Domestic Asset Protection Trusts - Are they Worth It?

December 15, 2023

Take-Away: The use of a domestic asset protection trust (DAPT) often attracts a considerable amount of negativity, some finding them to be morally wrong, or *per se* a fraudulent transfer. Yet the negative connotations associated with a DAPT are often the product of egregious facts that lead a court to place the DAPT's in jail for flaunting the court's order. DAPTs may not be as 'bad' as their reputation suggests.

Background: Michigan and 17 other states now have domestic asset protection trust (DAPT) statutes which are designed to enable the settlor to protect his or her assets from *future* creditor claims. Some commentators claim that the use of a DAPT is simply waving a 'red flag' in front of a judge which will lead the court to set-aside the trust as fraud on creditors, or it is an invitation to the court to exercise its contempt powers against the settlor. Michigan's DAPT called the Qualified Dispositions in Trust is at MCL 700.1041 through700.1050.

Common Law-Public Policy: There exists at common law a longstanding precedent that it is against a state's public policy for persons to have their wealth available for personal use and benefit but unreachable by their creditors. Because of this principle, for hundreds of years it has been the rule that terms of trusts that attempted to accomplish that result (benefiting the settlor but preventing creditor access) were ignored by the courts and that the maximum amount payable to the trust settlor would be enforced by the court from the self-settled trust. But that prevailing rule all changed back in 1997 when Alaska and Delaware enacted the first DAPT legislation, whether or not the DAPT settlor was a resident of that DAPT state.

DAPT Notoriety: Much of the negative publicity about the use of a DAPT stems from the notoriety of a few cases where the trust's settlor either committed criminal acts or blatantly refused to abide by court orders, leading to the settlor's incarceration. Most of these reported court decisions stem from the transfer of millions of dollars of assets to foreign asset protection trusts, often by

unscrupulous settlors who defrauded innocents. Often the self-settled trust settlor was caught in a 'big' lie, which became fodder for news media outlets. [See *Federal Trade Commission v. Affordable Media, 179 F.3d 1228 (9th Circuit, 1999.)*]

Civil Contempt: Some of the bad publicity associated with a DAFT arises when the settlor-beneficiary of the trust is jailed for contempt of court for his/her refusal to comply with court orders or when they falsely claim that they are unable to comply with the court order to transfer the asset out of the trust. This is civil contempt on which the court's order is based. Inherent in a civil contempt order is the belief that the settlor-beneficiary may thereby be convinced to access the money or assets held in the trust. In short, putting the settlor in jail for civil contempt is a form of coercion, not punishment, because the settlor 'holds the keys to the cell.' In contrast, criminal contempt is a form of punishment for defying a court order where the incarcerated individual does not have the 'keys to the cell.'

> Lawrence: One example of civil contempt is *In re Lawrence, 278 F.3d 1294 (11th Circuit, 2002.)* In this case from Florida, Mr. Lawrence transferred millions to an offshore trust just after a significant judgment was entered against him. That transfer to the offshore trust was clearly fraudulent. After making false statements and being unresponsive to a court order to repatriate the fraudulently transferred funds, Mr. Lawrence sat in jail for over *six years* until the Court finally recognized that he would never pay the judgment against him. The Court then released Mr. Lawrence from jail, despite the court having concluded that Mr. Lawrence had "lied through his teeth."
>
> Ryland: In another case where the settlor was jailed for civil contempt, *United States v. Rylander, 460 U.S. 752 (1983,)* the Supreme Court held that the settlor's impossibility of performance was a complete defense to the civil contempt charge against him. Consequently, if the settlor can convince the court that he or she is factually unable to comply with the court's order because he/she relinquished *all* control over their irrevocable trust, he/she cannot be held in civil contempt of court.

Bilzerian: In *SEC v. Bilzerian, 112 F. Supp. 2d 12 (D.D.C. 2000),* Mr. Bilzerian was convicted of securities fraud. He then transferred millions to his offshore trusts despite owing millions to the US government. The court easily found Mr. Bilzerian in civil contempt of court. He ultimately repatriated the funds to the court to satisfy the SEC's claims against him.

Each of these cases involved the transfer of millions to an offshore trust which attracted a lot of attention in the press. There is a strong record that trust settlors who deliberately flaunt rules, blatantly lie to judges, ignore court rules, thus leave a judge no choice but to incarcerate the settlor to give the settlor time to think about his/her actions, and provide to the recalcitrant settlor solitude along with 'room and board' to mull over their thoughts and legal positions.

Impossibility of Performance: The primary problem is that an DAPT is self-created. Accordingly, the DAPT is a self-created impossibility of performance by the settlor; in other words, the obstacle to compliance with the court order that compels a distribution/repatriation of trust assets is of the settlor's own making. This often troubles judges who before they became judges were schooled in the law that a settlor at common law cannot place assets in an irrevocable trust that benefits the settlor yet precludes access to those same trust assets by the settlor's judgment creditors. However, courts have repeatedly recognized that if a debtor truly does not have control over the funds or property held in the trust that the court has ordered them to produce, the judge should not hold the settlor in contempt, let alone punish the settlor. This moral dilemma of permitting one to create their own impossibility of performance with a DAPT has led courts to consider the following factors when deciding whether to use the court's civil contempt powers to jail the DAPT settlor:

1. Did the debtor-settlor act in good faith in establishing their DAPT?

2. Did the debtor-settlor act in anticipation of an existing, threatened, upcoming, or imminent claim against him or her?

3. Did the debtor-settlor retain adequate assets outside the DAPT to cover their regular expected living expenses and reasonably anticipate claims? and

4. Did the debtor-settlor transfer assets that rendered the DAPT funds or property beyond their reach proximate in time to the creditor's claim or the court order?

Moral Question of DAPTs: There always lurks with a DAPT the moral question of the nature of, and motivation behind, the transfer of assets to the irrevocable trust. The law usually provides recourse to a judgment creditor who is harmed by a person's transfer of assets that is intended to avoid satisfying the judgment. Realistically, when would establishing a DAPT be for any reason other than to make it difficult, or impossible, for the settlor's judgment creditor to reach the trust's assets? Probably never, so does that fact alone make a DAPT inherently morally wrong? If a DAPT is viewed as morally wrong because its purpose is to frustrate creditors, what does that say about corporations, LLCs, and other similarly protective legal arrangements? Or, what about gifts and other gratuitous transfers when the donor in later years falls upon hard times and faces creditor claims? Courts have found that asset protection planning is entirely permissible, and in some cases, encouraged by the state and federal governments, e.g., IRAs, which are not much more than a self-settled trust to hold assets for the account owner (settlor's) retirement years. In one often cited court case, *Hurlbert v. Shackleton, 560 So.2d 1276 (Florida, 1st DCA 1991)* one judge observed *"...as a prudent move, he (the debtor) sought to protect his assets from unforeseen adversity...That is not legal fraud."*

Conclusion: It is impossible to tell what the future is for DAPTs. There does seem to be a trend, however, for even more states to enact DAPT statutes, in effect relaxing the common law with respect to self-settled trusts. It is difficult to reconcile limiting the use of DAPTs as a creditor protection device, while both state and federal law seem to encourage the use and aggressive funding of IRAs, Roth IRAs and 401(k) accounts, all of which are fully creditor-protected, even if millions of dollars are held in their balances. Maybe the moral 'taint' associated

with DAPTs is overstated in a world that encourages the use and funding of IRAs, LLCs, and corporations.