Divorce and the Self-Settled Trust

Insights into how—and where—clients might protect their trust assets from financial risks of a future divorce

Before clients marry, or during a stable marriage, estate-planning attorneys may want to suggest that, as a responsible steward of the family’s wealth, the client consider the creation of a “self-settled” (as defined in this article) trust under the laws of a jurisdiction (for example, a state that’s enacted domestic asset protection trust (DAPT) law) that will shield the trust assets from unexpected creditors. Using trusts to hold a nest egg (whether offshore or domestic) can be effective in protecting assets at a time of a client’s later divorce or other creditor situations, if done with the proper motives, guidance, timing and appropriate jurisdictions.

It’s key, however, that the client be made aware that these protections aren’t absolute; there could always be the possibility that a court in a client’s home state may apply its own state laws in determining the availability of a trust’s assets, in a divorce proceeding in light of that court having authority to rule on matters within its jurisdiction. (See “Important Caveat,” below.)

General Rule
Most states don’t recognize any protection of assets in a trust created by a person (the “settlor”) for his own benefit (that is, a self-settled trust). Such self-settled trusts, therefore, do little to shield against a spouse who seeks to bring those assets to the table in divorce negotiations.

There are some anomalous cases. Take, for example, In re Marriage of Pooley, in which the Colorado Court of Appeals concluded that a creditor spouse couldn’t reach the corpus or income of a discretionary trust created by the debtor spouse, even though that spouse was also a beneficiary of the trust.

In that case, Barbie Pooley had contributed marital assets to a trust of which she was a beneficiary. Her parents were the trustees, with total discretion over making distributions to Barbie. During divorce proceedings from her husband, Douglas, he sought to have the trust assets included in the marital assets that would be divided. The court held that because Barbie had no right to distributions from the trust, the trust property wasn’t to be considered her property at all, let alone marital property subject to division. Therefore, Douglas couldn’t obtain any of the trust assets.

Nevertheless, the court had the authority to consider the trust as a resource to her, thereby allowing the court to assign more of Barbie’s other property to Douglas as part of the equitable distribution of assets in the divorce.

Safer Jurisdictions
Over a dozen states have laws that not only allow an individual to create a trust for his own benefit, but also to have an enforceable spendthrift provision preventing the settlor’s creditors from accessing the trust’s assets to satisfy the settlor’s debts or other financial obligations.

The 13 states that clearly provide some DAPT protection are: Alaska, Delaware, Hawaii, Missouri, Ohio, Nevada, New Hampshire, Rhode Island, South Dakota, Tennessee, Utah, Virginia and Wyoming. Some argue that two others—Colorado and Oklahoma, should also be viewed as DAPT states.2

A number of these DAPT states (as discussed below) still allow an ex-spouse to penetrate a self-settled trust to satisfy alimony/maintenance, child support and/or property settlement claims. These exceptions to the DAPT protections are known as “exception creditor” claims.
The settlor/beneficiary could consider forming an APT in one of the more protective DAPT states to afford protection for those trust assets in the case of the settlor’s later divorce. It’s important to note, however, that depending on the law of a particular state, such a trust can only be established either well before entering into the marriage or during a stable marriage. These self-settled spendthrift trusts can’t be formed and funded in anticipation of a foreseeable divorce.

Moreover, each DAPT state has a statute of limitations that must run before a creditor is precluded from challenging a transfer to the DAPT as a fraudulent transfer. If a creditor in those situations can show that the settlor anticipated or already had pending a claim, such transfers may be set aside.

State Roundup
Here’s a roundup of DAPT states that offer some protection against the marital and child support claims mentioned above. Alaska, Nevada and Utah are often cited as the strongest, protection-wise, with regard to such possible claims.

Alaska. Its DAPT laws provide that a divorcing spouse isn’t allowed access to the assets in a self-settled spendthrift trust created by the other spouse, other than for child support obligations 30 days or more in default at the time of a transfer to the trust.

Also, a surviving spouse will have a right to elect against the settlor’s estate at the time of the settlor’s death (that is, take an elective share). Elective shares, in general, allow a surviving spouse to choose to receive a percentage of the deceased spouse’s estate assets in lieu of what the deceased spouse may have intended. Alaska law may expose the DAPT to such a claim.

Property settlement claims won’t affect the trust assets unless the settlor was:

1. married at the time of funding the trust; or
2. married within 30 days after funding the trust.

In the latter case, the trust assets can still be shielded against any property settlement if the settlor provides written notice to the spouse of such funding.

Alaska also adopted Alaska Statute Section 34.40.113, which states that a beneficiary’s “discretionary interest” in an irrevocable trust isn’t a property interest or enforceable right. It’s a mere “expectancy” that may not be attached by creditors. Furthermore, the trust can pay the settlor’s expenses without interference by any creditor.

Delaware. A spouse can reach the DAPT assets only with respect to claims for alimony and property division in a separation or divorce action that’s brought by the spouse who was in existence at the time of transfer to the DAPT. Delaware law defines “spouse” as only the person to whom the settlor is married at the time of or before the transfer of assets into the trust. Therefore, allowed spousal claims encompass only those made by such existing or pre-existing spouses. Notwithstanding this restriction, child support claims can be brought against the trust assets.

Hawaii. Exception creditor claims under Hawaii law include claims for child support and maintenance only if the spouse existed at the time of transfer.

Missouri. Missouri falls in the not-so-protective DAPT category. In Missouri, DAPTs simply aren’t protective against child or spousal support claims.

Nevada. This state’s law is frequently cited as providing the strongest protections. In the right circumstances, one can form a self-settled APT in Nevada, which doesn’t permit an ex-spouse to access the trust, assuming no fraudulent transfers were involved.

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New Hampshire. The only spousal claims allowed
pertain to a spouse existing on the date of the transfer to the trust. No protection exists, however, against child support claims. Also, a surviving spouse can claim the elective share against the trust to the extent it was funded for the purpose of defeating an elective share right.

**Ohio.** Similar to Delaware, Ohio protects trust assets from a spouse, provided the settlor wasn’t married at the time of funding. Child support claims aren’t protected.

**Oklahoma.** The state laws provide that the spouse has no access to the trust assets. Child support claims, however, can gain access to the trust assets.

**Rhode Island.** The DAPT law protects the trust assets against any support and alimony claims that didn’t exist at time of funding. This is also true for any property settlement claims if the spouse wasn’t married to the settlor on or before the time of transfer.

**South Dakota.** The law doesn’t protect the DAPT assets from alimony or support claims, provided that the claim existed at the time of transfer. Property settlement awards aren’t protected if such action is brought by a spouse who was married to the settlor on or before the date of the transfer. Furthermore, a surviving spouse may be able to assert an elective share claim against the DAPT.

**Tennessee.** This state’s DAPT law doesn’t protect trust assets against child support claims. Tennessee doesn’t provide protection against alimony and other spousal claims if the spouse existed at the time of the transfer to the trust.

**Utah.** Being a very protective DAPT state, Utah provides protection of the DAPT assets against spousal and support claims.

**Virginia.** This state’s law isn’t totally protective in that the Virginia DAPT will be subject to child support claims.

**Wyoming.** This state ranks fairly high amongst DAPT jurisdictions. Wyoming DAPT law protects trust assets from both spousal and child support claims, even those that are 30 days or more in default.

**Important Caveat**

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For example, if a non-DAPT state court judgment states that the trust is an alter ego of the settlor or something along those lines, such as viewing the trust as an agent or nominee of the settlor, then the court would need to compel the trustee to make distributions to satisfy the judgment against the settlor. Can a court do that without jurisdiction over that trustee?

Perhaps the answer lies in the Full Faith and Credit clause of the U.S. Constitution. Generally, under that clause, one state must give deference to another state’s judgment. For example, would a Nevada court need to honor an Illinois court ruling that the trust is merely an alter ego or agent for the client; therefore, the trust assets actually belong to the settlor? Would the answer to this question depend on whether the Illinois court has jurisdiction over the Nevada trustee? These are some of the issues that call into question the asset protection strength of a DAPT.

Also, the forum court may look at the applicable “conflicts-of-law” factors that suggest which state law should apply. The DAPT law designated in the trust instrument may not be dispositive. A court may consider which laws were intended to apply by the parties. If the settlor was divorced in a non-DAPT state, this may indicate that the “parties” intended non-DAPT law to apply to the divorcing parties’ rights. Also, the beneficiaries’ state of domicile or the location of the trust assets could affect which state law applies. Public policy considerations can also result in the forum court applying its own laws. This occurs when the forum state determines that it has strong public policy views that self-settled trusts shouldn’t be protected. The bias appears to be that a forum court will lean toward applying its own laws
versus the law designated in the trust instrument when it comes to creditors’ rights.

In fact, case law has developed in which non-DAPT forum courts take the view that DAPTs are invalid. For instance, in the recent case of In re Huber, a Washington court held that Washington law controlled in a situation in which a Washington-domiciled settlor created an Alaska self-settled trust. The court cited Restatement (Second) of Conflicts of Laws (Section 270), which provides that a trust is valid

if valid (a) under the local law of the state designated by the settlor . . . provided that this state has a substantial relation to the trust and that the application of its law doesn’t violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship.

Two other cases have also been cited to support the same conclusion. One is Kilker v. Stillman, although that was more of a fraudulent transfer case. The other is Rush University Medical Center, Appellant v. Roger Sessions et al., Trustees, Appellees, finding self-settled trusts, no matter under what jurisdiction they were created, to be void as to creditors under Illinois law. Therefore, such view, coupled with the fact that trust assets were significantly comprised of real estate located in the United States, resulted in a court opinion that made the creditor’s access to such assets a realistic possibility.

Conversely, the case of Dahl v. Dahl, which involved a Nevada DAPT, has created arguments that the law designated in the trust instrument controls (but, keep in mind that Dahl was only a Utah district court level case and that both Utah and Nevada are DAPT states). This case involved a Utah ex-wife attempting to reach the assets in a Nevada DAPT created by her ex-husband while they were married. She was denied any access to the trust assets, applying Nevada law.

It’s interesting to note, however, that when this case evolved, Utah DAPT law didn’t protect trust assets from a spouse; yet, it followed Nevada law, which did protect trust assets from a spouse.

Fraudulent Transfers

Regardless of state law, if the trust is funded at a time when the settlor has any claims pending, threatened or expected, the trust assets won’t be protected. Those transfers are referred to as “fraudulent transfers” or “fraudulent conveyances.”

If a future creditor is unknown and unexpected, then this isn’t, generally, the type of creditor that can make a successful claim of fraudulent transfer (for example, a person injured in a car accident subsequent to funding the trust). However, in the divorce context, if a trust is created at a time when the settlor is contemplating or anticipating that a divorce could be on the horizon, the transfers to that trust can be unwound, forcing the trust assets to be accessible to the other spouse. Also, if the transfers to the trust leave the settlor virtually insolvent, those transfers can be undone. It’s critical that any funding of the trust be accomplished at a time and in a manner that doesn’t fall within a fraudulent transfer scenario.

If a settlor seeks stronger protection or protection from the remote possibilities that non-divorce related claims could arise someday, then an offshore trust may be the better vehicle.

For example, in the Colorado case of Kaladic v. Kaladic, in anticipation of a divorce, a spouse funded a trust for her own benefit as an attempt to remove the assets from the reach of a court’s power to direct how the property would be divided in the divorce action. This case involved a self-settled trust. The court, however, focused only on the fraudulent transfer aspect of the trust to expose its assets to marital division. Kaladic would likely have had the same outcome if a settlor in a DAPT state had created the trust, even if the settlor resided in that state.

Offshore Trusts Option

If a settlor seeks stronger protection or protection from the remote possibilities that non-divorce related claims could arise someday, then an offshore trust may be the better vehicle.

One reason for this becomes apparent in the case of
a forum court choosing its own law over the law designated in the trust instrument (as discussed above regarding conflicts of law and courts finding the DAPT state’s law as not being applicable). If the forum court applies its own law, the foreign jurisdiction, in applying its laws to the assets held offshore by the offshore trust, may very well be able to disregard the forum court’s application of the law regarding the lack of protection for those assets. If the trust had been a DAPT, on the other hand, the DAPT state may need to provide full faith and credit allegiance to the forum court’s findings.

These offshore trusts also better weather certain other claims, such as a claim that has a federal basis. In contrast, DAPTs are subject to the Supremacy Clause. This is the provision in the U.S. Constitution that stands for the proposition that if a claim against a client is based on federal law, the state law protections could be preempted. Consider the Mortensen case, which involved a debtor domiciled in Alaska, who created an APT in that state. The debtor became subject to the Federal Bankruptcy Court. This court considered the issue of whether the transfers of assets to the APT were fraudulent transfers. Under Alaska law, the fact that one funds a DAPT can’t be used as evidence of a fraudulent transfer. However, in applying federal law, the court held that federal bankruptcy law controls, which can take into account the use of a DAPT as one factor indicating a fraudulent intent for making the transfers.

There are other examples that show that federal Bankruptcy law trumps state law. Under the 2005 Bankruptcy Act, the Texas and Florida homestead credit to be given to child support claims. Another possibility lies in the federal law that requires full faith and credit to be given to child support claims. In the event an offshore trust holds assets outside of the United States, U.S. federal law will have no force and effect over the foreign laws to the extent such foreign laws would apply to the issue at hand in a manner that is contrary to what the U.S. law would have prescribed. Therefore, if U.S. creditor laws would mandate that the trust assets be made available to creditors, but the offshore law provides that the trust assets are insulated from such exposure, the offshore trust can provide more certainty of a favorable result for that debtor.

Endnotes
2. Colorado has some case law that supports protecting trust assets from a settlor’s creditors even though that settlor has some retained rights to the trust assets (See In re Baumann, 22 F.3d 1014 (10th Cir. 1994), in which the settlor retained the right to live in the residence owned by the trust provided, however, that the settlor “timely services all encumbrances against such residence, and pays all taxes, insurance and utilities on such residence or associated with its occupancy by the Settlor.” Also, consider In re Marriage of Pooley discussed above. In Oklahoma, the domestic asset protection trust (DAPT) statute applies only to certain revocable trusts that don’t include the settlor as a beneficiary. Nevertheless, if the settlor revokes the trust, the assets can return to the settlor, hence somewhat in the nature of a self-settled trust.
3. See Kaladic discussed in this article, infra, note 25.
6. See Alaska Stat. Section 34.40.110().
7. 12 Del. Code Ann. Sections 3570(9) and 3573(1).
10. Missouri Revised Statutes Section 456.5-503.
12. Ohio Revised Code Section 5816.03(B).
15. SD Codified Laws Sections 55-16-1 and 55-16-15.
19. Virginia Code Sections 55-545.03:2 and 55-545.03:3.
23. Rush University Medical Center, Appellant v. Roger Sessions et. al., Trustees, Appellees, 980 N.E.2d 45 (Ill. 2012).
24. Utah County Civil No. 090402989 (Utah Dist. 4th, Nov. 11, 2011).
28. U.S.C. Section 1738B(a) and (h).