

Domestic Assets Protection Trusts in Light of *Toni 1 Trust v. Wacker*

A spendthrift trust can protect trust corpus from claims by beneficiaries' creditors. It took until the late nineteenth century for all states to accept spendthrift trusts created by a third party. No state approved a spendthrift trust created by a settlor for his own benefit. In fact, one of the leading cases to that effect was from Tennessee.[1]

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This began to change in the late twentieth century. The Black Monday stock market crash of Oct. 19, 1987, coupled with perceived rampant tort litigation, fueled a widespread desire to shelter assets from future unknown creditors. In 1989, the Cook Islands amended its International Trust Act to allow for asset protection trusts, i.e., trusts in which the settlor could be a beneficiary while retaining creditor protection. By 1992, many other countries had followed suit, and scholars estimate that over one trillion dollars exist in such offshore trusts. In 1997, Alaska became the first of 17[2] states to authorize a self-settled spendthrift trust, generally known as a Domestic Asset Protection Trust (DAPT). Tennessee joined the club effective July 1, 2007, with its version of a DAPT uniquely known as a Tennessee Investment Services Trust (TIST).[3]

Two of my columns in 2007 outlined the requirements and effect of the new statute[4] and listed potential creative planning uses,[5] while also pondering the limits of such trusts against creditors.[6] After more than two decades and thousands of such trusts created, there are no cases reported where a DAPT has been set aside and the trust assets made available to a creditor, provided the DAPT is done correctly. Stated more positively, the consensus is that a DAPT works when the settlor is a resident in a DAPT state, the settlor's transfer to a DAPT is not a fraudulent transfer, the settlor is not subject to personal jurisdiction in a non-DAPT state, and the creditor claim is either outside of bankruptcy or the transfer of assets occurred more than 10 years before commencement of the bankruptcy case.

Greater uncertainty exists regarding residents of non-DAPT states who create a DAPT in a state where a DAPT is authorized. Indeed, many DAPT states, including Tennessee, have benefited from the influx of funds from residents of non-DAPT states creating such trust in DAPT states.

Proponents of DAPTs created by residents of non-DAPT states cite the undeniable paucity of reported cases as evidence of their great acceptance and success. But the shortage may be the result of creditors settling or conceding rather than litigating. After all, litigation might encourage the debtor to file for bankruptcy with potential rights to a payment plan. Skilled attorneys preparing DAPTs on behalf of residents of non-DAPT states might create additional protections unnecessary for residents of a DAPT state. For example, if all the settlor's assets are put into an LLC before transferring the LLC interest to the DAPT, then creditors may find that the sole remedy available from successful litigation is a "charging order" on the LLC interest, providing the creditor only the member's share of cash flow, if any, rather than an interest in any of the underlying assets. Other such planning devices exist.[7]

The few reported cases are suggestive.

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For example, the *Huber*[8] case in 2013 addressed a choice-of-law issue. A Washington state real estate developer created a DAPT in Alaska in 2008 for the benefit of himself and his descendants at a time when he was a guarantor on numerous real estate projects and the real estate market was foundering. The DAPT was funded with a 99 percent interest in an LLC that owned valuable interests in several companies in Washington plus $10,000 cash. The Trustees were family members plus an Alaska trust company, and the only asset actually located and administered in Alaska was the cash. The settlor filed for bankruptcy in 2011. In 2013 the Bankruptcy court ruled the Alaska trust ineffective to prevent access by creditors, holding that (1) the transfer to the DAPT violated Washington state's fraudulent transfer law; (2) the DAPT was created with the actual intent to defraud creditors within the meaning of Section 548(e) of the Bankruptcy Code; and (3) the laws of the state whose laws are selected by the settlor of a trust (here Alaska) will apply, so long as that state's law does not violate a strong public policy of the state with which the trust has its most significant relationship (here Washington). The court held that since the primary contacts were in Washington, which had a statute expressing a strong public policy against self-settled trusts, Washington law would apply to vitiate the creditor protection terms of the trust. The third holding may have been unnecessary in light of the first two, but the court clearly wanted to make its point.

The recent case of ***Toni 1 Trust***,[9] also involving an Alaska DAPT, clarifies further. Montana resident Donald Tangwall sued his neighbors, the Wackers, but the Wackers counterclaimed, obtaining judgments in Montana courts not only against Donald but also against his wife Barbara and mother-in-law Toni. Shortly before the judgments were entered, Toni transferred Montana real property to an Alaska DAPT for her own benefit, known as the *Toni 1 Trust*, naming her son-in-law Donald Tangwall as a Trustee. Toni later filed for bankruptcy in Alaska, adding a Bankruptcy Trustee as another creditor. Not surprisingly, both the judgment creditor and the Bankruptcy Trustee obtained judgments in Montana finding that the transfers to the *Toni 1 Trust* were fraudulent. Undeterred, the Trustee filed an action for declaratory judgment in an Alaska state court, alleging that the Alaska DAPT statute granted Alaska state courts exclusive jurisdiction over any fraudulent transfer actions against the trust, and that under the Alaska statute, the statute of limitations had already run. The trial court dismissed the complaint, which was appealed to the Alaska Supreme Court.

Interestingly, the Alaska Supreme Court wrote (omitting footnotes):

> Tangwall's argument is not frivolous. He is correct that a judgment is void if the court that entered the judgment lacked subject matter jurisdiction over the case. Furthermore, [the Alaska statute] AS 34.40.110(k) purports to grant Alaska courts exclusive jurisdiction over fraudulent transfer claims against Alaska self-settled spendthrift trusts. And having reviewed the legislative history of AS 34.40.110(k), we have no doubt the Alaska legislature's purpose in enacting that statute was to prevent other state and federal courts from exercising subject matter jurisdiction over fraudulent transfer actions against such trusts. The question, however, is whether AS 34.40.110(k) can achieve that intended result. We conclude that it cannot.

The Alaska Supreme Court quoted from an old U.S. Supreme Court opinion, *Tennessee Coal*,[10] that under the Full Faith and Credit Clause of the U.S. Constitution, "jurisdiction is to be determined by the law of the court's creation [here Montana], and cannot be defeated by the extraterritorial operation of a statute of another state [here Alaska], even though it created the right of action."

The Alaska Supreme Court continued (omitting footnotes):

> Alaska Statute 34.40.110(k) crosses the limit recognized by *Tennessee Coal*: it purports to grant Alaska courts exclusive jurisdiction over a type of transitory action against Alaska trusts. We acknowledge that the analogy is imperfect; the Montana court's judgment against Tangwall was based not on a fraudulent transfer cause of action created by an Alaska statute, but rather on a cause of action arising under Montana law relating to an Alaska trust. Nevertheless, *Tennessee Coal* controls. The *Tennessee Coal* court held that the Full Faith and Credit Clause does not compel states to follow another state's statute claiming exclusive jurisdiction over suits based on a cause of action 'even though [the other state] created the right of action.' The clear implication is that the constitutional argument rejected in *Tennessee Coal* would be even less compelling were a state to assert exclusive jurisdiction over suits based on a cause of action it did not create. In seeking to void the Montana court's judgment for lack of jurisdiction, Tangwall effectively argues that AS 34.40.110(k) can deprive Montana courts of jurisdiction over cases arising under Montana law. This is simply a more extreme interpretation of the 'full faith and credit' principle than the interpretation considered and rejected in *Tennessee Coal*.

The Alaska Supreme Court further held that the Montana court is not limited by Alaska's statute regarding jurisdiction merely because the trust is governed by Alaska law. States [here Alaska] can declare exclusive jurisdiction over matters, but other states where courts can also establish personal jurisdiction [here Montana] are not required to follow that other state's statute that claims exclusive jurisdiction. This is especially true of "transitory" matters, such as fraudulent transfer actions, as opposed to merely "local" matters.

In the end, *Toni 1 Trust* involved a blatant fraudulent transfer, and the outcome was entirely predictable and morally

correct. Still, the case firmly cements several propositions that may not have been as clear before. First, the statute of limitations for fraudulent transfers will not be determined solely by the law of the DAPT state. Second, if another state has personal jurisdiction over the settlor on account of significant contacts with that state, its courts may not recognize the spendthrift provisions of the DAPT, on grounds other than mere choice-of-law, such as the constitutional principle of full faith and credit. Third, if the trust property is located in the non-DAPT state, creditors are not required to file actions in the DAPT state.

It is doubtful that this case means that a DAPT will never work if the settlor is not a resident of a DAPT state, as one leading commentator suggested in *Forbes Magazine*.[12] If there had been no fraudulent transfers in *Toni 1 Trust*, then neither the settlor's residence in Montana nor Montana's in rem jurisdiction over the Montana real property would provide Montana courts with jurisdiction over the Trust or the Trustee. Asset protection lawyers are still waiting for a case that completes the analysis of the application of the Full Faith and Credit Clause when there are no "bad facts." In such case, based on the Full Faith and Credit Clause, would an Alaska court have to yield to a Montana resident's Montana judgment against the assets of an Alaska DAPT? Would a Montana court have to yield to the Alaska statute and exclusive jurisdiction of the Alaska courts? When such a case is presented and decided, it may be "the big one" that practitioners have pondered for years.

In any event, what many settlors really hope for, as previously discussed, is that the DAPT will at a minimum discourage creditors from filing any claims or at least encourage them to settle favorably.

As always, some may question the ethics of asset protection planning that can ultimately leave some legitimate creditors unpaid, but to the extent such planning is legal and avoids any hint of fraudulent transfers, it may be unethical not to counsel clients on the pros and cons of DAPTs as part of their overall risk management.

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NOTES

1. *State ex rel. v. Nashville Trust Co.*, 190 S.W.2d 785, 28 Tenn. App. 388, 401 (1944). ("All the authorities say that one cannot create a spendthrift trust with his own property for his own benefit." (citing prior Tennessee cases as well as treatises.) A son's creditors collected against a trust created by his father where the son had expended his own funds to improve the father's real property in anticipation and mutual agreement of the father's later creation of the trust, thus becoming a self-settled trust to the full extent of the amount contributed by the son.

2. For a list and a ranking of the DAPT statutes of all 17 states (Tennessee is tied for fourth), see https://www.oshins.com/state-rankings-charts. See also Merric et al., "Best Situs for DAPTs in 2019 – A ranking of jurisdictions that offer the best protection in light of recent case and the UVTA," *Trusts & Estates* (Dec. 13, 2018), at https://www.wealthmanagement.com/estate-planning/best-situs-dapts-2019.

3. *Tenn. Code Ann.* §35-16-101, et seq.

4. Holbrook, "The TIST Test: Tennessee Competes for Trust Dollars," *Tennessee Bar Journal*, August 2007.

5. Holbrook, "When to TIST? Here's a List," *Tennessee Bar Journal*, November 2007.

6. One immediately obvious limit of the TIST statute in 2007 was the lack of any exception for alimony or support obligations. The Tennessee legislature added both in 2013.

7. Several clever planning ideas in preparing a DAPT, especially for a settlor who is a resident of a non-DAPT state, include the following:

1) *Hybrid Trust*. The settlor could avoid naming himself as a beneficiary at all, but rather name a "Trust Protector" who has the authority to add beneficiaries, including the settlor, preferably only upon the existence of some objective standards or other "acts of independent significance," such as retirement from a risky profession, disability, divorce, insolvency, etc. Risk management might further suggest creating both a standard DAPT for some assets and a Hybrid Trust for other assets. On the other hand, under *Tenn. Code Ann.* §35-15-1202, a Trust Protector in Tennessee is a fiduciary, so it is not clear that a fiduciary for the existing beneficiaries could add beneficiaries without risk of a breach of fiduciary duty. See Steven J. Oshins, Esq., "The Hybrid Domestic Asset Protection Trust," https://docs.wixstatic.com/ugd/b211fb_65208d809a2b4f168ad9cba63703f4e3.pdf.

2) *Limited Power of Appointment.* The settlor could grant one or more named individuals a special or limited non-fiduciary power of appointment to appoint to the settlor and/or others. Absent collusion, courts typically have no jurisdiction over non-fiduciary exercises of powers of appointment.

3) *Third Party Trust.* If prior to the settlor's creation of a DAPT, a third party creates a spendthrift trust for the benefit of the settlor, funded modestly but significantly enough by the third party's own assets, then the DAPT could authorize the holder of the non-fiduciary limited power of appointment to transfer assets from the DAPT to the third party trust, minimizing the argument that any part of the third party trust was self-settled by the settlor, absent collusion.

4) *Discretion to Spouse Only.* If the DAPT permits distributions only to the settlor's spouse, and the marriage is stable, the practical effect is to benefit the settlor only indirectly. In the event of death or divorce, one of the other techniques described above could then be employed.

5) *Offshore Trust Option.* A DAPT may require the Trustee to transfer all assets to an offshore trust in the event of a significant liability challenge, potentially requiring the creditor to re-litigate in the offshore jurisdiction, perhaps already beyond that country's statute of limitations.

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

9. *Toni 1 Trust by its Trustee, Donald Tangwall v. Barbara Wacker, et al.*, 413 P.3d 1199 (Ala. 2018).

10. *Tennessee Coal, Iron & Railroad Co.* v. George, 233 U.S. 354, 360 (1914).

11. U. S. Constitution, Article IV, Section 1. "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State."

12. https://www.forbes.com/sites/jayadkisson/2018/03/05/alaska-supreme-court-hammers-last-nail-in-dapt-coffin-for-use-in-non-dapt-states-in-toni-1-trust/#41ef272362a7.