



Kobre & Kim's Claim Monetization Team



Jacob Kirkham
Delaware
jacob.kirkham@kobrekim.com



John Han
Hong Kong
john.han@kobrekim.com



Mark Rowlands
London
mark.rowlands@kobrekim.com



Renata Ramalhosa
São Paulo
renata.ramalhosa@kobrekim.com



Stephen J. Astringer
Delaware
stephen.astringer@kobrekim.com



Timothy de Swardt
BVI
timothy.deswardt@kobrekim.com

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The Potential of Delaware Trust Structures to Mitigate Creditor Risk

Delaware's Domestic Asset Protection Trusts (DAPTs) remain powerful tools for shielding assets, offering unique defenses against creditor claims and legal challenges. Delaware law protects settlors from fraudulent transfer claims, insulates trusts from "illusory trust" arguments, and enforces Delaware law even when challenged elsewhere. For debtors, understanding and strategically leveraging these features can help preserve assets and strengthen protection against aggressive creditors.

As creditors find ways to crack Delaware's Domestic Asset Protection Trusts (DAPTs), debtors should remain mindful of the debtor-friendly features embedded in Delaware trust law.

Several strategies may threaten Delaware's DAPTs, including attacks on the trust's validity, finding connections with a state that doesn't recognize such trusts, or fraudulent transfer claims. Delaware allows individuals to shield assets through a DAPT, where the trust's settlor is also the trust's beneficiary. Using DAPTs, a settlor can shield his or her assets from creditors while retaining the right to benefit from those assets.

Although DAPTs are inherently robust, settlors should maximize their protective measures, including against:

#1: Fraudulent Transfer Claims. Delaware law gives the trustee "a first and paramount lien" against the DAPT assets equal to the costs, including attorney's fees, the trustee incurs in defending the trust's assets against fraudulent transfer claims unless the trustee acts in bad faith. Any bad faith by the trustee must be shown with clear and convincing evidence. In practice, the prospect that trust assets will be used to pay for defending against a creditor's fraudulent transfer claims may reduce, if not eliminate, the creditor's appetite to pursue such claims.

#2: Claims That the Trust is Illusory. English law trusts can be challenged if the settlor retains too much control over the trust assets, such as where the settlor has a wide-ranging right to veto the trustee's decisions, if the settlor's approval of decisions is required, or if they have the power to remove and replace the trustees without cause. Some English authorities have held that in such cases the attempt to create a trust failed. In these situations, it does not matter if the settlor's powers under the trust instrument are held in their capacity as settlor, protector, beneficiary, investment advisor, or some other role. Trusts held to be invalid for this reason have been described as "illusory trusts."

However, the principle has no application in Delaware. Delaware trust law provides relatively broad rights to the settlor with respect to DAPT assets without a corresponding risk that the trust could be found to be "illusory." Thus, compared to trusts governed by English law, a Delaware trust might offer better protection against claims that the breadth of powers retained by a settlor could lead to a finding that the trust does not exist.

#3: Application of Non-Delaware Law. Delaware trust law also aims to curtail attempts by courts outside of Delaware to apply non-Delaware law to matters involving Delaware DAPTs. It provides that a decision by any court that Delaware law does not govern a Delaware DAPT will trigger (i) automatic dismissal of the existing trustee and (ii) appointment of a new trustee under either a designation made in the trust instrument or an order by Delaware's Chancery Court. Triggering the removal of an existing trustee may cause courts outside Delaware to lose personal jurisdiction over the claims against a Delaware DAPT, at least in cases where jurisdiction over the trustee is necessary to proceed with the claim.

The attractiveness of Delaware's trusts makes the state a repository of debtor assets and a potential source of high returns for creditors. The DAPT framework, combined with a diligent approach to exploring all avenues, will create a much stronger fortress.

About Kobre & Kim

Kobre & Kim is a global conflict-free law firm focused on disputes and investigations, often involving fraud and misconduct.

Often working closely with lawyers in key markets around the world, our Delaware team:

- Consists of experienced trial litigators in the Delaware Court of Chancery and U.S. Bankruptcy Court for the District of Delaware who focus on complex commercial disputes;
- Provides offensive and defensive cross-border litigation and crisis management strategies in and out of court;
- Has deep experience tracing and recovering misappropriated funds and defending against asset attacks.