Does Your Client Need Asset Protection Planning?

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ABSTRACT

An asset protection trust may be considered when a client is concerned about a future liability to a creditor that calls for protection beyond joint ownership or ownership of life insurance.

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We've all heard that we live in a litigious society. So, how important is asset protection planning for most people? And, beyond what's needed for "most people," what should be done for those for whom the prospect of being sued is not "if" but "when?"

Most People Don't Need Asset Protection Trusts

While clients may scare themselves with the prospect that a spouse may run over the next youthful Internet billionaire in the intersection, a bit of perspective can restore calm. It's a very good idea to review property and casualty insurance policies: auto and homeowner's coverage, as well as an umbrella liability policy. A substantial amount of general liability coverage can be obtained for a fairly inexpensive premium. Unless egregious circumstances pertain–the spouse was trying to hit that tech prodigy in the intersection–it is quite likely that, even if liability results, the payments required will be covered by insurance if reasonable amounts of coverage are maintained. Apart from traffic nightmares, doctors are perhaps the most likely clients to have justifiable concern about the liability that litigation may produce. For that matter, studies have shown that doctors who are more compassionate and less defensive when a medical error has occurred are better able to defuse a situation that might be aggravated by an uncaring response.

Many states allow assets to be owned as "tenants by the entirety," a particular form of legal ownership uniquely available to husbands and wives. In many cases, joint ownership by spouses will go a long way to keep assets so held away from a creditor of one spouse or the other. However, like most other flat statements made to summarize the law, there are qualifiers and nuances. First, an overriding principle of debtor-creditor law is that one may not transfer assets to defraud creditors. If a creditor has won a judgment against an individual who then decides to retitle the asset in joint names with his spouse, we have trouble in River City. In many types of estate planning, it's a really good idea to take action before it's obvious that action is needed. In asset protection planning, it's imperative.

Asset Protection Trust

An asset protection trust may be considered when a client is concerned about a future liability to a creditor that calls for protection beyond joint ownership or ownership of life insurance. First, a bit of context. A parent may establish a trust for a child that has a "spendthrift provision:" no distribution may be made to the child's creditors. That provision will generally be effective to prevent a distribution to a creditor. The child has no say in the matter because a third party, i.e., the parent, established the trust. A self-settled trust is a different matter. In many states, an individual cannot establish a trust that would put assets beyond the reach of that individual's creditors. However, a growing number of states have enacted laws that, subject to certain limitations, allow a self-settled trust to be established beyond the reach of the settlor's creditors.

This form of trust has long been available in certain foreign jurisdictions, and was often referred to as an offshore trust. In 1997, Alaska and Delaware enacted laws that permitted self-settled trusts to provide asset protection in their respective states. In the years since, many other states have created statutes that permit asset protection to be enjoyed by the settlors of trusts and their beneficiaries. In this column, I will refer to the Delaware law to discuss how insulation from liability may be obtained for assets transferred to a self-settled trust. Remember that state laws vary, so any advisor who offers asset protection guidance in any form should follow legal advice as to the effect of the laws of a particular state. It's especially important to be sure that legal guidance is current. Asset protection is an evolving area of the law and new or amended legislation is occurring in a number of jurisdictions.

Typical Structure of an Asset Protection Trust

While assets may be transferred to a Delaware Asset Protection Trust (DAPT or, the trust) that also has an estate and gift tax planning dimension, it often happens that DAPTs are not designed to provide tax benefits. For example, the settlor of a DAPT may retain a limited power of appointment, effective during life or at death. The retention of that power causes the gift to the trust to be incomplete for gift tax purposes. Frequently, the DAPT is also structured as a grantor trust so that the settlor owns it for federal income tax purposes and continues to be taxed as if the transfer had not been made. The settlor, the settlor's spouse, and the settlor's children may be trust beneficiaries during the settlor's lifetime. Provisions specified for trust beneficiaries following the settlor's death should be coordinated with the provisions otherwise included in the settlor's will and any trusts otherwise established for estate planning purposes. The asset protection features of the trust should continue after the settlor's death, so as to provide ongoing protection if a claim is brought against the trust during the settlor's lifetime, but is not resolved when death occurs.

The settlor who establishes a DAPT should be prepared to make certain representations regarding his or her financial situation before the trust is established. Ideally, the settlor can truthfully state that no liabilities to creditors, nor claims by creditors or potential creditors, are currently pending. If that is not the case as to a given creditor or claimant, the trust will not be effective to shield the settlor from liability as to that creditor, and possibly, a claimant. Delaware trust companies typically require a settlor to sign an affidavit or other form of representation in which disclosure of creditors and claimants, or the absence of same, is made.

How Much May Be Transferred to the Trust?

There is no hard-and-fast rule that dictates a limitation on the value of assets that may be transferred to the trust. The thought has been expressed that, perhaps, the value of the transferred assets should not exceed one-half of the settlor's net worth. While no strict standard exists, if the value of the transferred assets is very high in comparison to the value of those retained, the stage may be set for future problems. In subsequent litigation, a plaintiff may point to a particularly disproportionate transfer as evidence that the settlor knew an actual claim was imminent. If not much remains as a reserve for the settlor to draw upon as a supplement to the settlor's income, it is fair to infer that the settlor may have expected to have the trustee provide funds for extraordinary living expenses.

Keep in mind that I referred to the settlor, as well as the settlor's spouse and children, as trust beneficiaries. However, as much as possible, the assets held in the trust should be "walled off" from the reach of the beneficiaries. Typically, the trustee has absolute discretion as to whether a distribution of income or principal may be made to a beneficiary for any purpose. That breadth of discretion prevents the beneficiary from pointing to a standard, such as health or maintenance, that warrants a distribution; and likewise thwarts a creditor from having a righteous claim for a distribution. It may remain possible that a distribution will be made to the settlor or family members, but that should only occur in a truly dire situation. It is important to realize that no definitive case has yet emerged that defines the contours of Delaware law as to exactly how much protection from creditors a trust may provide in a given factual setting. Short of a definitive result in a court proceeding, the trust may prove useful if a claimant seeks to negotiate a settlement in excess of the settlor's applicable insurance coverage. If the settlor has maintained direct ownership of assets as a reserve outside of trust assets, and the trustee has made no distributions of income or asset to the settlor or family members, the claimant faces an uphill battle. If the settlor has taken any action or requested the trustee to take any action that would undermine the legitimacy of the trust, the claimant may not be motivated to incur major legal expenses to drill a dry hole.

Distribution Advisors, Investment Advisors, Trust Protectors

In certain states, the settlor may designate individuals other than the trustee to act in what may be called a quasifiduciary capacity. Specifically, the trust may name a distribution advisor who could effectively direct the trustee to make distributions, or to refrain from making distributions, from the trust, even endowing the advisor with a veto power over distributions that the trustee might otherwise make. The settlor, as investment advisor, may retain the right to direct how trust funds will be invested, and may designate a successor to act in his or her place. A trust protector may also be designated in the terms of the trust and authorized to remove and replace trustees, to designate successor distribution advisors or investment advisors, and to exercise other powers as the trust may specify. One might wonder how some of these advisors and protectors might coexist with the trustees, and, in many instances, the advice may be to stay tuned. While these other roles may be specifically defined by statute, the legislatures are far in front of the courts. Over time, the interrelationship of trustees, specified advisors, and trust protectors may be more clearly defined. However, for now, we can see how various states have enacted statutes to define "directed trusts." We have enough statutory definition to permit solid plans to be made, but we can expect further developments to emerge from both case law and anecdotal experience. ■

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