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ASSET PROTECTION TRUSTS ARRIVE IN SOUTH DAKOTA

A Legal Bulletin
***by*: Thomas E. Simmons**

On March 3, of last year, Governor Mike Rounds signed into law "An Act to Authorize Qualified Dispositions in Trust" after the bill had unanimously passed both the South Dakota Senate and House.

This technical-sounding Act is a bombshell, yet it has hardly generated a whisper of interest or commentary by the media in South Dakota thus far. The Act became effective on July 1, 2005. Individuals now have the opportunity, for the first time, to create self-settled spendthrift trusts in South Dakota. Self-settled trusts which contain enforceable creditor protections are often referred to as domestic asset protection trusts (or "DAPTs" for short).

"ALASKA TRUSTS" FOR SOUTH DAKOTANS (AND OTHERS TOO)

The idea of a self-funded trust with creditor protections was first enacted in offshore jurisdictions beginning in the 1980s. These trusts, often venued in exotic locations such as the Bahamas and the Cook Islands, sometimes suffered in the courts because of perceived abuses.

The first "domestic" jurisdiction to pass authorization for self-settled spendthrift trusts was Alaska in 1997. Since then, Nevada, Delaware, Oklahoma, Colorado and a few other states have passed similar legislation.

To qualify as a DAPT, the trust must (1) expressly incorporate South Dakota law; (2) have at least one South Dakota trustee; and (3) be irrevocable.

There are no limits to the amount of funds or property which can be transferred to a South Dakota DAPT. There is no requirement that the grantor of the trust be a South Dakota resident, nor that any property of the trust be located in our state. Thus, it is anticipated that South Dakota DAPTs will become popular with residents from other states wishing to take advantage of our favorable trust laws and state taxation.

HOW MUCH CONTROL AND ENJOYMENT CAN BE RETAINED?

The South Dakota Act permits the individual creating the trust to retain the following rights:

~ Veto power over distributions;

~ Income rights to trust property;

~ Rights to 5% of the principal balance of trust property annually;

~ Additional rights to principal in the trustee's discretion; and

~ The power to appoint to whom trust assets are distributed upon the grantor's death (with certain minor limitations).

LIMITATIONS

The South Dakota Act carves out two major exceptions to the creditor protection benefits of a DAPT:

~ Creditors claiming child support, alimony, and divorce decrees of property division are not protected;

~ Claims for death, personal injury or property damage caused by the grantor on or before the date the trust is created are not protected; and

~ As with all spendthrift trusts, once a distribution is actually made by the trustee and received by the grantor/beneficiary, it becomes an asset which is no longer protected from creditors.

In addition, creditors will sometimes be able to bring a "fraudulent transfer" claim associated with the funding of a DAPT. However, the South Dakota Act requires creditors to meet a very high burden of proof to do so. If an individual's financial situation so deteriorates that bankruptcy is triggered, the 2005 amendments to the Bankruptcy Code provide for a ten year "look back" period for transfers to self-settled trusts if a creditor can prove that the trust was intended to defraud and hinder creditors.[1]

There are additional limitations to the protections of a DAPT when state lines are crossed. Self-settled spendthrift trusts are considered to be against "public policy" in some states.

[1] 11 U.S.C. section 548(e)(1)(A).

Thus, if the trust owns assets in another state, the protections of South Dakota law may not be recognized if a creditor brings an action to satisfy a judgment against assets outside of South Dakota. Protections are at their highest when:

~ The Trustee is truly independent of influence or control by the grantor;

~ The Trust instrument scrupulously adheres to the requirements of South Dakota law;

~ The Trust is funded with assets located in South Dakota;

~ Any lawsuit arises out of events in South Dakota occurring after the trust was created; and

~ If bankruptcy is involved, ten years passes between the funding of the trust and the filing of a bankruptcy petition.

Individuals who are non-residents of South Dakota may avail themselves of the benefits of South Dakota DAPT statutes. These individuals, however, are at higher risk to sister state jurisdictions who permit "trust busting" of DAPTs.[2]

CASE STUDY

Dr. Blank[3] is a 45-year-old South Dakota physician with a net worth of $530,000. He has a $300,000 house with $30,000 in equity, a $200,000 IRA, $100,000 in savings and $200,000 in investments. Realizing that as a professional, with a higher exposure to risk in terms of professional malpractice claims, he decides to form a South Dakota DAPT.

Dr. Blank funds the trust with his $200,000 investment portfolio held at a respected local financial brokerage firm. He enjoys the income from his investments and retains rights to additional amounts if the need should arise. Specifically, his trust provides that the trustee shall distribute all the income and 5% of the principal to Dr. Blank every year. In addition, the trustee has the discretion to distribute unlimited amounts of additional principal to Dr. Blank if the trustee determines that Dr. Blank needs it. Dr. Blank retains the power to "veto" distributions to himself if he prefers to allow the trust investments to grow.

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[2] See David G. Shaftel and David H. Brundy, *Domestic Asset Protection Trusts and the Bankruptcy Challenge*, 32 ESTATE PLANNING 5, 11 (May 2005).

[3] This case study is fictional and illustrative only. No client confidential information is contained in this bulletin.

Eight years later, Dr. Blank is served with a summons, naming him as a defendant in a lawsuit. The facts out of which the lawsuit arose occurred in South Dakota after Dr. Blank's trust had been funded. Ultimately, despite the fact that Dr. Blank feels the claim to be frivolous, a jury awards the plaintiff a judgment in the amount of nearly half a million dollars, for which there is no specific coverage in his various liability insurance policies.

Dr. Blank is forced to file bankruptcy.[4] His savings have been depleted to $75,000 from lawyer fees and lost wages. He will lose the bulk of his remaining savings which will be used to partially satisfy the judgment creditor.

Following bankruptcy, the judgment is discharged. Dr. Blank keeps his house as the equity is protected by South Dakota's homestead exemption. He also keeps his IRA since that is an asset which, in many cases, can be exempted as well. The assets in his DAPT are also exempt from the reach of the judgment creditor.

Although the lawsuit had a devastating effect on Dr. Blank's savings, it left the remainder of his net worth intact.

WHO SHOULD CONSIDER A DAPT?

Individuals who should determine if a DAPT is right for them include:

~ Those whose net worth exceeds several hundred thousand dollars;

~ Those in higher risk profile professions;

~ Those whose assets may be exposed to lawsuits;[5]

[4] DAPTs have protections outside the context of bankruptcy, but bankruptcy is the context in which they would face their greatest test. Section 541(c)(2) of the Bankruptcy Code has been repeatedly held by bankruptcy courts to protect a traditional spendthrift trust, such as might be set up by a parent for a child (i.e., a "third party" spendthrift trust). There has yet to be published legal authority showing that bankruptcy courts will honor the shield of a DAPT in the same manner as a traditional spendthrift trust. The 2005 amendments to the Bankruptcy Code which create a "10-year look-back" for assets transferred to self-settled spendthrift trusts, however, implicitly recognize the enforceability of these trusts.

[5] Assets for South Dakota residents which carry a lower risk of seizure include 401(k)s up to $250,000, a homestead not exceeding $30,000 in equity, annuity contracts up to $250 per month and life insurance payable to a spouse/dependents up to $20,000. Federal law provides different protections. Interests in closely-held entities such as LLCs or corporations are not immune to creditors, but less attractive to creditors because of the limited remedies available. Assets with the highest exposure to risk would include real property and investments.

~ Those who believe their assets are worth protecting.

ADDITIONAL BELLS AND WHISTLES

Because South Dakota earlier repealed the "Rule Against Perpetuities" that previously prohibited trusts of an infinite duration, some individuals will likely pursue the option of combining the idea of a dynasty trust (which effectively escapes estate taxes at each generation with generation-skipping transfer tax provisions) with a DAPT. When a DAPT is used in this way, the savings in estate tax is icing on the cake of a solid asset protection strategy.

CREATING A DAPT

Flexibility is an exciting component of these trusts, and several different variations and types of trusts will be available to meet various objectives.

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