THE DOMESTIC ASSET PROTECTION TRUST

COMBINING IT WITH THE DOUBLE LLC STRATEGY

STEVEN J. OSHINS

A domestic asset protection trust (DAPT) is an irrevocable trust established under the special laws of one of the limited number of jurisdictions that allow the settlor of the trust to be a discretionary beneficiary and yet still protect the trust assets from the settlor's creditors. If such a trust were set up under the laws of a non-DAPT jurisdiction, the general rule is that the settlor's creditors can access as much of the trust as can be distributed to the trust settlor.

Each DAPT jurisdiction has a statute of limitations period that determines how long is necessary between the date of transfer to the DAPT and the date on which the transferred asset will be protected from the settlor's creditors. The number of years required before the assets are protected varies from state to state. The statute of limitations also differs for preexisting creditors versus nonpreexisting creditors. Generally, the statute of limitations period tolls for preexisting creditors to protect these creditors.

All the states except Nevada have certain "exception creditor" statutes that allow certain classes of creditors to access the trust assets even though most creditors are barred by statute from accessing the DAPT assets. For example, many states provide an exception for divorcing spouses. Many states extend this exception to alimony claims as well. A number of states have a statute that makes a child support creditor an exception creditor. Many states have an exception creditor statute for preexisting tort creditors. Some of the states have other types of exception creditors. As noted, Nevada is the only state that does not have any special classes of creditors that can pierce through the DAPT.

Stacking the Odds in Favor of the Debtor

The first DAPT statute was enacted in 1997. So far, not a single DAPT has been tested all the way through the court system. Presumably, this is because nearly everybody believes that the DAPT will ultimately stand up if and when it is tested. For a resident of a state that has a DAPT statute, there is no question that a properly formed and funded DAPT will work if tested. For a nonresident, however, there is still a question about whether it will ultimately work to protect the assets if the plaintiff refuses to settle the case and is determined to go through the court system.

Many practitioners fail to recognize that an asset protection plan is considered successful if it either (1) causes the potential plaintiff to avoid filing a lawsuit altogether or if it (2) causes the potential plaintiff to settle the dispute for less money than the amount that would have been owed on the debt. A misconception among many estate planners is that certainty is required before embarking on the use of a particular technique. These same estate planners generally end up doing no asset protection planning for their clients. In the case of doing nothing, there is a certainty—a certainty that the client will have no protection from creditors.

No technique has a 100% probability of success. It is the estate planner's job to use the tools that are available and to combine them in such a way that the odds are stacked in favor of the client. This article describes a way to combine the DAPT with two LLCs or LPs to better protect the underlying assets.

Charging Order Protection of LLCs and LPs

It is prudent to use multiple asset protection techniques to create as many walls around the assets as possible to further frustrate a potential creditor. Thus, even if the creditor is able to break through one wall, the creditor would still need to break through the next wall.

People often form LLCs and LPs to protect the underlying assets of the business entity from creditors of the members or partners. The assets are protected because the creditor gets a charging order over the membership interest or partnership interest. This article will reference LLCs throughout, but note that LPs can be used in place of LLCs in most cases.

A charging order is simply a lien. It is important to establish the LLC in a jurisdiction where the charging order

Steven J. Oshins is a principal in Oshins & Associates in Las Vegas, Nevada.

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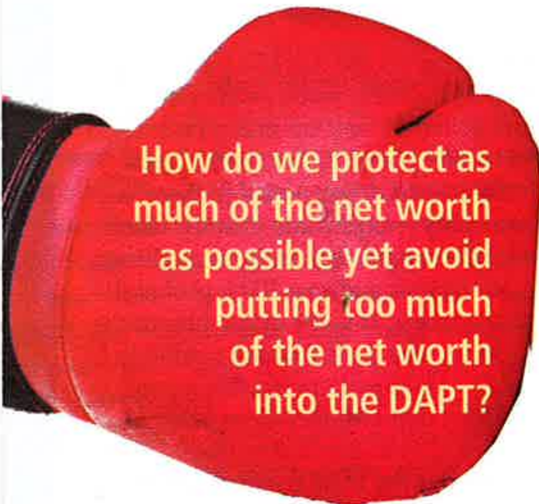
is the exclusive remedy of a judgment creditor. Because it is the exclusive remedy, this means that the creditor cannot make any investment decisions or force any distributions. Thus, the creditor has nothing more than a nearly worthless piece of paper giving the creditor a pro rata part of any member distributions if any are made. Because the debtor has control over distributions, the debtor will not make any distributions given this scenario.



It is also helpful to establish the LLC in a jurisdiction where the statute specifies that no equitable remedies can apply. Otherwise, it is possible that a judge will circumvent the charging order remedy by using an equitable remedy such as an alter ego theory, reverse veil piercing, a constructive trust, or a resulting trust.

Notwithstanding the foregoing, it is important to note that it is not clear which state law will apply for charging order purposes. It is always possible that a litigator will convince the court that it should apply its local charging order law rather than applying the more favorable law of the state where the LLC was formed. At a minimum, the use of a jurisdiction with favorable charging order laws gives the debtor significantly more negotiating leverage than the debtor would have if the charging order were not the exclusive remedy, so it makes sense in most cases to forum shop for the best jurisdiction to use to establish the charging order protected entity.

The charging order protected entity protects its underlying assets, but it does not protect the member's "lifestyle" because the member cannot take a distribution given that the distributions would go to the creditor. Thus, it is a very strong tool, but it is not the end-all of asset protection planning. This is why it is prudent to combine it with a DAPT—so the beneficiaries can safely live out of the trust, which receives distributions from the LLC without any interference from the creditor.

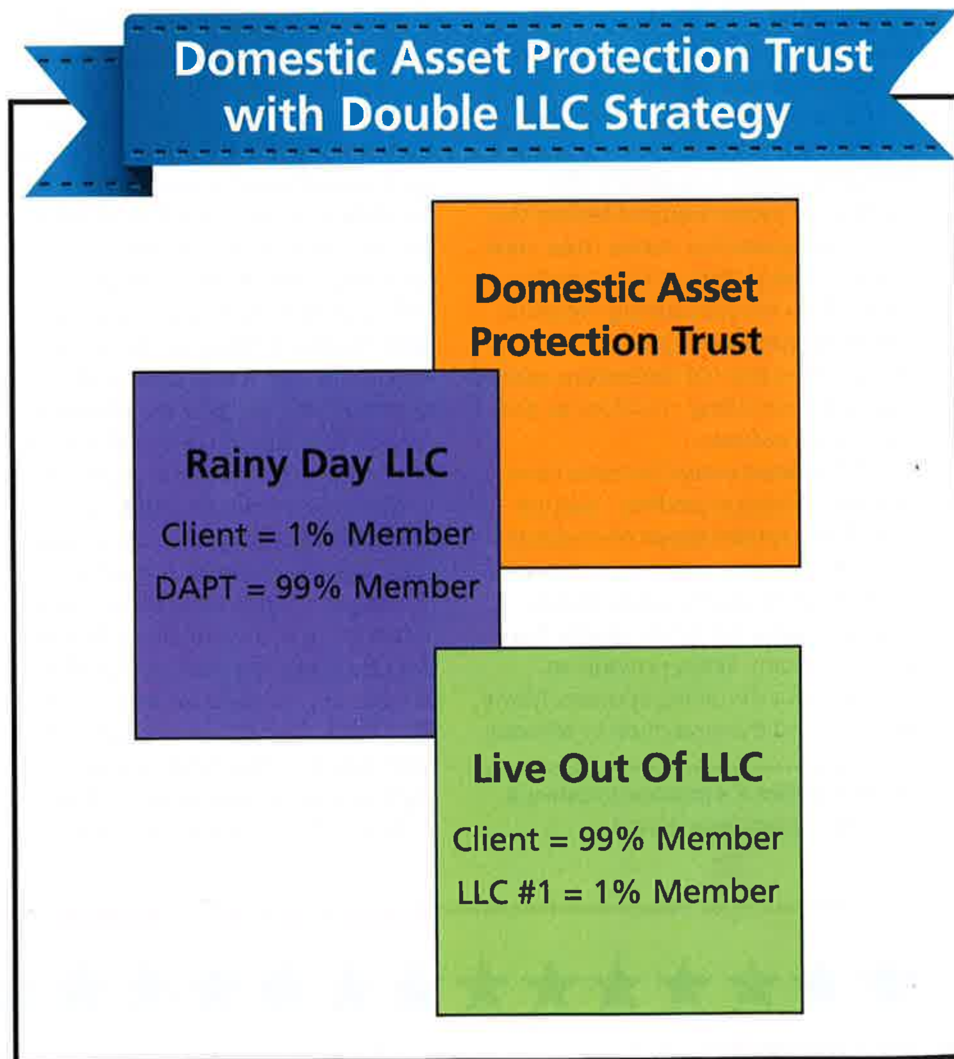
Thus, this article will describe a technique that combines the spendthrift protection of the DAPT with the charging order protection of the LLC.

The DAPT/Double LLC Combination

It is important not to transfer too great a percentage of a client's net worth into the DAPT. Otherwise, it is much more likely that a judge will find a fraudulent conveyance. This creates a predicament, however: how do we protect as much of the net worth as possible, yet avoid putting too much of the net worth into the DAPT?

Most asset protection planners use a structure in which the client owns 1% of the LLC (or LP) and the DAPT owns the other 99% of the LLC (or LP). They transfer a reasonably large percentage of the net worth into the entity, and they leave the balance of the assets in the client's hands, where those assets are exposed to potential creditors. The DAPT/Double LLC combination goes one step further by protecting the assets left out of the DAPT by using the charging order to help settlement negotiations.

More specifically, the general structure is as follows: LLC #1 is owned 1% by Client and 99% by the DAPT. This LLC is called the "Rainy Day



By combining the DAPT with the Double LLC strategy, the client should be in a much stronger position to negotiate a more favorable settlement or not have to face the creditor at all.

LLC" because 99% of it is owned by the rainy day DAPT. LLC #2 is owned 99% by Client and 1% by LLC #1. This LLC is called the "Live Out Of LLC" because 99% of it is owned by Client. Some of Client's assets are transferred to the Rainy Day LLC and some to the Live Out Of LLC.

As long as Client has not been sued and does not have a charging order against any of his interests, he can freely live out of the cash flow from distributions from the Live Out Of LLC by distributing 99% of the distribution to himself. But once Client has been sued, and assuming the two-year statute of limitations has passed (assuming Nevada law, but four years in most other DAPT jurisdictions), the judgment creditor will have a 1% charging order over the Rainy Day LLC and a 99% charging order over the Live Out Of LLC. At this point, Client would stop making distributions from the Live Out Of LLC (because the creditor would get 99% of the distributions) and instead would start making distributions from the Rainy Day LLC (because the creditor only gets 1% of those distributions). Because 99% of the distribution is made to the DAPT, Client can essentially live out of the DAPT like a self-created "trust fund baby."

Notwithstanding the ability to live out of the DAPT like a trust fund baby, the settlement negotiation should be in Client's favor given that Client can let the creditor know that Client does not need any assets from the Live Out Of LLC soon because there are sufficient assets in the Rainy Day LLC to live off of for some time. This will certainly expedite the settlement negotiation. Needless to say, the creditor is not going to want to try to bust through two walls—the charging order wall of the LLCs and the spendthrift trust wall of the DAPT. Therefore, this structure puts Client in a position to negotiate a very favorable settlement or avoid a lawsuit altogether.

The Hybrid Domestic Asset Protection Trust

The Hybrid Domestic Asset Protection Trust ("Hybrid DAPT") is a strategy that should increase the probability that the trust assets will be protected. The Hybrid DAPT is just like a regular DAPT except that the settlor is not an initial discretionary beneficiary of the trust but can be added later by a friendly, yet independent, trustee. Thus, the trust is initially set up for the benefit of the settlor's spouse and descendants, for example, but not for the settlor. By not including the settlor as a beneficiary of the trust, the Hybrid DAPT is by definition a third-party trust and therefore almost certainly avoids the potential risk of uncertainty of a regular DAPT.

Especially when the settlor is married and has a strong, trusting relationship with his spouse, is there any good reason that the settlor must have his name in the trust agreement as a beneficiary? It is very simple to indirectly access the trust assets through the spouse. And the trust agreement should define the "spouse" using a "floating spouse provision" that defines the spouse as the person the settlor is married to and living with from time to time. This gives the settlor the ability to access the trust assets through a subsequent spouse in the event of a divorce or the death of the settlor's spouse.

Summary

By combining the DAPT with the Double LLC strategy, the client should be in a much stronger position to negotiate a more favorable settlement or not have to face the creditor at all. This structure can be enhanced by drafting the DAPT as a Hybrid DAPT. The knowledgeable estate planner understands that "doing nothing" is not an option and that, although no asset protection strategy is 100% bulletproof, a well-designed structure will stack the odds in favor of the debtor. ■

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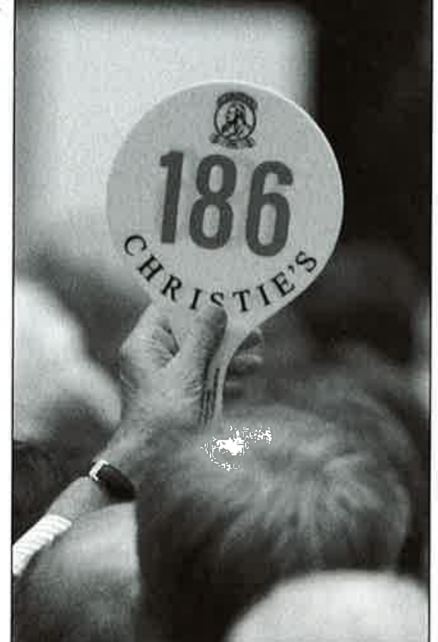

Contact
Tash Perrin
tperrin@christies.com
+1 212 636 2058

20 Rockefeller Plaza
New York, NY 10020

christies.com