The State of Domestic Self-Settled Asset Protection Trusts

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This discussion sets out the general provisions of self-settled asset protection trusts, such as the requirement for a spendthrift provision. Additionally, this discussion demonstrates the differences of law between the states that allow for such trusts (most notably the allowance of revocable self-settled asset protection trusts in Oklahoma). Finally this discussion addresses the potential upside and downside of specific provisions in such trusts, such as (1) the potential asset protection from creditors and (2) the grantor/beneficiary losing control over his or her assets.

Introduction

This discussion sets out the general provisions of self-settled asset protection trusts, the variations of law between the 17 states that allow such trusts, and the potential pros and cons of the specific built-in provisions in such trusts.

Under typical norms of trust creation, the grantor and the sole beneficiary could not be the same person. Otherwise a grantor could move her assets into a trust for her own benefit and possibly prevent creditors from accessing such assets in satisfaction of claims.

However, since 1999, 17 states have enacted legislation permitting self-settled asset protection trusts, which allow the grantor to create a spendthrift trust where the grantor is also a beneficiary. The states that allow for these types of trusts are Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.[1]

The creation of such trusts has caused controversy and legal challenges with regard to a myriad of issues, including jurisdictional matters as well as debtor-creditor relations. Certain states that allow self-settled asset protection trusts have built-in statutory provisions to provide protection to creditors. Most states, for example, require that these self-settled asset protection trusts be irrevocable, which means that the grantor cannot modify or revoke the trust.

In addition, all states that have recognized such trusts prohibit fraudulent conveyances to these trusts—that is, transfers that are intended to defeat the reach of known or future creditors. And some courts in the states that bar such trusts have refused to enforce self-settled trusts formed in one of the 17 states that recognize such trusts on public policy grounds.

Self-Settled Asset Protection Trusts

A self-settled asset protection trust allows for a grantor to convey her own assets into a trust where she is also the sole beneficiary. This differs from a typical trust where the grantor conveys her own assets into a trust for the benefit of others—often her family members or charitable organizations.

The trustee of such a trust can be a corporate trustee or even a family member. However, the trust must contain a few provisions to make it

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enforceable. The trust must contain a "spendthrift" provision, which prevents the beneficiary from spending or borrowing against trust funds (a voluntary transfer), and, more importantly, prevents creditors from accessing the trust assets (an involuntary transfer).

Therefore, the trust must only allow for permissive distributions—that is, the trust must not have an ascertainable standard forcing specific distributions to the beneficiaries.[2] Having required distributions would allow creditors to access the distributed assets.

In states that allow these types of trusts, the self-settled asset protection trust must, in fact, be self-settled. That is, the grantor/beneficiary must have funded the assets of the trust.

States That Allow Self-Settled Asset Protection Trusts

Typically, state laws have prevented a grantor from creating a trust for her own benefit where the trust contains a spendthrift clause applicable to existing and future creditors.[3]

These typical trusts allow creditors to access the assets the grantor transferred to the trust, which is the position still held by the majority of states and the Restatement (Third) of Trusts and the Uniform Trust Code.[4]

The typical rule is that spendthrift clauses can be used to insulate *other beneficiaries* from creditors, but they cannot be used to protect the grantor as the beneficiary from her own creditors.

This all changed with the creation of the domestic self-settled asset protection trust in the state of Alaska in 1997.[5] South Dakota enacted a similar statute next, and 15 other states followed behind, most notably Nevada and Delaware.[6] These new statutes allow a grantor to utilize a spendthrift clause in a trust for herself.[7]

Importantly, these new laws allow residents of any state to establish self-settled asset protection trusts in those states.[8] For example, a resident of Georgia could create a self-settled asset protection trust in Alaska, South Dakota, Nevada, or a host of other states that have amended their trust laws to allow these types of trusts.[9]

There are, of course, risks associated with such actions by nonresidents, as will be discussed below.

While the aim of the legislation is similar, different states have varying provisions to effectively create these new trusts. With the exception of Oklahoma, every state allowing for such trusts requires that the grantor establish an irrevocable trust.[10]

In Oklahoma, the grantor can create a revocable trust, and a court cannot force the revocation of the trust.[11] No state allows for fraudulent conveyances into the trust, but some states, such as Alaska, require a showing of actual fraud to establish such a conveyance.[12]

Nevada is also a popular state for the creation of self-settled asset protection trusts because of the short statute of limitations: "The assets are secure from the claims of creditors after the statute of limitations of two years from the date of transfer, or for an existing creditor, six months after the creditor discovers or reasonably should have discovered the transfer, whichever is the latter."[13]

Additionally, some states allow certain creditors to pierce the trust as a matter of public policy. In Delaware, for example, the spendthrift provision is not enforceable as to the payment of alimony or support for a former spouse, child support, property distribution because of a dissolution of marriage, or a tort committed on or before the date of the creation of the trust.[14]

Oklahoma exempts child support payments from the spendthrift provision,[15] and Alaska bars the creation of these trusts if the grantor is in default by 30 or more days of payment for child support.[16]

Universal provisions also exist. All of the states that allow self-settled asset protection trusts require that:

1. some assets are settled within the state,
2. the trust be administered by at least one resident trustee or trust company in that state, and
3. the trust be governed under the trust law of that state.[17]

This last provision, discussed below, has come under scrutiny by certain courts.[18]

States That Disfavor Self-Settled Asset Protection Trusts

Thirty-three states do not have a statute allowing self-settled asset protection trusts.[19] Simply because the state does not have an explicit statute allowing these trusts to be created within the state does not mean that the courts in the state will not recognize these trusts formed in one of the 17 states that explicitly allow these trusts. Whether courts within one of the states that does not allow self-settled asset protection trusts will recognize these trusts is no guarantee.

As an illustration, in 2013, a Washington U.S. bankruptcy court faced the issue of deciding whether to uphold an Alaskan-created self-settled asset protection trust where the trust "designat[ed] the law of Alaska to govern the Trust."[20]

In order to determine if the grantor created the trust based upon fraudulent intent, the court looked to Ninth Circuit precedent:

> [a]mong the more common circumstantial indicia of fraudulent intent at the time of the transfer are: (1) actual or threatened litigation against the debtor; (2) a purported transfer of all or substantially all of the debtor's property; (3) insolvency or other unmanageable indebtedness on the part of the debtor; (4) a special relationship between the debtor and the transferee; and, after the transfer, (5) retention by the debtor of the property involved in the putative transfer.[21]

These so-called "badges of fraud" assisted the court in ruling in favor of the creditors on summary judgment, despite the insistence of the debtor that there was a material fact if he actually intended to defraud his creditors.[22]

Noting that the presence of one badge of fraud would not necessarily prove fraudulent conveyance, the court went through each badge of fraud and determined that "the timing of the Trust's creation, the facts surrounding its creation, and timing of the asset transfers support a finding of a motive other than estate planning, that of asset protection at the expense of his creditors."[23]

From this posture, the court found that the trust violated the Washington "strong public policy against self-settled asset protection trusts . . . [and the court held that] transfers made to self-settled trusts are void as against existing or future creditors."[24]

While self-settled asset protection trusts can protect the grantor/beneficiary against certain creditors, the grantor/beneficiary must be careful to keep herself adequately capitalized and to avoid the appearance of fraud. In piercing the trust, the bankruptcy court in Washington noted, "Based on the evidence before the Court, the only reasonable conclusion is that the Debtor continued to use and enjoy the Trust assets just as he did before the transfers."[25]

While the law is developing on this issue, a bankruptcy court in New York also considered the public policy of New York when dealing with foreign self-settled asset protection trusts and held that the grantor "may not unilaterally remove the characterization of property as his simply by incorporating a favorable choice of law provision into a self-settled trust of which he is the primary beneficiary. Equity would not countenance such a practice."[26]

A risk remains that courts in states that do not explicitly recognize self-settled asset protection trusts will pierce the trusts because of issues regarding choice of law provisions and considerations of the fundamental fairness to creditors.

Important Provisions in Self-Settled Asset Protection Trusts

Some Assets Must Be Settled Within the State

The requirement that some assets must be settled within the state is rarely an issue for residents of

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the 17 states that have provisions allowing self-settled asset protection trusts. But for the majority of the population, residents must transfer property to the state in which they create the trust. And jurisdictional issues can arise from transferring property into a self-settled asset protection trust in a different state.

For example, suppose a grantor living in Washington (a state that does not have its own self-settled asset protection statute) created a trust in and under Nevada law (a state that does have its own self-settled asset protection statute), funded the trust with assets in Nevada, appointed a Nevada trustee, and a creditor in Washington sought to access the assets of that trust.

If the creditor sued in Washington, the court may have personal jurisdiction over the defendant. However, the court likely would not be able to exercise jurisdiction over the trust property if the Nevada trustee did not have sufficient contacts with Washington. Likewise, if the creditor sued in Nevada, the court likely would have jurisdiction over the trust, but the law in Nevada protects the trust assets. Such trust planning strategy may protect the grantor in this instance.

If, however, the Washington grantor created a Nevada self-settled asset protection trust, but funded the trust with assets in Washington, the Washington court likely would have jurisdiction over the trust assets. While this result could create complicated conflict of law questions, there is a possibility that a Washington court may decide that self-settled asset protection trusts are in direct conflict with Washington law—and thus refuse to recognize the protective aspect of the trust on public policy grounds.

Irrevocability

Besides Oklahoma, every state that has adopted self-settled asset protection trusts has a requirement that the trust be irrevocable.[27] Once created, irrevocable trusts cannot be modified or revoked.

While still a beneficiary, the grantor of the self-settled asset protection trust loses all control over the assets that she used to fund the trust. These assets could be managed by a trustee who, for example, makes financial decisions of which the grantor disagrees. Or the grantor’s financial circumstances could change, and the grantor may desire complete control over the assets in the future. The irrevocable trust prevents the grantor from revoking or modifying the trust to regain control over the assets in these scenarios.

The Oklahoma statute addressing irrevocability for a self-settled asset protection trust differs from all the other domestic provisions. Like some foreign self-settled asset protection trust laws, Oklahoma allows the trust to be revocable, and “[n]o court or other judicial body shall have the authority to compel a person holding a power of revocation or amendment over a preservation trust to exercise the power of revocation or amendment.”[28]

Oklahoma prevents courts from ordering the trustee from revoking or amending a revocable self-settled asset protection trust. “Hence, in effect, grantors can impress a self-settled trust in Oklahoma with a restraint on involuntary alienation without simultaneously restraining voluntary alienation. By exercising a reserved right of revocation, wholly personal to themselves, grantors can recover the corpus at will, but creditors cannot touch it.”[29]

Spendthrift Provisions

Additionally, states that recognize self-settled asset protection trusts require that the trust contain a spendthrift provision to provide an effective protection against potential creditors. The spendthrift provision gives the trustee discretion over how the assets are distributed to the beneficiaries.

For example, some trusts provide that a trustee may make distributions to beneficiaries for specific reasons, such as educational, medical, or other living needs. Such provisions prevent creditors from attaching assets and making claims against the trustee of the trust.

On the flip side, a beneficiary who seeks to borrow against a spendthrift self-settled asset protection trust is out of luck. And while the trustee of a self-settled asset protection trust owes fiduciary duties to the beneficiaries, those fiduciary duties do not necessarily require the trustee to distribute as much assets as desired by the beneficiaries. Rather, they must make such distributions based on the terms of the trust agreement. While the trustee has the potential to protect against creditors, the grantor/beneficiary must be willing to part with ownership and control over her assets.

Fraudulent Conveyances

Committing fraud upon creditors is against the public policy of every state.[30] Like any other trust, the self-settled asset protection trusts are subject to similar fraudulent conveyance rules. These trusts can be set aside if it is shown that the trust is used as an instrument to commit fraud to present and future creditors.

States that allow for self-settled asset protection trusts contain similar (if not more stringent) language in their relevant statutes to the language in the Alaska statute, which states that the trust will not be valid if "the creditor establishes by clear and convincing evidence that the grantor's transfer of property in trust was made with the intent to defraud that creditor. . . ."[31]

To void such trusts in Delaware, it requires a showing of an "actual intent to defraud [a] creditor,"[32] and Nevada's statute requires a showing of an intent "to hinder, delay or defraud known creditors."[33]

According to most states, "[i]f a fraud is shown, the trust is void, and a creditor of the beneficiary may reach its assets to satisfy the creditor's judgment claim."[34] Self-settled asset protection trusts created to defraud creditors, former spouses, or to avoid child support are disfavored by states and courts.[35]

For example, courts would likely disfavor those in a high-risk profession for tort liability—such as doctors—from refusing to carry liability insurance, making themselves insolvent, and conveying all of their assets to a self-settled asset protection trust, because it would appear that the trust was solely created to delay, hinder, or defraud potential creditors.[36]

Summary and Conclusion

Self-settled asset protection trusts remain controversial because of the possibility of a grantor protecting her own assets from recovery by legitimate creditors. Despite the controversy, 17 states have passed laws allowing the creation of such trusts, and more states are actively considering allowing the creation of such trusts.[37]

And while the states that allow such trusts have been steadily increasing, only one-third of the 50 states allow such trusts—even though it has been over 20 years since Alaska created the first statute allowing such trusts. The law is still developing on this issue and potentially difficult choice of law questions and creditor rights concerns remain unsettled.[38]

Notes:

1. https://www.aaepa.com/2019/01/domestic-asset-protection-trusts.
2. An example of a mandatory distribution requirement would be: "The trustee shall pay the beneficiary the income of the Trust each quarter."
3. Bogert, *Trusts and Trustees*, 2d ed. § 223, pp. 438, 439 (Grantor creates spendthrift trust for self).
4. *Id*.; *see also*, Restatement (Third) of Trusts § 58(2) (2003) ("A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the [grantor] of a trust is invalid."); Unif. Trust Code § 505(a)(2) (follows the Restatement (Third) of Trusts and traditional doctrine that a grantor "may not use the trust as a shield against the grantor's creditors").
5. Alaska Stat. § 34.40.110 (2018).
6. https://www.assetprotectionplanners.com/asset-protection-trust/domestic.
7. Bogert, *Trusts and Trustees*, 2d ed. § 223, pp. 438, 439 (Grantor creates spendthrift trust for self).
8. *Id*.
9. For more information regarding specific state law summaries, see Summary of State Laws That Authorize Self-settled Asset Protection Trusts, Fraudulent Transfers, Prebankruptcy Planning and Exemptions Appendix B.
10. Okla. Stat. tit. 31, § 13 (2019).
11. Okla. Stat. tit. 31, § 16 (2019) ("No court or other judicial body shall have the authority to compel a person holding a power of revocation or amendment over a preservation trust to exercise the power of revocation or amendment. The provisions of this act shall be considered restrictions on the transferability of the grantor's beneficial interest in the preservation trust that is enforceable under applicable nonbankruptcy law within

the meaning of Section 541(c)(2) of the United States Bankruptcy Code or any successor provisions.") (internal footnotes omitted).

12. Alaska Stat. § 34.40.110 (2019) ("the creditor establishes by clear and convincing evidence that the grantor's transfer of property in trust was made with the intent to defraud that creditor . . .").

13. https://alliancetrustcompany.com/services/trustee-services/asset-protection-trusts.

14. Del. Code tit. 12, § 3573 (2019).

15. Okla. Stat. tit. 31, § 13 (2019).

16. Alaska Stat. § 34.40.110 (2018).

17. Bogert, *Trusts and Trustees*, 2d ed. § 223, pp. 438, 439 (Grantor creates spendthrift trust for self).

18. *See, e.g.*, Toni 1 Tr., by Tangwall v. Wacker, 413 P.3d 1199 (Alaska 2018).

19. https://www.aaepa.com/2019/01/domestic-asset-protection-trusts.

20. In re Huber, 493 B.R. 798, 807 (Bankr. W.D. Wash. 2013).

21. *Id.* at 811.

22. *Id*.

23. *Id*. at 813.

24. *Id*. at 809.

25. *Id*. at 813.

26. In re Portnoy, 201 B.R. 685, 701 (Bankr. S.D.N.Y. 1996).

27. Okla. Stat. tit. 31, § 16 (2019).

28. *Id*.

29. Adam J. Hirsch, *Fear Not the Asset Protection Trust*, 27 Cardozo L. Rev. 2685, 2687 (2006). Professor Hirsch contends that the motivation behind the revocability provision in Oklahoma's statute is straightforward: "The driving force behind these legislative initiatives is clear enough. States are vying for trust business."

30. *See, e.g.*, Erickson v. Bank of California, N. A., 97 Wash. 2d 246, 254, 643 P.2d 670, 675 (1982) ("To hold otherwise would be to hand spendthrift trust beneficiaries an active sword for defrauding creditors against the public policy of this state."); Whitelock v. Geiger, 368 So. 2d 372, 374 (Fla. 3d DCA 1979) ("[A] scheme to defraud creditors is against public policy."); Vezina v. Kannen, No. CV 960557344S, 1996 WL 493228, at *2 (Conn. Super. Ct. July 31, 1996) ("the public policy against defrauding creditors . . . clearly outweighs any interspousal privilege that might otherwise exist.").

31. Alaska Stat. § 34.40.110 (2018); *see also*, Kulp v. Timmons, 944 A.2d 1023, 1029 (Del. Ch. 2002) (noting that the relevant Delaware statute states: "If such beneficiary has transferred property to the trust in defraud of the beneficiary's creditors the foregoing shall in no way limit the rights of such creditors with respect to the property so transferred.").

32. Del. Code tit. 12, § 3572 (2019).

33. Nev. Rev. Stat. § 166.040 (2019).

34. Kulp v. Timmons, 944 A.2d 1023, 1030 (Del. Ch. 2002).

35. § 211. Trusts for unlawful purposes, The Law Of Trusts And Trustees § 211 ("Many states have enacted either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act, each of which describes transfers or dispositions that are deemed fraudulent. Both Acts provide that a transfer made with actual intent to hinder, delay, or defraud creditors is fraudulent and can be set aside or disregarded by creditors of the transferor or grantor.") (internal footnote omitted).

36. *Id*.

37. *See, e.g.*, Georgia Bill 497 during the 2019-2020 session.

38. *See, e.g.*, Toni 1 Tr., by Tangwall v. Wacker, 413 P.3d 1199 (Alaska 2018).

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