protection strategies. Asset protection, simply put, is the method by which you structure the ownership of your assets to safeguard them from potential future risks. Keep in mind, there are no legal asset protection strategies that are 100% bullet proof. Instead, the success of your asset protection strategy is its ability



to make your assets very difficult and expensive to reach. By increasing the time and cost of reaching your assets, most US based creditors or plaintiffs will settle literally for pennies on the dollar. Strategies may include encumbering assets (more specifically real estate), converting assets from non-exempt to exempt, substituting assets or transferring ownership to legal entities and establishing trusts. Generally, these arrangements mean that you, debtor, can enjoy and maintain some degree of control over the assets without directly owning any asset.

## Trusts: an Overview

Trusts are widely used in asset protection. Not all types of trusts are effective asset protection devices, but a properly drafted and structured trust may be an almost bullet-proof form of asset protection.

### Revocable Living Trust

The most commonly drafted trust is the revocable living trust. A living trust, with appropriate spendthrift language, can protect its beneficiaries from creditors' claims. The same cannot be said of the grantor-beneficiary. Because of the revocability power the grantor retains, the living revocable trust will not provide the grantor-debtor with any degree of asset protection. Thus, any trust created to protect the assets of a grantor must be irrevocable whereby the grantor has effectively given up his or her right to change the trust. Such a trust must be established and funded, generally speaking, before the onset of any lawsuit against the client. Every state has a fraudulent conveyance statute. If the grantor-debtor makes a transfer for less than adequate consideration within two to four years (the exact period is state dependent) of the beginning of a law suit, the grantor has the burden of proof and he or she must prove that the transfer was for some other reason than to defraud creditors.

### Spendthrift Trust

The spendthrift trust limits or prevents a beneficiary from being able to transfer or assign his or her interest in the income or the principal of the trust.

Spendthrift trusts are typically used to provide for beneficiaries who are unable to take care of their own financial affairs. Today, almost every trust incorporates a spendthrift clause. If a trust incorporates a spendthrift clause, the beneficiary is prevented from transferring or assigning his or her interest in either income or principal, and the beneficiary's creditors will not be able to reach the beneficiary's interest in the trust.

The protection of the spendthrift trust extends solely to the property that is in the trust. Logically, if property has been distributed to the beneficiary then such property can be reached by a creditor. The distributed assets are treated as any other assets of the beneficiary-debtor, and there is no statutory protection available for such assets simply because the assets were previously held in a trust.

The trustee holds title to the trust assets for the benefit of the beneficiary. It is the duty of the trustee to administer the trust for the benefit of the beneficiary and no one else. A creditor's ability to satisfy a judgment against a beneficiary's interest in a trust is limited to the beneficiary's interest in such trust. Consequently, the common goal of asset protection trusts is to limit the interests of beneficiaries in such a way so as to preclude creditors from collecting against trust assets.

### "Self-settled" Trust

An exception to spendthrift trusts are what are called "self-settled" trusts. If the grantor of a trust is also a beneficiary of a trust, the assets will not be protected by the trust's spendthrift clause from creditor claims where the grantor retained a benefit in the asset. If the trustee of a self-settled trust has any discretion in making distributions, then the creditors of the grantor will reach the maximum amount that the trustee may distribute in his or her discretion to the grantor-beneficiary.

Most jurisdictions remove the trust's spendthrift protection clause when it is self-settled, although a number of jurisdictions no longer follow this rule. These jurisdictions include certain US states, like Delaware, Alaska and Nevada, and certain foreign nations, like Nevis and the Cook Islands (these domestic and foreign asset protection trusts will be discussed in more detail). Forming an irrevocable trust in one of these jurisdictions may be another way to preserve the protection of the spendthrift clause inside a self-settled trust. Most asset protection clients are looking to protect their own assets and are usually not beneficiaries of existing trusts. Consequently, the majority of asset protection trusts are self-settled. When a trust is self-settled, to obtain any asset protection for the grantor, discretionary powers should be avoided in favor of a clearly ascertainable standard.

### Discretionary Trust

A trust is called "discretionary" when the trustee has discretion (as to the timing, amount and the identity of the beneficiary) in making distributions. Because the trustee is not required to make any distribution to any specific beneficiary, or may choose when and how much to distribute, a beneficiary of a discretionary trust may have such a tenuous interest in the trust so as not to constitute a property right at all. If the beneficiary has no property right, there is nothing for a creditor to pursue. The statutes follow this line of reasoning by providing that a trustee cannot be compelled to pay a beneficiary's creditor if the trustee has



discretion in making distributions of income and principal.

Even if a trust is truly discretionary, it should have a spendthrift clause. While the trustee would not need to honor a beneficiary's demand for a distribution, it is possible that absent the spendthrift clause a creditor would force the beneficiary to assign his or her interest in the trust to the creditor. Should that happen, then any future distribution made by the trustee will be made to the creditor. To protect trust assets, it is important to have the protection of a spendthrift clause especially since few, if any, trusts are fully discretionary.

A properly drafted discretionary trust is an almost impregnable form of asset protection. But if the trust is discretionary, it means that there are no mandated distributions and no demand rights granted to the beneficiary. This situation potentially leaves the beneficiary at the mercy of the trustee. Trustees must always exercise their discretion reasonably, and even if the trustee is granted "sole and absolute" discretion, the discretion must not be exercised "arbitrarily" and must be exercised in accordance with fiduciary principles.

It is also advisable to set forth in the trust the grantor's intent for the trust. The intent can be stated in terms of providing for and taking care of the beneficiary, and not paying any monies to any party other than the beneficiary, including the beneficiary's creditors.

#### Domestic Asset Protection Trust (DAPT)

A number of US jurisdictions now allow self-settled trusts to afford their grantors the protection of the spendthrift clause. Alaska was the first jurisdiction to enact such laws in 1997 and was shortly followed by Delaware, Nevada and a few others. These domestic self-settled asset protection trusts shall be referred to as "DAPTs."

A typical DAPT must comply with the following requirements:

- the trust must be irrevocable and contain spendthrift language;
- at least one resident trustee (of the state having appropriate asset protection statutes) must be appointed;
- some administration of the trust must be conducted within that state; and
- the grantor cannot act as a trustee.

At first blush, the DAPT jurisdictions appear to be a simple solution for a grantor of a self-settled trust seeking asset protection if the grantor is a resident of a DAPT jurisdiction and has assets in the jurisdiction.

#### DAPT Risks: Conflict of State Laws

Trusts are generally governed by the laws of the jurisdiction that is designated by the grantor as the governing jurisdiction. There are two exceptions to the general rule:

- states will not recognize laws of sister states that violate their own public policy, and
- if the trust owns real property, such property will be governed by the law of jurisdiction wherein it is located.

Overcoming the latter is remedied to some extent by first establishing a family limited liability company or a family limited partnership (organized under the laws of the DAPT jurisdiction) and transferring the real estate into the company. This converts the real property into personal property. The second step is to re-title the new company in the name of the DAPT.

It is important to note that, to date, there are no cases dealing with the effectiveness of DAPTs.

#### DAPT Risks: United States Constitution, The Full Faith and Credit Clause

The Full Faith and Credit clause of the United States Constitution provides that each state has to give full faith and credit to the laws of every other state. Further, even under the Full Faith and Credit clause the states are not required to recognize the laws of sister states that are contrary to their own public policy.

Until such time as the application of the Full Faith and Credit clause is litigated in the context of a self-settled trust, it is the author's belief that the risk is too great that a DAPT would not afford the debtor with the required protection.

#### Foreign Asset Protection Trust

The term "foreign trust" usually means a trust that states that it should be interpreted under the laws of a foreign jurisdiction, which means that the laws of the foreign jurisdiction will apply to the trust and the enforceability of the trust's spendthrift clause. What advantages does that carry?

All foreign jurisdictions that compete in the asset protection market allow self-settled trusts to be an effective shield against creditors, similar to the US DAPT jurisdictions that have followed suit. However, foreign trusts are not subject to the Full Faith and Credit clause of the US Constitution. With a foreign trust there is never any doubt that the favorable law of the foreign jurisdiction will be applied to the trust, and there is also no doubt that the foreign jurisdiction does not have to enforce any judgment coming out of a US state (whereas a sister state may have to recognize such a judgment).

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Even setting aside these uncertainties with DAPTs discussed above, foreign trusts are vastly superior to the US domestic trusts. For example, the foreign asset protection jurisdictions provide that the creditor has the burden of proving a fraudulent conveyance. More importantly, the creditor's burden of proof is the higher criminal standard of "beyond a reasonable doubt." In foreign jurisdictions the statute of limitations on bringing a fraudulent conveyance action is not only short, but it also begins running on the date of the transfer, not the date the transfer is "discovered."

In addition, few US attorneys are licensed in the foreign jurisdiction where the trustee resides which means the creditor will have to find an attorney licensed to practice in that foreign jurisdiction to represent his or her claim. With significant retainers often demanded by foreign attorneys before accepting a case, US attorneys often recommend a negotiated settlement for pennies on the dollar. Furthermore, the foreign asset protection trust becomes quite a disincentive for US attorneys seeking contingency fees making it very expensive for creditors to pursue reimbursement. This expense, while not a legal deterrent, becomes an insurmountable obstacle to most creditors.

### Conclusion

As our fragile economy struggles to reassert itself, the wealth of millions of baby boomers hangs in the balance. Most of this wealth is held in residential homes and securities, which represent \$16 trillion in assets. This accumulated wealth is subject to creditors' or plaintiff attorneys' attack. As a result, asset protection strategies become a fertile field of discussion between the client and the adviser who strives to add value to client relationships. For the adviser who is not familiar with either traditional and/or non-traditional

asset protection strategies, it is best to develop a relationship with an attorney familiar with such matters to navigate a course of action that achieves the asset protection objectives of the client. By collaborating with legal counsel familiar with the peculiarities of asset protection strategies, including offshore planning opportunities, an adviser secures the client relationship.

Of course, as stated earlier, offshore asset protection trusts represent one strategy that is legally sound and that should be explored. Such trusts do not prevent any investment from residing state-side nor do they protect those assets from most taxable consequences; however, there are some favorable offshore techniques that permit tax deferral, not tax avoidance. The bottom line: there are sound traditional and non-traditional asset protection strategies that advisers should explore in collaboration with legal counsel that can assist the adviser in structuring a sound asset protection strategy. 



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