COZEN O'CONNOR

# BUSINESS LAW OBSERVER

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## MESSAGE FROM THE CHAIR

TO THE FRIENDS OF COZEN O'CONNOR:

Our Summer 2007 Observer covers several topics not typically examined in the daily business press but which are of significance to business persons.

The ever-increasing use of electronic communications has resulted in new rules governing the retention of electronically stored information and its production in litigation. Sarah Kelly's lead article presents a concise review of these new rules together with helpful alerts.

Business valuations of closely held businesses are extremely important when one of the shareholders is involved in a divorce. The recent Pennsylvania Superior Court case of *Smith v. Smith* has made the determination of the date to value the business more complicated. Ann Funge's article presents a summary of this recent case. Another article of interest to shareholders in closely held businesses is Leah Ricci's article on the fiduciary duties of majority shareholders to minority shareholders.

An article by Michael Stein examines the use of a domestic asset protection trusts to protect one's wealth from attachment by creditors.

We welcome your inquiries on the articles in this Observer, other matters of interest to you and suggestions for future topics.


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## WHAT BUSINESSES NEED TO KNOW ABOUT E-DISCOVERY

At the end of 2006, the Federal Rules of Civil Procedure, which govern all litigation in federal courts of the United States, were amended to include new provisions relating to the discovery of electronically-stored information ("ESI"). ESI includes, as the name suggests, anything that is electronically stored, including emails, instant messages, metadata, writings, drawings, graphs, charts, photographs, sound recordings, images and other data or data compilations stored in any medium from which such information can be obtained (*e.g.*, computers, cell phones, voicemail, DVDs, CD ROMS, blackberries, network servers, desktop computers, laptop computers, and home computers of your employees which may have work-related data). These electronic discovery rules, and similar rules in many state courts, will have an impact on businesses everywhere, because they will affect, and in most instances increase (perhaps dramatically), the cost of all litigation. By some estimates, businesses in the United States generated almost 20 trillion electronic documents last year. The cost of e-discovery in commercial litigation in the United States last year is estimated to have been $2 billion. Going forward, all businesses will need to understand what ESI is, and when the duty to preserve ESI arises. In this context, it is extremely important for businesses to anticipate potential ESI retention problems and issues, and to determine the best ways to store and collect potentially relevant evidence. This means adopting and following document and information retention policies relating to your business's ESI, and asking the fundamental question: Do you really need to keep everything you are keeping?

The affirmative duty to preserve documents and information, including ESI, arises whenever litigation is reasonably anticipated, even if your business anticipates being a plaintiff in such litigation. When this occurs, your business needs to issue a "litigation hold" to its employees. A litigation hold refers to the need to preserve documents and information, whether maintained electronically or otherwise, for purposes of the litigation. Hard copy documents and ESI that may contain information potentially relevant to the anticipated claim must be preserved. This is true even of attorney-client privileged documents and information. It is important to note that the duty to preserve this information is broader than the duty to produce such information. How does a litigation hold on ESI work and what are its ramifications? Typically, a business must suspend routine document and data destruction, save or suspend the recycling of back-up tapes, notify its archival facilities to suspend destruction and to preserve its ESI, and monitor compliance and send periodic updates and reminders of this obligation. Employees must be notified of this need to preserve information. These procedures must be put in place for as long as it takes to identify and preserve information that is relevant to the lawsuit.

Your information technology personnel will play a vital role in many of the issues relating to ESI and ESI retention. In addition to assisting (and in some cases overseeing) the development of appropriate practices relating to ESI retention, these individuals frequently will be named to testify, as corporate designees, about the existence of, and practices for retaining and destroying, electronically stored information. In this role, your IT personnel will need to work directly with your litigation counsel.

Unfortunately, experience has shown that preserving, reviewing and producing ESI can be very expensive. Companies need to take measures to store ESI in a form that is the cheapest to both preserve and produce, and to eliminate ESI that need not be kept. Anticipating and preparing for these issues are the best and only ways to prevent the costs of e-discovery from controlling the outcome of your case.

Accessibility of data is another important issue in electronic discovery. Accessible data is active data,


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routinely used data, or data that a company accesses for purposes of a lawsuit. Inaccessible data is deleted data, information on backup systems, and legacy data. Typically, it is least expensive to produce accessible data and significantly more expensive to produce inaccessible data. As part of any litigation, a party will have the obligation to produce during the discovery process its relevant, accessible ESI, and to identify and describe ESI that was not searched and not produced. If the opposing party believes that information it needs is contained only in inaccessible data, it can seek the discovery of the inaccessible data, and the court will determine whether to order such discovery, and which side will pay for it.

What can you do to prepare for and control the costs associated with electronic discovery? Your company should develop a data management plan which is supported by corporate leadership, and should prepare a written document and information retention policy relating to electronic and paper records. You should monitor and enforce compliance with this retention policy. You should document the ownership of all of your computer and network hardware, along with its location. When an employee terminates or transfers, you should ensure proper documentation and retention, as necessary, of his or her sources of electronic data. You should consider establishing a records management department, and developing an in-house litigation response team, which includes your IT personnel, so that you will be prepared when litigation strikes. Do not keep excessive back-up tapes. Limit the sizes of your employees' mail boxes and home directories. Seriously consider investing in software that enables you to standardize collection procedures and protocols for your electronically stored information.

For many businesses, preparation for electronic discovery issues before becoming involved in litigation may not seem like the most efficient use of time or money. However, with more and more frequency, stories are being reported about huge fines or verdicts being handed down against companies that have failed to manage their electronic discovery obligations appropriately. Preparation is the best defense in this new era of litigation discovery.

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## RELEVANT BUSINESS VALUATION DATE FOR DIVORCE PURPOSES

With the current U.S. divorce rate estimated somewhere between 40-50%[1] and the fact that businesses with less than 500 employees account for 99.7% of all U.S. employer firms[2] , the issue of how to treat a closely-held business asset when a marriage ends is common. Without a valid pre-nuptial or post-nuptial agreement removing the business from the marital "pie," the business must be valued. The issues involved with valuing business assets for divorce purposes and, then, how to distribute that value between the divorcing spouses literally fill volumes. Goodwill, "key man" discounts, valuation methods, and the relevant date for valuation are issues which must be addressed and resolved. Unfortunately, in Pennsylvania, the law on ***when*** to value a business recently became a bit more complicated with the Superior Court's decision in *Smith v. Smith,* 904 A.2d 15 (Pa. Super. 2006).

In *Smith*, the Pennsylania Superior Court affirmed in part and vacated and remanded in part a trial court's equitable distribution and alimony decision. In rendering its decision, the Superior Court, *inter alia*, held that when a family business interest is "clearly capable" of being valued as of the date of distribution, the relevant value for equitable distribution purposes should be the date of distribution, even when one of the parties had exclusive control over the business interest post-separation.

The facts of the *Smith* case are as follows: Husband and Wife married in 1965 and separated in October 2000. Three children were born of the marriage, all of whom were adults at separation. Husband, age 60, owned and operated a trucking business since 1969. Wife, age 62, had a 10th grade education and had worked primarily in Husband's trucking business during the marriage. Since separation, she had worked part-time as a cashier at K-Mart. Wife discontinued working in December 2001 due to injuries suffered in a car accident.

The trial court ultimately heard the case in early 2005, more than four years after the parties separated. Prior to trial, the trial court directed both parties to prepare business valuations as of the date of separation, October 16, 2000, and the stipulated date of distribution, June 30, 2004.

At trial, Wife argued that the 2000 date of separation value for Husband's business should be used, asserting dissipation due to Husband diverting business from his marital trucking business to the trucking business established in the sole name of his paramour after the parties' separation in 2000. Husband argued that the 2004 date of distribution value should be used. Ultimately, the trial court chose to use the date of distribution (not the date of separation) as the valuation date. The trial court found that "it is clear…that Husband…guided his paramour in the startup and operation of her trucking business, but the [c]ourt is not convinced that Husband influenced, impeded or dissipated the marital business to affect its value during the pendency of the divorce."[3] Because the marital trucking business was "clearly capable of being valued as of the date of distribution," the trial court employed Wife's 2004 date of distribution value, including a goodwill component, to value and divide the parties' marital estate.[4] Wife's date of distribution value was $279,000 and Husband's date of distribution value was $56,044. Wife appealed the trial court's decision to use the date of distribution value.

To support her argument on appeal, Wife argued that because Husband had sole control of the marital trucking business post-separation and, thus, opportunity to manipulate its value, the only proper date for valuation is the date of separation. The Superior Court rejected Wife's argument. In rendering its decision, the Court generally acknowledged circumstances in which a date of separation value might better effect economic justice, but opined that, in *Sutliff v. Sutliff*, 543 A.2d 534 (Pa. 1988), the Pennsylvania Supreme Court had stated a preference for date of distribution value for a business interest because such interests may be subject to great fluctuation. To affirm the trial court's decision, the Court relied on the trial court's factual finding that "it [was] not convinced that Husband influenced, impeded, or dissipated the marital business" post-separation and the fact that the business was "clearly capable" of being valued as of the date of distribution. To further Wife's disappointment with its decision, the Superior Court reiterated that the trial court had found no credible evidence that Husband diverted income from his trucking business to his paramour's trucking business and, thus, Husband's income figure used by the trial court in formulating Wife's alimony award was affirmed.

The ultimate impact of *Smith* is uncertain. While the Pennsylvania Supreme Court's decision in *Sutliff* does create a preference for date of distribution value dates for business interests, especially when a long time has passed between the date of separation and date of distribution, the *Sutliff* court also acknowledged situations where "…marital assets have been consumed or disposed of by one of the parties [post-separation], thus rendering a current valuation impossible and making it necessary to rely on data that would otherwise be considered stale…."[5] *Sutliff's* offspring have carved out one such specific exception: when one spouse has exclusive control of a closely-held marital business interest, a date of separation value may prevail based on that fact alone, without proof of dissipation.[6] The *Smith* decision, however, strongly erodes this exception. Thus, going forward, it appears that the likelihood of using a later valuation date, even when only one spouse solely controls the business interest post-separation, is higher.

In *Smith*, the Superior Court consistently relied on the trial court's finding that it was "not convinced" of Husband's dissipation. This reliance negatively affected Wife's claims regarding the value of Husband's business, the amount of her alimony award, and her claim for counsel fees. For practitioners, the lesson in *Smith* is that the burden to demonstrate dissipation is high. For business owners, *Smith's* lesson is that, with Pennsylvania law now more murky regarding the relevant valuation date for marital business interests, the choice of a knowledgeable and skillful family law advocate is essential.

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1 U.S. Dept. of Health and Human Services, Centers for Disease Control and Prevention, National Vital Statistics Reports, Vol. 54, No. 20, *Births, Marriages, Divorces and Deaths: Provisional Data for 2005* (July 21, 2006).

2 Office of Advocacy of the U.S. Small Business Administration, *The Small Business Economy for Data Year 2005, A Report to the President* (December 2006).

3 Trial Court Order and Opinion, 6/30/05 at 6-7.

4 *Id.*

5 543 A.2d 534, 536 (Pa. 1988).

6 *See, e.g., Benson v. Benson*, 624 A.2d 644 (Pa. Super. 1993) and *McNaughton v. McNaughton*, 603 A.2d 646 (Pa. Super. 1992).


## FIDUCIARY DUTIES OF MAJORITY SHAREHOLDERS TO MINORITY SHAREHOLDERS IN A CLOSELY-HELD CORPORATION

One cannot open a newspaper or turn on the evening news without reading about salary and severance controversies surrounding executives or former executives of large public companies. Home Depot's chief executive Bob Nardelli earned an average of $25.7 million a year, excluding stock options, and even though he was forced out over this exorbitant pay, he walked away with a severance package worth about $210 million.[1] Former chief executive officer Jack Welch of General Electric, Co. earned a reported $16.25 million in the year 2001.[2] The New York Stock Exchange paid its former boss Richard Grasso $187.5 million in severance.[3] Much to the chagrin of its shareholders, behind each of these payments lies directors that approved such payments in the face of their obligation to protect shareholders' interests.

In many ways the minority shareholders of a closely-held corporation can relate to the frustrations of public company shareholders, often on a smaller scale. A closely-held corporation's shareholders are usually divided into two groups: the shareholders that have a controlling interest in the corporation and, the shareholders that do not, also known as the "minority shareholders."

Because of the lack of a market for shares in a closely-held corporation, shares held by minority shareholders are generally illiquid. In most closely-held corporations, majority shareholders are, or have significant participation in, the corporation's management, which makes it very difficult for minority shareholders to meaningfully participate in corporate affairs. In addition, minority shareholders can find that their lack of corporate control is exploited for the financial benefit of majority shareholders. There is an old story of a reply given by a prominent newspaperman during an address to the Ohio State Bar Association to the question of what the shares in his company were worth. "There are 51 shares that are worth $250,000. There are 49 shares that not worth a [expletive]."[4]

While almost all commentators, courts and states have agreed that a buyout by the company or the majority owner of a minority owner's interest would be the best solution to resolve a minority shareholder's grievances, such a solution is not always available. The evolution of the law dealing with minority shareholder oppression has been slow and muddled. However, three approaches to remedying minority oppression have emerged: 1) the majority of states have developed relief for minority oppression as a matter of common law; 2) some states have established a statutory cause of action for minority shareholders;[5] and 3) there are a few states, led by Delaware, that have taken the position that it is the legislature's role to create protections for minority shareholders in closely-held corporations and that until such legislation is enacted, minority shareholder oppression must be dealt with on a case-by-case basis.[6]

In those states in which common law governs these matters, the majority rule is that closely-held corporation shareholders owe a fiduciary duty directly to one another, and that a breach of this duty is actionable in a court of law.[7] An increasing number of states have adopted the view that the majority shareholder has oppressed the minority when the majority's actions violate the minority shareholder's "reasonable expectations."[8] Such a broad definition of oppression has made it difficult to determine a black letter rule because the focus is not on the actions of the majority shareholder, but on the expectations of the minority shareholder, which is a very subjective analysis.

Contrary to many other areas of corporate law, the courts of Delaware have taken a hands off approach in determining a majority shareholder's duties to minority shareholders. In *Nixon v. Blackwell*, the Supreme Court of Delaware addressed the issue of whether Delaware courts should create a special set of rules to protect the interests of minority shareholders of closely-held corporations.[9] Interestingly, the Delaware court took the position that minority shareholders of a closely-held corporation are not at all helpless, but in fact, before agreeing to purchase the shares, the shareholders can bargain for rights relative to the majority shareholders.

> A stockholder who bargains for stock in a closely-held corporation and who pays for those shares can make a business judgment whether to buy into such a minority position, and if so on what terms… a stockholder intending to buy into a

> minority position in a Delaware corporation may enter into definitive stockholder agreements and such agreements may provide for elaborate earnings tests, buy-out provisions, voting trusts or other voting agreements. The tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration. It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted.[10]

The court concluded that absent legislative intervention, such shareholder disputes are intensely fact-driven and must be addressed on a case-by-case basis.

Commentators have suggested that a better approach to minority shareholder oppression might be for the states to adopt a model buyout statute that would establish uniform treatment for minority shareholders throughout the country. Such a statute would operate like a buy-sell agreement, and give the minority shareholder a remedy to seek separation and liquidity and in turn allow the majority to continue with its business plan without the hefty costs of litigation.[11] For now it appears that minority shareholders will have to continue to wage their battles in the courtroom unless they negotiate contractual protections for their interests prior to investing. The relative powers of and remedies available to minority shareholders of closely-held corporations vary widely depending on the corporation's state of incorporation. If the corporation was formed in Delaware, uncertainty abounds for minority shareholders. Minority shareholders would be well advised to engage experienced and knowledgeable legal counsel prior to buying into a minority position.

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1 Associated Press, "Bush Backs Linking of Executive Pay and Performance," N.Y. Times, January 31, 2007.

2 Id.

3 Id.

4 Humphrys v. Winous Co., 165 Ohio St. 45, 59 Ohio Op. 65, 133 N.E.2d 780, 783 (1956), quoting address of John H. Doyle before Ohio State Bar Association in 1893.

5 California, Florida, New Jersey, New York, Pennsylvania

6 John H. Matheson and R. Kevin Lamer, A Simple Statutory Solution to Minority Oppression in the Closely Held Business, 91 Minn. L. Rev. 657, 663 (February 2007).

7 Id.

8 Id.

9 Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993)

10 Id at 1380.

11 Id.

## DELAWARE MANDATES ELECTRONIC FILING OF ANNUAL FRANCHISE TAX REPORTS

Legislation passed by the Delaware General Assembly changes the notification and filing procedures for annual franchise tax reports, which all corporations incorporated in the State of Delaware are required to file, on or before March 1st each year. The notification process change is part of a plan to encourage, and then mandate, the electronic filing of annual reports beginning in 2008.

Previously, a Delaware domestic corporation received a printed paper annual report and a separate instruction sheet for filing the annual report. Delaware will no longer send paper copies; instead, domestic corporations will receive notification of their obligation to make the filing for the current tax year by a neon green postcard that will be mailed each December. The postcard will provide instructions on how to electronically file annual reports on the Secretary of State's website and to pay the franchise tax with a credit card (or through a checking or savings account). Domestic corporations failing to file their annual report will be prohibited from receiving a certificate of good standing. Late filers will be assessed a penalty of $100 and interest in the amount of 1.5% per month on any unpaid balance.

The notification process has been changed this year to encourage electronic filing of annual reports in anticipation of complying with the legislation which becomes effective January 1, 2008 that will require all Delaware domestic corporations to file their annual reports electronically. Also, the consequences of failing to file a complete annual report will be more severe than in the past. Domestic corporations that fail to file an annual report beginning in 2008 will have their corporate charter declared void by the Secretary of State (previously, the Secretary of State could only void a corporation's charter for failure to pay annual franchise taxes), in addition to being prohibited from receiving a certificate of good standing. The $100 and 1.5% interest penalty for failing to timely file a complete annual report will not change in 2008.

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## WEALTH PRESERVATION WITH DOMESTIC ASSET PROTECTION TRUSTS

The use of a domestic asset protection trust ("DAPT") may allow the settlor (*i.e.* the creator) of the trust to protect an unlimited amount of wealth from attachment by creditors. Since 1997, eight states have enacted statutes which enforce the provisions of DAPTs. While none of these statutes has been tested by a court, DAPTs have become a prevalent vehicle considered for wealth preservation by individuals who desire to conserve their assets for themselves and their offspring. In part, the rising interest in DAPTs is in response to the increasingly litigious societal climate, coupled with the inconveniences and expenses associated with offshore asset protection trusts.

Generally, the principles which form the basis for the protections offered by a DAPT statute are two-fold. First, by transferring assets to a DAPT, the settlor is considered to have given up sufficient control over the transferred assets to preclude the settlor from being the legal owner of the assets. Instead, legal ownership is transferred to the trustee of the DAPT, placing the assets beyond the reach of the settlor's creditors. Second, any claims against a DAPT must be brought pursuant to the laws of the state which governs a DAPT. Thus, under a DAPT statute, the assets transferred to a DAPT are recognized as being beyond the legal control of the settlor and subject only to the jurisdiction of the state which governs the DAPT.

This article briefly examines the Delaware DAPT statute, known as the Delaware Qualified Dispositions in Trust Act (the "Delaware Act")[1], as a general illustration of (i) the requirements to form a DAPT, (ii) the authority that may be exercised by the settlor of a DAPT and (iii) the extent of the protections afforded by a DAPT. This article also provides some suggestions and other factors to be considered when forming a DAPT in order to prepare for potential challenges to its enforcement.

### FORMATION OF A DAPT

*Initial Requirements.*

To form a DAPT under the Delaware Act, a settlor is required to create an irrevocable trust governed by a trust instrument that contains a spendthrift clause.[2] The provisions of the trust instrument should state that Delaware law governs the validity, construction and administration of the trust.[3]

*Use of Delaware Trustee.*

Under the Delaware Act, the trust instrument must appoint at least one Delaware trustee.[4] The Delaware trustee should be an individual who resides in Delaware or a corporation that is authorized to conduct trust business in Delaware.[5] The Delaware trustee should maintain or arrange for custody of all assets of the DAPT in Delaware.[6] Further, the Delaware trustee should prepare or arrange for the preparation of fiduciary income tax returns or otherwise materially participate in the administration of the DAPT.[7]

The Delaware Act allows non-Delaware co-trustees to serve with the Delaware trustee.[8] *However, as discussed below, the use of out-of-state trustees may encourage the state in which the non-Delaware trustee resides to attempt to exercise jurisdiction over the DAPT.*

*Use of Investment and Distribution Advisors.*

In addition to trustees, the Delaware Act provides that a DAPT may have advisors who are appointed by the settlor.[9] The provisions of the DAPT may require that the trustee obtain the consent or direction of the investment advisor prior to exercising any investment authority. The advisor may also be given the discretion to determine when distributions should be made from the DAPT. Accordingly, the use of an advisor may limit the role of the Delaware trustee to administrative decisions, while leaving investment and/or distribution decisions to others who have been appointed by the settlor for these specific purposes. An advisor does not have to be a Delaware resident. Also, although advisors are required to act in a fiduciary manner, unlike trustees they do not have legal ownership of the DAPT assets.

## THE AUTHORITY OF THE SETTLOR OF A DAPT

### *Limited Administrative Authority.*

The Delaware Act permits the settlor of a DAPT to maintain certain authority over the assets transferred to the DAPT. This limited authority may allow the settlor to veto distributions,[10] serve as a direction or consent advisor,[11] and replace trustees with persons who are not related to or subordinate to the settlor, as defined by the Internal Revenue Code.[12]

### *Limited Rights to Receive Distributions.*

The Delaware Act specifically authorizes a settlor to receive certain distributions from a DAPT.[13] These distributions include (i) principal or income distributions made pursuant to the discretion of the trustees or advisors, or some other standard to be exercised by the trustees or advisors, (ii) current income distributions, (iii) distributions from a charitable remainder trust which is formed as a DAPT and (iv) up to a 5% annual distribution interest from a grantor retained annuity trust, grantor retained unitrust or a total return trust which has been formed as a DAPT. In addition, the settlor may be given a non-general testamentary power of appointment over the DAPT assets.[14]

### *Authority Must be Expressed in DAPT Instrument.*

Under the Delaware Act, a settlor only has the powers and authorities expressly set forth in the provisions of the trust instrument. Any other agreement or understanding between the settlor, the advisors and/or the trustees, which provides rights to the settlor in excess of those contained in the trust instrument, is void under the Delaware Act.[15] *As discussed below, the less authority given to a settlor by the provisions of a DAPT, the easier it will be to defend against any potential challenges to the enforcement of the remaining provisions of the DAPT.*

## PROTECTIONS AFFORDED BY A DAPT AND EXCEPTIONS

### *Original Jurisdiction / Exceptions for Fraudulent Transfers*

The Delaware Act requires any action involving a Delaware DAPT to be brought in the Delaware Court of Chancery.[16] To that end, the Delaware Act precludes foreign actions from being enforced against a DAPT. These actions include original actions commenced in jurisdictions outside of Delaware, and actions to enforce judgments originally entered in other jurisdictions.[17]

Notwithstanding these protections, the Delaware Act does make exceptions by allowing certain claims to set aside a DAPT. These are claims which are intended to prohibit the enforcement of a DAPT that was formed to shelter assets which are the subject of a fraudulent transfer. Generally, a fraudulent transfer occurs when assets are transferred (i) to hinder, delay or avoid the rights of creditors, or (ii) after the transferor is insolvent. Any action brought under the Delaware Act to set aside a DAPT must be based on Section 1304 or 1305 of the Delaware Uniform Fraudulent Transfer Act.[18] As a result of the application of these statutes, there are four types of claims which may defeat a DAPT.

### *Claims Arising Prior to Creation of DAPT.*

If a creditor's claim arose before the DAPT was created and the creditor brings suit within four years after the creation of the DAPT, or later, if within one year after the creditor should have discovered the DAPT, then the claim is valid.[19] The claim will be enforced if the creditor can prove by clear and convincing evidence that the transfer of assets to the DAPT was a fraudulent transfer.[20]

### *Claims Arising After Creation of DAPT.*

A claim which arises after a DAPT was created will be valid if the creditor brings suit within four years after the date of creation.[21] Again, to be enforced, the creditor must prove by clear and convincing evidence that the creation of the DAPT was a fraudulent transfer.[22]

### *Claims Related to Alimony, Child Support.*

A claim arising from an agreement or court order providing for alimony, child support or property division may be enforced against a DAPT.[23] This exception is available only to a spouse who was married to the settlor before the DAPT was created.[24]

*Personal Injury Claims.*

A claim arising as a result of death, personal injury or property damage may reach the assets of a DAPT which is created after the claim has ripened.[25]

*Effect of the Exceptions.*

Should any of the four exceptions apply, the DAPT will be set aside only to the extent necessary to pay the claim and any related costs.[26] Related costs may include attorneys fees.[27]

## POTENTIAL CHALLENGES TO THE ENFORCEMENT OF A DAPT

The state statutes which enforce DAPTs are intended to prevent DAPTs from being subject to the laws of other states which do not recognize DAPTs. For example, a settlor who resides in Pennsylvania forms a Delaware DAPT. Five years later, the settlor is sued by a plaintiff in a Pennsylvania court. The court determines that the plaintiff's claim is valid under Pennsylvania law, and enters judgment against the settlor. Thereafter, the plaintiff attempts to enforce the Pennsylvania judgment against the assets of the DAPT, as though the settlor has legal title to the assets. The enforcement of the Pennsylvania judgment against the DAPT would be barred by the Delaware Act. Specifically, under the Delaware Act, the settlor is not the legal owner of the DAPT assets. Further, under the Delaware Act, the spendthrift clause in the DAPT prevents the settlor's beneficial interest in the DAPT from being attached. Moreover, the Delaware Act would not recognize any action brought by the plaintiff against the DAPT in a Pennsylvania court, or any other court, except for the Delaware Court of Chancery.

Notwithstanding the foregoing example, and as stated at the outset of this article, the effectiveness of any DAPT statute (including the Delaware Act) has not been tested by any court. Thus, uncertainties exist with regard to the ability to enforce a DAPT. Potential constitutional challenges to a DAPT statute may arise under the full faith and credit clause and the contracts clause of the United States Constitution. Other challenges to DAPTs may arise from the remedies available under state and federal bankruptcy laws, and the multitude of principles of conflicts of laws that are recognized by the each of the fifty states. The basis of these challenges is that (i) the mere transfer of assets to a DAPT does not prevent the settlor from retaining sufficient control to be the legal owner of the transferred assets, and (ii) the state law which governs a DAPT cannot preclude the enforcement of judgments or other actions which are the result of valid claims against the settlor. However, like the statutes that are intended to enforce DAPTs, the effectiveness of the potential challenges to a DAPT also has not been tested by any court.

## FORMATION CONSIDERATIONS

*When to Form a DAPT.*

To prevent the potential enforcement of any claim that may be brought against a DAPT, individuals desiring to form a DAPT should consider certain factors. The most obvious factor is that the DAPT should be formed *before* any claim against the settlor has ripened.

*Notice to Existing Creditors / Establishing a Reserve.*

The settlor should consider notifying and/or satisfying any creditors in existence as of the date the DAPT is formed. Also, the settlor may set aside a reserve of funds outside of the DAPT to be used to pay any existing or potential claims as of the date the DAPT is formed.

*How Much Should be Transferred to a DAPT?*

A settlor should transfer only a portion of his or her assets to the DAPT, while retaining sufficient assets outside of the DAPT to satisfy customary living expenses. This will help negate any appearance that there is an implied agreement between the settlor and the trustee, that the trustee will distribute DAPT assets to the settlor, regardless of the distribution standard set forth in the trust agreement. Obviously, if all of the settlor's assets are transferred to a DAPT, it will be difficult to sustain any argument that the settlor does need the DAPT assets to pay for everyday needs.

*Which Assets Should be Transferred to a DAPT?*

Assets transferred to a DAPT should be located in the state whose law governs the DAPT. Any DAPT assets, such as real estate, located in a state without a DAPT statute, could become subject to the jurisdiction of that state. If a settlor desires to transfer out-of-state real estate to a DAPT, the settlor should transfer the real estate to a single member



limited liability company (or similar entity), and then assign the settlor's ownership interest in the entity to the DAPT.

*Settlor Authority over Transferred Assets.*

A settlor should carefully consider what authority to maintain over the DAPT, and retain only that authority which is absolutely necessary. The fewer powers retained, the stronger the argument that the assets transferred by the settlor are out of the settlor's control. In addition, the use of an institutional trustee, such as a bank or trust company which maintains an independent internal procedure for responding to distribution requests, will enhance the validity of the limitations imposed on a settlor's ability to access trust assets.

*Use of Out-of-State Trustees.*

Also, a settlor should consider whether the use of an out-of-state trustee is necessary. In the event a trustee resides in a state which does not have an DAPT statute, that state may seek to obtain jurisdiction over the trustee, the DAPT and/or the trust assets, to enforce a claim that is valid under the law of that state.

## OTHER CONSIDERATIONS RELATING TO DAPTS

*Income, Gift and Estate Tax Implications.*

Asset protection is only one factor that should be considered whenever a DAPT is implemented. A prospective settlor should also consider any income tax, gift tax and estate tax effects that may result from the formation of a DAPT. Often, the use of DAPT may have adverse tax consequences for the settlor. These consequences, which may outweigh the advantages of forming a DAPT, will vary depending upon the circumstances surrounding each settlor.

*Dispositive Considerations.*

In light of the irrevocability of a DAPT, the disposition of assets pursuant to the DAPT instrument should be determined in connection with the remainder of the distribution scheme present in the estate plan of a settlor. In some instances, the use of a limited power of appointment over the DAPT assets may provide for the requisite flexibility to respond to this consideration.

## CONCLUSION

DAPTs offer a form of wealth preservation to individuals desiring to protect their assets from creditors. The extent of the protection available is dependent upon the specific circumstances of the prospective settlor as of the date a DAPT is formed, and other asset preservation factors, such as income tax and estate planning consequences. Despite the potential challenges that may exist with regard to the enforcement of a DAPT, the use of a DAPT should be considered by those concerned about preserving wealth for their lifetimes and for the future generations of their families.

*For more information, please contact Michael Stein (Philadelphia) at 215.665.5579 or mstein@cozen.com.*

1 12 Del.C. §§ 3570 to 3576.
2 12 Del.C. § 3570(10)(b) and (c).
3 12 Del.C. § 3570(10)(a).
4 12 Del.C. § 3570(9).
5 12 Del.C. § 3570(9)(a).
6 12 Del.C. § 3570(9)(b).
7 Id.
8 12 Del.C. § 3570(9).
9 12 Del.C. § 3570(9)(c).
10 Del.C. § 3570(10)(b).
11 Del.C. § 3570(9)(d).
12 Del.C. § 3570(10)(b)(7).
13 Del.C. § 3570(10)(b)(2)-(6).
14 Id.
15 Del.C. § 3571.
16 Del.C. § 3572(a).
17 Id.
18 Id.
19 Del.C. § 3572(b)(1).
20 Del.C. § 3574(c).
21 Del.C. § 3572(b)(2).
22 Del.C. § 3574(c).
23 Del.C. § 3573(1).
24 Del.C. § 3570(7).
25 Del.C. § 3573(2).
26 Del.C. § 3574(a).
27 Id.

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