Minimizing Risk: Should a Virginia Domestic Asset Protection Trust Be Part of Your Client's Estate Plan?

(Article written by Kevin B. O'Donnell, Esq.)

Many clients wish for you as their financial advisors to minimize their exposure to risk. They trust you to use your expertise and experience to navigate them through stock market crashes and market volatility so that they meet their financial goals. But how can you protect clients from the risk of a lawsuit?

Certain financial products offer some protection, but these solutions are not always enough or do not fit a client's particular needs. We cannot prevent our clients from being sued, but there are legal solutions that can work with a client's overall financial plan to minimize the risk of a future lawsuit and give clients peace of mind. One of these legal solutions is a "domestic asset protection trust" (hereinafter referred to as a "DAPT"). DAPTs have many appealing features but are not ideal for every client. This article will provide general information about DAPTs so that you can add a valuable, alternative solution for clients who desire to maximize their asset protection.

Why use a DAPT?

A DAPT is an effective way for a client to protect assets from future creditors. A client can create a DAPT and fund it with a home, a beach house, or investment accounts. If the client is subsequently sued, then the home, beach house and investment accounts are all protected by the DAPT. If the client loses the lawsuit and insurance is insufficient to cover the loss, he can rest assured knowing that property in the DAPT will not be seized to pay the debt.

DAPTs do not require the client to surrender complete control over the assets to obtain the desired asset protection. The creator of a DAPT is still entitled to receive discretionary distributions of both income and principal from the DAPT. If the client needs or wants money or property, he can easily direct the trustee to distribute income or principal out of the trust for him to spend. More importantly, he can do so without fear that the distribution will grant future creditors the right to seize the DAPT property to pay future obligations.

This type of trust may sound too good to be true, but DAPTs are not without their drawbacks and are not the right solution for every client.

How does a DAPT work and how is it different from a revocable living trust?

A trust is a legal relationship between three parties: the person who creates the trust, known as the trustor or settlor; the person who manages the trust property, known as the trustee; and the person who enjoys and consumes the trust property, known as the beneficiary. The client will typically be both the trustee and the beneficiary during his or her lifetime when using a revocable living trust. A revocable living trust also allows the client to retain absolute control over all trust property. The client can amend the trust, revoke the trust, and remove property from the trust for any reason and without limitation. The risk is that the assets in the revocable living trust are not protected from creditors because the client retains such a high degree of control over the trust and its property.

A DAPT, on the other hand, requires the client to give up some control over assets in exchange for creditor protection. First, a DAPT must be irrevocable. This means that once the client creates the trust and transfers his property into the trust, he no longer has unfettered access to the trust property. Specifically, the client cannot remove property from the trust unless the trustee approves a discretionary distribution of income or principal. It also means that, as a general rule, the client cannot change the terms of the trust after it is created and funded.

This general rule has many exceptions but changing the terms of the trust is not a process that should be taken lightly. The client can retain the right to appoint additional beneficiaries to the trust, modify the trust in limited circumstances through the use of a trust protector, or terminate an irrevocable trust in certain circumstance. Usually, however, the trust cannot be easily modified, and assets cannot be easily removed from a DAPT. This fact should be carefully considered before moving forward.

The second major difference between a DAPT and a revocable living trust is that a DAPT requires at least one "qualified independent trustee." A qualified independent trustee is someone who is neither related nor subordinate to the client (such as an employee). This means the client cannot create a DAPT and name himself, his family members, or an employee as trustee to manage the trust property and to approve discretionary distributions of trust property. Typically, this results in the appointment of a trust company, bank, or law firm to serve as the trustee. These professional trustees charge fees for their services, but this is a small price to pay for peace of mind that asset protection brings.

Finally, a DAPT must also name at least one beneficiary other than the creator of the trust. The other beneficiary can be the client's spouse, the client's children, or the client's parents. This beneficiary has the same right to demand distributions from the trustee but if you are wise in choosing the correct independent trustee and the correct beneficiary, they will be beneficiary in name only and will not actually receive distributions of your property.

Thus, the creator of a DAPT must be comfortable with giving up some control over assets in order to gain the desired creditor protection. If creditor protection is important to a

client, however, the amount of control lost is minimal when compared with the creditor protection received.

Who is a good candidate for a DAPT?

DAPTs are not for everyone, but they are great legal solutions for the right clients. Clients who work in high risk industries such as physicians, contractors, engineers, or entrepreneurs are typically good candidates for a DAPT because they are more likely to be involved in a lawsuit than others. Clients who work in less risky industries but prioritize asset protection as part of their estate planning are also good candidates for a DAPT. A DAPT is an effective way to ensure their assets are protected from creditors while permitting them to keep some of the benefits of owning those assets, such as the right to discretionary distributions. These types of clients will see the value in giving up a limited amount of control over their property to gain the peace of mind that creditor protection brings.

A client who is already facing current or past creditor issues is not a candidate for a DAPT. DAPTs cannot be used to avoid paying current or past creditors because transfers to a DAPT are subject to prohibitions against "fraudulent transfers." Fraudulent transfers are beyond the scope of this article, but essentially the law forbids the transfer of assets into a DAPT to avoid paying creditors who are presently due money. Therefore, if a client indicates concern about current creditors, a DAPT will offer no protection.

Conclusion

Domestic asset protection trusts are an alternative solution for protecting your clients from the risks of future lawsuits. As financial advisors, you are intimately aware of your clients' goals and apprehensions. If asset protection is one of their main priorities, a domestic asset protection trust may be the right solution. Contact us today, and we can discuss the benefits of the domestic asset protection trust and how it fits in with your client's overall plan.