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The United States as an Asset Protection Jurisdiction

By: Alexander A. Bove Jr. and Melissa Langa - August 25, 2014

Are offshore trusts still the only option for asset protection?

Reversing more than 100 years of settled law, more and more states are adopting asset protection trust legislation. These new laws are directly contrary to prior U.S. law, in that they allow one to establish a trust from which that person can receive unlimited benefits at the discretion of the trustee, while at the same time preventing that person's creditors from reaching the trust assets.

In Massachusetts and most other states, the "self-settled spendthrift trust rule," which stands for the opposite result, still applies. The rule basically holds that the creditors of a settlor of a trust may reach the trust assets to whatever extent the trustee may apply them for the benefit of the settlor, even though the settlor herself could not demand payment.

For 15 states, however, that law has changed, and a person can establish a trust for her own benefit, while her creditors are locked out after a period of time. The question is, will that trend cause the U.S. to be now known as an asset protection jurisdiction?

The undisputed reason for efforts to portray the United States as an asset protection jurisdiction is an endeavor on the part of the domestic banking and financial institutions, and perhaps to a limited extent the legal profession, to divert to the U.S. some of the huge flow of funds to trusts in the so-called foreign asset protection trust jurisdictions. These include the Cook Islands, Gibraltar, the Isle of Man and Liechtenstein, where in most cases it is virtually impossible for a creditor of the settlor to reach the trust assets if the trust was properly established.

The question raised by this new battle of the continents is, will the U.S. asset protection trusts — USAPTs — be able to successfully compete with the foreign APT? And does it matter where the settlor is domiciled?

In fact, most settlors who establish a USAPT are domiciled in a state other than that of the APT state. Thus, a Massachusetts resident may establish an APT in Delaware, Rhode Island or Ohio, as Massachusetts still follows the self-settled spendthrift trust rule.

But even in a USAPT state, a trust would not be protected against the U.S. settlor's creditors if the transfer to the trust was considered a "fraudulent transfer."

Briefly, that would be a transfer that was made to prejudice the creditor and one that was made within the applicable "period of limitations." Every jurisdiction prescribes a period after any gratuitous or prejudicial transfer within which a creditor may ask a court to cause the transferred assets to be applied to satisfy the debt (the “open period”).

Thus, transfers outside the open period would be considered to be beyond the reach of the transferor’s creditors even if it seemed to prejudice the creditor.

A USAPT established by a U.S. person, however, may be vulnerable to something more than the period of limitations on fraudulent transfers.

One of the critical unresolved issues that faces a person who establishes an APT in any state is the “full faith and credit” clause of the U.S. Constitution. The clause basically provides that each state will give full faith and credit to the acts, records and judicial proceedings of every other state.

Thus, if a creditor of the Massachusetts settlor obtains a judgment, can the creditor apply U.S. constitutional law to enforce that Massachusetts judgment against the Rhode Island trust established by the Massachusetts settlor, when the laws of Rhode Island expressly provide that the trust assets may not be reached by that creditor?

To date, that question, which is vital to the success of USAPTs, remains largely unanswered, but there is convincing commentary arguing that the APT assets would be protected if the trust and the circumstances met the necessary protective requirements.

So let’s take a look at the requirements among the several states to consider which might be the “better” states in which to establish an APT — specifically noting here that we offer no comments on any tax considerations that might apply, except to say that a USAPT established by a U.S. settlor where she or her spouse is a beneficiary may be drafted in a way that makes it tax neutral for federal income tax purposes.

The laws of all 15 states that are considered APT states have certain requirements in common for a trust to qualify. Generally, they require the trust to be irrevocable; to contain a “spendthrift” provision (declaring that the trust assets are not available or reachable by creditors); to have a trustee in the APT state; and to have some of the trust assets administered in the state.

Obviously, in all cases the settlor’s beneficial interest, if any, must be fully discretionary with the trustee (except in certain states where charitable remainder trusts, certain unitrusts and annuity trusts could qualify, but these are not generally regarded as asset protection trusts).

The settlor of the trust may, and typically does, retain a special testamentary power of appointment to allow changes in the ultimate disposition (after the settlor’s death) and to avoid making a taxable gift on transfer of assets to the trust.

So, with all these provisions in common, what separates the good from the better and the best APT states?

In our opinion there are two criteria that should be considered before considering any others. The first is whether the law of the APT state in question recognizes “exception creditors,” who could reach trust assets even though all other protective requirements are met.

Exception creditors typically include those having claims for alimony, child support and certain tort claims. Almost all the states make an exception for alimony and child support, Nevada being the only one that does not allow alimony. Of course, if such claims are not a concern for the particular settlor, then that criteria is not so important.

As for tort claims (e.g., personal injury or property damage), Delaware, New Hampshire, Rhode Island, Mississippi and Utah make exceptions, but except for Utah, the exception applies only to claims that arose before or on the date of the transfer to the APT.

The other, perhaps more critical criteria is the open period of limitations, discussed above, within which a creditor may make a claim against the trust assets without interference from the protective law of the APT state.

The period ranges from five years (currently the longest, as provided in Virginia), to 18 months, (the shortest, as provided in Ohio). In between are Rhode Island, Delaware, Alaska and the majority of others, which call for four years; Nevada, South Dakota and Mississippi, two years; and Utah, three years.

A special extension is applied to these periods if the creditor’s claim exists at the time of the transfer to the APT. The extension is six months in the case of the shorter periods, as with South Dakota, Ohio, Mississippi and Nevada, and one year for the longer periods.

The extension period begins at the time the creditor could reasonably have discovered the transfer, which typically happens after a judgment is obtained. For future creditors (those whose claim arises after the transfer to the APT), the respective periods are absolute, generally with no extension.

To illustrate, say that Sally transfers assets to a Rhode Island APT on June 1, 2014, and a creditor’s claim unexpectedly arises one month later, but the creditor does not bring suit for three years.

If the trust were established in Ohio, Nevada or South Dakota, the creditor would seem to be out of luck as to reaching any assets in the trust, because their open periods would have expired.

In Rhode Island and most of the other APT states, however, there would still be time (about a year) for the creditor to attempt to prove that Sally had the intent to prejudice her foreseeable creditors when she established the trust, and if the creditor were successful, the trust assets could be reached by that creditor.

All that said, it is relevant to note that it is neither a simple nor an inexpensive matter for a creditor to launch an attack on an APT. First, in most cases, he must bring an action in the debtor’s home state and obtain a judgment. Next, he must bring an action in the APT state to have the judgment enforced. Then, he faces the difficult question of whether the judgment may be enforced against the “trust,” because the judgment is against Sally, individually, and the trustee of the trust is not the judgment debtor.

The battle then would be joined, because the trustee has a duty to protect the trust assets, the APT state courts have a duty to apply and uphold the law of the APT state, and the creditor wants his money.

Lastly, regardless of the outcome (other than a settlement), the case would likely then go to a federal court if either party appeals. More legal fees, anyone?

There are two other important, if not vital, aspects to the use of a USAPT. Both fall into the “sensible planning” category.

First, it would be quite foolhardy and reckless, for example, to attempt to defeat a creditor’s claim after the creditor has made the claim, let alone after an actual lawsuit, by a transfer to a hastily settled USAPT. There, the court would have no choice but to order the transfer (to the APT) rescinded (among other remedies) as a fraudulent transfer.

Along with that doomed maneuver is the “sham” tactic. That tactic suggests that although certain moves were made and steps taken to make it look like a legitimate trust was established, even a cursory inspection would reveal that it wasn’t the real thing.

Both mistakes were made and the above two points illustrated in the real-life case of *In Re Huber* (*In Re Huber*, 201.B.R.685 (Bkr.W.D WA, May 17, 2013).

In that case, briefly, Mr. Huber, a Washington resident, had invested in several parcels of Washington real estate, all heavily mortgaged. As the property values decreased (while the mortgages did not), the mortgagee banks pressed Huber for payment of the mortgages, which he was unable to make.

Huber resorted to establishing a USAPT in Alaska, funding it with $10,000, and was planning to transfer to the trust the LLC interests that held the real estate.

Subsequently, he filed for bankruptcy (perhaps the third mistake, since the 2005 Bankruptcy Act gives the bankruptcy trustee 10 years to attack the settlement of a self-settled asset protection trust established by the debtor).

In any event, Huber’s plan was quickly defeated on the basis that Washington, not Alaska laws, applied to the transaction under conflict-of-laws principles. Additionally, the transfer to the trust was clearly fraudulent.

Aside from egregious cases like *Huber*, which clearly never had a chance of succeeding, for those USAPTs that are established when there are no claims against the settlor that are pending, threatened or expected, and given the fact that hundreds, if not thousands of USAPTs have been established over the various APT states, and that to date there have been no reported cases showing results one way or another, we can at the very least conclude that creditors are not readily defeating such trusts in the courts, and the U.S. (or at least parts of it) just might be seen as an asset protection jurisdiction.

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