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BANKRUPTCY & TROUBLED LOANS PRACTICE GROUP | APRIL 2014

## Otten Johnson Alert -

### Domestic Asset Protection Trusts: What Are They, and Do They Work?

Since the late 1990s, several states have enacted statutes allowing for the creation of Domestic Asset Protection Trusts, or "DAPTs." A DAPT is an irrevocable trust under which (a) the person creating the trust can be a beneficiary and (b) under certain conditions, the assets of the trust cannot be reached by that person's creditors.

Allowing a debtor to place assets into a trust for his or her own benefit, and beyond the reach of creditors, cuts directly against commonly accepted principles of debtor-creditor law; including the concepts that assets held in "self-settled trusts" can be reached by creditors, and that fraudulent transfers (transfers intended to hinder, delay or defraud the creditors of the transferor) can be avoided by an injured creditor.

#### States Enacting DAPT Statutes

About a dozen states have enacted DAPT statutes. Some are much more comprehensive than others, and each has different provisions. Full consideration of the varying conditions and restrictions on DAPTs in each state is well beyond the scope of this Alert.

Nevada and South Dakota are generally recognized as having two of the most aggressive DAPT statutes (i.e., allowing debtors the greatest ability to shield assets from the claims of creditors).

#### How the Statutes Work: Statutory Exceptions

In general, a DAPT must be irrevocable; must appoint an individual or corporate trustee residing in the state under whose statute the trust is formed; and must contain a "spendthrift" clause, which provides that the beneficiary's interests in trust assets cannot be transferred (voluntarily or involuntarily) before the trustee distributes those assets to the beneficiary.

Importantly, DAPT statutes provide that assets in the DAPT are protected from creditor claims only after the expiration of a statute of limitations, which runs from the time the assets are placed in the DAPT. The statutes of limitations are different for "preexisting creditors" (creditors who have

AUTHOR:

[David T. Brennan](#)

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claims against the debtor at the time the assets are transferred to the DAPT) than for "future creditors" (creditors whose claims arise after the assets are placed in the DAPT). In Nevada, for example, assets transferred to a DAPT will be protected from the claims of a preexisting creditor two years after the transfer, or six months after the creditor discovers or should have discovered the transfer, whichever is later. Those same assets will be protected from the claims of a future creditor two years after the transfer – with no extension for the creditor's "discovery" of the transfer.

Almost all of the statutes define certain "exception" classes of creditors that can still reach the assets in the DAPT, even after the statute of limitations has run. Examples include divorcing spouses, alimony/maintenance creditors and child support creditors. Nevada's very aggressive statute, however, includes no such exceptions.

#### Will DAPTs Withstand Creditor Challenges?

There has been very little case law on whether a DAPT can successfully shield assets from the claims of creditors. The dearth of cases challenging DAPTs has given rise to a widely held belief that residents of a state with a DAPT statute can successfully transfer assets to a DAPT and, within the restrictions of the statute (expiration of the applicable time period following the transfer, "exception" classes of creditors, and the like), protect those assets from the transferor's creditors. The American College of Trust and Estate Counsel, for example, has expressed that view.

A separate question is whether a resident of a non-DAPT state can take advantage of the DAPT statute in another state to shield his or her assets. There is virtually no case law on this question. A court considering this issue would likely consider whether the nonresident's state of domicile has a "strong public policy" against the protection of assets with devices like a DAPT.

#### Does Colorado Have a DAPT Statute?

In a word, no. Some commentators have counted Colorado among the ranks of DAPT states based on a statute, section 38-10-111, first enacted in 1861 (not a typo). That statute says that transfers "made in trust for the use of the person making the same shall be void as against the creditors existing of such person." (Emphasis added.) By negative inference, those commentators suggest that perhaps the legislature intended that such a transfer should be valid as against future creditors. Leaving aside that questionable discernment of intent, it's clear that Colorado has no intentionally enacted DAPT statute, and none of the requirements, restrictions and declared protections set forth in such statutes.

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