Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #105

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From: Steve Leimberg's Asset Protection Planning Newsletter

Subject: Searching for Favorable DAPT Legislation: Tennessee Enters the Arena

Tennessee has recently joined the ranks of states having domestic asset protection trust (DAPT) legislation. **Mark Merric, John E. Sullivan III**, and **Robert D. Gillen** offer their analysis of the new law.

Mark Merric is a national speaker on estate and asset protection planning. Mark is also a co-author of CCH's treatise on asset protection – first edition, *The Asset Protection Planning Guide*, and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I* and *Asset Protection Strategies Volume II*. Mark Merric frequently speaks nationally on estate planning, asset protection, and international taxation.

John E. Sullivan III has published numerous materials regarding asset protection trusts and debtor-creditor law. He is a co-author of *International Trust Laws and Analysis*, has contributed chapters to the ABA's *Asset Protection Strategies Volume I* and *Asset Protection Strategies Volume II*, has published a law review article on fraudulent transfers and another on the Delaware asset protection trust act, and has been favorably cited and quoted in a published federal bankruptcy opinion. He frequently speaks on asset protection issues.

Robert D. Gillen has been teaching, lecturing, writing and assisting clients with asset protection for over twenty-five years. He has authored or coauthored articles for the American Bar Association, CCH, American Medical Association, Journal of Estate Planning and of course for Steve Leimberg. Bob is a frequent international and national asset protection speaker who has instructed for various CPA organizations, State, County and City Bar Associations, national meetings of various medical associations, for banks, trust companies and estate planning organizations.

EXECUTIVE SUMMARY:

In 1996, Alaska enacted the nation's first domestic asset protection trust ("DAPT") statute. The next year Delaware followed and over the years eight more states have passed DAPT statutes, including the two most recent DAPT states of Tennessee and Wyoming. The trend over the past ten years is becoming clear as twenty percent of the states have now enacted DAPT legislation.[1]

This LISI newsletter compares Tennessee's new DAPT statute to those in the states commonly considered to have the best DAPT legislation, specifically being (in alphabetical order) Alaska, Delaware, Nevada, and South Dakota. A separate newsletter to be published next week will discuss Wyoming's act. Because these articles focus on statutory comparisons, only minimal consideration will be given to the effectiveness of DAPTs in a litigation setting .

BACKGROUND:

How Most DAPT Statutes Work

DAPT statutes typically use one of two basic statutory frameworks. The most common approach is to draft a free-standing DAPT statute, which is frequently referred to as a qualified disposition statute. The second approach is to incorporate DAPT elements into a trust code that also addresses more traditional trust issues. Alaska, Delaware, South Dakota and now Tennessee are all examples of the former approach, while Missouri and Wyoming are examples of the latter.

The key aspect of qualified disposition type of DAPT statutes is the authorization of spendthrift clauses that are effective against the settlor's own creditors, provided the transfer of property into the trust doesn't violate the relevant fraudulent transfer statute. Each state's statute then usually gives some creditors (e.g., divorcing spouses or children claiming support) preferential rights to attach the trust fund, even when transfers into trust are non-fraudulent, thereby creating exceptions to the general DAPT rule that a settlor's own creditors can't attach the trust fund. The claims that can be asserted by "exception creditors" can vary considerably from state to state. States that integrate their DAPT laws into other trust statutes may generate significant interpretation issues. For instance, Missouri and Wyoming, by making their DAPT laws part of their local version of the Uniform Trust Code, may inject into their DAPT laws some of the UTC weaknesses that have often been pointed out by UTC critics. States adopting a free-standing DAPT statute may avoid such difficulties, particularly if, like Delaware, Alaska, and South Dakota, their states don't have the UTC.

Tennessee has a separate DAPT law, but is also a UTC state, so it's unclear what parts of the Tennessee UTC will apply to its DAPT law.

COMMENT:

Key Elements of a DAPT Statute

While there are many bells and whistles in DAPT statutes, most of our focus will be on the following issues:

- ♦ Types of distribution interests protected
- ♦ Fraudulent conveyance issues
- ♦ Jurisdiction over the DAPT's trustee
- ♦ Protection of advisors

There are other factors that an estate planner should consider when selecting a DAPT venue. For example, Alaska, Delaware, South Dakota, and Tennessee all protect CRUT and QPRT interests. However, only Alaska protects the full amount of a GRAT or unitrust interest, while Alaska, Delaware, South Dakota, and Tennessee limit this protection to five percent of the trust property. Another example is that only Alaska provides that there are no exception creditors (except, perhaps, for certain domestic relations claimants). This may be a determinative factor in favor of Alaska for a self-settled DAPT that is designed to be a completed gift with the hope it will be excluded from the settlor's estate. Finally, there are some bells and whistles such as permitting an out of state co-trustee, the settlor being able to hold a veto power over distributions, or the settlor serving as an investment advisor, all of which may work very well within the courts of the DAPT state. Note, though, that these bells and whistles may also create conflict of law issues or dominion and control arguments that might be used in the courts of a non-DAPT state.[2]

Please note for purposes of this analysis, since Delaware and South Dakota are virtually identical, they will be in one category for table comparison.

A. Types of Distribution Interests Protected

Under common law, there were primary three types of trusts: (1) discretionary trusts, (2) support trusts, and (3) mandatory trusts. With a discretionary trust, a beneficiary does not have an enforceable right or a property interest. The beneficiary holds nothing more than a mere expectancy. Almost all states' common law permit a discretionary trust to be coupled with a distribution standard.[3] With a support trust, a beneficiary has an enforceable right to a distribution based on the standard in the trust,[4] and with a mandatory trust a beneficiary has an absolute right to the distribution.[5]

The following tables compare the extent of protection that DAPT statutes give these various types of distribution interests. A "Yes" denotes the settlor's interest is protected, a "No" means that the settlor's interest is not protected by the statute.

Distribution of Income	**Alaska**	**Delaware & S. Dakota**	**Nevada**	**Tennessee**
Discretionary Interest	Yes	Yes	Yes	Yes
Support Interest	Yes	Yes	No	Yes
Mandatory Interest	No	Yes	No	Yes

Distribution of Principal	**Alaska**	**Delaware & S. Dakota**	**Nevada**	**Tennessee**
Discretionary Interest	Yes	Yes	Yes	Yes
Support Interest	Yes	Yes	No	HEMS
Mandatory Interest	No	No	No	No

As far as protecting income interests, the Tennessee statute is similar to Delaware and South Dakota since all three kinds of distribution interests are protected. Regarding distributions of principal, while there appears to be a little ambiguity in the statute, the authors would interpret the statute as follows:

- Section 11(6)(A) protects all discretionary interests. This would include both simple and extended discretion as defined under Section 187 of the Restatement Second.
- Section 11(6)(B) protects support interests that are limited by the ascertainable standard of health, education, support, and maintenance. The authors assume the definition of a support trust would be limited to something similar as "the trustee shall make distributions for HEMs."

C. Fraudulent Conveyance Issues and How the Lead DAPT Statutes Work

Qualified disposition style DAPT laws typically provide that, unless a creditor is an exception creditor, the only claim that a creditor may bring is a fraudulent transfer action. Control and dominion arguments are precluded by this sole remedy fraudulent conveyance approach. Therefore, each DAPT states' fraudulent transfer law becomes important. A brief summary is supplied below:

	Alaska	**Delaware & S. Dakota**	**Nevada**	**Tennessee**
Act Specifically Limited to "defraud"	Yes	No	No	No
Length for Present Creditors	4/1	4/1	2/6 mo.	4/1
Length for Future Creditors	4	4	2	4
Quantum of Proof	Act Silent	Clear & Convincing	Act Silent	Act Silent

A standard fraudulent conveyance rule allows avoidance of any transfer that "hinders, delays, or defrauds" a creditor. While direct authority regarding "hinder and delay" is sparse, what little exists indicates that transfers can "hinder" or "delay" without involving fraud. Hence, Alaska has a competitive edge over all other DAPT states on this point. Tennessee has a fairly common limitations approach. Under Nevada DAPT law, a present creditor must bring an action within two years of the transfer or six months of learning of the discovery of the Nevada DAPT. A future creditor must bring an action within two years from the date the property is conveyed to a Nevada DAPT or the claim is forever barred. Hence, there is no "date of discovery" rule available for future creditors in Nevada. There is also no "date of discovery" rule for future creditors in Alaska, Delaware, South Dakota, and Tennessee. This differs from the approach of the UFTA, which allows future creditors to invoke a "date of discovery" rule for purposes of determining when limitations periods commence. However, Tennessee, like many other

DAPT states, has a one year "date of discovery" rule for present creditors. Nevada's shorter date of discovery rule gives it an edge over all states on this point. Nevertheless, this Nevada advantage may be compromised in bankruptcy, since the Bankruptcy Code imposed a ten year limitations period in connection with certain fraudulent transfer claims against self-settled DAPTs and other vehicles[6].

In determining whether a fraudulent conveyance has occurred, a plaintiff's quantum of proof can be important. Delaware and South Dakota statutorily impose the elevated "clear and convincing" standard. Other statutes, including Tennessee, are silent, which probably means the local standards applicable to all fraudulent transfers apply. In Tennessee, that's a source of uncertainty, as some cases suggest a mere preponderance will suffice, although the better view is probably (not certainly) that clear and convincing evidence is needed.

D. Jurisdictional & Protection of Advisor Issues

Will a non-DAPT state apply the law of the DAPT state? This has been a constantly debated subject between those who believe that DAPT statutes don't work and those that believe that they do. This concern will not be addressed in this article as we are only trying to compare DAPT legislation. The following table shows how some of the DAPT statutes attempt to limit an out-of-state court's attempt to ignore the relevant DAPT law:

	Alaska	**Delaware & S. Dakota**	**Nevada**	**Tennessee**
Assert Exclusive Jurisdiction Over APTS	Yes	Yes	No	No
Automatic Removal of Trustees	No	Yes	No	Yes
Protection of Advisors	Yes	Yes	No	No

Alaska, Delaware, and South Dakota all have provisions stating that their courts have exclusive jurisdiction over actions involving their DAPTs. It is uncertain whether other states will respect such a provision, and whether the U.S. Supreme Court will uphold such a provision. However, at a minimum this provision provides another hurdle that a creditor must surmount.

Even if the action is not brought within the DAPT state's forum (i.e., the non-DAPT state does not respect the jurisdiction provision), Delaware, South Dakota, and Tennessee provide for the automatic removal of the trustee if a foreign court does not follow these states' DAPT laws. A successor trustee or new trustee under these DAPT statute will be appointed. Again, it is uncertain whether these provisions will survive challenge, but they still create a major statutory hurdle that a creditor must surmount.

Some articles have voiced a concern that an attorney or advisor who drafts or assists in the creation of an asset protection trust may be subject to liability claims by a creditor. Assuming the attorney or advisor did not participate in a fraudulent conveyance or violate some other statute, case law does not appear to justify such concerns. And, just in case,

Tennessee, like Alaska, Delaware, and South Dakota, provides additional significant statutory protection for advisors.

UTC Issues

The authors of the Tennessee DAPT should be commended for crafting a stand-alone DAPT statute using the Delaware statute as a model. In general, we find the stand-alone qualified disposition style of DAPT more protective than statutes that are added onto another trust code. Unfortunately, due to Tennessee's UTC, there may be some unintended consequences with the Tennessee DAPT statute. Some of the unanswered and continually unaddressed issues regarding discretionary trusts under the UTC are:

1. What is the definition of a discretionary trust? Related to this question, may a discretionary trust contain a standard? Could the standard be ascertainable?
2. Under common law, the beneficiary of a discretionary trust does not have an enforceable right or a property interest. Does the Tennessee UTC reverse common law, and adopt the Restatement (Third) position that a beneficiary of a discretionary trust almost always has an enforceable right to a distribution?
3. Does the Tennessee UTC retain the common law standard under Restatement Second § 187(j) that removes the reasonableness review standard, which in turn prevents the creation of the enforceable right?

We agree with Richard Covey and Dan Hastings that the 2005 comment amendments to Section 814(a) attempting to address the third issue above were not helpful and added nothing but more confusion.[7] We would further conclude that the 2005 amended UTC comment implies that it prefers adopting the Restatement (Third) view that almost anytime there is any standard in a discretionary trust a beneficiary will have an enforceable right to a distribution. If this is the case, the Tennessee DAPT will have a major structural flaw.

Think of the very common situation where a DAPT is created with current beneficiaries that include the settlor and the settlor's children. The settlor then goes through a divorce, and the settlor's estranged spouse gets some type of custody over the minor children. Can the settlor's estranged spouse now sue the trustee for a distribution on behalf of the children? If a discretionary beneficiary has an enforceable right to a distribution, then of course the estranged spouse may sue on behalf of the children. Please note that the estranged spouse is not suing as a creditor or an exception creditor. The estranged spouse is instead suing on behalf of the child beneficiary.

Another ambiguity exists under the Tennessee DAPT. Does it import the exception creditors of the Tennessee UTC? If so, Section 503(b) of the Tennessee UTC8, which allows attorney fees to those who provide services to protect a beneficiary's trust interest, could easily allow the estranged spouse or the spouse's attorney to recover attorney fees from the trust after suing to compel a "discretionary" distribution to one of the minor children.

Questions regarding discretionary trusts and the UTC may affect DAPTs in other ways. Note that the key to the asset protection of a third party common law discretionary trust is not spendthrift protection; instead it is based on the beneficiary not having an enforceable right to a distribution or a property interest, and therefore no creditor may step into the beneficiary's shoes to force a distribution. Further, while the key to self settled DAPT statutes is self-settled spendthrift protection, not discretionary trust protection, many DAPT statutes (including Tennessee's) clearly contemplate that many DAPTs will be wholly discretionary. However, whether the trust is third-party discretionary trust or a DAPT geared towards discretionary distributions, it is very important to know whether the beneficiary has an enforceable right to a distribution or a property interest, and whether any creditors may step into the beneficiary's shoes to compel the trustee to make such a distribution or attach the property interest.

South Dakota may have an edge over all DAPT states on this point. South Dakota's new discretionary and support trusts statute (SB 98) expressly states that a beneficiary's interest in discretionary distributions is a mere expectancy; is not a property right; and further that neither a beneficiary nor a creditor can force a trustee to make a discretionary distribution.

Conclusion:

Relying primarily on the Delaware DAPT statute as a model, Tennessee may well become a top DAPT state. We believe that the drafters took the superior approach of creating a stand alone statute, rather than attempting to draft asset protection legislation through the UTC. However, due to ambiguities and concerns under the Tennessee UTC, out of state settlors evaluating a DAPT state may be a bit hesitant to use this jurisdiction until these issues are resolved.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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CITES:

1 The following jurisdictions have asset protection legislation: Alaska, Delaware, Missouri, Nevada, Oklahoma, South Dakota, Tennessee, Rhode Island, Utah, and Wyoming.

2 For a detailed discussion of these issues, please see Merric, *Domestic APT Statutes Outline*, Idaho Bar Association 2006.

3 Ohio, Pennsylvania (when combined with some other factors), and Connecticut classify a trust with discretionary distribution language coupled with a standard as a support trust where a beneficiary has an enforceable right to a distribution. For further discussion of this issue please see Merric, Stein, Stevens, Solem, Stewart, and M. Osborne, *The UTC, A Continued Threat to SNTs Even After Amendment*, Journal of Practical Estate Planning, April to May of 2005. This article may be downloaded at www.InternationalCounselor.com. New York law generally requires that the standard cannot be ascertainable to be classified as a discretionary trust.

4 A typical support trust would contain distribution similar to "the trustee shall make distributions for health, education, maintenance, and support." Warning – The Restatement Third abolishes the 125 year common law distinction between discretionary trusts and rewrites the definition of a discretionary trust so that seldom there will be a case when a beneficiary does not have an enforceable right to a distribution.

5 For a detailed discussion of discretionary, support, and mandatory interests, please see Merric & Oshins, *The Effect of the UTC on Spendthrift Trusts*, Estate Planning Magazine, August, September, and October of 2004. This article may be downloaded at www.InternationalCounselor.com.

6 11 U.S.C. § 548(e)(1).

7 Covey and Hastings, *Follow Up on Uniform Trust Code Issues*, Practical Drafting, April 2005 page 8080.

8 Tenn. Code. § 35-15-503(b).