DOMESTIC ASSET PROTECTION TRUSTS

Impact of New Bankruptcy Provision on Domestic Asset Protection Trusts

New bankruptcy legislation allows certain transfers of a debtor made within the previous ten years to be set aside. This article, which is a follow-up to the authors' prior articles, examines the impact of this new provision on domestic asset protection trusts.

DAVID G. SHAFTEL AND DAVID H. BUNDY, ATTORNEYS

DAVID G. SHAFTEL practices law in Anchorage, Alaska. He is also a member of the California Bar and the American College of Trust and Estate Counsel. Mr Shaftel has written frequently for ESTATE PLANNING. DAVID H. BUNDY practices law in Anchorage, Alaska, with an emphasis on bankruptcy law. He has a certification in business bankruptcy law from the American Board of Certification. Copyright © 2005, David G. Shaftel and David H. Bundy.

On 4/20/05, the President signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[1] During the debate on the Act in the Senate, the *New York Times* published an article describing the "millionaire's loophole" created by domestic asset protection trusts ("DAPTs").[2] The article pointed out that the "Senate bill is favored by banks, credit card companies, and retailers, who say that it is now too easy for consumers to erase their debts through bankruptcy." The article presented the views of two law professors who described DAPTs and stated, "the millionaire's loophole that is the result of these trusts needs to be closed."[3] Further, "this is just a way for rich folks to be able to slip through the noose on bankruptcy, and, of course, the double irony here is that the proponents of this bill keep pressing it as designed to eliminate abuse . . . ."[4] The *Times* article stated that "asset protection trusts have become increasingly popular in recent years among physicians, who fear large medical malpractice awards, and corporate executives, whose assets are at greater peril now because of new laws."[5]

In response to the *New York Times* article, Senator Schumer (D-NY) introduced an amendment that would have allowed a bankruptcy trustee to set aside transfers in excess of $125,000, cumulatively, to a DAPT within ten years of filing for bankruptcy.[6] This amendment was defeated by a vote of 56

---

[1] For background on domestic asset protection trusts, see the authors' prior articles: Part 1, Shaftel and Bundy, "Domestic Asset Protection Trusts Created by Nonresident Settlors," 32 ETPL 17 (Apr. 2005); and Part 2, Shaftel and Bundy, "Domestic Asset Protection Trusts and the Bankruptcy Challenge," 32 ETPL 14 (May 2005).

[2] Morgenson, "Proposed Law on Bankruptcy Has Loophole," New York Times (3/2/05).

[3] *Id.*, quoting Elena Marty-Nelson, Nova Southeastern University.

[4] *Id.*, quoting Elizabeth Warren, Harvard Law School.

[5] *Id*.

[6] Amendment No. 42, introduced 3/3/05; 151 Cong. Rec. S1980.

to 39.[7]

Senator Talent (R-MO) responded with a compromise approach, which states:

(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if--

(A) such transfer was made to a self-settled trust or similar device;

(B) such transfer was by the debtor;

(C) the debtor is a beneficiary of such trust or similar device; and

(D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

(2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by--

(A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or

(B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78l and 78o(d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f).[8]

---

[7] 151 Cong. Rec. S1994 (3/3/05).

[8] Senate Amendment 121, 151 Cong. Rec. S2137 (3/7/05). This amendment was enacted as 11 U.S.C. §548(e).

Senator Talent's discussion on the floor of the Senate emphasized the need to prevent "dishonest people," "crooks," and "criminals" from protecting their assets by transferring them to DAPTs.[9] His discussion focused especially on corporate criminals involved in corporate fraud. He concluded by stating, "I urge my colleagues to support this amendment--it simply cracks down on criminals."[10] This amendment passed the Senate by 73 to 26.[11]

The enacted amendment requires a showing of "actual intent to hinder, delay, or defraud" before the bankruptcy trustee could avoid a transfer to a DAPT. Senator Schumer vigorously protested the "actual intent" requirement, stating "I do not have to tell anyone here who is a lawyer that to prove that intent, especially when the filer would want to make sure that intent could not be proven and would leave no paper trail, no documents or anything else, would be next to impossible."[12] Both senators' discussions focused on a debtor who had previously transferred assets to a DAPT and who now is taking advantage of the Bankruptcy Act by declaring bankruptcy and discharging debts. No mention was made of creditors forcing a debtor into an involuntary bankruptcy.

When Senate Bill 256 was considered in the House Judiciary Committee, Representative Delahunt (D-MA) submitted an amendment that would limit the amount of DAPT assets protected from creditors to $125,000.[13] Representative Cannon (R-UT) responded by arguing that fraudulent transfers made to DAPTs may be avoided both under state law as well as under Senator Talent's amendment, which allows transfers to DAPTs to be set aside if made with actual intent to hinder,

---

[9] 151 Cong. Rec. S2427 (3/10/05).

[10] 151 Cong. Rec. S2428 (3/10/05).

[11] *Id*.

[12] 151 Cong. Rec. S2427 (3/10/05).

[13] H. Rep't 109-031, Part I.

delay or defraud a creditor, and concluded that this is adequate to eliminate the "millionaire's loophole." Representative Cannon emphasized that "[t]he states should be able to determine for themselves what property their citizens can protect from the claims of creditors."[14] Representative Delahunt's amendment was defeated by a vote of 15 to ten.[15] Senate Bill 256, which included Senator Talent's amendment, passed the House on 4/14/05, by a vote of 302 to 126.[16]

DAPTs are commonly used in estate planning not only for asset protection purposes but also for a variety of tax and nontax planning purposes, including transfer tax minimization, state tax planning, and prenuptial planning.[17] The legitimate use of DAPTs for asset protection planning is to set aside a "nest egg" at a time when the settlor either does not have existing liabilities or such liabilities are covered by other assets. The amendments proposed by Senator Schumer and Representative Delahunt would have had the practical effect of eliminating the effectiveness of DAPTs for these purposes. Therefore, this Bankruptcy Act debate placed squarely before Congress the question of whether DAPTs, formed without fraudulent transfers, should be allowed. Congress decided affirmatively, by a wide margin.

The key operative language of the DAPT amendment (i.e., 11 U.S.C. §548(e)) to the 2005 Bankruptcy Act is identical to the existing fraudulent transfer language of Bankruptcy Code section 548(a)(1)(A), with the one-year limitations period extended to ten years. Similarly, the operative language "actual intent to hinder, delay, or defraud" is identical to the language used in the Uniform

---

[14] *Id*.

[15] *Id*.

[16] 151 Cong. Rec. H2076 (4/14/05).

[17] See Part 1 of this article, note 1 *supra*, p. 18.

Fraudulent Transfer Act ("UFTA"),[18] which has been enacted in 42 states.[19]

UFTA has a four-year statute of limitations but contains a one-year discovery exception to that limitations period. Thus, if a creditor reasonably discovers a transfer to a DAPT after the four-year limitations period has expired, the creditor has an additional year in which to file an action and argue that the transfer to the DAPT was made with the intent to hinder, delay, or defraud the creditor. All the DAPT states, except Alaska, have enacted UFTA.[20] Further, all the DAPT state statutes provide that fraudulent transfers to a DAPT will not be given spendthrift protection.[21] As a result, if the new amendment is construed and applied similarly to Bankruptcy Code section 548 and UFTA, then the enactment of this provision will have added little to the law in this area.

The discussion in both the Senate and House, and the need for the enactment of the above-quoted amendment, support the conclusion that DAPTs are included within the protection provided by section 541(c)(2) of the Bankruptcy Code, which excludes the assets of spendthrift trusts from the bankruptcy estate. This has been an open issue, which now appears to be resolved in favor of DAPTs.[22] Interestingly, the Senate discussion also assumed that nonresidents of DAPT states can

---

[18] UFTA §4(a)(1).

[19] "Legislative Fact Sheet." www.nccusl.org.

[20] *Id.* Alaska has limited its fraudulent transfer statute to only "fraud" and has severely restricted the discovery exception.

[21] Alaska Stat. §34.40.110(b)(1); Del. Code tit. 12, §§3572(a) and 3572(b); Mo. Rev. Stat. §456.5-505.3(1), et seq.; Nev. Rev. Stat. §§112.180, .230, and 166.170; Okla. Stat. Ann. §8; R.I. Gen. Laws §§18-9, 2-4(a) and (b); S.D. Senate Bill 93, §§9 and 10; and Utah Code Ann. §25-6-14(1)(c)(ii).

[22] Whether DAPTs were included in the protection of section 541(c)(2) was discussed in Part 2 of this article, *supra* note 1, p. 19. See also Eason, "Developing the Asset Protection Dynamic: A Legacy of Federal Concern," 31 Hofstra L. Rev. 23, 57; and Sjuggerude, "Defeating the Self-Settled Spendthrift Trust in Bankruptcy," 28 Fla. St. U. L. Rev. 977, 999 (2001).

protect their assets by transferring them to a DAPT.[23] This is another open DAPT issue.

The enacted amendment was evidently drafted hastily in response to the attempt to close the so-called millionaire's loophole by the more drastic provisions described above. As a result, the amendment contains a number of ambiguities. An initial reading leaves one wondering if the amendment was intended only to apply to the securities fraud acts stated in subsection (e)(2). However, reference to the "millionaire's loophole" in Senate and House discussions supports the conclusion that the expressly stated securities fraud violations were only examples, but not limitations. The Senate and House discussions and the above-referenced examples suggest that the thrust of this amendment is to apply to criminal conduct, although the amendment is not expressly so limited.

The enacted amendment applies to "a self-settled trust or similar device." Therefore, it should apply not only to DAPTs but also to foreign asset protection trusts ("FAPTs"). What is a "similar device"? For example, would a transfer to a family limited partnership or a family limited liability company be covered by this new bankruptcy ten-year rule? Was the amendment intended to apply to contributions to pension accounts and individual retirement accounts ("IRAs"), which are self-settled arrangements?

The operative language that the debtor made such transfer with "actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted," which was taken verbatim from Bankruptcy Code section 548, needs

[23] Statement of Senator Schumer, 151 Cong. Rec. S1980 (3/3/05). The issue of choice of spendthrift trust law when the settlor is not a resident of the DAPT state is thoroughly discussed in Part 1 of this article, *supra* note 1, pp. 21-22.

clarification.[24] The terms "hinder, delay, or defraud," which have their roots in UFTA, can be traced back to the English Statute of Elizabeth.[25] Was it Congress' intent that this language be construed to be consistent with these existing statutes? The above-quoted phrase also clearly includes future creditors. Which future creditors? With the extension of the limitations period from one year to ten years, the identification of qualifying future creditors becomes an important issue. Would these be just reasonably foreseeable future creditors, or any future creditor whose claim accrues during the ten-year period?

The Senate and House discussions are entirely centered on a debtor taking advantage of the bankruptcy laws by filing a voluntary bankruptcy action. Did Congress intend to include involuntary bankruptcy filings within the scope of this enacted amendment? One view is that fraudulent transfers should be avoided regardless of whether the bankruptcy action was initiated by the debtor or by the creditors. The alternative argument is that Congress's concern was that wealthy individuals would voluntarily take advantage of the Bankruptcy Code to discharge their debts, while still retaining the benefits of the DAPT. The intent was not to apply to cases where the debtor was involuntarily forced into bankruptcy.

The following proposed changes would clarify the scope of the amendment and make its application much more certain. Transfers to pension accounts and IRAs should be excluded. There is no indication that there was concern about transfers to these types of self-settled devices. The limitations period should be consistent with that of UFTA: four years with a one-year discovery exception. If securities fraud is considered to be unique, the ten-year limitations period could be

[24] The term "entity" is defined in the Bankruptcy Code broadly and includes a person. 11 U.S.C. §101(15).

[25] 13 Eliz. Ch. 5.

retained for such violations. Only reasonably foreseeable creditors as of the date that the transfer to the DAPT was made should be able to take advantage of this new provision. Otherwise, any transfer to a DAPT within the limitations period could arguably be avoided. Such blanket avoidance, as proposed by Senator Schumer, was specifically rejected by Congress. Finally, consideration should be given to limiting the enacted amendment to voluntary bankruptcy filings. Many of these clarifications could be enacted as part of a technical corrections act.

In summary, proposals were made in both the Senate (Sen. Schumer) and the House (Rep. Delahunt) which would have severely limited DAPTs. Congress rejected these proposals. Instead, Congress extended the section 548 fraudulent transfer remedy, which duplicates a remedy that already exists in the 42 states that have adopted UFTA. The major apparent difference is a fixed ten-year limitations period instead of four years plus a one-year discovery period. The main consequence of this amendment is that it now provides a uniform fraudulent transfer remedy in all 50 states. However, because every DAPT state statute provides that fraudulent transfers to a DAPT will not be protected, the new Bankruptcy Act provision does not significantly change the effectiveness of DAPT asset protection.

All the DAPT state statutes provide that fraudulent transfers to a DAPT will not be given spendthrift protection.

The new Bankruptcy Act provision does not significantly change the effectiveness of DAPT asset protection.