A Creditors' Rights Perspective on Domestic Asset Protection Trusts

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James J. White, *Fraudulent Conveyances Masquerading as Asset Protection Trusts*, 47 **UCC L.J.** 367 (2017), available at SSRN.

Property rights are contingent. While property owners enjoy exclusive access to property owned, laws governing creditors' rights moderate owners' rights under certain conditions. Failure to satisfy a debt can trigger legal processes that may even lead to a complete stripping of ownership rights in favor of the creditor. Viewed this way, the sorting of rights to property is a zero-sum game where a creditor's gain offsets an owner's loss.

Trusts can reduce the vulnerability of an owner's property rights by adding additional complexity to the ownership arrangement. The spendthrift trust is the obvious example. In such an arrangement an owner transfers the ownership bundle in manner that is said to "split" new ownership rights between a trustee and one or more beneficiaries. Afterwards, the beneficiaries enjoy the benefits of ownership, but neither a beneficiary nor most third parties are capable of diminishing beneficial ownership rights in the spendthrift trust arrangement.

Spendthrift trusts are typically explained as devices. Reference is to the law governing trusts. In these explanations informed by trust law, the fact that creditors' property rights, including those of involuntary creditors, are diminished by spendthrift trusts is incidental to the main event—the legal operation of the trust device itself. Policy justification focuses on the freedom of the original owner to "dispose" of property as he or she pleases. And while beneficiaries gain a beneficial interest that diminishes baseline property rights of creditors, we phrase our explanations in terms of what is missing from the beneficial owner's bundle of rights. So we point out that, in a spendthrift trust, a beneficiary has no right to grant creditors an up-front inchoate right to beneficially-owned property. And despite that involuntary creditors lose baseline rights to the beneficial owner's property, we focus on the beneficial owner's loss of the "involuntary" right to transfer property rights to a creditor. But in fact, spendthrift trusts are no exception to the zero-sum sorting of property rights between owners and creditors. Rights gained by beneficiaries are lost by creditors.

Crucial to creation of a spendthrift trust is a benefactor who transfers property rights to the trust arrangement. But a newer legal invention, the so-called "self-settled domestic asset protection trust" (DAPT), dispenses with the necessity of the gratuitous third-party transfer. In these devices, the settlor becomes the beneficiary; the trust is "self-settled." The DAPT is necessarily statutorily enabled, as the common law justification for spendthrift trusts, the freedom of disposition of the original owner, is absent from the facts. The original owner retains, rather than disposes of, his or her beneficial ownership rights. Yet the nomenclature reveals the bias in favor of the trust beneficiary. Trust properties are "assets" and assets are "protected." Of course, to "protect" an asset is to increase an owner's rights, and to diminish the rights of creditors. Here, however, it may not be so easy to de-emphasize the zero-sum nature of property rights. A scholar viewing these devices from the creditor's standpoint may in fact cry "foul." Professor James J. White, in a provocatively entitled essay appearing in the Uniform Commercial Code Law Journal, concludes that these devices "are fraudulent conveyances plain and simple." Although White considers his view both "dispassionate" and "slightly skeptical," he

seems particularly concerned about involuntary creditors; his primary examples being “ex-wives and malpractice plaintiffs.”

Professor White first briefly reviews the history of the DAPT, pointing out that while prior to 1997 the device was not available in any U.S. jurisdiction, now seventeen states enable some version of the DAPT. Before enactment of DAPT statutes, Americans wishing to curb creditors’ rights to property they owned by placing that property in trust had to do so through the laws of certain foreign jurisdictions such as the Cook Islands. In 1997, however, the states of Delaware and Alaska enacted statutes enabling domestic self-settled trusts that curbed creditors’ rights to the settlor/beneficiary’s property. Since that time, another fifteen states enacted similar statutes. According to Professor White, while the sponsors of the Delaware and Alaska legislation were entrepreneurs, lawyers, and trust companies who saw a market for these trusts, later “unsuspecting and uninformed” legislators were simply swayed by the argument that their jurisdictions needed similar statutes in order to keep assets and trust business from flowing to other states. White attempts to assure us that with these reasons for the legislation, legislators did not actually face the “reprehensible” reversal of longstanding public policy that self-settled trusts could not foil the rights of creditors and “stiff ex-wives and deprive successful malpractice plaintiffs from satisfaction out of a settlor/defendant’s trust assets.” Perhaps Professor White assumes too much naiveté on behalf of legislators here. It seems at least as likely that many of these legislators were sympathetic to the favored causes of certain constituents and campaign donors.

Regardless of the reasons for enactment in the various states, Professor White is certainly correct when he notes that the promoters of these trusts, post-adoption by the legislature, focus on the DAPT’s ability to protect assets from claims of creditors. Some promoters are very specific, listing divorce and tort actions as occasions where these trusts offer protection. As White sums it up, “the multiple pages of internet listings, some subtle, some strident, and some with false denials make plain that keeping assets out of the hands of creditors, particularly tort plaintiffs and former wives, is a principal purpose of these trusts.” But the value of White’s insights for the trusts and estates bar lies in his discussion of the changes that the statutes made to fraudulent conveyance law, and his consideration of whether those changes mean that property transfers to these trusts fall outside the rather complicated determination of a fraudulent conveyance. DAPT statutes reduce the statute of limitations for filing claims based on a fraudulent conveyance and require the claimant to prove actual intent on the part of the property owner to “hinder, delay or defraud” a creditor.

White admits that since the case law is scarce or nonexistent, the effect of these legislative changes in actual cases is unknown. However, he suggests that current law as to determining actual intent “will be relatively easy to meet in view of the skepticism that many courts will have and because the advertising and sales information reveal a pervasive intent to hamper creditors.” On the other hand, he concedes that shortening the statutes of limitations for bringing such claims could be a “powerful restriction” on them. White takes the reader through an analysis of the steps for proving actual intent to hinder, delay or defraud future creditors, including involuntary creditors, which likely make up the bulk of those potential creditors with which the typical DAPT settlor/beneficiary is concerned. Although White reviews some case law helpful in this analysis, given the general paucity of cases much of White’s musings here are speculative. In an interesting observation on this subject, White notes that commentators do not even agree on the definition of “future creditor,” with some asserting that courts “are unwilling to void transfers whose purpose and effect is to shelter assets from creditors that were unknown at the time of the transfer” while others do not so conclude.

White also explores the question of which jurisdiction’s laws will apply in these cases. In federal bankruptcy cases, he points out that a ten-year statute of limitations may apply to fraudulent transfers regardless of state law. Further, since only seventeen states enacted DAPT legislation, many out-of-state settlor/beneficiaries must rely on a choice of law term in the trust instrument in order to take

advantage of a DAPT. In such cases the public policy exception in the state where the settlor/beneficiary resides may negate the choice of law provision. White cites a federal bankruptcy case from a court sitting in Washington in observing that “it was no surprise that the court inferred a public policy against self-settled trusts from a Washington statute that prohibits self-settled trusts.” White also very briefly confronts the arguments that the DAPT is no different from a limited liability company (LLC), a homestead exemption, and other statutory diminishments of creditors’ rights. A more thorough comparison with these devices would give additional context.

In his concise essay, Professor White’s creditors’ rights perspective alerts us to potential legal and public policy uncertainties created by the DAPT. Regardless of whether the reader agrees with White that the DAPT is a form of fraudulent conveyance, his essay is a reminder of what I describe above as the zero-sum aspect of property rights. Strengthening the property rights of beneficial owners decreases the rights of creditors. Whether a particular increase and decrease is desirable invokes important questions of law and policy. In considering the DAPT from the standpoint of fraudulent conveyance law, Professor James J. White offers trusts and estates specialists a fresh perspective.

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