

Domestic Asset Protection Trust Fails

Take-Away: Not all states respect the creditor protection afforded by a self-settled asset protection trust.

Background: Whenever the topic of a domestic asset protection trust (DAPT) comes up, there is always the cautionary remark that other states which do not have DAPT legislation may not respect a DAPT that is established in another state that does recognize such a trust. This was (sort of) the situation in a recent federal court decision.

United States v. Huckaby, USCOURTS-caed-2 23-cv-00587-3.pdf

Facts: California residents created a self-settled asset protection trust using Nevada's DAPT statute and thus asserted that it was an asset protection trust. The California residents were the sole trustees of their trust. The trust held California residential real estate. The IRS asserted a tax lien against the realty, and it sought foreclosure of the California real property. The California residents claimed that Nevada's DAPT protected the real estate from the lien foreclosure action. The facts are not fully explained in the court decision, but it appears that the settlors had engaged in a fraudulent transaction, which is a voidable transaction under California's laws.

Federal Court: The Court held against the settlor-trustees, but it took the 'long road' to reach that conclusion.

Short Road: The Court could have taken the much easier route to reach its conclusion because the trust did not even qualify as a DAPT under Nevada law. Like Michigan's DAPT statute, Nevada's DAPT statute requires that the trust must have a qualified Nevada trustee, meaning either a Nevada trust company or a Nevada resident trustee with specifically identified powers. Here, the California settlors also served as sole co-trustees of their trust, meaning the trust was not even a DAPT under Nevada law.

Long Road: Instead of focusing on the settlors' failure to comply with Nevada's DAPT statutory requirements, the Court instead applied conflict of law principles, focusing on the location of the trust's asset, i.e., California real estate.

Law of Realty Situs Governs: Under basic law principles, real estate is usually governed by the law where the real estate is located, and because the real estate was in California, the Court felt comfortable applying California law to determine if the beneficiary's creditors could reach it.

Self-Settled Trust: California does not have a DAPT statute, and as such it does not recognize self-settled spendthrift trusts. Consistent with common law, when a settlor creates a trust for his/her own benefit, the settlor's creditors can reach the trust's assets.

In short, Nevada law did not control creditor's rights analysis when a California residence was held in the trust.

Comments: A couple of steps might have produced a different outcome, although when the facts suggest that a fraudulent transfer was the motivation to hinder the settlors' creditors, the outcome may still have been in doubt.

Use an LLC Wrapper? Ignoring for a moment the short road the Court could have taken, there might have been a different result applying conflict-of-laws principles if the settlors had transferred title to their residence to an LLC and then transferred the LLC units to their Nevada trust. A membership interest in an LLC is usually treated as intangible personal property. If that had been done, then the situs of the residence would not have dictated the outcome under conflict-of-laws principles.

Use a Hybrid DAPT? This type of trust is close to, but not the same thing as a 'traditional' DAPT. A hybrid DAPT is one that is created by a third party, where the settlor is not a beneficiary. The discretionary beneficiaries are normally the settlor's family members. The trust's distribution trustee has sole discretion over distributions from the trust. The trust also uses a trust director who can add and/or remove beneficiaries from a class that

includes the trust settlor. Since the settlor is not a beneficiary of the trust, the trust is classified as a third-party irrevocable trust, not a self-settled trust, and most states at common law will respect the spendthrift provisions of a third-party trust. If a hybrid DAPT had been used, the settlors would then have leased their residence from the trust.

Conclusion: This a cautionary tale about the risks involved when using a DAPT to hold real estate located in another state (one that does not respect self-settled trusts.) Steps can be taken at the planning stage to minimize the risk of creditors accessing trust assets, like using LLCs or a hybrid DAPT structure, but as noted, they must be taken well in advance of assets being retitled in the name of the trust.

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