No Surprise Here

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There has been quite a bit of buzz about a recent bankruptcy case involving an Alaska asset protection trust. However, the case merely confirms a weakness in the use of domestic asset protection trusts that was obvious even before this case.

Domestic asset protection trusts (DAPTs) promise the holy grail of creditor protection – a trust where the settlor/grantor can transfer assets to, be a discretionary beneficiary of, but still have the assets of the trust be protected from the settlor's/grantor's creditors. Alaska, Delaware, and Nevada are three popular jurisdictions for these trusts.

There are open questions about the effectiveness of the trusts for creditor protection purpose, including enforceability across state lines under the U.S. Constitution. A major issue is the 10 year voidability provision of 11 U.S.C. §548(e) that entered the U.S. Bankruptcy Code in 2005. That provision provides that a trustee in bankruptcy can reach the assets a debtor transferred to a trust:

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.

A transfer to a DAPT will typically meet the requirements of (A)-(C) above. The big question is whether a transfer to a DAPT demonstrates the requisite "actual intent to hinder, delay or defraud" under (D). Since DAPTs were created to address creditor issues, and are marketed as providing that benefit, a reasonable person would suspect that the use of one demonstrates the actual intent to hinder, delay or defraud, even if the settlor was not rendered insolvent by reason of the transfer. Note, however, that Alaska law expressly provides that a settlor's expressed intent to protect trust assets from a beneficiary's potential creditors is not evidence of an intent to defraud.

In *Battley v. Mortensen*, a bankruptcy court in Alaska found that a transfer to a DAPT could run afoul of 11 U.S.C. §548(e), even though the debtor was solvent at the time of creation of the trust. The court noted:

when property is transferred to a self-settled trust with the intention of protecting it from creditors, and the trust's express purpose is to protect that asset from creditors, both the trust and the transfer manifest the same intent. In this case, I found that the trust's express purpose could provide evidence of fraudulent intent.

The court did not give any effect to the provision of Alaska law that indicated the trust language could not be used as evidence of an intent to defraud. There were other factors that the court found that evidenced intent to defraud, so it is uncertain how the court would have ruled absent those other factors.

Nonetheless, the case confirms the exposure that the use of a DAPT leaves the door open to the reach of a trustee in bankruptcy within 10 years of the funding of the trust. Since a debtor can be placed in bankruptcy by his creditors on an involuntary basis, one cannot simply avoid this exposure by not filing for bankruptcy protection.

DAPTs are still useful for those that do not expect to have significant creditor issues within the next 10 years, but are in a high risk field and thus still desire its protections over an extended period beyond 10 years. Further, DAPTs can provide tax benefits via moving assets out of the taxable estate of a grantor while still allowing a discretionary beneficiary interest to the grantor. Nonetheless, in these circumstances, the constitutional issues regarding DAPTs still remain.

Battley v. Mortensen, Memorandum Decision & Memorandum on Defendant's Motion for Reconsideration (Case No. A09-00565-DMD, United States Bankruptcy Court, D. Alaska)

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