

Drafting and Other Suggestions to Enhance Creditor Protection in Self Settled Spendthrift Trusts

©Robert L. Manley 2003

A. Facilitate changing the situs of trusts.

The law of some states is more favorable to particular estate planning goals. For example, consider the repeal or limitation on the Rule Against Perpetuities as well as the self-settled trust laws in Alaska and other jurisdictions. Also consider the limited liability company and limited partnership laws of jurisdictions such as Alaska. The ability to move the trust situs from Alaska may become important at some point in the future.

Appropriate drafting can facilitate changing trust situs. See, e.g., J. Sligar, *Changing Trust Situs: The Legal Considerations of "Forum Shopping"* 135 *Trusts & Estates* 40 (July 1996); E. Tralow and R. Breed III, *When and How to Change the Situs of an Irrevocable Trust Without Adverse Effects* 11 *Estate Planning* 24 (1984); W. Newton III, *Choice and Change of Trust Situs* 35 *U. Fla. L. Rev.* 798 (1983); see also R. Henderickson and N. Silverman, *Changing the Situs of a Trust* (1997).

However a strongly worded "flight clause" drawn from standard offshore trust forms might present the appearance of a trust focused solely on asset protection. Refer to N. (Appearances are Important).

Under AS 13.36.157 a trustee who has absolute discretion under a trust to invade principal for the a beneficiary may exercise that discretion by appointing all or part of the trust principal in favor of a trustee of another trust provided the new trust does not reduce any fixed income interest of the beneficiary, is in favor of the beneficiary of the prior trust and does not violate the Alaska rule against perpetuities.

Planners considering use of this approach should analyze whether the proposed conversion will inadvertently trigger the Delaware tax trap. See IRC § 2514(d) and G. Cushing, *Federal Tax Aspects of Trustees' Powers*, *Sophisticated Estate Planning* 36-37 (ALI-ABA September 1998).

All fiduciaries are probably under a continuing duty to administer the trust in a place appropriate for the purposes of the trust and to its sound, efficient management. In some circumstances, this may require the re-situating of a trust. See Uniform Probate Code §7-305.

- B. Start the fraudulent conveyance statute of limitations running as to current creditors.

Send them actual notice that you have created a trust and the nature of its funding. Under AS 34.40.110(d)(1), persons who are creditors at the time the transfer to trust is made, have the later of four years after the transfer or one year after the transfer is or reasonably could have been discovered within which to bring an action for a fraudulent conveyance. In order to synchronize the expiration of the statute of limitations, perhaps notice should be given three years after the transfer.

- C. Exercise due diligence to make sure the client is not planning a fraudulent or illegal transfer.

For a discussion of ethical issues, refer to R. Manley, The Impact of Ethical Rules on Estate Planning, Estate Planning Techniques (ALI-ABA, June 1999).

For a review of attorney liability issues involved in asset protection, refer to W. Siegel, Minimizing Attorney Liability in Asset Protection Representation (parts 1-4) 3 J. of Asset Protection 20 (September/October, 1997) 39 (January/February, 1998) 26 (March/April 1998) and 57 (May/June 1998); P. Spero, Asset Protection: Legal Planning & Strategies Ch. 2 (1994); K. Ballsun, American Legal Ethics and Offshore Trusts - How Well Do They Mix?, 1993 ACTEC Annual Meeting Symposium II.

For a review of due diligence procedures, refer to J. Mintz, Steps in Investigating Potential Asset Protection Clients 3 J. of Asset Protection 28 (January/February 1998); W. Schmidt T. Stevner and A. Wehner, Using On-Line Searches in Investigations 3 J. of Asset Protection 39 (July/August 1998); and J. Claud, Completing a Due Diligence Investigation of a Potential Client 3 J. of Asset Protection 47 (September/October 1997).

Also note AS 34.40.110(f) which provides that in the case of a properly established Alaska self-settled spendthrift trust, a creditor may not assert a cause of action or claim for relief against a trustee or others involved in the preparation or funding of the trust for conspiracy to commit fraudulent conveyance, aiding and abetting of fraudulent conveyance or participation in the trust transaction. The creditor is limited to recourse against trust assets and the settlor to the extent allowed under Alaska law.

D. Maintain your situs.

Use only Alaska qualified trustees with minimum activities outside of the chosen situs. While only one of the trustees needs to be a qualified trustee, it is better to minimize contacts out of the chosen situs. This makes it harder for non-situs courts to ignore the trust choice of law and situs. More importantly it makes it more difficult for such courts to get jurisdiction over trustees.

E. Use completed gifts.

This establishes an estate planning rationale for the transaction and makes the trust less subject to attack as a fraudulent conveyance. Do not transfer all of settlor's assets into the trust. The settlor should not expect regular income or distributions from the trust.

Similarly, take care in allowing settlors the rent-free use of trust assets. This kind of conduct makes it more likely that a court will presume an implied understanding between the trustee and the settlor which may cause estate tax inclusion or successful claims of settlor's creditors. But see J. Blattmachr, R. Thwaites, Jr., & H. Zaritsky, New Alaska Trust Act Provides Many Estate Planning Opportunities, 24 Estate Planning 347, 348 (October 1997) (Commentators argue that occasional use of trust property by settlor/beneficiary actually "should help refute any such inference").

F. Real estate.

Absent other compelling reasons, use an Alaska limited liability company to hold the real estate. Valuation discounts may be available if the entity and ownership are structured appropriately. In addition, for non-Alaska real estate, using an LLC makes it more likely that the law of Alaska will be applied in the event of a challenge in some other jurisdiction.

G. Don't Make the Settlor an Immediate Beneficiary.

Establish the settlor as a permissible beneficiary only in the event the settlor's spouse predeceases or the settlor and spouse divorce or are separated. This approach is most appropriate in a stable, long-term marriage situation.

If the settlor is not a beneficiary eligible to receive distributions, it is more difficult for a creditor of the settlor to reach trust assets.

H. Utilize Perpetual Trusts Options.

This provides another estate planning (non-asset protection) rationale.

I. Limit Use of Trust Protectors.

Trust protectors are generally non-beneficiary individuals with the power to discharge trustees and appoint successor trustees. The use of trust protectors frequently gives settlors comfort regarding the continued proper management of the trust. On the other hand, it suggests that settlor has an indirect way to shop for compliant trustees. Depending on settlor concerns, perhaps the power of trust protectors can be limited to certain situations such as mismanagement or failure of performance. Successor trustees appointed by the trust protector could be limited to institutional fiduciaries.

J. Terminate the Settlor as a Permissible Beneficiary.

To avoid arguments that trust assets should be included in the settlor/beneficiary's estate for estate tax purposes, the settlor could relinquish the ability to receive discretionary trust distributions. This relinquishment would not be effective for estate purposes unless accomplished more than three years prior to the settlor/beneficiary's death. IRC §§2035(d)(2), 2038(a).

However, if the power to terminate the settlor as a permissible discretionary beneficiary were held by an appropriate trustee, then even if the settlor were eliminated as a beneficiary immediately prior to the settlor's death, the three-year limitation should not apply because the settlor will not have made any transfer by reason of the trustee's action.

K. Transfer the Assets

Have the Alaska Trustee custody the assets. This should reduce the ability of a non-Alaska court to assert in rem jurisdiction. If there are stock certificates, bonds or LLC certificates issued in physical form, the Alaska trustee should take actual possession. If the assets are held in street name by a broker or investment advisor it would be better if the account was transferred to an Alaska office with the statements issued by that office or under its letterhead.

L. Use Multiple Beneficiaries

If the Settlor is subject to collection actions, the Trustee may exercise its discretion to make distributions to other beneficiaries

M. Sign the Documents and Make the Asset Transfers in Alaska

Conflict of law principals rely significantly on the location of assets and the place where events or injuries occur, thus establishing the transfer and creation of the trust as an event occurring in Alaska and makes it more likely that courts will apply Alaska law in reviewing the validity of the trust and the transfers.

N. Appearances are Important

Do not title the trust as an asset protection trust or a “rainy day trust” (service mark of the Alaska Trust Company). Appearances can be important in fraudulent conveyance actions. Accord C. Kruse, The “M” word – Medicaid Considerations for Lawyers Representing the Upper Crust, 33 Heckerling Inst. on Estate Planning at 6-37 (1999) (trust language “should be structured to cause least offense to those who will be later determining whether what we have said is lawful judged by changing concepts of what is right and good for us – public policy by any name”).

O. Ability to Defend

Provide adequate liquid assets to allow trustee to properly administer the trust. If the only assets are a \$10,000 certificate of deposit and illiquid LLC membership certificates, the trustee may not be able to mount a vigorous legal defense of the trust. Also consider adding trust language that authorizes or directs the trustee to vigorously defend the trust.