Domestic Asset Protection Trusts

Which jurisdictions are the most effective to set up this powerful tool?

A domestic asset protection trust (DAPT) is a formidable strategy that not only helps clients legally shield assets from third-party liability, but also permits clients to be discretionary beneficiaries of their own trusts.

Asset protection trusts have a relatively short history in the United States. Prior to 1996, 18 nations provided offshore asset protection trust statutes. While Missouri amended its spendthrift trust statute in 1986 in a way that may have permitted the creation of a DAPT, the Missouri law lacked information about the statute’s intent. As such, many advisors were concerned that the Missouri law wouldn’t prove to be an effective DAPT statute. In 1996, Alaska passed the first DAPT legislation, followed by Delaware in 1997. Today, there are 14 states, possibly 15, that have passed asset protection statutes, with Ohio most likely being the latest addition in 2012. (As of this writing, the statute passed both houses of the Ohio legislature and is awaiting the governor’s signature.)

In January 2010 and again in 2012, we analyzed trust legislation to determine, in our view, which jurisdictions provided the best trust protection. Using a similar analysis for this article, we’ve determined that five states: Alaska, Delaware, Ohio, Nevada and South Dakota, have emerged as the leaders in providing DAPT legislation. Obviously, when evaluating whether a jurisdiction is the "best" for DAPT protection, different authors will have different conclusions regarding which factors are more important than others. We believe that because over 50 percent of the population will experience at least one divorce, protection against marital claims is one of the most significant factors to consider when evaluating the strength of a DAPT statute. Unfortunately, almost all DAPT statutes, by themselves, omit one of the most critical issues regarding marital claims: whether a beneficiary has an enforceable right to a distribution. Thus, we further examined discretionary support legislation enacted by many states. We also looked at some of the more important DAPT statute provisions, including whether a statute limits a creditor’s claim solely to a fraudulent conveyance, whether the fraudulent conveyance law is debtor-friendly and the effect of forcing litigation into a DAPT state. Finally, since most DAPTs are combined with either a limited liability company (LLC) or a limited partnership (LP), we also considered the strength of a DAPT state’s charging order statute.

For a summary of our conclusions, see “Which DAPT Jurisdictions Make the Grade?” on p. 54, which provides our comparative analysis of 14 DAPT jurisdictions. Note that while Oklahoma is included in our analysis, because the Oklahoma statute only protects transfers of up to $1 million of assets into a DAPT (and the appreciation thereon), it tends only to be used by residents of Oklahoma. Further, for now, we’ll only address asset protection features of the different DAPT jurisdictions. In a subsequent article, we’ll discuss the Internal Revenue Code Sections 2036 and 2038 possible estate inclusion issues with a DAPT and how best to minimize them.

Two Methods of Drafting

Asset protection planners draft DAPTs with two different objectives: (1) for asset protection only; or...
In almost all DAPT statutes, asset protection is primarily based on spendthrift protection.

With respect to claims by creditors and exception creditors, the asset protection of a discretionary trust is completely unrelated to spendthrift protection. That is, discretionary trust protection, which originated under English common law, is based on whether a beneficiary does or doesn’t have an enforceable right to a distribution, and therefore, whether a potential creditor may stand in the shoes of a beneficiary. If the beneficiary has no enforceable right to receive a distribution under a trust, the beneficiary’s interest isn’t a property interest and is nothing more than an expectancy that can’t be attached by any creditor. Because of the beneficiary’s lack of an enforceable right to force a distribution, a discretionary trust offers more protection against creditors’ claims than a spendthrift trust, particularly with respect to many marital claims.

This lack of an enforceable right in a discretionary DAPT is key to protecting against creditors’ claims that arise in the following marital issues:

1. Will the beneficiary’s trust interest be considered marital property subject to division in a divorce?
2. Will an estranged spouse be able to force a distribution through a minor child beneficiary?
3. Will undistributed income be imputed by a court in the computation of a beneficiary’s child support or alimony?

To answer the first question, 10 states have created “marital property” rights in certain trust interests that rise to the level of a property interest and are, therefore, subject to division in divorce. As to the second question, an estranged spouse may force a distribution through a minor child beneficiary based on the
Which DAPT Jurisdictions Make the Grade?

Compare the elements of each state's domestic asset protection trust statute

<table>
<thead>
<tr>
<th>Listed Alphabetically</th>
<th>Discretionary (marital protection)</th>
<th>Type of exception creditors</th>
<th>Only remedy: fraudulent conveyance</th>
<th>Fraudulent Conveyance Law</th>
<th>Burden of proof</th>
<th>Present creditor length of time (years)</th>
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<td></td>
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<td>Clear and convincing 2 years/6 months</td>
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<td>Clear and convincing</td>
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Endnotes

1. Tenn. Code, Section 35-16-104(a).
2. Virginia has an older style of fraudulent conveyance statute that doesn’t follow the Uniform Fraudulent Conveyance or Uniform Fraudulent Transfer Acts. In this respect, it doesn’t specifically mention the date-of-discovery rule. Some commentators have interpreted the Virginia statute as the claim must be made within five years from the recordation of the transfer, or, if not recorded, within five years from when the transfer should have been discovered. Va. St. Section 55.545.03(20). See, e.g., David G. Shaftel, Comparison of Domestic Asset Protection Trust Statutes updated through June 30, 2012, www.actec.org/public/.../chart_06_30_2012.pdf.
3. Alaska, Delaware, Hawaii, New Hampshire, Rhode Island, South Dakota, Tennessee and Wyoming have language stating something similar to “Notwithstanding any other provision of this Code, no action of any kind, shall be brought at law or in equity for attachment of other personal remedies” unless such action is brought pursuant to the fraudulent conveyance statute. Conversely, the Nevada statute states, “A creditor may not bring an action with respect to a spendthrift provision unless the creditor can prove” a fraudulent conveyance or that the “transfer violates legal obligation owed to the creditor under a contract or a valid court order that is legally enforceable by the creditor.” While not as clear as the other state statutes, we would interpret the Nevada statute as eliminating other equitable remedies, such as a constructive trust, resulting trust, alter ego, piercing the veil or a dominion and control remedy.
4. Hawaii’s statute allows only Hawaii income taxes as an exception creditor, not all governmental claims.
5. Delaware’s proposed solution is to prohibit a Delaware court from using Articles 50 and 60 of the Restatement (Third) of Trusts, but rather use the judicial review standard of the Restatement (Second) of Trusts, Section 187. While this approach is significantly weaker than the New Hampshire, Nevada, Oklahoma and South Dakota models, it’s a major step in the right direction.
6. Ohio’s definition of a discretionary trust is incredibly limited; it only provides discretionary asset protection if the distribution standard contains no standards or guidelines. Ohio may want to look to Nevada’s, Oklahoma’s or South Dakota’s discretionary support act to provide marital protection for many more types of discretionary trusts. Also, the Ohio statute doesn’t explicitly state that a beneficiary doesn’t have an enforceable right to a distribution. Rather, the statute is based on case law. Pack v. Osborn, 117 Ohio St.3d 14 (2008).
**FEATURE: FIDUCIARY PROFESSIONS**

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<thead>
<tr>
<th>Future creditor length of time (years)</th>
<th>Forcing litigation to the DAPT state</th>
<th>Automatic removal of trustees</th>
<th>Charging order protection</th>
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<td>Best LLC and LP</td>
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<td>Silent LLC and LP</td>
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**Key:**

Distribution standard, if such child has an enforceable right to a distribution. And, the law is still evolving in the states where domestic relation courts are considering whether income should be imputed for the purpose of child support or alimony when a beneficiary has an enforceable right to a distribution. (For more detail regarding these marital issues, please see our *Trusts & Estates* January 2012 article, “Which Situs is Best in 2012?” p. 51.) Note that no DAPT statutes address these marital issues. In almost all DAPT statutes, asset protection is primarily based on spendthrift protection.

**Exception Creditors**

Some advisors focus on the existence of exception creditors as a key element to determine the strength of a state’s DAPT statute. These advisors note that some states, such as Delaware, Ohio and South Dakota, allow an ex-spouse to reach the trust assets for child support or maintenance. Conversely, states such as Alaska or Nevada, which are silent with respect to those exception creditors, haven’t developed any case law regarding exception creditor status for child support or maintenance.

We generally disagree with the idea that a child support exception creditor or the maintenance exception creditor substantially dilutes the creditor protection of a DAPT. First, it’s uncertain whether an Alaska or Nevada court will create a court exception creditor in future case law. Second, if a client who’s located in a non-DAPT state uses a DAPT to skirt a child support or maintenance obligation, we strongly suggest that a non-DAPT domestic relations court wouldn’t follow conflicts-of-law principles and use every equitable remedy within its power to conclude that an ex-spouse could reach the trust assets under local law. This would be a “bad facts” case that makes a “bad law” situation. For these reasons, we don’t consider these two exception creditors (child support and maintenance) found in the majority of the DAPT statutes to be a major asset protection dilution issue. Conversely, by having clear rules, the courts are less free to develop remedies of their own.

In contrast, permitted exception creditors, other than child support and maintenance, may weaken DAPTs for certain types of clients or clients who have certain types of claims against them. For example, Delaware, Hawaii and New Hampshire have created a “tort creditor exception” for a claimant who was injured before the creation of a tortfeasor’s DAPT, thus,
permitting a tort creditor to reach trust assets. The general effect of this exception creditor is to extend the statute of limitations for a tort creditor to bring an action against the DAPT.

Let’s look at an example. Assume a neurosurgeon committed a negligent act. Shortly thereafter, the neurosurgeon created a Delaware DAPT. Assume the statute of limitations in Delaware to bring a medical malpractice action is six years. In Year 5, a patient brings an action against the neurosurgeon. In Year 8, the patient obtains a judgment against the neurosurgeon. The tort creditor exception allows the patient/creditor to recover against the Delaware DAPT, regardless of Delaware’s 4-year fraudulent conveyance statute of limitations. This issue becomes much more problematic in terms of DAPT protection if the doctor wasn’t a neurosurgeon, but rather an obstetrician/gynecologist, which generally has a 6-year medical malpractice statute of limitations that begins from the date a minor patient reaches age of majority. This means potential recovery for a tort creditor up to 24 years after the alleged act was committed (age of majority (18), plus six years).

Regarding other exception creditors, Hawaii, Utah and Wyoming provide for an exception creditor if the creditor demonstrates written reliance on assets transferred into the trust prior to the transfer. Nevada has a related exception creditor provision if a transfer violates a legal obligation. A few other DAPT states allow an exception creditor for governmental claims and/or taxes. Finally, Utah adds the following three exception creditors: public assistance provided under the Medical Benefits Recovery Act; a court order for the division of marital property; and a category that includes fraud, intentional infliction of harm or a crime.

Marital Property Claims

Probably one of the most misunderstood exception creditors is Utah’s court order for the division of marital property. Utah is the only state that allows this exception creditor without any qualification. Utah’s statute doesn’t depend on whether the court order occurred prior to or after the transfer to the DAPT. It also doesn’t depend on whether the spouse is an ex-spouse, current spouse or a future spouse. Simply, any court order from any state for the division of marital property will reach the assets of a Utah DAPT.

Conversely, five states (Delaware, New Hampshire, Ohio, South Dakota and Tennessee) have DAPT statutes that prevent a less than honorable spouse from misappropriating marital property for his own use by providing the following exception creditor to spendthrift protection:

To any person to whom the transferor is indebted on account of . . . for a division or distribution of property incident to a separation or divorce proceeding in favor of such transferor’s spouse or former spouse . . .

Alaska also has a similar provision that denies spendthrift protection for transfers of property during marriage to an Alaskan DAPT without the written consent of the current spouse.

Some advisors misinterpret the above language and make the erroneous claim that these DAPT statutes don’t protect against marital claims. These advisors misunderstand the distinction discussed at the beginning of this article regarding discretionary interest protection and spendthrift protection for marital claims. Moreover, these advisors miss a key definition in these five DAPT statutes. Only a “spouse or former spouse,” as defined in their DAPT statutes, qualifies for this exception. “Spouse or former spouse” is defined as “only persons to whom the transferor was married at, or before, the time the...
qualified disposition is made [italics added].

Thus, if a less than honorable spouse seeks to transfer marital property into a DAPT solely for his own benefit, Alaska, Delaware, New Hampshire, Ohio, South Dakota and Tennessee won’t allow him to misappropriate marital property from his current spouse. Also, if a former spouse was awarded marital property, Delaware, New Hampshire, Ohio, South Dakota and Tennessee won’t allow him to transfer property subject to this marital claim into a DAPT, in an attempt to shirk an ex-spouse who had a valid claim before the transfer.

Does the absence of such a provision in other DAPT statutes mean that courts in these states will allow less than honorable spouses to misappropriate marital assets from their current or former spouses who had claims before the transfer? Obviously, a spouse could bring a fraudulent conveyance action in these states. However, if the fraudulent conveyance statute of limitations period had expired, would these other DAPT statutes allow him to succeed in his scheme?

We say, “no.” Rather, courts facing this type of fact pattern will most likely try to render an equitable result. By analogy, take the case of Sheikh Fahad Mohammed Al-Sabah Fahad (Sheikh Fahad), the prime minister under the Shah of Iran. After Iran fell, Sheikh Fahad created the Bluebird Trust in the Bahamas. When Iran sought to lay claim to the Bluebird Trust assets, the fraudulent conveyance statute of limitations had expired. However, the Bahamas court still pierced the trust under the common law theory that Sheikh Fahad had transferred stolen assets. Since Sheikh Fahad never had valid title to the assets, the trust couldn’t have valid title. We suggest that DAPT courts in Alaska, Delaware, New Hampshire and South Dakota—jurisdictions where DAPT statutes lack specific language—will reach the same result: Courts won’t allow DAPT statutes to be used to steal marital assets from one spouse or shirk a valid marital claim that originated before the transfer.

On the other hand, do all DAPT statutes, except Utah, allow a client to transfer separate property to a DAPT prior to marriage? The answer is “yes,” with the caveat that Alaska requires that the transfer must be made at least 30 days prior to the marriage, or the fiancé must be notified in writing of the transfer. For these reasons, we find only Utah has a significant exception creditor regarding marital property.

How Lead DAPT Statutes Work

With the exceptions of Missouri, Oklahoma, Utah and Virginia, the other 10 DAPT statutes provide that the only remedy a creditor may bring is a claim that there was a fraudulent transfer to a DAPT. In essence, this should eliminate all other legal and equitable claims against trust property, such as constructive trust, resulting trust, alter ego, piercing the veil or dominion and control types of arguments. Equitable remedies, such as alter ego, piercing the veil and dominion and control arguments require the client to dot all “i’s” and cross all “t’s” in the administration of the trust. Further, the dominion and control argument allows any court (whether DAPT state or non-DAPT state) to use its standards to determine whether a settlor retained too much control.

Eliminating all remedies other than a fraudulent conveyance is a major asset protection feature that distinguishes these 10 states from the other four.

Fraudulent Transfers

So, if the only remedy a creditor can bring is to prove a fraudulent transfer, then the focus turns to: How debtor-favorable is the DAPT fraudulent transfer statute? The standard Uniform Fraudulent Transfer Act (UFTA) allows any creditor to prove a fraudulent conveyance based on a preponderance of the evidence if the transfer was done to hinder, delay or defraud any creditor. The standard period of time for a creditor to bring a fraudulent transfer action is typically four years.

When reviewing the debtor-friendliness of a DAPT fraudulent transfer statute, here are five key questions to ask:

1. Does the statute limit claims to fraudulent intent?
2. Does the statute require the specific creditor alleging a fraudulent transfer to prove intent as applied to that specific creditor?
3. Does the statute require the creditor to prove the transfer was fraudulent by clear and convincing evidence?
4. What’s the statute of limitations period for a present creditor?
5. What’s the statute of limitations period for a future creditor?

A standard fraudulent transfer law allows
avoidance of any transfer that “hinders, delays or defrauds” a creditor. While direct authority regarding “hinder” and “delay” is sparse, what little authority that does exist indicates that transfers can “hinder” or “delay” without involving fraud. Alaska, Delaware, Ohio and South Dakota have a competitive advantage over Nevada on this point, as their statutes limit a fraudulent conveyance action against a DAPT to only actual fraudulent intent.

Interestingly, the UFTA allows any fraudulent transfer against any creditor to be used by a different creditor when there was no fraudulent transfer against the complaining creditor as a basis to void a transaction. Alaska, Delaware, Ohio and South Dakota have all changed this rule so that the complaining creditor must prove a fraudulent transfer specifically as to him, her or it. With these DAPT statutes, the complaining creditor can’t argue that the transfer was a fraudulent transfer to someone else.

Nevada law is a bit unclear. Nevada Revised Statutes (NRS) Section 166.170(3) references NRS Section 112, which mimics the standard language from the UFTA. So, at first blush, it appears that Nevada uses an “any creditor” standard. However, there’s qualifying language in Section 166.170, which states that proof by one creditor that a transfer was fraudulent doesn’t constitute proof as to any other creditor. Conversely, it doesn’t state that the specific creditor must prove a fraudulent transfer as against himself.

The UFTA requires a preponderance of the evidence standard (that is, greater than 50 percent) to prove a fraudulent transfer. Either by case law or statute, all DAPT states except New Hampshire, Tennessee and Wyoming require a creditor to prove the transfer was a fraudulent transfer by clear and convincing evidence (that is, greater than 70 percent to 80 percent). New Hampshire, Tennessee and Wyoming retain the UFTA preponderance of evidence burden of proof.

The national version of the UFTA requires a present creditor to bring a claim within four years from the time of transfer or one year from the date of discovery of the transfer. Almost all DAPT states, except possibly Virginia, follow this dual-prong approach, with the only difference being the number of years to bring a claim. For example, Alaska and Delaware allow a 4-year period from the time of transfer or a 1-year period from the date of a present creditor’s discovery of the transfer. South Dakota and Nevada have a 2-year period from the date of the transfer and a 6-month period from the date of discovery; Ohio has an 18-month period from the date of transfer and a 6-month period from the date of discovery.

Ten DAPT states make a substantial asset protection improvement to the UFTA. They eliminate the date-of-discovery rule. In other words, a future creditor can’t claim that he was unaware of the transfer and then file a fraudulent transfer action based on the date of discovery of the DAPT. Conversely, the date-of-discovery rule remains for future creditors in Missouri, Oklahoma, Virginia and Wyoming.

In the event that a debtor is in bankruptcy, differences in DAPT state fraudulent conveyance law are irrelevant. That’s because the Bankruptcy Code extends the statute of limitations to 10 years for a bankruptcy trustee to exercise his avoidance powers if transfers were made to a self-settled trust or “equivalent” with the intent to hinder, delay or defraud a creditor. The Bankruptcy Code also retains the date-of-discovery rule for future creditors, the rule that any creditor may be used to prove a fraudulent conveyance and the preponderance of evidence burden of proof.

Litigation Issues

Alaska, Delaware, Nevada, Ohio and South Dakota all have provisions stating that their courts have exclusive jurisdiction over actions involving their DAPTs. This is a critical difference between lead trust jurisdictions and the next tier. Assume that a creditor files first in a Colorado court (a non-DAPT state) against a DAPT. Will the DAPT state accept a concurrent action? When a DAPT statute states that it has exclusive jurisdiction, it appears that the answer is “yes.” Conversely, in the non-lead DAPT states, the courts may well state that the foreign court already has jurisdiction over the matter.

Moreover, even if an action isn’t brought in the DAPT state’s forum (that is, the non-DAPT state doesn’t respect the jurisdiction provision), Delaware, Hawaii, Ohio and Wyoming provide for the automatic removal of the trustee if a foreign court doesn’t follow these states’ DAPT laws. A successor trustee or new trustee under these DAPT statutes will be appointed. It’s uncertain whether these provisions will survive a constitutional challenge, but they still create a major statutory hurdle that a creditor must surmount.

Charging Orders

Most of the time, either a family LP or LLC is owned
partially or wholly by a DAPT. This strengthens the likelihood that an out-of-state judge will apply the governing law of the trust under conflict-of-laws principles. This is because an LLC or FLP interest is personal property. So now, in addition to the factors of the governing law of the trust and the place of administration, some of the trust property is held in the same state. That’s when charging order protection becomes important. A charging order is a court-authorized right given to a judgment creditor, which allows him to attach distributions from an entity such as a family LP or LLC, but only when such distributions are made. The creditor doesn’t receive voting rights to decide whether there should be a distribution.

When evaluating state charging order statutes, consider that the “best” jurisdictions have a statute that: (1) prevents the judicial foreclosure sale of the partner’s or member’s interest; and (2) provides either a provision denying any legal or equitable remedies against the partnership or a provision preventing a court from issuing a broad charging order interfering with the activities of the partnership. We use the label “SR” in “Which DAPT Jurisdictions Make the Grade?” to designate the jurisdictions where a charging order is the “sole remedy” and there’s no other language in the statute (or comments, in the case of a state UTC) stating that a court may issue additional orders to effect the charging order or a court may order the judicial foreclosure sale of the partner’s or member’s interest. The label “JF” designates that either the statute or case law allows the judicial foreclosure sale of the partner or member’s interest.

Endnotes
2. Note that we haven’t listed Colorado on “Which DAPT Jurisdictions Make the Grade?” p. 54, as a state with domestic asset protection trust (DAPT) legislation, due to case law that severely questions whether Colorado’s statute, C.R.S. Section 38-10-111, was ever intended for such a purpose. See In Re Cohen, 8 P3d 429 (Colo. 1999) and In Re Bryan, 415 B.R. 454 (Bankr. D. Colo. 2009). Contrast with In Re Baum, 22 F.3d 1014 (10th Cir. 1994).
4. For example, see David G. Shaftel, Comparison of Domestic Asset Protection Trust Statutes (Updated Through June 30, 2012), published by Ameri-