The "New" Michigan Domestic Asset Protection Trust Statute

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Introduction

- Michigan recently became the 17th State to approve domestic asset protection trust ("DAPT") legislation by enacting the Michigan Qualified Disposition in Trust Act, MCL 700.1041 *et seq.* ("Act"). The Act was signed into law by Governor Snyder on December 8, 2016 and became effective on March 8, 2017.

- The primary benefit of a DAPT, as compared to other types of trusts, is that a DAPT allows the settlor of the trust to retain a beneficial interest in the trust while limiting the ability of his or her creditors to reach the assets of the trust.

- The Act expressly permits DAPTs in Michigan, and overrides the long-standing common law and statutory rule in Michigan that invalidated self-settled trusts with respect to claims by the settlor's creditors.

- Contemporaneous with the enactment of the Act, Governor Snyder also signed into law Public Act No. 331, which amends various provisions of the Michigan Uniform Fraudulent Transfer Act, MCL 566.31 *et seq.* (the "UFTA") to be consistent with the Act, which also became effective on March 8, 2017.

- Governor Snyder also signed into law Public Act No. 552 on January 6, 2017, whereby Michigan adopted the Uniform Voidable Transactions Act (the "UVTA"). The UVTA replaces the UFTA and will become effective in Michigan on April 10, 2017. Michigan is one of ten States that has now adopted the UVTA.[1]

DAPTs Under the Act

- If properly drafted, a DAPT can be funded with a settlor's assets, provide the settler with access to those assets as a beneficiary and give the settlor the right to make certain fiduciary and administrative decisions regarding the DAPT and the assets placed therein, while at the same time, protect the assets from the settlor's creditors.
  - DAPTs are not a vehicle to be created and used for all individuals.
  - DAPTs are most beneficial for individuals who have a high net worth and who in the future may be subject to claims from creditors due to reversals in the economy or being subjected to malpractice or D&O claims not covered by insurance (*i.e.*, real estate developers, doctors, corporate executives and professionals).

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[1] The following States have adopted the UVTA: California, Idaho, New Mexico, North Dakota, Minnesota, Iowa, Michigan, Kentucky, Georgia and North Carolina. The UVTA has been introduced and is pending in the following States: Washington, Indiana, South Carolina and New York.

- The Act establishes several statutory requirements that need to be satisfied for a self-settled trust to qualify as a DAPT, including:
  - The trust must be irrevocable;
  - The trustee of the trust must be a corporate trustee or an individual, other than the transferor, that resides in Michigan;
  - The settlor must execute an affidavit stating, among other things, that: (i) the transfer won't render the settlor insolvent (*i.e.*, the settlor cannot transfer all of his or her assets into a DAPT), (ii) the transfer isn't being completed with intent to defraud a creditor, and (iii) the settlor is not aware of any pending or threatened litigation, other than that which is disclosed in the affidavit; and
  - The settlor's rights are limited as set forth in the Act, most notably, that a settlor cannot demand that the trustee make a distribution to the settlor.
- The Act allows the settlor to retain certain rights, powers and interests, including:
  - Power to direct investments;
  - Power to veto distributions;
  - Power to remove and appoint trustees and advisors;
  - Right to receive income;
  - Right to receive principal under a discretionary trust provision or support provision, or under the direction of an advisor with respect to either;
  - Right to receive income or principal to pay income taxes on trust income; and
  - After the settlor's death, the trustee has the power to pay the settlor's debts, the expenses of administering the settlor's estate, or any estate or inheritance tax imposed on or with respect to the estate.

<u>Creditors' Rights Under the Act</u>

- While a DAPT can provide tax and estate planning benefits, the primary reason for creating a DAPT is to protect an individual's assets from claims of creditors.
- A creditor's <u>sole remedy</u> with respect to assets transferred into a DAPT is to bring a cause of action to avoid a transfer to the DAPT (referred to in the Act as a "qualified disposition" as a fraudulent transfer under the UFTA or, once enacted, the UVTA by showing either:
  - <u>Actual fraud</u> – the creditor of the settlor must show that the transfer was made with "actual intent to hinder, delay or defraud creditors"; or

- Constructive fraud – the creditor of the settlor must prove that the transfer was made for less than a reasonably equivalent value and while the settlor was insolvent.

    - MCL 566.34(3)(e) provides that a transfer or set of transfers consisting of substantially all of the debtor's assets is one of the delineated statutory "badges of fraud." Thus, a settlor will want to take care not to transfer "substantially all of his or her assets" to a DAFT to negate consideration or application of this issue.

- Other traditional remedies, such as seeking to declare the trust void, an alter ego of the settlor and garnishment, are precluded if the DAPT is created in compliance with the Act.

- A plaintiff's burden of proof is also heightened in the Act:

  - Generally, the burden of proof to avoid a transfer as a fraudulent transfer is "preponderance of evidence."

  - The Act establishes a higher "clear and convincing" standard for setting aside a qualified disposition under the Act.[2]

- The statute of limitations for avoiding a qualified disposition as a fraudulent transfer is shortened:

  - If a creditor's claim arose before the qualified disposition, the action must be commenced by the later of: (a) two years after the qualified disposition was made; or (b) one year after the qualified disposition was or could reasonably have been discovered by the claimant if the claim was fraudulently concealed.

    - It is important to make appropriate disclosures of the existence of a DAPT and any qualified disposition so as not to risk extending the statute of limitations.

    - "Fraudulent concealment" to toll a statute of limitations under non-DAPT case law generally requires a material misrepresentation by the debtor that is intended to be, and is in fact, relied on by the creditor to its detriment.

  - If a creditor's claim arose after the qualified disposition, the action must be commenced within two years of the qualified disposition.
- Once the statute of limitations has expired, a creditor has very little recourse with respect to assets placed in a DAPT.

  - A notable exception to this rule is that, in the event that a bankruptcy of the settlor is initiated, either voluntarily by the settler or involuntarily by one or more creditors, section 548(e) of the United States Bankruptcy Code establishes a ten year look-back period for avoiding transfers to a self-settled trust.

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[2] While the UFTA was recently amended to make this standard clear with respect to setting aside a "qualified disposition," the UVTA does not contain a similar provision. While it probably would have been clearer if the UVTA so provided, the failure to so provide may not be critical since the Act specifically provides the standard for setting aside a "qualified disposition."

- The Act further limits the remedies of a creditor who successfully avoids a transfer to a DAPT as a fraudulent transfer:

    - A qualified disposition may be avoided only to the extent necessary to satisfy the present value of the creditor's claim, taking into consideration any uncertainty with respect to the validity or amount of that claim.

        - Contingent claims, such as personal guarantees are estimated based on the likelihood of the contingency coming to fruition.

    - Arguably, a qualified disposition is not actually avoided. Rather the Act provides that the sole remedy is for the trustee to pay the settlor – not the creditor – an amount to satisfy the creditor's claim. Thus, if the trustee does not have cash and is merely holding a piece of property, there is arguably nothing to transfer to the creditor.

    - The Act does not permit a judgment creditor of the settlor to attach, execute on or garnish the property held in the DAPT or any distributions to be made to beneficiaries of the DAPT.

    - As long as the trustee has not acted in bad faith, fees and expenses incurred by the trustee for defending the fraudulent transfer action arguably get paid first out of the amount payable to the settlor, thereby further reducing the potential amount available to the creditor.

    - While the Act does not prohibit a trustee from continuing to make distributions to a beneficiary, once an action seeking to avoid a qualified disposition has been commenced by a creditor, nevertheless, the trustee should consider whether to continue making distributions under such circumstances.

Creditor Protections Under the Act

- A valid lien that attaches to property before it is transferred to a DAPT survives the disposition and the trustee takes the property subject to the lien.

- The Act expressly provides that a written agreement between a settlor and a creditor may provide for any of the following:

    - The settlor will have a continuing or periodic obligation to disclose qualified dispositions to the creditor;
    - A qualified disposition will require the prior written approval of the creditor; and

    - That the settlor is under those other obligations as the creditor may require.

- A qualified disposition in violation of any such agreement is void with respect to such creditor only.

Additional Considerations

- The Act provides that if entireties property is transferred into a DAPT by a married couple, the property retains its entireties character despite what would otherwise appear to be a transfer that would destroy or negate it.

- Whose law governs a fraudulent transfer action?

  - The UFTA does not contain a choice of law provision. The case law generally looks to the situs of the property transferred or the law of the State having the most significant relationship to the occurrence and the parties. *See e.g.*,, Kettering Kenneth C., *Codifying a Choice of Law Rule for Fraudulent Transfer: A Memorandum to the Uniform Law Commission*, 19 Am. Bankr. L. Rev. 319, 341-342 (2011)

  - The UVTA specifically provides that a claim for relief thereunder is governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred:

    - An individual is located in the State of his or her principal residence.[3]

    - An organization that has only one place of business is located at its place of business. If the organization has more than one place of business, it is located in the State of its chief executive office.

- The Act provides express protection and immunity for claims against the trustee of a trust, an advisor of a trust, or a person involved in the counseling, drafting, preparation, execution, or funding of a trust that is the subject of a qualified disposition.

- The Act provides that property transferred into a DAPT at least thirty days prior to a trust beneficiary's marriage is excluded from marital property. Thus, a DAPT can serve as a form of a prenuptial agreement.

- A DAPT means giving up control over the assets subject to the qualified disposition.

- A DAPT is not bulletproof.

  - Despite growing approval of DAPTs by state legislatures, there are few published court opinions validating or enforcing DAPTs and when the courts are involved, despite what may be clear and unambiguous statutory language, there is always some uncertainty.

  - If the settlor/beneficiary becomes a debtor in bankruptcy, the statute of limitations for avoiding transfers into a DAPT is significantly expanded to ten years.

  - Choice of law issues may complicate the analysis if settlors or their assets are located outside of Michigan.

[3] A potential amendment of the UVTA is being considered that would provide in the case of a "qualified disposition" to a DAPT, the location of the trustee of the DAPT, as opposed to where the individual making the "qualified disposition" is located, governs choice of law.