January 15, 2014

In Defense of Asset Protection and South Dakota's Domestic Asset Protection Trusts

Thomas E. Simmons, *University of South Dakota School of Law*

In Defense of Asset Protection and South Dakota's Domestic Asset Protection Trusts

Thomas E. Simmons
Siouxland Estate Planning Council, Inc.
Wednesday, January 15, 2014
12:00 pm
Marina Inn, Sioux City, Nebraska

The views and opinions expressed by Thomas E. Simmons and/or contained within these written materials are his own and not those of the University of South Dakota, its School of Law, faculty, administrators, agents, affiliates or employees. These materials are educational and informational only. Any liability for reliance on these materials is expressly disclaimed.

I. INTRODUCTION

Asset protection is often viewed as something seedy, something unseemly or underhanded. For example, my predecessor at the law school, Professor Randall Gingiss, wrote fifteen years ago – prior to the enactment of South Dakota asset protection trust statutes -- that such planning constituted a sham, offended public policy, and that their use should be subject to criminal sanctions:

> Asset protection trusts, be they offshore or domestic, offend the public policy of the overwhelming majority of American states. (. . .) [A] settlor's every wish is accommodated . . . Creditors or spouses who are disadvantaged by these shams are entitled to redress, the most effective of which is to take judicial notice of the sham and find in civil contempt each such settlor who does not affect repatriation of the trust assets. Failing that, statutes should be enacted to provide criminal penalties for those who establish self-settled trusts which can be made unavailable to satisfy an American judgment.[1]

Presumably, this view rests on the assumptions that (a) as a general principal, each person should, to the extent of his or her ability, pay his or her just debts and obligations; and (b) that asset protection frustrates this principal. As a society, tend to prioritize and attach greater urgency to the payment of certain types of debts such as those for child support and taxes and thereby elevate them "super creditor" status with rights not available to run of the mill creditors.

It has also been argued that "without the risk that his or her assets will be subject to creditor claims, a settlor no longer has an incentive to act in morally acceptable ways… Thus, [an asset protection trust] allows the settlor to take risks that he or she otherwise might not have taken or engage in hazardous activities without endangering the assets placed in [such a trust]."[2]

---

[1] Randall J. Gingiss, *Putting a Stop to "Asset Protection Trusts,"* 51 BAYLOR L.REV. 987, 1032-33 (1999).

[2] Brandon Beck, *Viability of Ohio Domestic Asset Protection Trusts: A Review of the Proposed Ohio Legacy Trust Act*, 39 OHIO N. U. L.REV. 329, 350-351 (2012).

As a general principal, the ethical obligation of individuals to pay their debts and obligations is a sound one. But it must also be recognized that as a society, we have generally agreed to put some limitations on the operation of the principal (a) in order to preserve certain fundamental or threshold standard of living (including, by way of example, food, basic shelter, and clothing to preserve one's body from annihilation); and (b) in recognition of the basic property rights to transfer and convey one's property.

II. DISCUSSION

A. Exemptions

The laws of every state recognize certain property as entitled to exemptions or qualified exemptions – putting certain assets beyond the reach of creditors. We can think of a debtor in a Dickens novel, hungry, suffering from consumption, living in a hovel with only a rough coat and a few crumbs of bread. Ought we not to limit a creditor's ability to wrest the coat from his back or the crumbs from his table?

This natural impetus finds expression in the list of exemptions.[3] Primary among them is the asset representing shelter from the elements: the homestead. Homestead protections vary widely from state to state, sometimes under-inclusive[4] and sometimes over-inclusive of achieving their goal.

---

[3] For example:

The property mentioned in this section is absolutely exempt from all such process, levy, or sale, except as otherwise provided by law:

(1) All family pictures;
(2) A pew or other sitting in any house of worship;
(3) A lot or lots in any burial ground;
(4) The family Bible and all schoolbooks used by the family, and all other books used as a part of the family library, not exceeding in value two hundred dollars;
(5) All wearing apparel and clothing of the debtor and his family;
(6) The provisions for the debtor and his family necessary for one year's supply, either provided or growing, or both, and fuel necessary for one year;
(7) All property in this state of the judgment debtor if the judgment is in favor of any state for failure to pay that state's income tax on benefits received from a pension or other retirement plan while the judgment debtor was a resident of this state;
(8) Any health aids professionally prescribed to the debtor or to a dependant [sic] of the debtor.

SDCL sec. 43-45-2.

[4] Arguably, U.S. law has tended to favor creditors at the expense of debtors, given the realities of the greater organization and influence of trade groups on legislators. *See, e.g.*, Henry J. Lischer, Jr., *Domestic Asset Protection Trusts: Pallbearers to Liability?*, 35 REAL PROP. PROB. & TR. J. 479, 499-600 (2000).

As a society, we have also identified retirement funds as deserving of protections. Congress has provided that as a matter of federal law, assets in an ERISA plan should be exempt regardless of value. And IRA accounts can be exempt up to a value of $1 million in bankruptcy in the discretion of the bankruptcy judge.

The law further limits the amounts by which wages can be garnished. Federal law exempts certain federal benefits such as proceeds from social security benefits as well as veteran's benefits. And the use of asset protection entities such as the limited liability company and the corporate form are not seen as contrary to public policy.[5]

B. Fraudulent Transfers and Other Creditor Remedies

The second primary exception to the general policy favoring individual responsibility for that individual's debts is based on the premise of property rights, including, as property rights do, the right to transfer and convey one's property to another.[6] The right to transfer necessarily includes the right to transfer without consideration (i.e., a gift) or to transfer for less than full and fair consideration (i.e., a partial gift or bargain sale).

Every gift comes with some consequences to third parties such as creditors of the transferor for if prior to the transfer the gifted asset could have been reached to satisfy a claim, once the asset is no longer owned by the transferor, it may no longer be available to satisfy his or her debts.

A transfer carried out with the aim or intent to defraud a legitimate creditor rightfully gives us pause, however, and the law recognizes, in the jurisprudence of "fraudulent transfers" that allowing the exercise of the right to transfer should be limited in those cases where a bona fide creditor is being defrauded or unjustly frustrated.[7] And in many cases, it may be difficult or

---

[5] *E.g.*, Walkovszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966) (noting that "[t]he law permits the incorporation of a business for the very purpose of enabling its proprietors to escape personal liability…").

[6] *See, e.g.*, Nielsen v. Logs Unlimited, Inc., 2013 SD 76, 839 N.W.2d 378.

[7] South Dakota, which has adopted the Uniform Fraudulent Transfer Act, provides by statute that:

> (a) Any transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
>
> (1) With actual intent to hinder, delay, or defraud any creditor of the debtor; or
>
> (2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
>
> (i) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
>
> (ii) Intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.

SDCL sec. 55-8A-4. The statute of limitations for undoing a transfer accomplished with actual intent to defraud a creditor under subsection (1) is four years from the date of the transfer or

impossible for such a creditor to prove that the debtor made a transfer with actual intent to harm the creditor – after all, fraud is simply a state of mind, and the crafty debtor will seldom cooperate in helping his creditor prove a case of fraud, but simply answer, "A gift was made, but without any intent to defraud yonder creditor." Thus, a creditor is permitted to rely on a theory of "constructive fraud."

In addition to the law of fraudulent conveyances, creditors may assert those rights provided by federal Bankruptcy law (which contains its own rules of fraudulent transfers along with an extended statute of limitations applicable to transfers to domestic asset protection trusts). And courts have even fashioned remedies for creditors based upon the law of contempt.[8]

Limits on the reach of "fraudulent transfer" law are necessitated since otherwise every gift of property would always be subject to being undone but a creditor, and no donee would ever safely hold a gift without fear that the donor's creditors might someday come knocking.

The law of fraudulent conveyances neatly balances these two competing concerns as follows:

Two types of fraudulent transfers are recognized: transfers with an actual intent to defraud or hinder a creditor, and those termed partaking of "constructive fraud" based on the surrounding circumstances. As to each flavor of fraudulent transfer (one actually fraudulent, one not necessarily fraudulent at all), statute of limitations are articulated, in order to provide a "point of no return" when a creditor can no longer complain about a given transfer.

It is primarily the law of fraudulent conveyances which constrains the ability of a property owner to utilize asset protection planning to defraud or hinder their creditors.

C. Trusts

(a) *The Common Law*: No Spendthrift Protections for Settlor-Beneficiaries

Since before the time of Queen Elizabeth I, the law has held that one may not create a trust for oneself and immunize the assets of the trust from one's creditors. Self-settled trusts offer no creditor protections, said the law.[9]

---

within one year after the transfer could reasonably have been discovered by the creditor, whichever is is later. The statute of limitations for a "constructive fraud" case under subsection (2) always expires four years after the transfer. SDCL sec. 55-8A-9.

[8] F.T.C. v. Affordable Media, 179 F.3d 1228 (9th Cir. 1999); *see also* In re Lawrence, 279 F.3d 1294 (11th Cir. 2002); In re Brooks, 217 B.R. 98 (Bankr. D. Conn. 1998).

[9] *See* Gingiss, *supra* note 1 at 987 n.1 *citing* 2A Austin W. Scott & William F. Fratcher, THE LAW OF TRUSTS 156, 168 (4th ed. 1987) (quoting 3 Hen.7, ch. 4 (1487) (Eng.)) (making reference to an English statute of 1487, prescribing that "'(a)ll deeds of gift of goods and chattels, made or to be made in trust to the use of that person or persons that made the same deed or gift, be void and of none [sic] effect.'").

For example, if your author were to create an irrevocable trust, naming a corporate trustee, and providing in the trust that distributions of income may be made from time to time in the trustee's discretion to or for the benefit of your author, with the remainder to be paid to the United Way of Siouxland for its general charitable purposes at your author's death, a creditor of your author could reach some or all of the trust assets to satisfy a debt of your author, regardless of your author's intent in funding the trust, and regardless of how long ago the trust was funded, even to the possible detriment of the remainder beneficiary.[10]

> The invalidity of self-settled spendthrift trusts stems from the idea that no settlor… should be permitted to put his own assets in a trust, of which he is [a] beneficiary, and shield those assets with a spendthrift clause, because to do so is merely shifting the settlor's assets from one pocket to another, in an attempt to avoid creditors.[11]

Contrast this, however, with the ability to simply make outright gifts of one's property. If, for example, your author were to simply make an outright gift of, say, $100,000 to his spouse, his friend, or his child (in trust, we'll say, since said son is a minor), then the creditor would have no recourse after the expiration of the applicable statute of limitations for fraudulent conveyances had run.

(2) *The 20th Century*: Offshore Trusts

For many years, offshore jurisdictions have been crafting reversals of this rule prohibiting self-settled asset protection trusts. Currently, approximately sixty nations have "asset protection trust" statutes which permit a settlor to create an irrevocable trust for her own benefit while shielding those assets from the settlor's creditors.[12]

Offshore trusts are popular in jurisdictions such as the Bahamas, Barbados, Belize, Bermuda, the Cayman Islands, the Cook Islands, Cyprus, Gibralter, Brenada, Liechtenstein, Maritius, Nevis, Samoa, and St. Lucia.

---

[10] Another example:

> O, a surgeon, transfers property to X in trust to pay so much of the income and principal to O as X determines in X's sole and absolute discretion. Five years later, O botches a routine surgery, causing grievous injury to the patient, A. A may enforce an award of damages against the entire corpus of the trust, because X could, in X's discretion, pay the entire corpus to O. This is true even if the trust instrument provides that O's interest may not be assigned or reached by O's creditors (a spendthrift clause). Nor does it matter that O's right to the trust assets is subject to X's discretion.

Jesse Dukeminier, Robert H. Sitkoff and James Lindgren, Wills, TRUSTS AND ESTATES (8th ed. 2009) at 625.

[11] Phillips v. Moore, 690 S.E.2d 620, 623 (Ga. 2010).

[12] Michael A. Passanati, *Domestic Asset Protection Trusts: The Risks and Roadblocks Which May Hinder Their Effectiveness*, 32 AM. COLL. OF TR. & EST. COUNSEL J. 260 (2006).

> First, if the APT is properly established in a foreign country, in most cases a court in the United States will lack personal jurisdiction over the trustee... Second, many offshore jurisdictions recognize the role of a trust "protector", a person granted special non-fiduciary powers to control the administration of the trust, with respect to such matters as removal and replacement of trustees, control over discretionary actions of the trustees, etc. By use of the trust protector mechanism, a settlor is able to vest in some trusted person substantial control over trust administration, while at the same [time] being able to resist the claim that the settlor himself or herself (whose actions will be subject to the authority of a United States court) retains such control... Third, many offshore APTs include a so-called duress clause, under which the trustee is directed to ignore any directions received from a settlor or trust protector who is under duress [, which is defined to include]... a United States court's order. Finally, most offshore APTs also include a "flight" clause, under which the trustee is authorized to change the situs of the trust, change the applicable law, and move the trust assets to a new jurisdiction, if a claim against the trust threatens to be successful.[13]

Thus, the typical offshore trust duress provision triggers a kind of "lock down" by the trustee which secrets the trust assets in a faraway jurisdiction (with perhaps a less than accommodating legal framework for recovery against the trustee) and forbids any distributions to the settlor/beneficiary so long as the trustee deems the settlor to be making distribution requests or demands under duress (such as would be present under a court order to repatriate trust assets in satisfaction of a judgment or other judicial decree).

(3) *Today's Law*: DAPTs

Beginning with Alaska in 1997, domestic jurisdictions began enacting such legislation (hence, "domestic asset protection trusts" or DAPTs, in order to contrast them with offshore asset protection trusts).[14] Other states soon followed suit.[15] But in states which have not recognized DAPTs by statute, the common law or statutory rule prohibiting valid spendthrift protections in self-settled trusts still prevails.[16]

---

[13] Robert T. Danford, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287, 309-310 (2002).

[14] ALASKA STAT. sec. 34.40.110 (2012).

[15] DEL. CODE ANN. title 12, sections 3570-3576 (2012); HAW. REV. STAT. sections 554G-1 to -11 (2012); MO. REV. STAT. sections 456.5-.505 (2012); NEV. REV. STAT. sections 166.010 - .170 (2012); N.H. REV. STAT. ANN. sections 564-D:1-18 (2012); OKLA. STAT. title 31, sections 10-18 (2012); R.I. GEN. LAWS sections 18-9.2-1 to 18-9.2-7 (2012); S.D. CODIFIED LAWS SECTIONS 55-16-1 to -16 (2012); TENN. CODE ANN. Sections 35-16-101 to -112 (2012); UTAH CODE ANN. sections 25-6-14 (2012); VA. CODE ANN. sections 64.2-744, -747 (2012); WYO. STAT. ANN. sections 4-10-505 and 510 to -523 (2012).

[16] The Uniform Trust Code, for example, provides:

> (a) Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:
>
> (. . .)

In 2005, South Dakota enacted its own DAPT statutes.[17] A trust must meet certain statutory requirements to qualify for self-settled spendthrift protections.[18]

---

(2) With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit.

UTC section 505. The comments explain that this section "follows a traditional doctrine in providing that a settlor who is also a beneficiary may not use the trust as a shield against the settlor's creditors. The drafters of the Uniform Trust Code concluded that traditional doctrine reflects sound policy." UTC sec. 505 cmt.

[17] SDCL ch. 55-16.

[18] The requirements are:

For the purposes of this chapter, a trust instrument, is an instrument appointing a qualified person or qualified persons for the property that is the subject of a disposition, which instrument:

(1) Expressly incorporates the law of this state to govern the validity, construction, and administration of the trust;

(2) Is irrevocable, but a trust instrument may not be deemed revocable on account of its inclusion of one or more of the following:

(a) A transferor's power to veto a distribution from the trust;

(b) An inter vivos power of appointment, other than an inter vivos power to appoint to the transferor, the transferor's creditors, the transferor's estate, or the creditors of the transferor's estate, exercisable by will or other written instrument of the transferor effective only upon the transferor's death;

(c) A testamentary power of appointment;

(d) The transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument;

(e) The transferor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust as such terms are defined in § 664 of the Internal Revenue Code of 1986, 26 U.S.C. § 664, as of January 1, 2009;

(f) The transferor's receipt each year of a percentage of the value as determined from time to time pursuant to the trust instrument, but not exceeding the amount that may be defined as income under § 643(b) of the Internal Revenue Code of 1986, 26 U.S.C. § 643(b), as of January 1, 2009;

(g) The transferor's potential or actual receipt or use of principal if the potential or actual receipt or use of principal would be the result of a qualified person, including a qualified person acting at the direction of a trust advisor described in this section, acting either in the qualified person's sole discretion or pursuant to an ascertainable standard contained in the trust instrument;

(h) The transferor's right to remove a trustee, protector, or trust advisor and to appoint a new trustee, protector, or trust advisor, other than a trustee who is a related or subordinate party with respect to the transferor within the meaning of § 672(c) of the Internal Revenue Code of 1986, 26 U.S.C. § 672(c), as of January 1, 2009;

(i) The transferor's potential or actual use of real property held under a qualified personal residence trust within the meaning of such term as described in the regulations

The trust must be irrevocable and name a "qualified person" as a trustee. A "qualified person" is defined as: (1) as to an individual, one who "resides in this state, whose true and permanent home is in this state;" and (2) as to a corporate trustee, one whose principal place of business is in South Dakota.[19] The settlor may retain the power to remove and replace trustees but the settlor himself (or herself) may not serve in this role.

Assets contributed to the trustee are immune from the settlor's creditors[20] – including child support or spousal support creditors -- unless the claims arose prior to the transfer to the

---

promulgated under § 2702(c) of the Internal Revenue Code of 1986, 26 U.S.C. § 2702(c), as of January 1, 2009;

(j) A pour back provision that pours back to the transferor's will or revocable trust all or part of the trust assets;

(k) The transferor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on income of the trust if the potential or actual receipt of income or principal is pursuant to a provision in the trust instrument that expressly provides for the payment of the taxes and if the potential or actual receipt of income or principal would be the result of a qualified person's acting in the qualified person's discretion or pursuant to a mandatory direction in the trust instrument or acting at the direction of an advisor described in § 55-16-4; or

(l) The ability, whether pursuant to discretion, direction, or the grantor's exercise of a testamentary power of appointment, of a qualified person to pay, after the death of the transferor, all or any part of the debts of the transferor outstanding at the time of the transferor's death, the expenses of administering the transferor's estate, or any estate or inheritance tax imposed on or with respect to the transferor's estate; and

(3) Provides that the interest of the transferor or other beneficiary in the trust property or the income from the trust property may not be transferred, assigned, pledged, or mortgaged, whether voluntarily or involuntarily, before the qualified person actually distributes the property or income from the property to the beneficiary, and such provision of the trust instrument shall be deemed to be a restriction on the transfer of the transferor's beneficial interest in the trust that is enforceable under applicable nonbankruptcy law within the meaning of § 541(c)(2) of the Bankruptcy Code, 11 U.S.C. § 541(c)(2), as of January 1, 2009.

A disposition by a trustee that is not a qualified person to a trustee that is a qualified person may not be treated as other than a qualified disposition solely because the trust instrument fails to meet the requirements of subdivision (1) of this section.

SDCL sec. 55-16-2.

[19] SDCL sec. 55-3-41, 55-16-3.

[20] The relevant statute states:

Notwithstanding any other provision of law, no action of any kind, including an action to enforce a judgment entered by a court or other body having adjudicative authority, may be brought at law or in equity for an attachment or other provisional remedy against property that is the subject of a qualified disposition or for avoidance of a qualified disposition unless the settlor's transfer of property was made with the intent to defraud that specific creditor.

trustee.[21] A unique set of fraudulent transfer rules apply specifically to transfers to a DAPT trustee under state law.[22] As to creditors existing prior to a transfer to a DAPT trustee, a claim against trust assets is barred after two years following the transfer unless the creditor "[c]an demonstrate that the creditor asserted a specific claim against the settlor before the transfer" in which case the statute runs for six months following the date the transfer could reasonably have been discovered.[23]

As to creditors who become creditors of the settlor after the transfer to the DAPT trustee, all claims are barred within just two years.[24] In other respects, the existing statutory framework for fraudulent transfers, including the burden of showing actual or constructive fraud, carry forward, except that an elevated standard of proof applies to creditors seeking to assert a fraudulent transfer claim against a settlor of a DAPT: the claim must be proved "by clear and convincing evidence."[25]

III. CONCLUSION

Despite the criticisms of asset protection trust planning, given the existing and continuing creditor remedies against fraudulent transfers along with the patchwork of other asset protection laws (such as the homestead and ERISA plan assets), the assertion that DAPTs are contrary to public policy seems difficult to sustain.

The underlying justification of recognition of DAPTs should resonate with an understanding of trust law insofar as a settlor who has irrevocably conveyed assets to a third party trustee has indeed parted with legal rights to the property and it stands to reason, especially with statutorily authorized provisions, that the rights of the settlor's creditor's to the trust corpus would similarly be limited.

Thomas E. Simmons
Assistant Professor
University of South Dakota School of Law
414 East Clark Street, Law School ste. 212
Vermillion, SD 57069
Tel. 605.677.5361
Email: tom.e.simmons@usd.edu

SDCL sec. 55-16-9.

[21] SDCL sec. 55-16-15 (amended in 2013).

[22] SDCL sec. 55-16-9, 55-16-10.

[23] SDCL sec. 55-16-10.

[24] *Id.*

[25] *Id.*