How the Financial Pros are Protecting Their Assets

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During the past year of financial turmoil we have seen a clear refocusing of attention on strategies to minimize financial and liability risks. In almost every area, real estate prices are down, financing is difficult or impossible and beyond merely losing a substantial investment, many are concerned about large potential liabilities to lenders in the form of foreclosures and deficiency judgments and personal loan guarantees. The question that many are asking is how do we protect our remaining savings and retirement nest egg from the risk of these liabilities?

Delaware Asset Protection Trusts

In previous articles I've discussed a variety of strategies used for asset protection from business risks ("Analyzing Risk and Shielding Personal Wealth") but lately a particular technique known as a Delaware Asset Protection Trust has been the focus of considerable attention. A recent article in the New York Times pointed out that the Delaware Asset Protection Trust, once popular with physicians and business owners, are now favored by hedge fund managers, bankers and others in the investment world for protecting substantial assets from government regulators and unhappy investors.

The fact that financial pros are protecting their assets may or may not be good news depending on your point of view. Nevertheless it's always interesting to know what the so called 'smart money" is up to. So let's see what these Delaware Asset Protection Trusts really can and can't do and whether they can be a useful strategy in a sophisticated asset protection plan.

Let's understand the goals of these trusts - what they are intended to accomplish. Many people want asset protection for their nest egg while continuing to use the income and maybe the principal, to pay for their personal living expenses. For example, a retired client wants to protect his savings of $5 million from general lawsuit risks. The problem is that he needs the income to live on each year. These types of trusts are called "Self-Settled" trusts and for centuries, English and American laws have held that an individual cannot protect savings from creditors with a trust while reserving a right to use the income and/or principal for his or her own benefit. This rule certainly makes sense (at least to creditors) and reflects the dominant public policy that one should not be able to maintain full enjoyment of his property without meeting his legitimate obligations.

For those individuals who don't need the income from their savings to live on because they have an independent source of income from a business or professional practice, there are many asset protection strategies that will be successful and we have discussed some of them in previous articles. Physicians who live on the income from their practice and not on the income from their savings are usually in a good position to implement these strategies. But for those without an independent source of income, until fairly recently,

the only hope for asset protection was an offshore trust, organized under the laws of a country that legally sanctioned trusts for these asset protection purposes (See "Is Offshore the Right Asset Protection Choice?")

As these offshore trusts gained in popularity some U.S states viewed the demand for these trusts as a ripe business opportunity to provide a lucrative financial service for clients in a local setting without the uncertainty and inconvenience of foreign banking. So about 10 years ago, Delaware and Alaska and subsequently seven other states adopted laws which essentially duplicated the rules in the offshore jurisdictions by creating a category of Domestic Asset Protection Trusts (DAPT's). Simply put, under these new laws, Self Settled trusts were permitted. Asset protection could be accomplished even for trusts reserving to the Settlor a right to the income or principal, if the appropriate rules are followed. Each of these states has some differences in their laws but generally DAPT's must have at least one independent trustee located in the state of choice and any distributions to the Settlor must be approved by that trustee.

Are these DAPT's effective for asset protection? There has been a surprising lack of case law on this issue but it's probably true that if you live in Delaware or one of the other states with these laws and keep your assets and the administration of the DAPT within that jurisdiction then the legal asset protection should be strong. In the case of a bankruptcy, The Bankruptcy Reform Act of 2006 states that "Asset Protection Trusts" can be set aside by the Bankruptcy Trustee if formed within the previous 10 years with an actual intent to hinder, delay or defraud a creditor. What constitutes such prohibited "intent" is a fairly large and debatable issue but it seems likely that DAPT's created prior to the ten year period, will be respected under Federal Bankruptcy Law, even if formed with an "evil" intent. Further, for those living in other states and attempting to use a DAPT, we don't yet know whether assets in these trusts can be protected from a legal judgment and a collection action in your home state.

Recommendations

Because the laws are not yet settled on these DAPT's we generally make the following recommendations to our clients:

1. If you need to live on the current income from your savings, a DAPT is useful if you live in a state with DAPT legislation. If you live in another state then its usefulness is less certain. For a bankruptcy, however, regardless of your home state, and especially if it is formed more than 10 years from the filing, the DAPT should be respected. The most solid foundation is a DAPT combined with an offshore asset protection trust to maximize the protective attributes.

2. If you have a secure source of income from a professional practice or business and wish to protect a retirement nest-egg, the DAPT can be very successful for you. The drawbacks are that they are fairly expensive to maintain and other less expensive more flexible strategies may work just as well.

As always, please consult your local attorney and tax advisor to discuss the effect of these strategies on your particular situation.