Michigan Asset Protection Trusts

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I. What are Domestic Asset Protection Trusts (DAPTs)?

A. Introduction

A Domestic Asset Protection Trust (DAPT) is a trust created in a jurisdiction where by statute a person is permitted to create a trust and retain certain interests in the trust while limiting the ability of that person's creditors to reach the assets of the trust. DAPT are statutory creatures because at common law, if a person created a trust and retained an interest in the trust, that person's creditors could essentially ignore the existence of the trust. *In re Hertsberg Inter Vivos Trust*, 578 NW2d 289, 457 Mich. 430 (1998). At a minimum, a DAPT statute overturns the common law and permits a person to retain certain limited interests in a trust without subjecting the trust to creditor claims provided certain requirements are met. Most DAPT legislation goes further and also modifies the provisions or limitation periods applicable under that state's Uniform Voidable Transfers Act or similar law.

Michigan's DAPT statute is the Michigan qualified dispositions in trust act. MCL 700.1041 *et seq.*

B. Why Did Michigan Need DAPT Legislation?

From an estate planning perspective, Michigan needed DAPT legislation[1] in order to remain competitive with other states. For some clients, DAPTs are attractive planning techniques. Previously, if a client wanted to create a DAPT, another state's law would need to be used. This meant that the client (or the attorney) needed to work with an out of state attorney to either prepare or review the trust agreement and other documentation. The probate section was in favor of the legislation because some of the work we could be doing gets referred out to another state.

There is also an economic advantage to having DAPT legislation in Michigan. Every state's DAPT legislation requires that the trust have some presence or connection with the state typically through the use of a local trustee (or at least a local co-trustee) such as a bank or trust company in that state. Therefore, Michigan residents who were setting up DAPTs were creating their DAPTs in other states such as Delaware, Ohio, and Nevada and a result are retaining trustees and attorneys outside of Michigan in order to create and manage their DAPTs. This means that the states that authorized DAPTs were drawing trust business from Michigan.

Michigan's DAPT legislation is structured to be competitive with other jurisdictions. The hope is that Michigan may ultimately become a favorable destination for Illinois (i.e., Chicago) residents to create DAPTs.

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[1] Michigan did previously permit one variation of a DAPT. That is, if an individual created a QTIP Trust and retained a beneficial interest that follows the spouse's life interest, the trust was not considered self-settled under MCL 700.7506(4).

C. What Other Have Passed DAPT Legislation?

With passage Michigan joins 16 other states (Alaska, Delaware, Hawaii, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming) in passing domestic asset protection trust (DAPT) legislation.

At least one commentator, provides a ranking system for the various states with DAPT legislation. The most current rankings can be found at:

http://www.oshins.com/images/DAPT_Rankings.pdf

Note: the attorney who prepares the rankings, Steve Oshins, is a Nevada attorney. Not surprisingly, Nevada is almost always the highest ranked state. However, Nevada has also been aggressive in revising its DAPT legislation to stay at the forefront of legislative trends.

II. Features of Michigan's DAPT Legislation?

A. Override of Common Law

The most important characteristic of DAPT legislation is the override of the common law rule permitting a creditor to gain access to the assets of a self-settled trust.

MCL 700.1049(2) of the qualified dispositions in trusts act provides that:

> "Except as otherwise provided in this act, the interest of a beneficiary in a trust or portion of a trust that is a qualified disposition is not subject to a process of attachment issued against the beneficiary, and may not be taken in execution under any form of legal process directed against the beneficiary, trustee, trust estate or any part of the income of the trust estate, but the whole of the trust estate and the income of the trust must go to and be applied by the trustee solely for the benefit of the beneficiary, free, clear, and discharged of and from all obligations of the beneficiary."

B. Permissible Retained Interests

MCL 700.1044(2) identifies the powers that the settlor is permitted to retain in the trust. They are:

- The power to direct the investment decisions;
- The power to veto a distribution from the trust;
- A special power of appointment effective only upon the transferor's death;
- The potential or actual receipt of income;
- The potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust; and the transferor's right, at any time and from time to time by written instrument delivered to the trustee, to release the transferor's interest in that trust, in whole or in part, in favor of a charitable organization that has or charitable organizations that have a succeeding beneficial interest in the trust;
- The potential or actual receipt of income or principal from a grantor-retained annuity trust or grantor-retained unitrust;
- The receipt each year of a percentage (not to exceed 5 percent) specified in the governing instrument of the initial value of the trust property (which may be described

either as a percentage or a fixed amount) or their value determined from time to time pursuant to the governing instrument.

- The potential or actual receipt or use of principal if the potential or actual receipt or use of principal is the result of (i) a trustee acting in accordance with a discretionary trust provision, (ii) a trustee acting in accordance with a support provision, or a (iii) trustee acting at the direction of a trust protector who is acting in its discretion or in accordance with a support provision.
- The right to remove a trustee or advisor and to appoint a new trustee or advisor;
- The potential or actual use of real property held under a qualified personal residence trust, or the possession and enjoyment of a qualified annuity interest;
- The potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on income of the trust;
- After the transferor's death, the ability of a qualified trustee to pay the transferor's debts, the expenses of administering the transferor's estate, or any estate or inheritance tax imposed on or with respect to the transferor's estate, no matter the source of the qualified trustee's ability.
- The transferor's actual or potential receipt of any minimum required distributions as defined in 26 USC 4974(b) with respect to any retirement benefit.

Important Definitions for this Section
-Investment Decision: A decision regarding whether or not to purchase, sell, exchange, tender or pledge trust property. Other decisions affecting ownership or rights in any trust property, other than distribution decisions. A loan to an entity that the trust has a debt or equity interest in is an investment decision.
-Distribution Decision: A decision regarding the distribution of trust property to or for the benefit of a trust beneficiary. Also includes a decision whether or not to make a loan or guaranty a loan for the benefit of a trust beneficiary.
-Discretionary Trust Provision: EPIC section 7103
-Support Provision: EPIC section 7103

C. Qualified Trustee/Contacts With Michigan

In order to be a qualified disposition, there must be at least one qualified trustee.

A qualified trustee is:

1. A Michigan trustee: either an individual who is a resident or a corporation authorized to conduct trust business in Michigan.
2. The qualified trustee must custody all or some of the trust property in Michigan.
3. The trustee must administer at least part of the trust in Michigan.
4. The trustee's usual place of business must be in Michigan. For corporate trustee, the primary trust officer must be in Michigan. For individuals, the business office (i.e, where records are kept) must be in Michigan or the residence must be in Michigan if there is no business office.

MCL 700.1402(r).

Note: in addition to requiring a Michigan trustee the trust agreement must expressly incorporate Michigan law. MCL 700.1042(aa)(i).

D. Exception Creditors

Exception creditors are creditors who may reach the assets of a DAPT even though the common law rules regarding the settlor's creditors have been overturned. In looking at other states the primary categories of exception creditors are: alimony, spousal support, child support, preexisting torts, and governmental entities.

Alimony and Spousal Support. If the DAPT was created more than 30 days prior to the marriage, the trust is not subject to division in the event of divorce.

Child Support. If the transferor is more than 30 days behind on child support at the time of the transfer, the transfer is not a qualified disposition.

Preexisting Torts. There is no exception for pre-existing torts.

Government Entities. There is no exception for government entities.

E. Statutes of Limitations/Burdens of Proof

The primary method for creditors to attack a DAPT is through an argument that the statute is a fraudulent transfer under the Uniform Fraudulent/Voidable Transfer Act. Under those acts, a transfer can be set aside or voided if the transfer was done with actual intent to defraud creditors or with constructive intent to defraud. *See*, Mich. Comp. Laws § 566.34. Michigan's statute addresses UFTA/UVTA in several ways.

First, Michigan's statute provides that a challenge under UFTA/UVTA is the only way to challenge a transfer to a DAPT. MCL 700.1045(2).

Second, for a claim that arose after the qualified disposition, the creditor must show actual intent to defraud.

Third, the limitations period is shortened. The general limitations period for challenges under UFTA/UVTA is 6 years. However, for qualified dispositions the period is 2 years for an existing creditor (with a one year discovery rule) and two years for future creditors.

Fourth and most importantly, Michigan's statute bars claims or causes of action against the trustee, advisor to the trustee and ***"a person involved in the counseling, drafting, preparation, execution, or funding of a trust.***" MCL 700.1045(7)(c).

F. Tenancy By the Entireties

If husband and wife create a qualified disposition, and transfer property that was previously held as tenants by the entireties that property will remain entireties property.

G. Other Features

If more than 1 qualified disposition is made, each disposition is treated separately. In other words, a later qualified disposition that fails for one reason or another does not impact the validity of the prior disposition. MCL 700.1045(8)(a).

If more than 1 qualified disposition is made, distributions are considered to be made from the most recent qualified disposition. MCL 700.1045(8)(b).

There is a flee provision. If a court declines to apply Michigan law, the trustee is immediately disqualified. MCL 700.1045(9).

A debtor and creditor may contractually limit the debtor's ability to create a qualified disposition, but those limitations only apply as to that creditor. MCL 700.1045(11), (12).

H. Other Documents Or Requirements

In addition to the Trust Agreement itself, MCL 700.1046 provides that the transferor shall sign an affidavit that:

- The transferor has title and authority to transfer the property to the trust;
- The transfer will not render the transferor insolvent;
- The transferor does not intend to defraud a creditor by transferring the property to the trust;
- The transferor is not aware of pending or threatened litigation or administrative proceeding against the transferor, except for the items identified in the affidavit;
- The transferor is not more than 30 days behind on child support;
- The transferor does not contemplate filing for bankruptcy; and
- The property was not derived from unlawful activities.

Affidavits are not required:

- For a fiduciary qualified disposition (i.e., trustee decanting)
- From a transferor who is not the settlor, unless the transferor is a beneficiary and the transferor has not already provided and affidavit.
- A transferor that is part of a prior qualified disposition and supported by an affidavit.

Failure to provide an affidavit may be used as evidence in a proceeding by the creditor, but the validity is not affected in any other way.

III. What Happens if Creditor Successfully Challenges

A disposition may only be avoided to extent necessary to satisfy or provide for the present value taking into account uncertainty of the debt. Technically, the transfer is not avoided but trustee is to transfer assets to the beneficiary sufficient to satisfy award.

Except with regard to tenancy by the entireties property, the creditor's sole remedy is an order directing the trustee to transfer funds to satisfy the creditor.

If tenancy by the entireties, the only remedy is order to transfer to husband and wife as tenancy by the entireties.

As long as trustee has not acted in bad faith, the trustee has a lien for its administration expenses and defense costs and those are paid before the creditor.

IV. What Clients are Potential Candidates for Asset Protection Trusts

Asset protection trusts are not for every client.

First, a key component of a DAPT is that the settlor has to give the assets away. Although DAPT legislation permits a client to retain some interests/powers over the Trust, the client does not have the unfettered right to get the assets back. Therefore, a client who does not

have excess funds is not a candidate for a DAPT. Of those clients with excess funds many of them will not be willing to give up enough control to create a DAPT.

Second, given the cost and expense involved in establishing a DAPT, the transfer should probably be relatively significant. If a corporate trustee is being considered, the Trustee's fee schedule should be considered when determining the size of the transfer. This consideration may be mitigated somewhat if you are using an individual as opposed to a corporate trustee. However, an individual trustee's ability to comply with the requirements of a DAPT should be considered. Also, if the DAPT is challenged, a court may be more likely to view a trust with a close friend or relative as a trustee as a sham than one with a third party trustee.

Third, the purpose of DAPT legislation is to permit a trust to be protected from creditors. Therefore, a person who has no creditor concerns (or whose children have no creditor concerns) may not need a DAPT. That said, a DAPT is a useful device to set aside a reserve in the event the family's fortunes take a turn for the worse.

With those concerns in mind, the following are the types of clients for whom a DAPT might be appropriate:

- Physicians,
- Executives (particularly executives who sign financial statements);
- Business owners (particularly owners who have guaranteed corporate debt);
- Celebrities and athletes;
- Aircraft owners/pilots;
- Watercraft owners;
- Real estate developers; and
- Individuals contemplating marriage.

V. Backstop to Prenuptial Agreement

On January 31, 2017, the Michigan Court of Appeals released its decision in Allard v. Allard, COA No. 308194 (January 31, 2017). Although the full scope of the decision is unclear, there is language that suggests that the parties to a prenuptial agreement may not waive the court's equitable power to adjust the division of property. However, a qualified disposition created and funded more than 30 days before the marriage is not subject to division.

VI. Discussing Asset Protection Trusts with Client

A. Discussing Whether a DAPT is Appropriate

Clients need to have a realistic understanding of what a DAPT can and cannot do.

1. **A DAPT Means Giving Up Control.** The client must actually transfer assets to the DAPT and cannot demand the assets return. Nor can there be a side that the trustee will return the assets on request.

2. **A DAPT Is Not Bulletproof.** Clients need to understand that DAPTs are not guaranteed. Creditors can challenge the DAPT under UVTA if it has not been in existence long enough. Moreover, although DAPT legislation may provide for a shortened limitations period, the bankruptcy code has a 10 year lookback period on

DAPTs. 11 U.S.C. § 548(e)(1).[2] In addition, there is relatively little case law interpreting DAPTs and their effectiveness.

The client should think of a DAPT as a negotiation tool rather than bulletproof vest. Much of asset protection planning is creating hurdles a creditor to overcome so that the creditor is willing to take less than the full amount owed to settle a debt.

3. **Explore Potential Creditor Exposure**. It is important to determine whether the client is concerned about existing creditors or merely possible future creditors. Given the statute of limitation issues, a DAPT is much more likely to succeed in dealing with future creditors than current creditors.

4. **Explore Other Creditor Protection Techniques**. Ask about the client's insurance. Homeowners, auto, professional and umbrella insurance are the first line of defense. How are assets held? Retirement accounts and tenancy by the entireties property are already protected. For assets not already held in a protected form, the shortened limitations period for a DAPT is a benefit to weigh.

B. Gathering Information

Once the client has decided to create a DAPT you will need to gather information. You will need to obtain the following information:

1. **Asset Information**. Obtain detailed information about the client's assets. You need to know the assets being transferred to the trust as well as the assets remaining outside of the trust. In addition to the values, you will want to look at the types of assets both inside and outside of the DAPT. The client needs to have sufficient resources outside of the DAPT so that the client will not need the DAPT assets to maintain lifestyle. Also, I would not recommend only leaving exempt assets outside of the DAPT.

   Pay attention to asset location. You want as many contacts with Michigan as you can create. I have physically sent stock certificates and membership certificates to the Trustee.

   Pigs get fat, hogs go to market. In funding a DAPT, the client should keep in mind that the goal of the DAPT is to establish a reserve for the settlor to fall back on if there is a financial reversal.

   Before transferring closely-held assets, review the governing documents to make certain that the transfer to the DAPT is permitted. Also, directors and officers likely

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[2] Section 548(e)(1) provides that:

> In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property 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.

have disclosure obligations for any transfers of their company's securities. Highly regulated industries, such as gaming and alcohol, may have additional reporting or disclosure requirements.

2. **Liability Information**. It is probably more important to be diligent in gathering liability information than asset information. The client's situation needs to be examined for the following issues under UVTA:

- Is the sum of the clients debts greater than all of the assets at a fair valuation?
- Are the debts being paid as they come due?
- Will the transfer cause the value of the debts to exceed the value of the remaining assets?
- Will the transfer impair the ability of the client to pay debts as they become due?
- Does the client anticipate incurring any debts in the future?
- Has the client recently obtained additional loans or credit? If so, what assets were disclosed in obtaining that credit?
- Has the client guaranteed any debts?
- Is the client the subject of any pending or threatened litigation?

Review the applicable loan agreements and guaranties. Make certain the client is complying with all covenants and disclosure requirements.

C. Picking a Trustee

Some factors to consider in selecting a DAPT trustee

- Will an individual properly administer the trust?
- Does the client have a significant debt relationship with the financial institution? If a claim is made against a DAPT, the client should certainly hope that the trustee vigorously defends against the claim. Even though the trust company and lending arm may be different entities, if a client has a lot of debt with particular financial institution a different financial institution may make more sense as the trustee of the DAPT
- What are the corporate trustees fees? The client may want to investigate a few institutions to compare fees and services.
- How much experience does the trustee have with DAPTs?

VII. Representing Creditors

Creditors need to prepare for and deal with the issues raised by DAPTS.

A. Are The Assets Available?

Creditors need to recognize that assets held in a DAPT are not likely to be available to satisfy the creditor's claim. This raises two questions for the creditor. First, if the borrower has disclosed that some assets are held in trust, it is likely incumbent upon the borrower to ask follow up questions to determine the nature of the beneficiary's interest in the trust and whether the trust is a DAPT. Second, if the creditor is relying upon the borrower's assets for future repayment of the loan, the creditor will need a mechanism in place to require the borrower to report any future transfers to a DAPT.

B. **Recognize the Shortened Limitations Period.**

Creditors need to recognize that they only have 2 years to challenge a DAPT outside of bankruptcy. Therefore, in the event of a breach or default the borrower may need to act more expeditiously to protect its rights than in the past.

C. **Proactive Planning**

Some actions lenders may contemplate taking to protect themselves include the following:

- If assets are identified on a balance sheet as held in trust, follow up may be necessary to confirm that the assets are not held in a DAPT.
- If a customer discloses a transfer to a trust, follow up to determine the nature of the trust.
- Review loan agreements and consider revising them to address the possibility of a client having or creating a DAPT.
- If the borrower's assets are considered a significant source of repayment but the assets are not subject to a lien, consider adding language imposing an obligation on a borrower to disclose any transfers to DAPTs.
- It may be possible to require advance approval of any transfers to a DAPT. However, other than in troubled loan situations that may not be palatable to borrowers.
- The contract or loan agreement should provide that the failure to provide required notice of a DAPT transfer is a breach or event of default.
- Be aware of the possibility of shortened statutes of limitations. If a borrower is in trouble or is in a workout, the due diligence should include looking for any evidence of a transfer to a DAPT.
- If a transfer to a DAPT has occurred, it is essential to determine what state's law applies as that may reduce the applicable statute of limitations.

VIII. **Case Law**

I am only aware of 4 US cases interpreting DAPT statutes. In two of them the creditor was successful in challenging the DAPT. Those cases are a lesson in what not to do.

Battley v. Mortensen, 2011 Lexis 5560 (Bankr. D.C. Alaska 2011). Mortensen was an Alaska resident, but was not an attorney. He drafted the "Mortensen Seldovia Trust (An Alaska Asset Preservation Trust)" by himself. At the time Mortensen prepared the Trust he had income of about $60,000 per year. Mortensen transferred his only assets (real estate in Seldovia worth approximately $60,000) to the Trust. The trustees were his brother and a personal friend and his mother was the trust protector. Around the same time, his mother gave him checks totaling $100,000. Mortensen used $20,000 to pay of some debts and deposited the remaining $80,000 in the trust. At the time he created the trust he had approximately $50,000 to $80,000 in credit card debt. Four years later the credit card debt had ballooned to $250,000 and the money from his mother was gone.

The bankruptcy court found that the trust was valid under Alaska law and that Mortensen was not insolvent at the time the trust was created. However, the court found that the transfer to the trust should be set aside under 11 USC § 548(e) which provides a 10 year period to set aside a transfer that is:
1) Made to a self-settled trust or similar device;

2) by the debtor;
3) the debtor is a beneficiary of the device; and
4) the transfer was made with the actual intent to hinder, delay, or defraud.

The Trust Agreement provided that the trust's purpose was "to maximize the protection of the trust estate or estates from creditors' claims of the Grantor . . . and to minimize all wealth transfer taxes." Id. at *18. Mortensen argued that Alaska's statute prohibited the use of the settlor's expressed intention to protect trust assets as evidence of intent to defraud. The bankruptcy court disagreed and held that "a settlor's expressed intention to protect assets placed into a self-settled trust from a beneficiary's future creditors can be evidence of an intent to defraud." Id., at *19.

Not surprisingly, the Court also found ample other evidence of an intent to defraud in Mortensen's poor economic circumstances.

In re Huber, 493 B.R. 798 (Bankr. W.D. Wash. 2013). Don Huber was a real estate developer in Washington. The real estate projects were typically owned in an entity but Huber was frequently required to guaranty the loans.

On September 4, 2008, Huber created DGH, LLC an Alaska limited liability company and transferred most of his assets, including his personal residence (through another Alaska company), to DGH, LLC. On September 28, 2008, Huber created an asset protection trust and transferred his interests in DGH and other assets to the trust. He transferred essentially all of his assets to the trust. The only asset actually held in Alaska was a $10,000 certificate of deposit. Huber's son, Kevin, and Alaska U.S.A. Trust Company (AUSA) were the Co-Trustees.

Huber filed for bankruptcy on February 10, 2011. From its creation through the bankruptcy the trust made substantial distributions to Huber and his family. The bankruptcy trustee alleged that Kevin never turned down a distribution request and that AUSA did not participate in the preservation or protection of the trust property.

The bankruptcy trustee sought summary disposition arguing that the trust was not valid as a self-settled asset protection trust under Washington law, 11 USC 548(e), and Washington's fraudulent transfer act. The trustee won on all counts. Of particular note, the bankruptcy court found that Washington law applied instead of Alaska despite the trust's designation of Alaska law. The court found that the trust did not have a substantial relation to the trust in large part because the assets were not located in the state.

Interestingly, after the trust was created Huber's relationship with one of his partners soured and when that partner threatened to create an asset protection trust, Huber replied in an email that doing so would be fraudulent as to Huber because Huber considered himself Terhune's creditor.

In re Reuter, 499 B.R. 655 (Bankr. W.D. Mo. 2013). The court upheld the spendthrift protections for debtor who had created an irrevocable trust with his spouse.

In TrustCo Bank v. Mathews, Del. Ch. 8374-VCP (January 22, 2015), the Delaware Chancery Court declined to apply New York's statute of limitations in a challenge brought against three asset protection trusts. The trusts were created by a New York resident in 2006 with additional transfers taking place in 2007 and 2010. The settlor had guaranteed loans for the construction of a storage facility in Florida. Under conflict of laws principles, the Chancery Court found that Florida or Delaware law would apply.

IX. Conclusion

Although DAPTs are not for everybody, they can be a valuable tool in the right circumstances. Done correctly, a DAPT is a great technique to set aside a reserve of funds for the settlor and the settlor's family to fall back upon in the event a financial disaster occurs.

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