Self-Settled Asset Protection Trust Upheld By Delaware Court

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Consider a self-settled asset protection trust to protect your wealth from claims.

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Case May Provide A Roadmap to Better Planning

A Delaware court (by the Magistrate in Chancery) recently upheld the validity of a domestic asset protection trust (DAPT). In the Matter of the CES 2007 Trust, C.A. No. 2023-0925-SEM. The claimant sought to pierce the trust to reach assets held in limited liability companies (LLCs) and the Court refused. The Court found that the trust met the requirements of Delaware law to qualify as an asset protection trust and should be respected. This is a big deal! This case provides you with a roadmap of many dos and "don'ts" in pursuing this type of planning.

What is a Self-Settled Domestic Asset Protection Trust (DAPT)?

An asset protection trust is an irrevocable trust you create that you can be a beneficiary of. That is the estate planning and asset protection nirvana – you may protect assets from your creditors while you may still benefit from those assets. The ruling in this case gives anyone (perhaps you?) considering this type of planning more confidence that it may work. And this type of planning, especially after this case, may be beneficial for lots of people. For people who are not uber wealthy, being able to give assets to a trust that you can also be a beneficiary of, is a key that may make you comfortable pursuing asset protection (or estate tax) planning. The biggest impediment for most people is that they may need to access or benefit from the money they want to protect.

Risks Remain to this Planning

The reason for the use of the word "may" is that this case, while favorable to asset protection and the use of asset protection trusts, doesn't resolve every issue with this type of planning. The one big issue that many commentators have questioned about using the self-settled trust technique that was the subject of this case is if you live in a state that does not permit such trusts, e.g., New York or California, but you create this type of trust in a state that does, e.g., Delaware in this case (but there are about 20 states that permit this type of planning), will your home state have to respect the trust created in Delaware? That critical issue was not addressed in this case. But it should be noted that in the many years since Alaska created the first domestic asset protection law in 1997 no case has taken this adverse position.

Finally, this case, like all cases, is fact sensitive. In a different situation with different circumstances any court might reach a different conclusion. But in the Court's discussion of these matters, it provides valuable insights on things that you might do, and stuff you should probably avoid, if you are doing this type of planning. That is really valuable to learn and those points will be discussed below. Being methodical and deliberate in your planning, and in particular, doing the planning years before a claim arises, may put you in a favorable position like the person in this case (we'll call him the "settlor") to protect your wealth.

Why Asset Protection and Estate Planning Often Go Hand-in-Hand

If you give away or sell assets, e.g., to an irrevocable trust (see below), and those assets are not reachable by your creditors (that is asset protection planning), those assets will generally also be outside of your taxable estate for estate tax purposes. This is why if you pursue estate tax planning you are also obtaining asset protection planning benefits too. The flip side is also true, and is why so many more people that should take steps to protect their assets also get estate tax benefits. If you move assets outside your estate, e.g., by a

gift to an irrevocable trust, those assets should also be difficult to reach by future claimants or creditors. This is a misunderstanding many people have: “My estate is not big enough to worry about estate taxes.” That may be, but that doesn’t mean you shouldn’t be taking similar steps to protect your assets. So, even if your estate is well under the exemption amount it doesn’t mean that setting up planning similar to what wealthier taxpayers might do will be beneficial for you, for another reason, protecting what you own.

Defendant’s Asset Protection Plan Explained

The following is an oversimplified overview of the asset protection plan the person in the case put in place that the court upheld. Big picture the donor (the person transferring assets to a trust) created an irrevocable trust. Irrevocable simplistically means that the trust cannot be changed. A cornerstone of most estate and asset protection planning is one or more irrevocable trusts. Although an irrevocable trust might be modified by various techniques after it is created (decanting, non-judicial modification, etc.), not everything can be changed, there are limits.

The settlor in this case took a further step in his planning beyond just an irrevocable trust. This was smart, and something you should consider (and we’ll give you some tips on how to do it better below). Instead of gifting assets directly to the trust he gave interests in limited liability companies (LLCs). That is a smart move. If a creditor pierces through the trust they then may face a challenge having to reach assets inside an entity owned by the trust, like an LLC. Now in this case he probably had to have the assets owned by an LLC since they were real estate assets outside of Delaware which was where the trust was based. You should not have a trust in a trust-friendly state like Delaware own real estate or tangible personal property (e.g., artwork) located in a different state. Instead, if an entity, like an LLC owns those assets, the trust can own the entity. If this is not done the trust could be subject to the jurisdiction of that other state where the property is located and that could undermine the trust. But using entities like LLCs is not an assured protection. The plaintiff in this case argued that the settlor had maintained too much control over the entities in the trust and that on that basis those entities should be pierced (reached through to get at the LLC real estate). The court declined to do that, but important lessons are to be learned.

What’s The Big Deal of Being A Beneficiary of Your Own Trust?

As mentioned briefly above, being a beneficiary of your own trust is a big deal! If you are really wealthy (wealth relative to your income/cash flow and net worth) you might be able to set up a trust that you won’t need to benefit from. But for most people it may be uncomfortable if not scary to give away money that you may not be able to get to. For

example, many married couples create a special type of irrevocable trust called a spousal lifetime access trust (SLAT). That type of trust, if done properly, can provide valuable asset protection. But if you are the settlor creating such a trust you can only benefit indirectly from that trust through your spouse. It is not really clear how permissible indirect benefits are defined so there is risk associated with that. But more worrisome, what if your spouse divorces you or dies prematurely? That would cut off your indirect access to the trust. That could be financially devastating. So, when you weigh the potential asset protection benefits of using a trust plan, versus the worries of running out of money, you may reasonably determine that the creditor and other liability risks are less worrisome then losing control over your money. But that is precisely why a self-settled trust or DAPT is so powerful. You arguably can give your money away to a trust, protect it from claimants (and perhaps future estate taxes) yet you can remain a beneficiary! That's the asset protection version of having your cake and eating it too! And, this is why this recent case is so important, it found that this type of trust worked. For those who are not zillionaires, this type of planning (still not without risk) could be the mechanism that gets you comfortable taking steps to protect your assets.

The Trust/LLC Plan in This Case Is Common

The overall structure or plan that the settlor used in this case is very common in estate and asset protection planning. Setting up irrevocable trusts to hold entity interests that hold valuable assets is pretty classic estate and asset protection planning. There really is no data on how many of Each variation of trust is created, and there are a myriad of variations, but it's likely that most trusts are not self-settled trust (he was a beneficiary of his own trust in this case). Planning is more often done without the person doing the planning (the "settlor" who created the trust) being a beneficiary. That is in part due to the fact that, while about 20 states permit this planning, about 30 states do not. Also, many lawyers are not familiar with this type of planning and of those that are familiar some are hesitant to do this planning because of the perceived risks that a self-settled trust, especially if you live in a state that does not have that type of law, could be overturned. The fact that the Court upheld the plan with the settlor as a beneficiary is a valuable development for anyone doing similar planning and may encourage more people and more lawyers to consider this approach.

With the above background we can now review the case.

Facts

The settlor created the Trust on April 30, 2007, for the benefit of its beneficiaries, namely the settlor's wife (if any), parents, and issue. The trust predates the claimant's loan and the follow-on Michigan litigation.

In 2014, the claimant loaned one of the settlor's companies' money to finance a luxury real estate development project in Michigan. The deal wasn't successful and the claimant sued. In 2019, the Michigan Court entered a judgement of almost $14 million in favor of the claimant.

A Michigan court held in favor of the claimant and gave him an award the settlor of the trust plan was personally required to pay. Because the settlor had no assets to pay the claim, the claimant tried to pierce the trust plan involved in this case to get at the valuable real estate assets it held.

Pause and consider how much time all this litigation took, and the costs in terms of not only legal fees, but also, lost time, and undoubtedly incredible stress.

Wonky Transfers and Transactions by the Settlor

For reasons that are unclear the settlor engaged in a number of unusual transactions with the properties or LLCs that were ultimately held in the trust. Many of these were bad facts that would have been better to have been avoided. Below are a few excerpts of some of the transactions that the settlor had with the properties and/or entities in the trust [footnotes from the case omitted]:

"*The Birmingham Property is currently owned by the 305 LLC. But it was originally the Respondent's, personally. On June 30, 1999, the Respondent purchased the Birmingham Property for $450,000. To finance construction, the Respondent then procured a loan of approximately $1.3 million, secured by a mortgage on the Birmingham Property. After construction, the Respondent used, or claimed, the Birmingham Property as his primary residence from 2001 to 2018. Ownership of the Birmingham Property changed hands several times through transactions initiated at the whims of the Respondent. In 2004, the Respondent quitclaimed the Birmingham Property to a bonding agency for collateral related to a lawsuit. Then in 2006, the Respondent transferred ownership from himself (presumably having regained ownership after the 2004 quitclaim) to the 305 LLC for $1.00. That transfer did not last long, though, and on the same day, the Respondent transferred the Birmingham Property back to himself for the same de minimus price. He again transferred the Birmingham Property to the 305 LLC on March 19, 200735 and several years later, on March 4, 2014, shored up that conveyance. Finally, in early 2020, the Birmingham Property went through successive transfers out of the 305 LLC to the Respondent,*

personally, who pledged the property toward a personal indebtedness, before quitclaiming it back to the 305 LLC a few days later. It remains owned by the 305 LLC."

The repeated transactions with respect to a property that had been a residence should not have been undertaken, and regardless of the success in this case such repeated transfers that some, such as the claimant, interpreted to reflect control over the property should be avoided. Similar odd transactions occurred with other assets and entities.

Claims Made Against the Trust and LLC

The case was brought by a creditor of the trust's grantor or settlor.

- The claimant wanted to pierce through the trust/LLC structure discussed above and reach the real estate assets in the LLCs owned by the trust to satisfy his claim. More specifically, the claimant wanted the Court to void a spendthrift provision in the Delaware trust. That provision was critical to the protection the trust offered saying, in general terms, that the assets cannot be assigned to a creditor of the settlor.
- The claimant asked the Court to invalidate the trust altogether. The claimant was asking the Court to find that the trust didn't qualify as a Delaware asset protection, or qualified disposition trust. A Delaware "qualified disposition trust" is precisely defined by Delaware law and that law must be complied with.
- A claim was made that the trust was a "sham." That would mean that the trust should not be respected as it was bogus and did not qualify as an asset protection trust.

Requirements for a Delaware Asset Protection Trust.

The Qualified Dispositions in Trust Act (the "Act") permits someone to create an Asset Protection Trust, and irrevocably transfer assets to the trust, to protect those assets from claims against the grantor/former owner. The requirements are contained in 12 Del. C. §§ 3570–76. The requirements include:

1. The transfer must be a "qualified disposition."
2. To a qualified trustee, which is a Delaware resident or an entity authorized to act as a trustee in Delaware who is subject to supervision by the Bank Commissioner of the State, the Federal Deposit Insurance Corporation, or the Comptroller of the Currency.
3. The trust agreement must invoke Delaware law.
4. The trust must include a spendthrift provision.

5. The trust must be irrevocable.
6. The trustee must maintain or arrange for custody in Delaware some of the property that is the subject of the qualified disposition.
7. Records for the trust should be maintained.
8. The trustee must either prepare or arrange for the preparation of fiduciary income tax returns for the trust, or the trustee must otherwise materially participate in the administration of the trust.

A qualified disposition to a qualified trustee may only be reached by a claimant in limited circumstances. Pre-transfer creditors (claims that existed before the transfers were made to the trust), can be overturned if they were fraudulent transfers. For post-transfer creditors, they must prove that the qualified disposition was made with an actual intent to defraud such creditor.

Court's Rulings

The trust was found to have met the statutory requirements for the protections of a Delaware asset protection trust. The trustees were found to be a qualified trustees as required under the Delaware statute for an asset protection trust. The claimant argued that the settlor was a de facto trustee because of transactions with the LLCs held by the trust, and for serving as investment trustee, but the Court found that he had not acted as a trustee. Finally, the claimant failed to prove that the spendthrift provision in the trust, which is critical to the protection the trust provided, should be invalidated.

Lessons to Learn from the Case

There are many lessons to learn from this case. Most of the points below are based on specific facts or court comments in the case, a few suggest planning points that were not addressed in this case but which may be helpful.

1. **Reasons for the Plan**: Document reasons why you are setting up the trust other than protecting against claims. Having income or estate tax, formal administration, etc. reasons may all help deflect a challenge that the trust plan is a sham, a claim made in this case.
2. **Timing**: The Court said that the claimant was: "*seeking to pierce into a trust established by the Respondent [settlor] long before the Judgment and Injunction*." Timing is critical. The DAPT should exist and be funded long before the claim. How long is long enough? There are never answers for questions like that so, set up your trust plan long before you need it. Put assets into the trust long before you face a

claim. Since no one has a crystal ball, that means planning should be done yesterday. This is a classic "if you snooze you lose," or if you prefer the Nike approach "just do it."

3. **Irrevocable**: The trust must be irrevocable to provide meaningful asset protection. Many consumers confuse "revocable trusts" (typically used to avoid probate) as providing asset protection. There are even (no surprise) YouTube videos of "experts" saying that revocable trusts provide asset protection. If protecting your wealth is a goal, go irrevocable. Also, in this case the Delaware law required that the trust be irrevocable to qualify as an asset protection trust.

4. **DAPT State**: Set up the trust in one of the states that permits self-settled trusts.

5. **Local Lawyer**: Be sure a lawyer in that state reviews the trust to confirm that it qualifies as an asset protection trust under that state's laws. Some folks get cheap or lazy and don't take this formal step. If you are using an attorney in your home state who doesn't practice in the state with the DAPT laws, consider hiring local counsel that knows the laws of the state where the trust will be. Consider going a step further and having that local attorney give you a written confirmation (opinion) that the trust meets the requirements of local law.

6. **Spendthrift**: Include a spendthrift provision in the trust that meets any requirements of the law in the state where the trust was formed. The following is an excerpt of the spendthrift provision contained in the trust document to give you the "flavor" of what was done: "*No beneficiary's interest in any trust hereunder, whether in income or in principal, shall be subject to anticipation, assignment, pledge, hypothecation, sale or transfer in any manner, and no beneficiary of any such trust or other person interested therein shall have the power to anticipate, assign, pledge, hypothecate, sell, transfer, encumber or charge his or her interest therein, and no trust estate created hereunder shall be liable for or subject to the debts, contracts, obligations, liabilities or torts of any beneficiary of any such trust or other person interested therein…*"

7. **State Law DAPT Requirements**: If the state law has requirements to qualify as a DAPT or qualified disposition trust" (or whatever state law calls the trust you are creating) be sure you comply with those rules.

8. **Independent Trustee**: The Court favorably noted that the trustees were not related or subordinate to the settlor, and were not beneficiaries of the trust's income or principal. Many people prefer to name family members as trustees. That can be a mistake if not done carefully. But read the next recommendation below. The default

approach (what you start with unless there is a good reason to do something different) is a professional or institutional trustee that is independent. This advice applies to other types of trusts, like SLATs discussed above, when used for asset protection purposes. Instead of naming a spouse, name a trust company, and a different one for each SLAT.

9. **Limit Trust Amendment Rights**: Many irrevocable trust documents permit the trust to be amended or modified by the trustee, a trust protector or another person given specified powers. Consider carefully whether they should hold the power to change the interests or rights of beneficiaries under the trust. The Court in this case noted that the rights to amend the trust could only be exercised "*…in a manner that would not alter any beneficial interest in the Trust…* "A power to amend will not necessarily taint the intended asset protection results but this is a fine point to evaluate with an attorney. While the Court did not address amendment by a trust protector who is not a fiduciary it is not clear that would have a different result. Note that the Court did say the amendment power could not alter beneficial interests in the trust.

10. **Limit the Settlor's Role**: "*[Settlor]: (1) retained for himself as the "Advisor" with "full power to manage the investments of the trusts" "in a fiduciary capacity…"* This is one role that most advisors have believed that the settlor can serve in without jeopardizing the protective status of the trust. The settlor can serve as an investment trustee in a fiduciary capacity and that did not taint the trust plan's protection. In this capacity the settlor as investment trustee can determine which investments the trust can hold. This is commonly done when the trust owns private or family equity interests, as in this case. An issue may still arise if the settlor abuses that power or exceeds what may be appropriate in actions, a court might view this conclusion differently. For example, if the settlor as investment trustee makes investment decisions that enhance his economic benefits, etc. The court noted favorably that the trust agreement expressly prohibited the settlor from ever becoming a trustee. That was important because the trustee had the power to make decisions on distributions.

11. **Distribution Powers**: The trustee had sole responsibility and discretion regarding distribution to the beneficiaries. Having distribution powers held by an independent institutional trustee, as in this case, is clearly the safest route to plan to avoid the reach of creditors and for the same reasoning the reach of the IRS to cause estate inclusion.

12. **Trust Administration Should Occur in the State**: Because merely holing passive private equity and a bank account may require such a minimal level of involvement

by the trustee, deliberate efforts might be made to corroborate that the trustee is "materially participating in trust administration." This could include evaluation of periodic distributions, signing governing documents as directed trustee for an underlying entity, holding periodic or annual trust administrative meetings, etc. For those creating any type of irrevocable trust plan, which invariably has asset protection benefits, even if not a DAPT, similar steps should be considered.

13. **Use an Institutional Trustee in DAPT State**: You may need to hire an institutional trustee so that your trust can have sufficient nexus or connection to the favorable state whose laws you want to apply. But even if Uncle Joe lives in that state, weigh the benefits of using an institutional trustee that understands what is required for your trust to qualify and who has policies and procedures, and skilled personnel in place, to properly administer the trust. Family trustees, even if they live in the state you want to use, rarely have the expertise that an institutional trustee does. Yes, the institution will bill you, but that may be a cheap insurance policy to help backstop your plan.

14. **Details Matter/Avoid Foot Faults**: All of this type of planning is complicated. It is probably impossible not to have some nitpick issues, or worse. But you should always try for 100% perfection because there is no way to determine how many minor mistakes can be made before a court (or the IRS) is swayed to rule against you. The Court noted in a footnote that the trust indicated an establishment date of July 13, 2007. But, the Trust document was dated April 30, 2007. Be careful with dates and all even seemingly inconsequential details to avoid an issue.

15. **Avoid Wonky Stuff**: The settlor in this case did a bunch of funky stuff with the trust assets. Avoid wonky and funky. It never looks good. While the settlor in this case was able to sustain the attack against the trust plan, goofy planning that doesn't pass the "smell test" may just torpedo the results. If you are going to engage in any type of planning, and certainly asset protection planning, talk to professional advisers before engaging in transactions with assets that may end up in your trust/LLC structure, and especially after they do. Minimizing the number of transactions may be important as too much fiddling may look like you have control. Avoid transactions that look odd or wonky. If you can, get professional advice to restructure the transactions so they look typical. If that cannot be done assess whether you should really do them.

16. **Trust Protector**: The settlor's brother was named as the initial Trust Protector, and given the power to remove the trustee, appoint a successor trustee, appoint a successor advisor, and appoint co- trustees or co-advisors. The Trust Protector's

powers were limited to removal and replacement. This does not necessarily provide any implication to other powers commonly given to Trust Protectors but practitioners may consider whether granting powers that are too broad to a trust protector may create an implication that could be negative to the result. Presumably the brother was not a current beneficiary of the trust.

17. **Use LLCs**: Valuable assets held in a trust can and perhaps should be held in entities, such as LLCs. In the case the trust held In pertinent part, the Trust's assets include a ninety-percent interest in three Delaware limited liability companies. Using entities is smart (see discussion above). The settlor in this case also did another smart thing that most people miss. The LLCs were created in Delaware where the trust was located. It may be a good idea to have the entities to be owned by your trust formed in whichever state the trust is created in. That may enhance your connections to the host state which may be helpful. If you own real estate in a different state you should ask an attorney in the state in which the property is located about having the LLC authorized to do business in that state. The settlor in the case seems to have also had properly done operating agreements. Those are the governing documents for the LLCs. If those documents are properly done they should make it harder for a claimant to pierce the LLCs. Getting a cheap form online, or having AI draft it for you, may not be the wisest move. In this case the trust owned 90% of each LLC. Having another owner is a good plan. If the LLC is attacked by a creditor, because there are multiple members, in most states there would be what is called "charging order protection." That means that a creditor at most would get your economic interest in the LLC, not control over it. The creditor would also be prevented from forcing the LLC to sell assets (real estate in this case). Basically, all the creditor might get is your right to distributions if and when they occur. That is a pretty protective results. But although the settlor in this case did lots of things right, you might make an improvement to the plan if you and your attorney felt it worthwhile. You might create two trusts that are different and have each trust own 50% or less of each entity to further fractionalize ownership and to thereby perhaps make it more difficult for a claimant. If each trust is in a different DAPT state, e.g. one in Delaware and another in South Dakota, that may make it harder still for a claimant. While this type of planning has been commonly done by wealth taxpayers seeking to enhance valuation discounts, it may be adaptable to your asset protection plan.

18. **Manager of LLCs**: In the case each of the LLCs were managed by the settlor. Although that fact was not fatal to the settlor's protection in the instant case, it was challenged by the claimant as the settlor retaining control over the trust. So, it may

be advisable to have someone other than the settlor serve as manager of any LLC owned by a DAPT (or similar positions for other entities). Also, care should be taken to corroborate that all actions taken in such capacities are reasonable, have business purpose, etc. If a settlor served as manager of an LLC and took, for example, a salary that exceeded what was reasonable or arm's length, that might be used by a claimant in a challenge to the structure. Here's another tidbit of advice that if you not a lawyer you might make a face at when you read. Meet with an attorney and your CPA annually and review LLC documentation and operations to be certain you take as many steps as feasible to keep everything arm's length (like what unrelated parties would do) and that you document or otherwise corroborate that you have.

19. **Due Diligence**: It was not apparent in this case that the settlor had financial forecasts, lien and judgement searches and other steps done before the plan was implemented. But it seems like all was well as these issue were not discussed in the case. Before you begin implementing your asset protection plan have third party independent corroboration that there are no known claims and that you have sufficient economic resources to cover your lifestyle expenses.
20. **Prepare a Checklist**: The number of moving parts in the trust/LLC plan in this case are pretty significant. Many plans are far more complicated and have many more components. Develop a detailed checklist that all advisers, trustees, and other persons with powers in the trust contribute to that outlines as many steps to the proper administration of the plan as feasible. That was not mentioned in the case but will prove prudent in almost every similar situation.

Conclusion

If you have not undertaken asset protection steps, or might benefit from further protective measures, review the possible use of a self-settled asset protection trust holding entities that hold underlying assets with your estate planning attorney.