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Back to the Basics: First Party vs. Third Party Asset Protection

By Richard M. Morgan & Loraine M. DiSalvo

At our firm, most of our clients are hard-working and successful. Having worked hard to accumulate the assets that they have, these clients are often concerned about protecting those assets, so that they benefit themselves and their loved ones while being protected from predatory outsiders or creditors. "Asset protection," in this context, generally means using a combination of insurance, business entities, asset titling, and, in some cases, trusts, to protect a person's assets against claims by outsiders, which can include divorcing spouses, debts resulting from failed business ventures, or claims resulting from an accident, and attack from predatory people who try to take advantage of someone to gain access to the person's assets. In order to determine what options are available for protecting assets, it is important to have a general understanding of asset protection rules. The options available often depend on where the protected assets came from, and the creditors and predators who are being protected against. We go back to the basics in this issue of The Passionate Estate Planner to discuss the concepts of "first party" and "third party" in the context of asset protection.

What is the difference between first party and third party asset protection? In the asset protection context, "first party" and "third party" refer to both the source of the assets being protected and the source of the problems being protected against. First party asset protection attempts to protect your assets from your problems. Third party asset protection attempts to protect your assets from someone else's problems. Historically, most states' laws discouraged first party asset protection, because it was viewed as against public policy to allow people to protect their assets from their own creditors. State legislatures feared that allowing first party asset protection would lead people to protect their assets and then enter into contracts that they did not intend to honor, causing innocent third parties to bear the resulting losses with no recourse. However, most states did historically allow third party asset protection, meaning that you had at least some way to protect your assets from other people's problems if you set the assets aside for another person. These options tended to take the form of laws that allowed "spendthrift" trusts. Allowing third party asset protection was justified on the grounds that your property ownership rights included your rights to control who, and to what extent, others may benefit from your assets.

Much estate planning uses third party asset protection, by having assets that pass to a client's family pass in trust, instead of outright. These trusts can protect the assets that the client passes to her family from the family members' future potential problems, such as divorcing spouses, student loan debts, debts from failed business ventures, and bankruptcy. While the level of protection provided can differ from state to state, this kind of asset protection is generally accepted and fairly easy to accomplish.

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In the 1990s, the historical view that first party asset protection should not be allowed started to lose favor, and a trend began, under which states changed their laws to allow self-settled trusts. In addition, many foreign nations also allow these trusts, and they began to become fairly popular amongst the wealthy. While the laws that allow self-settled trusts differ widely, in most jurisdictions, the concept works something like this: The trust's creator signs a trust agreement with a third party, and does not serve as the trustee. The trustee often must be a person or corporation that lives in the jurisdiction whose law is intended to apply to the trust. The trust's creator transfers assets to the trust. The trust is irrevocable, and generally allows benefits to be paid to the creator and the creator's family if, and to the extent, the trustee decides to do so. The trust generally does not require that any distributions be made to the creator; the trustee is free to refuse to make any. In many of these jurisdictions, as long as the trust's creator was not insolvent at the time the trust was created and did not become insolvent as a result of the transfer to the trust, the trust is intended to be protected against the trust creator's creditors. However, because not all states allow self-settled trusts, and because there currently is still not a lot of case law involving challenges to these trusts, there are a lot of open questions as to how well these trusts will provide the first party asset protection they are intended to provide, especially for trust creators who do not live in the state where the trust was created. In addition, it currently appears that the federal government may take a dim view of these trusts. Therefore, people who create these trusts should be exceptionally careful in how they create and maintain these trusts. In addition, it is generally not advisable to try to protect all of one's assets: instead, make sure when creating a self-settled trust that you retain plenty of other assets outside of the trust.

How does the law attempt to prevent first party asset protection? In addition to case law or older statutes that say a person is not allowed to avoid his own creditors by placing assets in trust for his own benefit, most states have some variation of the Uniform Fraudulent Transfer Act ("UFTA"). In general, the UFTA protects creditors from debtors who make any transfer or incur any obligation with the actual intent to hinder, delay, or defraud a creditor. It can also protect creditors if the debtor simply makes a transfer or incurs an obligation that causes the debtor to become insolvent, even if the debtor did not intend to hinder, delay, or defraud the creditor by making the transfer or incurring the obligation. The most significant issue with the UFTA is that it covers a very wide range of debts, and can even include debts that are not actually expected to arise at the time a transfer is made. If a transfer is deemed to have been a fraudulent transfer under the UFTA, a creditor or a bankruptcy court may be able to void or undo the transfer, attach the assets, and possibly obtain additional penalties. At this time, it is not clear how well transfers to a U.S.-based self-settled trust will hold up where the trust creator does not live in the state where the self-settled trust was created. However, like other forms of asset protection planning, having a self-settled trust in place may provide the trust's creator with some additional leverage in negotiating with creditors, and can still be an option worth considering for some clients.

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Whether you are interested in first party asset protection or third party asset protection, there are options available that can let you protect your assets from potential future problems. Third party protection is relatively easy to design and implement, and should be considered as an option when you are considering other estate planning issues. For first party asset protection, there are no magical, one-size-fits-all solutions available, but there are still options. The kind of planning required for good first party protection is highly individualized in nature, depends on multiple factors, and can be fairly complex. However, for first party planning to work, you must do the work well before a problem arises. If you already have notice of a current or potential creditor claim, you are likely too late to protect yourself from it. So, if you are interested in first party asset protection, you need to move as soon as possible, before your potential concerns become reality.

If you have questions about the difference between third party and first party asset protection, or if you want to consider how to better protect your own assets from your own potential problems or those of your loved ones, we are here to help. Please contact our office at (678) 720-0750 or at info@MorganDiSalvo.com to schedule an estate planning consultation with one of our attorneys.