THE IMPLEMENTATION AND USE

OF

DELAWARE ASSET PROTECTION TRUSTS

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I. INTRODUCTION

A. It's no secret that the United States is a litigious society, and there's no indication that the trend line with respect to lawsuits will go anywhere but up. Timely and professional asset protection planning, and in particular, the use of Delaware "asset protection" trusts, can help individuals weather this storm of litigation. The seminar to which this outline relates is intended to provide:

1. A review of the proper structuring, implementation and administration of Delaware asset protection trusts;

2. A comparison of Delaware's law with that of other domestic (i.e., Nevada, South Dakota), and foreign asset protection trust jurisdiction alternatives;

3. An analysis of the most important case law involving the use of domestic (and foreign) asset protection trusts;

4. A discussion of the use of Delaware asset protection trusts as a pre-nuptial agreement alternative; and

5. Consideration of the benefits of integrating a client's estate tax planning into a Delaware asset protection trust.

B. The current litigation environment is often thought to create greater exposure to risk of loss than ever before. A number of reasons for increased litigation exposure have been postulated, including:

1. Ever expanding theories of liability

2. Higher and higher jury awards

3. Unpredictable, and result oriented, judges and juries

C. Traditional forms of protection are often thought to be inadequate:

1. Insurance

   a. Exclusions

   b. Policy limits

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c. Policy lapses

d. Insurer insolvency

2. Incorporation

a. Piercing the corporate veil

b. New theories of shareholder/officer liability

D. Candidates for asset protection planning include (amongst others):

1. Professionals

2. Corporate officers and directors

3. Fiduciaries

4. Real estate owners

5. Individuals exposed to lawsuits arising from claims alleging negligent acts, intentional torts (i.e., discrimination, harassment, libel, etc.), or contractual liability

6. Individuals seeking a prenuptial alternative

E. Although asset protection trusts may be relatively new, asset protection planning itself is not. Consider:

1. Incorporation of business activities

2. Formation of LLCs, LLPs, LPs, etc.

3. Third-party settled spendthrift and discretionary trusts

4. Exemption planning and pre-bankruptcy planning

F. Asset protection, and the use of asset protection trusts in appropriate situations, should be considered an integral part of the larger wealth preservation process, including:

1. Financial planning

2. Insurance planning

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3. Income tax planning

4. Gift, estate and generation-skipping transfer tax planning

II. FRAUDULENT TRANSFER ISSUES

A. Every asset protection plan must account, in the very first instance, for the law of fraudulent transfers. In general, the law of fraudulent transfers, which dates back to the enactment of the Statute of Elizabeth in England in 1571, provides that the transfer of assets in anticipation of a creditor problem will be disregarded by the courts and the creditor will be allowed to enforce its judgment against the transferee of the property.

B. Fraudulent transfer statutes can be found under the law of every state and almost all foreign jurisdictions, as well.

C. In the United States today, for federal purposes, Bankruptcy Code § 548, entitled *Fraudulent Transfers and Obligations*, provides for the avoidance of fraudulent transfers in Bankruptcy.

D. At the state level, fraudulent transfer law in the United States is largely governed by one of two main bodies of law promulgated by the National Conference of Commissioners on Uniform State Laws.

1. The Uniform Fraudulent Conveyance Act, promulgated in 1918 by the National Conference of Commissioners on Uniform State Laws, which remains in effect in only two jurisdictions – Maryland and New York.

2. The Uniform Fraudulent Transfer Act, approved by the National Conference of Commissioners on Uniform State Laws in 1984 is in effect in forty three states, as well as the District of Columbia and the U.S. Virgin Islands.

3. The remaining states either follow a version of the Statute of Elizabeth, or provide for a civil law analogue to the common law suit to set aside a fraudulent transfer (*i.e.*, Louisiana).

E. Notwithstanding the semantic similarity between the term "fraud" and the terms "fraudulent transfer" and "fraudulent conveyance", the two concepts are wholly unrelated under the law.

1. According to Black's Law Dictionary, a "fraud" is "[a] knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."

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2. By contrast, the most common incidence of a "fraudulent transfer" is simply a transfer made with the intent to hinder, delay or defraud a creditor.

   a. In addition, a transfer made without fair consideration by a person who is insolvent, or who will be rendered insolvent by reason of the transfer, is also deemed to be a "fraudulent transfer."

   b. Moreover, in certain jurisdictions (of which New York is an example), the fact that a person has been named as a defendant in a lawsuit would render all transfers made by that person without sufficient return consideration as *per se* fraudulent transfers irrespective of the transferor's actual intent in making the transfer.

3. The difference between a fraud and a fraudulent transfer is also evidenced by the remedy available to the injured party; fraud vitiates all transactions *ab initio*, whereas a fraudulent transfer is merely voidable.

F. In determining when a transfer was made with the intent to hinder, delay or defraud a creditor, fraudulent transfer law divides creditors into three categories:

1. Present creditors; being those persons of whom the transferor has notice when making the transfer.

2. Probable future creditors; being those persons against whom the transferor harbored an actual fraudulent intent when making the transfer.

3. Potential future creditors; being those nameless, faceless persons of whom the transferor had no awareness when making the transfer.

G. One can easily imagine that it will be the rare debtor who, in defense of a claim alleging that he or she fraudulently transferred his or her property, admits or otherwise disgorges sufficient proof that such transfers were made with an actual intent to hinder, delay or defraud known creditors. As a consequence of this inherent difficulty in proving the debtor's intent, the courts have permitted various "badges of fraud", frequently thought to attend the fraudulent transfer of property, to be taken into account as "proof" of the requisite intent.

H. The Uniform Fraudulent Conveyance Act relies upon common law badges of fraud. The Uniform Fraudulent Transfer Act, however, provides a non-exhaustive list of factors that may be considered in determining the debtor's actual intent in transferring property or incurring an obligation. Those factors are:

1. Whether the transfer or obligation was to an insider;

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2. Whether the debtor retained possession or control of the property transferred after the transfer;

3. Whether the transfer or obligation was disclosed or concealed;

4. Whether before the transfer was made or the obligation was incurred, the debtor had been sued or threatened with suit;

5. Whether the transfer was of substantially all of the debtor's assets;

6. Whether the debtor absconded;

7. Whether the debtor removed or concealed assets;

8. Whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

9. Whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

10. Whether the transfer occurred shortly before or shortly after a substantial debt was incurred; and

11. Whether the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

I. Effect of Finding a Fraudulent Transfer and Transferee Liability

1. The Uniform Fraudulent Transfer Act provides for several alternative remedies where a fraudulent transfer is found to have been made. Those remedies include:

    a. Avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim;

    b. An attachment or other provisional remedy against the asset transferred or other property of the transferee; and

    c. An injunction against further disposition by the debtor, the transferee or both, of the asset transferred or of other property of the transferee, or any other relief the circumstances may require.

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2. A ceiling imposed upon the relief available where a fraudulent transfer has been found is that the creditor can obtain no greater relief in the face of the fraudulent transfer than such creditor might have obtained had the fraudulent transfer not been made.

J. It is notable that, except as specified hereinabove, it is unimportant whether or not a creditor's claim has yet coalesced into a lawsuit (which, of course, might be months or years after the actual claim arose).

K. **It is absolutely imperative that asset protection planning, including the establishment of a Delaware asset protection trust, be undertaken as far in advance of a potential creditor claim as possible in order to ensure that any transfer of property incident to such plan is not later undone as a fraudulent transfer!**

III. A BRIEF (AND SELECTIVE) HISTORY OF SPENDTHRIFT AND DISCRETIONARY TRUST PROTECTIONS

A. Spendthrift Trusts

1. "Trusts in which a beneficiary cannot assign the interest, or that provide that creditors cannot reach it, are known as 'spendthrift trusts.'" SCOTT AND ASCHER ON TRUSTS § 15.2, Vol. 3 at 898 (5th ed. 2007).

2. "The term 'spendthrift trust' refers to a trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests." RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

B. Discretionary Trusts

- A "discretionary" trust is a trust in which distributions to the beneficiary are left wholly within the discretion of the trustee, generally without regard to any ascertainable standard. RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

C. Combined Discretionary and Spendthrift Trusts

- "A spendthrift trust is to be distinguished from a discretionary trust but may or may not also contain discretionary interests..." RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

D. A discretionary spendthrift trust has the potential to afford a beneficiary a significant amount of creditor protection. A series of cases is instructive in this regard; they are (i) *Nichols v. Eaton*, 91 U.S. 716 (1875), (ii) *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997), (iii) *Scheffel v.*

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Krueger, 782 A.2d 410 (N.H. 2001), and (iv) *Gibson v. Speegle*, 1984 Del. Ch. LEXIS 475 (DE Ct. of Chancery, Sussex County, May 30, 1984)

1. *Nichols v. Eaton*, 91 U.S. 716 (1875)

    a. It was not until 1875, with the Supreme Court decision in *Nichols v. Eaton*, that a break with the English common law on spendthrift trusts was affected, and their validity became generally accepted throughout the United States.

    b. The theoretical basis underlying the general acceptance of the validity of spendthrift trusts in the United States, as demonstrated by the Supreme Court in *Nichols*, is the idea that an individual should be able to transfer property subject to certain limiting conditions upon which the property will be available to the beneficiary.

        i. In this regard, the maxim "*cujus est dare, ejus est disponere*," or "[w]hose it is to give, his it is to dispose" is frequently cited in connection with references to the validity of spendthrift trust restrictions.

    c. In *Nichols*, the trust in question was a testamentary trust established by a mother for a son who had failed in business and who had assigned all of his property for the benefit of his creditors and then later filed for bankruptcy. The mother's will included a provision that stated that if any of her sons should "alienate or dispose of the income to which they were entitled under the trusts of the will, or if, by reason of bankruptcy or insolvency, or any other means whatsoever, said income could no longer be personally enjoyed by them respectively, but the same would become vested in or payable to some other person, then the trust expressed in said will concerning so much thereof as would so vest should immediately cease and determine. In that case, during the residue of the life of such son, that part of the income of the trust fund was to be paid to the wife and children, or wife or child, as the case might be, of such son, and in default of any objects of the last-mentioned trust, the income was to accumulate in augmentation of the principal fund." *Nichols* at 718.

    d. In establishing the modern rule with regard to spendthrift trusts, the Supreme Court in *Nichols* stated that:

        - "[w]e concede that there are limitations which public policy or general statutes impose upon all dispositions of

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property, such as those designed to prevent perpetuities and accumulations of real estate...We also admit that there is a just and sound policy...to protect creditors against frauds upon their rights...But the doctrine, that the owner of property...cannot so dispose of it, but that the object of his bounty...must hold it subject to the debts due his creditors...is one which we are not prepared to announce as the doctrine of this court." *Nichols* at 725.

2. *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997)

   a. In *Sligh v. First National Bank of Holmes County*, the beneficiary of two spendthrift trusts established by the beneficiary's mother with the defendant bank as trustee was operating a vehicle while intoxicated and was involved in an accident with the plaintiff. The accident left the plaintiff paralyzed with the loss of the use of both legs, the loss of all sexual function and the loss of his ability to control his bowel and urinary functions. The plaintiff won a $5 million civil judgment against the beneficiary for compensatory and punitive damages and tried to collect against the trusts by alleging that the beneficiary's mother had actual knowledge that the beneficiary was an alcoholic and that the beneficiary's mother had created the trusts to shield her beneficiary son's interest from the likely claims of involuntary tort creditors. The beneficiary had no other assets aside from his beneficial interests in the trusts.

   b. The plaintiff alleged that it was a violation of public policy to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against the beneficiary, and urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary tort creditors. The Mississippi Supreme Court ultimately allowed the plaintiff to collect against the trusts by concluding that spendthrift protection should not extend to judgments for "gross negligence and intentional torts."

   c. Most significant, however, is the fact that the Mississippi legislature promptly negated the import of *Sligh* in future cases through the enactment of the "Family Trust Preservation Act of 1998." Miss. Code Ann. §§ 91-9-501, *et seq.* (1998). That act provides that except in the case of a self-settled trust, a beneficiary's interest in a spendthrift trust may not be transferred nor subjected to a money judgment until the interest is actually paid to the beneficiary.

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3. *Scheffel v. Krueger,* 782 A.2d 410 (N.H. 2001)

   a. In *Scheffel v. Krueger*, the defendant was a convicted child molester who was the beneficiary of a discretionary spendthrift trust established by his grandmother in 1985. The plaintiff filed suit in 1998 asserting tort claims against the defendant in connection with the molestation charges and seeking an attachment of the defendant's beneficial interest in the discretionary spendthrift trust. Under the terms of the trust, all income was to be distributed to the defendant annually and distributions of principal were to be made in the trustee's discretion. The defendant had the power to invade the principal of the trust only following his fiftieth birthday on April 6, 2016.

   b. The court found no basis for relief for the plaintiff and held that nothing in the language of the relevant statute suggested that the legislature intended to exempt a tort creditor from a spendthrift provision.

      i. The court also found that the defendant's ability to direct trust income and principal after attaining age fifty did not in and of itself disqualify the trust as a spendthrift trust.

4. *Gibson v. Speegle*, 1984 Del. Ch. LEXIS 475 (DE Ct. of Chancery, Sussex County, May 30, 1984)

   a. In February, 1976, Gary Barwick pled guilty to several crimes including arson, all of which resulted in damage to the Hawaiian Village Restaurant and Lounge in Delmar, Delaware, a property that Aetna insured and in connection with which Aetna paid out monies to the policyholder. At sentencing, Gary was ordered, *inter alia*, to pay restitution, including monies to Aetna. Less than five months after Gary's sentencing, his mother, Virginia, executed a Last Will and Testament which included a discretionary spendthrift trust for Gary until he should reach the age of forty (40) years. Virginia then died and Aetna made claim against Gary's trust.

   b. Delaware Code § 3536(a) provides, in pertinent part, that "[a] creditor of a beneficiary of a trust shall have only such rights against such beneficiary's interest in the trust or the property of the trust as shall be expressly granted to such creditor by the terms of the instrument that creates or defines the trust or by the laws of [Delaware]. The provisions of this subsection shall be

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effective regardless of the nature or extent of the beneficiary's interest or of any action taken or that might be taken by the beneficiary. Every interest in a trust or in trust property or the income therefrom that shall not be subject to the rights of creditors of such beneficiary as provided herein shall be exempt from execution, attachment, distress for rent, foreclosure, and from all other legal or equitable process or remedies instituted by or on behalf of any creditor, including, without limitation, actions at law or in equity against a trustee or beneficiary that seeks a remedy that directly or indirectly affects a beneficiary's interest..."

c. The Delaware Court of Chancery stated "I am not at all comfortable with the fact that Virginia Barwick, by use of a spendthrift trust, assisted her son in avoiding his obligation to pay for his crimes. However, it is not the Court's function to write the law but only to interpret it. The statute enacted by the General Assemble contains no exceptions."

E. Exception Creditors

1. Exception creditors are creditors whose claims are "excepted" from spendthrift trust protections under certain circumstances, generally due to an overriding public policy concern.

2. Exception creditors sometimes include:

a. creditors with claims for necessaries provided to the beneficiary

b. creditors with claims for services to protect the beneficiary's interest in the trust

c. claims by a governmental entity

d. spouses with support claims

e. children with child support claims

f. (very rarely) involuntary tort creditors

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IV. SELF-SETTLED SPENDTHRIFT TRUSTS

A. Domestic Asset Protection Trusts

1. Although every state recognizes the validity of spendthrift clauses to protect a third party beneficiary's interest from creditor claims, as a matter of public policy such clauses have historically not been enforceable with respect to a settlor who is also a beneficiary to the extent of such settlor's beneficial interest. In this regard, many states have statutes or common law prohibiting such so-called "self-settled trusts" and provide that a settlor cannot create such a trust to protect him or herself from creditors.

2. However, since 1997 fourteen states have enacted legislation extending spendthrift protections to a settlor-beneficiary of a discretionary trust (provided that the funding of the trust is not a fraudulent transfer). Those states are:

   a. Alaska

   b. Delaware

   c. Hawaii

   d. Mississippi

   e. Missouri

   f. Nevada

   g. New Hampshire

   h. Ohio

   i. Rhode Island

   j. South Dakota

   k. Tennessee

   l. Utah

   m. Virginia

   n. Wyoming

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