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Articles

Rethinking the Law of Creditors' Rights in Trusts

by
ROBERT T. DANFORTH*

Whoever has the right to give, has the right to dispose of the same as he pleases. *Cujus est dare ejus est disponere*, is the maxim which governs in such case.¹

It is against public policy to permit a man to tie up his own property in such a way that he can still enjoy it but can prevent his creditors from reaching it.²

Introduction

The last several years have witnessed the beginning of a revolutionary and controversial trend in the law of trusts in the United States: as a means of attracting business for its banks and other professional fiduciaries, several states, most notably Alaska and Delaware, have enacted legislation to facilitate the creation of so-called asset protection trusts (APTs), which allow trust settlors to shelter their assets from the claims of most creditors. This trend follows a decades-long development that has allowed the creation of such trusts offshore, and the changes in domestic law reverse a long-standing American rule under which the asset-protection features of

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1. *Ashhurst v. Given*, 5 Watts & Serg. 323, 330 (Pa. 1843) (declining to allow a beneficiary's creditor to reach his interest in a trust).

2. 1 AUSTIN WAKEMAN SCOTT, THE LAW OF TRUSTS § 156, at 782 (1st ed. 1939) [hereinafter SCOTT ON TRUSTS (1st ed.)].

such trusts generally have been viewed as ineffective. This new development in American law also has generated a wealth of academic commentary, all of it negative.³ The trend appears likely to continue unabated, as other states compete for the investment funds of settlors seeking to shelter their assets from creditors.

This article examines the theoretical underpinnings of the traditional American rule concerning creditors' rights in trusts established for the settlor's own benefit. Under the traditional rule, a creditor of a settlor is entitled to reach the assets of a trust for the settlor's own benefit even though, in the case of a discretionary trust,⁴ the settlor may himself or herself have no enforceable right to trust distributions, and even though allowing creditor access to the trust assets may compromise the otherwise enforceable interests of other trust beneficiaries. The article concludes that the traditional American rule is theoretically unsound. This conclusion is based on the principles of law and practical considerations that guide the behavior of trustees in determining the size and frequency of trust distributions and in determining to whom those distributions should be made. The article concludes that, as a general proposition, the rights of a creditor in an APT should be no greater than the rights of the settlor, and the rights of the settlor's creditors should not be permitted to defeat the rights of other trust beneficiaries.

By calling the traditional American rule into question, the article points to a provocative conclusion: APTs may and should be effective under some circumstances. But the purpose of the article is not to advocate for APT legislation. Nor is its purpose to answer all outstanding policy questions about the circumstances under which APTs should be respected. Rather, the article has some more modest goals. First, the article seeks to refocus the debate about APTs, by evaluating creditors' rights based on realistic assessments of the nature of the settlor's interest in an APT and the nature of the trustee's duties to the settlor and other trust beneficiaries. Second, recognizing the perhaps inevitable tide of legislation permitting APTs, the article seeks not to stem the tide, but rather to guide it to produce a reasonable balance between the rights of creditors and the interests of trust beneficiaries. At stake are the competing objectives of property owners, whose goal is to impose limits on their own and

3. See Randall J. Gingiss, *Putting a Stop to "Asset Protection" Trusts*, 51 BAYLOR L. REV. 987 (1999); Henry J. Lischer, Jr., *Domestic Asset Protection Trusts: Pallbearers to Liability?*, 35 REAL PROP. PROB. & TR. J. 479 (2000); Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035 (2000); Karen E. Boxx, *Gray's Ghost—A Conversation About the Onshore Trust*, 85 IOWA L. REV. 1195 (2000).

4. A discretionary trust is one in which the trustees have discretion concerning distributions to beneficiaries.

others' access to their property, and their creditors, who seek to pierce those limits by raising public policy concerns.⁵

Part I of the article provides an overview of the American law of trusts in connection with the rights of creditors of trust beneficiaries. Part I begins with an introduction to basic trust law concepts and terminology. Part I next describes the law of creditors' rights applicable to trusts of which the settlor is not a beneficiary. As Part I explains, the law generally allows the assets of such trusts to be sheltered from the claims of the beneficiaries' creditors. Part I then describes the contrary rule that has applied traditionally to so-called self-settled trusts, that is, trusts for the (exclusive or non-exclusive) benefit of the settlor. Until the recent legislative developments mentioned above, the firmly established American rule was that the assets of a self-settled trust were, with limited exceptions, fully accessible by the settlor's creditors. Part I considers the historical roots of this rule, examines its theoretical basis, and concludes that the rule is theoretically unsound.

Part II describes the legal developments that, beginning in the mid-1980s, led to a substantial offshore trust industry, which caters to the asset-protection objectives of Americans and others whose domestic laws fail to afford such protection. Part II then describes the legislative efforts in several American states to institute the self-settled APT as a feature of American law. Part II also considers briefly whether the creditor-protective features of these trusts will be respected by courts in United States jurisdictions that continue to follow the traditional rule. This discussion is followed by Part III, which considers the law of fraudulent transfers and its significance in evaluating creditors' rights in self-settled trusts.

Part IV of the article reexamines the law of creditors' rights in trusts by analyzing those rights from the perspective of basic fiduciary principles. Based on this reexamination, Part IV concludes that the traditional American approach to creditors' rights in self-settled trusts is based on a fundamental misunderstanding of the relationships among settlors, other trust beneficiaries, and trustees. In considering the use of APTs, Part IV also examines other creditor-protection planning tools available under present law (such as limited partnerships and tenancies by the entirety) and concludes that allowing APTs under some circumstances would serve to extend creditor protection to individuals for whom these other tools are not practicably available. Part IV then considers the policy arguments for and against the use of APTs and suggests some possible limitations that should be placed on their availability and effectiveness.

5. The article's opening quotations, *see supra* text accompanying notes 1-2, articulate the standard supporting arguments.

I. Background

A. Basic Trust Law Concepts and Terminology

A trust is an asset-management device that divides the burdens and benefits of ownership of property between a trustee, on the one hand, and beneficiaries, on the other. This division of ownership interests creates a fiduciary relationship between the trustee and the beneficiaries. The trustee is said to hold the "legal interests" in the trust property (i.e., the trustee holds legal title), while the beneficiaries are said to hold the "equitable interests" in the property. Thus, although the trustee is strictly speaking the "owner" of the trust assets, the trustee owns those assets not for the trustee's own benefit, but for the benefit of the beneficiaries, for whom the trustee is a fiduciary. The rights and obligations of the trustee and the beneficiaries are established by the terms of the trust instrument and through a body of law that has developed principally through decisions by courts of equity defining and enforcing the interests of trust beneficiaries. Trust law from time to time may also be modified by statute.

To create a trust, a property owner transfers assets to a trustee. The transfer is usually accompanied by a written trust instrument that sets forth the terms of the trust, including both the dispositive provisions (i.e., the instructions for how the trustee is to dispose of the assets) and the administrative provisions (which specify most powers and duties of the trustee in managing the assets). The person who creates the trust is known as the "settlor."⁶ The trustee is usually, although need not be, someone other than the settlor. The beneficiaries of the trust may or may not include the settlor,⁷ depending on the objectives for which the trust is established. A trust will typically include "current beneficiaries," persons to whom the trustee is authorized or required to make current distributions, and "future beneficiaries," persons who will or may receive trust distributions in the future.⁸

6. Or, alternatively, the "grantor." This article uses the term "settlor."

7. In fact, under some circumstances, the settlor will be the sole beneficiary of the trust. Note, therefore, that one person can assume any number of the roles of settlor, trustee, and beneficiary. In order to have a valid trust, however, the trustee must owe a duty to someone other than only herself. Thus, although the trustee and the beneficiary can be the same person, the sole trustee cannot also be the sole beneficiary, for under that circumstance there would be no division between the legal and equitable interests.

8. Future beneficiaries often include both persons who may or shall receive periodic distributions of income and principal, commencing at some point in the future, and remainder beneficiaries, who may or shall receive outright distributions of principal at the trust's termination.

A trust typically establishes different dispositive schemes for trust "income" and trust "principal." For example, the trust instrument may authorize or direct the payment of income to one beneficiary or group of beneficiaries and also authorize or direct the payment of principal to the same or different beneficiaries. The concepts of "income" and "principal" are defined under applicable state law (sometimes with variations prescribed by the trust instrument). In simple terms, "principal" includes the original trust assets, proceeds from the sale of those assets, and any replacement assets purchased with the proceeds, reduced by certain charges (as prescribed by applicable law); "income" includes all trust earnings, such as rents, dividends, and interest (but excluding realized capital gains, which constitute principal), reduced by all charges not allocable to principal.

B. General Rules Regarding Creditors' Rights in Trusts

Except as otherwise provided by law⁹ or by the governing instrument, a beneficiary's interest in a trust is freely transferable. Thus, a beneficiary entitled to all income of a trust for life can transfer the income interest, either gratuitously or for consideration, to some other person, who then holds a trust income interest *pur autre vie*. By transferring the interest for consideration, the beneficiary is able to anticipate the interest by receiving for it funds worth approximately the present value of the income stream, as measured by the beneficiary's life expectancy. The beneficiary's income interest can also be transferred *involuntarily*, through attachment by a judgment creditor of the beneficiary.¹⁰

Both voluntary and involuntary transfers of trust interests can disrupt a trust's dispositive plan. Consider, for example, a trust created for the benefit of the settlor's child, who lacks the requisite judgment and skill to handle outright ownership of property. If the child could anticipate her interest by selling it or using it as collateral for a loan, the trust would lose its effectiveness as a tool for managing assets on the child's behalf. Similarly, if through improvidence the child were to incur a debt which could then be satisfied from trust assets, the trust would fail to serve its purpose of protecting against such improvidence.

9. In New York interests in trusts are not transferrable unless the settlor expressly provides otherwise. See N.Y. EST. POWERS & TR. LAW § 7.1-5 (McKinney 1992).

10. The judgment creditor will seek to satisfy the beneficiary's obligation in one of two ways: (i) by obtaining a court order requiring the trustee to make the income payments to the creditor, until the beneficiary's obligation is satisfied or (ii) by obtaining a court order requiring the trustee to sell the income interest and pay the proceeds to the creditor. The latter alternative is usually not available as a practical matter, due to the lack of a market for trust income interests.

To guard against such disruptions, most trusts include a so-called spendthrift provision, of which the following is typical:

To the extent permitted by law, the principal and income of this trust shall not be liable for the debts of any beneficiary or subject to alienation or anticipation by a beneficiary.

Almost all American jurisdictions give effect to such provisions under most circumstances, although most jurisdictions also refuse to give effect to spendthrift provisions for certain types of creditors, most significantly persons seeking delinquent child support payments and governments seeking collection of unpaid taxes.¹¹

A spendthrift provision is not the only means of providing creditor protection for trust beneficiaries. Consider, for example, a so-called discretionary trust for the benefit of the settlor's child, under which the trustee is authorized to distribute income and principal in such amounts and for such purposes as the trustee deems appropriate. In the absence of a spendthrift provision (or if the spendthrift provision were for any reason ineffective), the child's interest in the trust could be attached by the child's creditors. Yet, as a practical matter, attaching the child's interest would provide creditors with little or nothing of value, because the creditors (in the child's stead) could not compel the trustee to make (and thus the trustee would be unlikely to make) any distributions. Thus, in the case of a discretionary trust, it is the *nature* of the beneficiary's interest rather than a provision prohibiting transfers of the interest that protects the trust assets against creditors' claims. Because the beneficiary could not compel trust distributions, neither can the beneficiary's creditors.¹²

C. Traditional Rules Regarding Creditors' Rights in Self-Settled Trusts

Until recently, in the United States the asset protection attributes of trusts described above were not available with respect to trusts for the settlor's own benefit.¹³ The apparent origin of this rule lies in a fifteenth century English statute, which provided that "all deeds of

11. Moreover, as discussed below, virtually all jurisdictions refuse to give effect to spendthrift provisions for the benefit of the settlor. See *infra* notes 13-16 and accompanying text.

12. This is not to say, however, that the beneficiary of a discretionary trust can *never* compel distributions. Under some circumstances a trustee's refusal to make distributions under a wholly discretionary standard might be considered unreasonable and thus an abuse of discretion. See *infra* notes 274-276 and accompanying text. As a practical matter, however, a creditor in the beneficiary's stead would face an even greater challenge than the beneficiary in compelling a trustee to make distributions from a wholly discretionary trust.

13. For a discussion of recent domestic legislation allowing asset protection trusts, see *infra* notes 89-119 and accompanying text.

gift of goods and chattels made or to be made [in] trust, to the use of that person or persons that made the same deed of gift, be void and of none effect."¹⁴ This statute has been enacted in a number of American jurisdictions, though in most cases with the modification that the transfer is void only "as against creditors" of the settlor.¹⁵ In virtually every state in which the issue is not addressed by statute, there is judicial authority to the same effect.¹⁶ Thus, the traditional rule in the United States, as reflected in section 156(1) of the Restatement (Second) of Trusts,¹⁷ is that a spendthrift provision for the benefit of the settlor is not effective. For example, if a settlor were to create a trust, reserving the right to income for life and including a spendthrift provision, the settlor's creditors could reach the income interest notwithstanding the spendthrift provision.

Can a settlor shelter trust assets from creditors' claims by reserving a discretionary interest in the trust? In the United States, the traditional answer to this question is "no." Although the settlor of a discretionary trust cannot compel the trustee to distribute trust income or principal to the settlor, the settlor's creditors *are* able to compel such distributions. The standard formulation of this rule is set forth in section 156(2) of the Restatement (Second) of Trusts as follows:

Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.¹⁸

Applying the Restatement rule, suppose a settlor creates a trust, the terms of which authorize the trustee to distribute to the settlor

14. 3 Hen. 7, c. 4 (1487); *see also* 2A AUSTIN WAKE SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 156, at 168 n.4 (4th ed. 1987) [hereinafter SCOTT ON TRUSTS (4th ed.)].

15. 2A SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 156, at 169.

16. 2A SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 156, at 165-67 n.1.

17. The Second Restatement describes the rule as follows:

Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.

RESTATEMENT (SECOND) OF TRUSTS § 156(1) (1959); *see also* RESTATEMENT (THIRD) OF TRUSTS § 58(2) (Tentative Draft No. 2, 1999) (stating that "[a] restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor is invalid"); UNIFORM TRUST CODE § 505(a) (2000) (creditors can reach settlor's interest "[w]hether or not the terms of a trust contain a spendthrift provision").

18. RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959); *see also* RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (Tentative Draft No. 2, 1999) (stating that the settlor's creditors "can reach the maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor"); UNIFORM TRUST CODE § 505(a)(2) (2000) (stating that a "creditor . . . of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit").

such amounts of income and principal as the trustee deems appropriate for any purpose. A creditor of the settlor can reach all of the trust assets, because the maximum amount that can be distributed by the trustee is the entire trust. Suppose instead the settlor creates a trust, the terms of which authorize the trustee to distribute to the settlor (or for the settlor's benefit) such amounts of income and principal of the trust as may be necessary for the settlor's support. Under these circumstances, a creditor of the settlor is entitled to reach the maximum amount that could be distributed for the settlor's support, regardless of whether the creditor supplied goods or services in connection with the settlor's support.¹⁹

The origin of and rationale for the Restatement rule is murky. The rule appears in the original Restatement²⁰ and also in the original edition (and all subsequent editions) of the classic treatise on the law of trusts written by the late Professor Austin Wakeman Scott,²¹ who was also the Reporter and principal author of the First and Second Restatements. Neither Restatement nor the Restatement Reporter's Notes offer a rationale for the rule. The most recent edition of Professor Scott's treatise provides only the following:

Clearly, the policy that prevents a person from creating a spendthrift trust for his own benefit also prevents him from depriving his creditors of a right to reach the trust property by creating a discretionary trust.²²

Thus, to understand Professor Scott's rationale for the rule, we must also look to his discussion of the invalidity of spendthrift provisions in self-settled trusts. Unfortunately, that discussion, too, offers little elaboration or analysis. In that context, Professor Scott states simply that "[i]t is against public policy to permit a man to tie up his own property in such a way that he can still enjoy it but can prevent his creditors from reaching it."²³ In discussing the distinction between self-settled trusts and trusts established for persons other than the settlor, Professor Scott states that "[i]t is against public policy to permit the owner of property to create for his own benefit an interest

19. 2A SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 156.2, at 176. This rule may be contrasted with the rule applicable to support trusts for the benefit of persons other than the settlor, which in general may *not* be reached by the beneficiaries' creditors. See RESTATEMENT (SECOND) OF TRUSTS § 154 (1959).

20. RESTATEMENT OF TRUSTS § 156(2) (1935).

21. 1 SCOTT ON TRUSTS (1st ed.), *supra* note 2, § 156.2 at 784; 2 AUSTIN WAKEMAN SCOTT, THE LAW OF TRUSTS § 156.2 (2d ed. 1956); 2 AUSTIN WAKEMAN SCOTT, THE LAW OF TRUSTS § 156.2 (3d ed. 1967); 2A SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 156.2.

22. 2A SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 156.2, at 176.

23. 2A SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 156, at 167; *see also* 1 SCOTT ON TRUSTS (1st ed.), *supra* note 2, § 156, at 782.

in that property that cannot be reached by his creditors."²⁴ Most modern cases elaborate little on these rationales, simply citing the Restatement or Professor Scott's treatise.

Note two essential components of the Restatement rule. First, the rule grants to creditors greater rights than those retained by the settlor himself or herself: the settlor cannot compel trust distributions, but the settlor's creditors can. Second, the rule applies notwithstanding that allowing the settlor's creditors to reach the assets of the trust may defeat not just the settlor's interests, but also the interests of other beneficiaries.

In connection with the latter point in particular, consider *Greenwich Trust Co. v. Tysons*.²⁵ In *Greenwich Trust Co.*, the settlor created a trust in which the trustee was authorized (but not required) to pay income to or for the benefit of the settlor, his wife, and his children for a period of 20 years, at which time the trust assets reverted to the settlor; if the settlor died before the end of the 20-year term, the trust continued for the benefit of the settlor's wife and children. Relying in part on the original Restatement, the court held that the settlor's creditor could reach the entire income interest of the trust, despite the fact that the income could be distributed currently to someone other than the settlor and despite the fact that any accumulated income (in case of the settlor's death during the 20-year term) would pass to persons other than the settlor. In responding to the trustee's concern that paying the settlor's creditor would defeat the interests of other trust beneficiaries, the court stated:

The outstanding factor in the situation is that, under a trust where the trustee has absolute discretion to pay the income or expend it for the settlor's benefit, the trustee could, even though he had a like discretion to expend it for others, still pay it all to the settlor. Such a trust opens the way to the evasion by the settlor of his just debts, although he may still have the full enjoyment of the income from his property. To subject it to the claims of the settlor's creditors does not deprive others to whom the trustee might pay the income of anything to which they are entitled of right; they could not compel the trustee to use any of the income for them. The public policy which subjects to the demands of a settlor's creditors the income of a trust which the trustee in his discretion may pay to the settlor applies no less to a case where the trustee might in his discretion pay or use the income for others.²⁶

Thus, the court characterized the interests of the non-settlor beneficiaries as merely a device to permit "evasion of the settlor of

24. 2A SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 156, at 168.

25. 27 A.2d 166 (Conn. 1942).

26. *Id.* at 173.

his just debts,"²⁷ not worthy of protection in face of the right of the settlor's creditor to be paid.

Two elements of the quoted passage are particularly noteworthy. First, the court observes that, under the terms of the trust, the settlor "may still have the *full enjoyment* of the income from his property."²⁸ Second, the court states that satisfying the claim of the settlor's creditor "does not deprive others to whom the trustee might pay the income of anything to which they are entitled of right; *they could not compel the trustee to use any of the income for them.*"²⁹ Each statement reflects a misunderstanding of basic fiduciary principles, topics on which the article elaborates in Part IV, but which bear emphasis here as well. The court's first observation—that the settlor may still have "full enjoyment" of trust income—suggests, without directly saying, that the settlor gave up no rights to income when he included his wife and children as beneficiaries, i.e., that he might be entitled to receive *all* the income, notwithstanding that other beneficiaries were potential income recipients. This statement ignores the fact that the trustee would be required to consider the interests of the wife and children in making income distributions and would be exposed to potential liability to the wife and children if it distributed all of the trust income to the settlor. The second statement—that the wife and children could not compel the trustee to distribute income to them—ignores the fact that a trustee, even one operating under a wholly discretionary standard, can be held liable for unreasonably withholding distributions to a beneficiary. The corollary of this proposition, of course, is that the trustee could be compelled to make distributions to the wife and children under certain circumstances. Thus, allowing the settlor's creditor to reach the income stream may very well have compromised enforceable interests of non-settlor beneficiaries.

As noted earlier,³⁰ the principal sources of the traditional rule—the Restatements and Professor Scott's treatise—offer little guidance on its rationale. Most cases that postdate the Restatement simply cite the Restatement or Professor Scott's treatise, with little or no analysis or elaboration of why the rule is being adopted.³¹ Moreover, as observed in connection with *Greenwich Trust Co.*, the traditional rule may be based on misunderstandings of fiduciary principles governing the relative rights and interests of multiple trust beneficiaries. These

27. *Id.*

28. *Id.* (emphasis added).

29. *Id.* (emphasis added).

30. See *supra* notes 19-24 and accompanying text.

31. See *Ware v. Gulda*, 117 N.E.2d 137, 138 (Mass. 1954); *In re Robbins*, 826 F.2d 293, 295 (4th Cir. 1987) (applying Maryland law); *In re Hertsberg Inter Vivos Trust*, 578 N.W.2d 289, 291 (Mich. 1998); *Hanson v. Minette*, 461 N.W.2d 592, 596 (Iowa 1990).

observations prompt the question whether Professor Scott, in writing his treatise and in drafting the Restatement,³² properly analyzed the available precedent. The materials immediately following consider this question by reviewing the principal cases cited by Professor Scott in the first edition of his treatise.³³

32. The first Restatement predates the treatise by several years, but the American Law Institute did not publish Reporter's Notes for the First Restatement. See Herbert F. Goodrich, *Introduction to RESTATEMENT (SECOND) OF TRUSTS* viii (1959) (noting that the Second Restatement, unlike the first, includes published Reporter's Notes); see also <http://www.ali.org> (same) (last visited June 7, 2001). Because the first edition of the treatise postdates the Restatement by only a few years, it is likely that the same precedents served as authority for both works.

33. In support of his assertion that the creditor of a settlor can reach the maximum amount that could be distributed by the trustee, Professor Scott in the first edition of his treatise cites the following cases: *De Rouse v. Williams*, 164 N.W. 896 (Iowa 1917); *Warner v. Rice*, 8 A. 84 (Md. 1887); *Bryan v. Knickerbacker*, 1 Barb. Ch. 409 (N.Y. Ch. 1846); *McLean v. Button*, 19 Barb. 450, 1854 WL 5847 (N.Y. 1854); *Sloan v. Birdsall*, 11 N.Y.S. 814 (Sup. Ct. 1890); *Nolan v. Nolan*, 67 A. 52 (Pa. 1907); *Hay v. Price*, 15 Pa. D. 144 (Ct. Com. Pl. 1906); *J.S. Menken Co. v. Brinkley*, 31 S.W. 92 (Tenn. 1895); *Petty v. Moores Brook Sanitarium*, 67 S.E. 355, 356 (Va. 1910); *Crane v. Illinois Merchants Trust Co.*, 238 Ill. App. 257 (1925). See 1 SCOTT ON TRUSTS (1st ed.), *supra* note 2, §§ 156.1 n.2 & 156.2 n.2. *Warner v. Rice*, *Hay v. Price*, *Bryan v. Knickerbacker*, and *J.S. Menken Co. v. Brinkley* are discussed in greater detail below. See *infra* notes 34-52 and accompanying text. This footnote briefly considers the other cases. As this footnote suggests, most of the cases cited by Professor Scott provide, at best, marginal support for his statement of the general American rule.

Consider, for example, *Petty*, 67 S.E. 355. In *Petty*, the settlor was the sole beneficiary of the trust during his lifetime, and the settlor retained a testamentary power of appointment over the trust assets. *Id.* Thus, any distributions made by the trustee would necessarily benefit the settlor only, and the disposition of any amounts not distributed by the trustee was subject to the settlor's control at his death. *Id.* at 355-56. The case therefore does not support a rule in which the rights of the settlor's creditors are allowed to defeat the interests of non-settlor beneficiaries. Similarly, in *Nolan*, the settlor was the sole beneficiary for life and held a testamentary power of appointment over the remainder. See 67 A. at 54.

Sloan is ambiguous concerning the extent to which a settlor's creditors can defeat the interests of other trust beneficiaries. 11 N.Y.S. 814. *Sloan* involved a trust that permitted income distributions for the support of the settlor, but which also permitted distributions to the settlor's wife and daughter under certain circumstances. *Id.* After reviewing the law concerning the rights of the settlor's creditors to reach the assets of the trust, the court stated:

[T]he trust-deed given by the [settlor] was valid as between the parties, and as to all the world except his creditors, and . . . it was also valid as to his creditors, so far as the trusts for the benefit of his wife and daughter were concerned. The trusts that were valid did not fail because the instrument creating them also contained one that became invalid when the superior rights of creditors were involved.

11 N.Y.S. at 816-17. This portion of the opinion is confusing, because the case did not involve multiple trusts; it involved a single trust, with the settlor as principal beneficiary during his and his wife's joint lifetimes, the daughter as beneficiary with respect to periodic distributions of principal, and both the wife and the daughter as remainder

A review of the precedents on which Professor Scott relied suggests that he read them somewhat generously in support of his position. Consider, for example, *Warner v. Rice*,³⁴ cited by Professor Scott in support of what has now become the traditional American rule. In *Warner*, the settlor created a trust "for the use and benefit of [the settlor] and his immediate family," the trustee being granted the authority to apply the income of the trust "to the support and maintenance of [the settlor] and his said family, during [the settlor's] life."³⁵ The settlor also retained a testamentary power of appointment, which allowed him to direct to whom the trust assets would be distributed following his death.³⁶ The court ruled that the settlor's creditors were entitled to recover from the trust assets,

beneficiaries. The above quoted passage suggests, therefore, that the settlor's creditors would not be able to defeat the interests of the wife and daughter (and thus that the creditor was *not*, in fact, entitled to the maximum amount that could be distributed to the settlor by the trustee).

McLean involved not a discretionary trust at all, but a non-gratuitous transfer, for which the consideration was the transferee's agreement to support the transferor, his wife, and his children. 1854 WL at 5847, at *1-*2. Although the court subjected the transfer to the claims of the transferor's creditors (treating the transfer, for this purpose, as if it were a transfer in trust), the opinion nowhere supports Professor Scott's view that the transferor's creditors are entitled to receive the maximum amount that could be distributed to the transferor.

DeRousse involved an ex-wife's claim for alimony against a trust for the benefit of the ex-husband. 164 N.W. at 897. The opinion principally concerns whether the ex-husband should be deemed the settlor of his interest in the trust, which he acquired in a transaction for consideration. No portion of the opinion describes the terms of the trust (it describes it simply as a "spendthrift" trust, with no elaboration); the case, therefore, provides no support for Professor Scott's rule concerning the rights of creditors in self-settled discretionary trusts.

Crane does generally support Professor Scott's position, although its facts suggest that the case should apply under limited circumstances. 238 Ill. App. 257. *Crane* held that the settlor's creditors could reach the assets of a self-settled discretionary trust, notwithstanding that the settlor himself could not have compelled distributions. The transfer of assets to the trust occurred *after* the settlor had incurred the debts, and the transfer apparently rendered the settlor insolvent. *See id.* at 261, 267. In reaching its conclusion, the court specifically considered whether it was appropriate to grant the settlor's creditors greater rights than those held by the settlor himself. Referring to "[t]he general rule that a judgment creditor in a proceeding by garnishment acquires no greater rights against the garnishee than the judgment debtor has," the court observed that this general rule "is subject to [exceptions] in cases of fraud affecting the rights of judgment creditors . . . and in cases where . . . property of a debtor has been transferred . . . for the purpose of defrauding creditors." *Id.* at 268. Under these circumstances, the court allowed the settlor's creditors to reach the assets of the trust. The court does *not* state that it would permit creditors to reach self-settled discretionary trusts *only* under these circumstances; nevertheless, the facts of the case and the quoted discussion suggest that less egregious circumstances might have prompted a different conclusion.

34. 8 A. 84 (Md. 1887).

35. *Id.* at 85.

36. *See id.*; *see also infra* note 258 (explaining power of appointment terminology).

despite the fact that the settlor's interest was a discretionary one and thus the settlor himself could not have compelled distributions to himself. In this respect the decision is consistent with the rule Professor Scott advocated. The court, however, goes to great lengths to describe the trust as being *for the sole benefit of the settlor*—although distributions could have been made for the benefit of the settlor's "immediate family," the court interpreted this as allowing distributions only for the purpose of discharging the settlor's support obligations to those persons.³⁷ Moreover, as the court also emphasized, the settlor retained complete control over the disposition of the property following his death, through exercise of his testamentary power of appointment.³⁸ In sum, therefore, the trust was established for the sole benefit of the settlor, and any amounts not distributed to the settlor during his lifetime would be subject to disposition by him at death. The case thus provides little support for Scott's rule concerning discretionary interests in trusts, under which the settlor's creditors are allowed to defeat the interests of non-settlor trust beneficiaries. Moreover, a trust in which the settlor both is the sole beneficiary and holds a testamentary power of appointment does not implicate the fiduciary duty questions raised above in connection with *Greenwich Trust Co.* A trustee of such a trust will be less constrained in making lifetime distributions to the settlor, because no future beneficiary has an enforceable interest that could be compromised by such distributions.

Consider also *J.S. Menken Co. v. Brinkley*,³⁹ which Professor Scott also cites in support of the traditional American rule. Like *Warner*, *Brinkley* involved a discretionary trust for the sole benefit of the settlor during his lifetime, with respect to which the settlor retained a testamentary power of appointment.⁴⁰ In holding that the settlor's creditors could reach the assets of the trust, the court expended significant effort in distinguishing a case cited by the trustee⁴¹ (in support of sheltering the trusts assets from creditors' claims), the most important distinction being that the trust in the other case was for the collective benefit of the settlor and certain family members, not solely for the benefit of the settlor.⁴² Accordingly, *Brinkley* offers only weak support for Scott's position

37. See 8 A. at 87 (noting that the trust authorized distributions for the benefit of "those bearing the relation to him of dependents for support" and that no family member otherwise held an enforceable interest in the trust).

38. See *id.* at 86.

39. 31 S.W. 92 (Tenn. 1895).

40. See *id.* at 93.

41. *Mills v. Mills*, 40 Tenn. (3 Head) 705 (1859).

42. *Brinkley*, 31 S.W. at 95.

and it offers no support for allowing a settlor's creditors to defeat the interests of non-settlor beneficiaries.

Another case cited by Professor Scott directly contradicts his position. *Bryan v. Knickerbacker* involved a self-settled trust, the terms of which authorized the trustee to distribute to or for the benefit of the settlor as much of the income of the trust as the trustee determined to be necessary for the settlor's support.⁴³ Any income not distributed to the settlor was to be accumulated by the trustee for eventual distribution to the remainder beneficiaries, the settlor's heirs at law. Although the trustee's authority to distribute income to the settlor was phrased in discretionary terms, the Chancellor interpreted the settlor's retained interest as giving the settlor an enforceable right to receive reasonable amounts of income from the trust for his support.⁴⁴ Based on this interpretation, the Chancellor held that the settlor's creditors could reach the settlor's interest, i.e., the amounts that the trustee would otherwise have distributed to the settlor for his support.⁴⁵ The Chancellor's opinion includes an extensive discussion of *Snowden v. Dales*,⁴⁶ which involved a self-settled trust in which the settlor retained a discretionary interest in the trust income, and in which the settlor expressly retained no right to compel distributions to himself. Any income not distributed to the settlor was to be accumulated by the trustee for distribution to the remainder beneficiaries. The Vice Chancellor in *Snowden* held that the entire income interest could be reached by the settlor's creditors.⁴⁷ The Chancellor in *Bryan* indicated that it would have come to a different conclusion on the facts of *Snowden*.⁴⁸ Because the settlor in *Snowden* had no right to compel trust distributions, the Chancellor reasoned, he would have ruled that the settlor's creditors "were only entitled to so much of the interest of the trust fund as the trustees should not, in their discretion, think proper to retain and accumulate for the benefit of the ultimate remaindermen."⁴⁹

Bryan thus directly contradicts Professor Scott's statement of the general American rule. Under Professor Scott's formulation of the rule, a settlor's creditor has greater rights than the settlor himself or herself; the creditor can compel the trustee to distribute to the creditor the maximum amount that could be distributed by the trustee, notwithstanding that the settlor could not compel such distributions. Moreover, under the traditional formulation of the

43. See 1 Barb. Ch. 409, 410, 426 (N.Y. Ch. 1846).

44. See *id.* at 428.

45. See *id.* at 430-31.

46. 6 Sim. Rep. 524 (Ch. 1834).

47. *Id.*

48. 1 Barb Ch. at 409

49. *Id.* at 430.

rule, the rights of creditors are allowed to defeat the interests of non-settlor trust beneficiaries. *Bryan* states that a creditor should be permitted to reach only those assets with respect to which the settlor could compel distributions and with respect to which the trustee has not in its discretion decided to retain in trust for the benefit of the non-settlor beneficiaries.

Another case cited by Professor Scott similarly does not fully support his position, but may offer a clue as to why Professor Scott's statement of the rule has been followed. In *Hay v. Price*,⁵⁰ which involved a discretionary trust for the sole benefit of the settlor during his lifetime, the court held, as in *Brinkley* and *Warner*, that the settlor's creditor could reach the assets of the trust. Thus, as in both *Brinkley* and *Warner*, allowing the settlor's creditor to reach the trust assets did not serve to defeat the interests of other trust beneficiaries,⁵¹ and the case accordingly does not support this aspect of the traditional rule. In reaching its conclusion that the assets should be subject to the creditor's claim, the court stated:

It is true that the trustee, under the terms of the [trust], has a wide discretion as to the use of the property for the benefit of the [settlor]. Nevertheless, whatever use shall be made of it must be for the benefit of the [settlor] and of no one else. The mere giving of such discretion to the trustee does not, as we conceive, alter the fact that it was the settlor who attempted to put his property beyond the reach of the creditors and at the same time enjoy the benefits of it. We do not think that there is any reason for holding that the rule laid down in *Mackason's Appeal* and other cases [which held invalid spendthrift provisions in favor of trust settlors] should not be given full and controlling application to this case [involving not a spendthrift provision, but a discretionary trust for the settlor's benefit]. To hold otherwise would enable improvident persons, by adoption of the device of conferring discretion on trustees as to the disposition of property or properties, to have a secret understanding with such trustee that all the income of the trust property, or all the corpus of it, should be used for the benefit of the settlor, and thus entirely to avoid the effect of the salutary principle laid down in the cases [concerning spendthrift provisions].⁵²

50. 15 Pa. D. 144 (Ct. Com. Pl. 1906).

51. The opinion does not clearly identify the remainder beneficiaries of the trust (in this case, the persons who would receive the trust assets at the settlor's death). The opinion indicates that, at the settlor's death, the trust assets would pass "to such person or persons and in such proportions or shares as may be directed under [Pennsylvania law]." *Id.* at 145. This language likely means either that the property would pass pursuant to a testamentary power of appointment held by the settlor or that the property would pass to the settlor's estate, to be distributed under the terms of his will or by intestacy. In either case, no person other than the settlor would have an enforceable interest in the trust during the settlor's lifetime. Thus, in this respect, too, the case fails to support the general rule articulated by Professor Scott.

52. *Id.* at 146 (emphasis added).

Although this point is nowhere discussed by Professor Scott, the quoted passage suggests that the real concern behind the traditional rule is that, with a discretionary trust for the benefit of the settlor (whether or not others are also beneficiaries), the settlor and the trustee could have a collusive arrangement, under which the trustee will make all trust assets available to the settlor.⁵³ Elaborating on this typically unstated concern, a court applying the traditional rule would reason as follows. If the settlor and the trustee are in a collusive relationship, it is appropriate to treat the settlor as if he or she is the outright owner of the property held in trust—if the trustee will do the settlor's bidding, then the trust is a sham, because the settlor at any time could revest all legal and equitable interests in the assets in himself or herself. Thus, allowing creditors access to the trust gives creditors no more powers over the property than are held by the settlor. Moreover, under these circumstances, the court has no concern that allowing creditors access to trust assets will defeat the interests of other beneficiaries—in practical effect, the non-settlor beneficiaries have no interests to defeat, because whether they receive any distributions is subject to the absolute veto power of the settlor. In sum, it is appropriate to allow creditors to recover from the assets of the trust, because the trust is the settlor's alter ego.

The foregoing discussion suggests that, in writing his treatise and in drafting the Restatement, Professor Scott either misread the applicable precedent or simply focused on those aspects of the precedent that supported the position that he advocated, while ignoring those aspects that contradicted his position. More importantly, for several reasons, the discussion suggests that the Restatement rule stands on shaky theoretical ground. First, the rule fails to take into account the interests of non-settlor beneficiaries that may be defeated by subjecting trust assets to creditors' claims. Most of the cases cited by Professor Scott involved trusts for the exclusive benefit of the settlor and over which the settlor held a testamentary power of appointment; as previously demonstrated, these cases do not support a rule that subjects assets to the claims of the settlor's creditors even if the settlor is not the sole beneficiary and does not retain control of trust distributions. Second, the rule is based on an

53. This concern was also a factor in at least two other cases cited by Professor Scott. See *J.S. Menken Co. v. Brinkley*, 31 S.W. 92, 94 (Tenn. 1895) (observing that the settlor "need only select, as trustee, a near kinsman or tried friend, on whom he may rely for liberality [in making distributions to the settlor], and thus indirectly accomplish what he cannot do directly [i.e., shelter the settlor's assets from his creditors]"); *Petty v. Moores Brook Sanitarium*, 67 S.E. 355, 356 (Va. 1910) (quoting *Brinkley*, 31 S.W. at 94). For a more recent case expressing the same concern, see *Greenwich Trust Co. v. Tyson*, 27 A.2d 166, 171 (Conn. 1942) (also quoting *Brinkley*, 31 S.W. at 94), discussed *supra* notes 25-29 and accompanying text.

erroneous presumption—that the settlor and the trustee are in a collusive relationship, in which the trust is merely an alter ego of the settlor. Although such a collusive relationship may under some circumstances exist, the Restatement apparently presumes that to be true. As discussed in greater detail in Part IV, such a presumption ignores both legal and practical considerations about the behavior of fiduciaries.

Only a few cases that postdate the first Restatement adopt a position contrary to the Restatement and Professor Scott.⁵⁴ Of these, the most well-reasoned is *Herzog v. Commissioner*.⁵⁵ In *Herzog*, the settlor transferred property to a trust, the terms of which authorized the trustees to distribute income to the settlor, the settlor's wife, and (after the death of the wife) the settlor's children, at such times and in such shares as the trustees deemed appropriate.⁵⁶ Following the settlor's death, the trust continued for the benefit of the wife if she survived the settlor and otherwise terminated in favor of the settlor's descendants. At issue was to what extent the settlor's transfer to the trust constituted a completed gift for purposes of the gift tax. The question whether the settlor's creditors could reach the income interest of the trust was relevant to the completed gift question, because, if under state law the settlor's creditors could reach the entire income interest, then the settlor would be deemed to have made a completed taxable gift only with respect to the remainder interests.⁵⁷

In an opinion by Judge Augustus Hand, the court decided that the settlor's creditors could *not* reach the income of the trust; thus, the settlor's transfer to the trust was properly characterized as a completed gift of both the income interest and the remainder interest. In reaching this conclusion, the court expressly rejected the Restatement view that the settlor's creditors could compel the trustees to distribute the entire income interest to them. The court saw the Restatement rule as inapposite when the settlor is not the sole beneficiary and when the settlor has not retained a power of appointment over the assets not distributed to him.⁵⁸ Thus, in the court's view, the settlor's creditors would have no right to reach his

54. Tax cases admittedly involve concerns—the interplay between federal tax law and state trust and property laws, the policies underlying the tax law, etc.—that limit their value as precedent for creditors' rights and other trust law questions. Nevertheless, *Herzog*, *Uhl*, and the other tax cases discussed in this section, *see infra* notes 55-65 and accompanying text, are at least instructive in their analysis of state law creditors' rights questions.

55. 116 F.2d 591 (2d Cir. 1941).

56. *Id.*

57. *See id.* at 594.

58. *See id.*

wholly discretionary interest in the trust. Note that, unlike the Restatement's approach to this question, the court's opinion grants the settlor's creditors no more rights than those retained by the settlor himself. Moreover, the opinion recognizes that allowing the settlor's creditors to reach the entire income interest would impair interests held by non-settlor beneficiaries. Finally, the opinion recognizes that, while the Restatement rule may make sense if the settlor has retained a power of disposition over trust assets remaining at the settlor's death, the rule makes no sense if, as a result of the transfer, the settlor has given up all such powers of disposition.

The court in *Estate of Uhl v. Commissioner*⁵⁹ reached a similar conclusion concerning a closely analogous issue—whether a settlor's retained discretionary interest in a trust triggers inclusion of the trust assets in the settlor's estate for estate tax purposes.⁶⁰ The settlor in *Uhl* transferred assets to a trust, the terms of which directed the trustee to distribute to the settlor at least \$100 monthly from the income of the trust and which authorized the trustee to distribute a sum greater than \$100 per month "if it shall deem advisable."⁶¹ At issue was to what extent the settlor had retained a *right* to income from the trust within the meaning of section 811 of the 1939 Internal Revenue Code (the predecessor to present section 2036 of the Code),

59. 241 F.2d 867 (7th Cir. 1957).

60. Without discussing the creditors' rights issue, the court in at least one other case reached the same conclusion as the court in *Uhl*. In *Helvering v. St. Louis Union Trust Co.*, 75 F.2d 416, 417 (8th Cir.), *aff'd*, 296 U.S. 39 (1935), the settlor transferred property to a trust for the principal benefit of his daughter and the daughter's family, the terms of which authorized the trustee to distribute all of the trust assets back to the settlor if the trustee should "deem it wise" to do so. The Court of Appeals held that the settlor's discretionary retained interest in the trust did not cause the trust assets to be includible in his estate under section 302(c) of the 1924 Internal Revenue Code (the predecessor to sections 2036 and 2038 of the present Code under which, in simple terms, with respect to transferred property, either a retained right to income or a retained right to revoke will trigger inclusion in the transferor's estate, *see* I.R.C. §§ 2036, 2038 (1994)). Although the court did not address the creditors' rights issue, implicit in the court's decision is that the settlor's creditors could not reach his retained discretionary interest in the trust; if the settlor's creditors could reach the trust assets, the settlor could indirectly revoke the trust by incurring debt and then relegating his creditors to the trust to satisfy their claims. The Supreme Court affirmed, again without discussing the creditors' rights issue, but stating that the settlor "left in himself no power to resume ownership, possession, or enjoyment." *St. Louis Union Trust Co.*, 296 U.S. at 43. The *St. Louis Union Trust Co.* approach was followed in a later Eighth Circuit decision concerning the same issue that arose in *Herzog*—whether the settlor's retained discretionary interest in a trust rendered a transfer partially incomplete for gift tax purposes. *Rheinstrom v. Commissioner*, 105 F.2d 642 (8th Cir. 1939). Citing *St. Louis Union Trust Co.* and without discussing the creditors' rights question, the Court of Appeals ruled that the possibility that the settlor would receive distributions from a portion of a trust did not render the settlor's transfers to the trust incomplete for gift tax purposes. *Id.* at 648.

61. 241 F.2d at 868.

which triggered estate tax inclusion of assets transferred by a decedent with a retained right to income.⁶² Both the government and the settlor's estate agreed that the settlor had retained a right to \$100 monthly; thus, the trust was includible under section 811 to the extent necessary to generate that income stream. The government also asserted, however, that the settlor should be deemed to have retained a right to *all* of the income of the trust. Under the government's theory, the settlor could have indirectly obtained the benefit of the entire income stream by incurring debt and then relegating his creditors to the trust for reimbursement;⁶³ this theory, of course, depended on a finding that the settlor's creditors could have reached his entire discretionary interest in the trusts. The Court of Appeals rejected the government's argument. Looking at Indiana law, the court concluded that the settlor's creditors could not have reached the discretionary component of the income interest—because the settlor himself could not have compelled distribution of that portion of the income, his creditors similarly should be unable to compel distribution.⁶⁴ In this connection, the court refused to apply an Indiana statute—making self-settled trusts void with respect to creditors' claims—to the transaction; the court concluded that the statute applied only to trusts for the sole benefit of the settlor and not to trusts in which non-settlors have beneficial interests.⁶⁵

To summarize the observations in this portion of the article, the traditional rule concerning creditors' rights in self-settled discretionary trusts—as articulated by Professor Scott and the Restatement—is flawed in two significant respects. First, the rule grants creditors greater rights than the rights retained by the settlor; in so doing, the rule also fails to safeguard the rights of non-settlor beneficiaries. Second, the rule fails to distinguish between self-settled trusts in which the settlor retains a power of disposition and those in which the settlor does not; that failure is apparently based on an assumption that self-settled trusts are collusive arrangements in which the trustee will do the settlor's bidding. As more fully developed in Part IV, a better-reasoned approach to this subject would take proper account of both the fiduciary duties of the trustee and the relative rights and powers of the settlor and other trust beneficiaries. At least in those cases in which the settlor is not the sole beneficiary and retains no powers of disposition, the traditional rule is both

62. *Id.* at 868-69.

63. *Id.* at 868 (discussing the Tax Court decision from which the settlor's estate appealed).

64. *See id.* at 870.

65. *See id.*

theoretically unsound and based on an inaccurate reading of precedent.

This is not to say, however, that *all* multi-beneficiary, self-settled trusts in which the settlor retains no power of disposition should be entitled to creditor protection. Whether the law should extend creditor protection to such trusts should depend on the nature and extent of the settlor's retained interest and the interests of other trust beneficiaries, the identity of the trustee and the relationship between the trustee and the beneficiaries, and the identity of the creditor and the facts giving rise to his or her claim. Nor do these observations about the traditional rule mean that *all* self-settled trusts in which the settlor retains a power of disposition or in which the settlor is the sole or primary beneficiary should be subject to creditors' claims. Whether the law should allow creditors to reach such trusts should depend on those factors described above, as well as on the nature and extent of the power of disposition. In all cases, the extent of creditors' rights should form a continuum, with the greatest rights existing in those trusts over which the settlor has reserved substantial interest and control and the least rights existing in those trusts for which the opposite is true.

II. Offshore Developments and the Domestic Response

As described in Part I of the article, trust laws in the United States have traditionally held invalid spendthrift provisions in favor of trust settlors, and the traditional American rule concerning discretionary interests in trusts has prohibited settlors from sheltering trust assets from the claims of their creditors. Largely in response to the limitations of American trust law, a number of foreign jurisdictions have developed laws favorable to settlors seeking to establish APTs.⁶⁶ In recent years, several American jurisdictions have followed suit. This part of the article describes and analyzes the significance of these developments.

A. Offshore Asset Protection Trusts

Beginning in the mid-1980s, a number of small, mostly island jurisdictions⁶⁷ envisioned and ultimately realized an extraordinary

66. See generally Sterk, *supra* note 3, at 1047-51; Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating it Too*, 47 RUTGERS L. REV. 11, 56-71 (1994).

67. The jurisdictions commonly used as havens for offshore APTs include Bahamas, Barbados, Belize, Bermuda, Cayman Islands, Cook Islands, Cyprus, Gibraltar, Mauritius, Nevis, Neuc, and Turks and Caicos Islands. See Gideon Rothschild, *Establishing and Drafting Offshore Asset Protection Trusts*, EST. PLAN., Feb. 1996, at 65, 66 n.1; Marty-Nelson, *supra* note 66, at 62; Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1,

business opportunity: the development of an offshore trust industry, designed to satisfy the appetites of Americans and others for protecting their assets from the claims of creditors. Most offshore APT legislative schemes are structured around three discrete, but related objectives—validating spendthrift and discretionary trust protection for trust settlors, limiting fraudulent transfer claims, and making it difficult or impossible to enforce foreign judgments. In these respects, the law in the Cook Islands is typical and is described in the paragraphs that follow.

The Cook Islands commenced its offshore APT business venture with the enactment of the International Trusts Act of 1984. The Act, which applies only to trusts established by non-resident settlors,⁶⁸ accomplishes its asset protection objectives through several key provisions. First, the Act establishes comprehensive spendthrift protection for international trusts.⁶⁹ These rules apply regardless of

32-33 & n.143 (1996).

Professor Jeffrey A. Schoenblum describes five principal "hubs" for offshore asset protection planning:

The first is in the Caribbean and largely serves the asset protection needs of a United States clientele with respect to creditor's claims and a Latin American as well as European clientele with respect to forced heirship claims and taxes. A second hub is the Channel Islands off the coast of France, serving European and Middle Eastern creditor, tax, and forced heirship claims, as well as a shelter from domestic or third country expropriatory efforts. A third hub is in the Mediterranean and essentially serves the same clientele as the second hub, but with the addition of a sizable Russian clientele. A fourth hub consists of island states in the Indian Ocean. These offshore centers, such as Mauritius and the Seychelles, tend to serve a clientele that is largely Middle Eastern, and Southern and Southeastern Asian. The fifth hub consists of certain island states of the Pacific. Here, United States grantors and those from Latin America, Australia, and the Far East tend to converge.

1 JEFFREY A. SCHOENBLUM, MULTISTATE AND MULTINATIONAL ESTATE PLANNING § 18.23[C][1] (2d ed. 1999) (footnotes omitted).

68. International Trusts Act of 1984 § 22 (1996) (Cook Islands) [hereinafter Cook Islands International Trusts Act] (*reprinted in* PETER SPERO, ASSET PROTECTION app. D (1994 & Supp. 1999)). As one commentator has observed, limiting the legislation only to international trusts demonstrates that it was designed to attract foreign capital. *See* Sterk, *supra* note 3, at 1048.

69. Section 13F of the Act provides in relevant part as follows:

Spendthrift beneficiary—

(1) For the purposes of this Act, and notwithstanding any rule of law or equity to the contrary, it shall be lawful for an instrument or disposition to provide that any estate or interest in any property given or to be given to any beneficiary shall not during the life of that beneficiary or such lesser period as may be specified in the instrument or disposition be alienated or pass by bankruptcy, insolvency or liquidation or be liable to be seized, sold, attached, or taken in execution by process of law and where so provided such provision shall take effect accordingly.

(2) Where property is given subject to any of the restrictions contained in

whether the settlor is a beneficiary, and they apply even if the settlor retains extensive controls over the trust.⁷⁰

Second, the Act substantially narrows the categories of transfers to international trusts that can be attacked by creditors under fraudulent transfer rules.⁷¹ Under the Act, assets transferred to an international trust are subject to a creditor's claim only if the creditor can prove "beyond a reasonable doubt" that the settlor made the transfer "with the principal intent to defraud the creditor" and that the transfer rendered the settlor "insolvent or without property by which that creditor's claim (if successful) could have been satisfied."⁷² Moreover, section 13B(4) of the Act provides that a transfer to an international trust shall not be considered fraudulent if the transfer occurred "before that creditor's cause of action against the settlor accrued."⁷³ Thus, unlike in the United States,⁷⁴ in the Cook Islands, transfers to APTs are never fraudulent with respect to future creditors. The Act also imposes a short statute of limitations on

subsection (1), the right to derive income from such property by a beneficiary and any income derived therefrom shall not pass by bankruptcy, insolvency or liquidation or be liable to be seized, attached or taken in execution by process of law.

(3) Where property is given subject to a restriction against alienation then the right to derive income from that property shall not be alienated for as long as that restriction remains in force.

Cook Islands International Trusts Act § 13F.

70. Section 13C of the Act provides:

Retention of control and benefits by settlor—An international trust and a registered instrument shall not be declared invalid or a disposition declared void or be affected in any way by reason of the fact that the settlor, and if more than one, any of them, either—

- (a) Retains possesses or acquires a power to revoke the trust or instrument;
- (b) Retains possesses or acquires a power of disposition over property of the trust or the subject of the instrument;
- (c) Retains possesses or acquires a power to amend the trust or instrument;
- (d) Retains possesses or acquires any benefit interest or property from the trust or any disposition or pursuant to the instrument;
- (e) Retains possesses or acquires the power to remove or appoint a trustee or protector;
- (f) Retains possesses or acquires the power to direct a trustee or protector on any matter;
- (g) Is a beneficiary trustee or protector of the trust or instrument either solely or together with others.

Cook Islands International Trusts Act § 13C.

71. For a discussion of fraudulent transfer laws in the United States, see *infra* notes 160-202 and accompanying text.

72. Cook Islands International Trusts Act § 13B(1).

73. Cook Islands International Trusts Act § 13B(4).

74. See *infra* notes 161-165 and accompanying text.

fraudulent transfer claims; under the Act, no transfer to an international trust shall be deemed fraudulent if the creditor fails to bring its action within one year of the transfer.⁷⁵

Third, the Act expressly provides that the Cook Islands courts shall not enforce or recognize a foreign judgment against an international trust, if the judgment is based on the application of any law inconsistent with the Act.⁷⁶ The practical effect of this rule is that a creditor who obtains a judgment outside of the Cook Islands against the settlor of an international trust not only will be unsuccessful in its attempt to levy upon the trust assets, but will also be forced to relitigate the substance of its claim in a Cook Islands court.⁷⁷

Several other features of offshore APTs further insulate trust assets from creditors' claims. First, if the APT is properly established in a foreign country, in most cases a court in the United States will lack personal jurisdiction over the trustee. Consequently, regardless of whether the United States court is inclined to respect the asset protection features of the APT, the court will be unable to exert any powers over the foreign trustee. Second, many offshore jurisdictions recognize the role of a trust "protector," a person granted special non-fiduciary powers to control the administration of the trust, with respect to such matters as removal and replacement of trustees, control over discretionary actions of the trustees, etc.⁷⁸ By use of the trust protector mechanism, a settlor is able to vest in some trusted person substantial control over trust administration, while at the same being able to resist the claim that the settlor himself or herself (whose actions will be subject to the authority of a United States court) retains such control.⁷⁹ If the trust protector is a United States person (and thus subject to the authority of a United States court), the trust instrument will typically give the protector no affirmative powers, but only veto powers, with the consequence that a United States court will be unable to compel the protector to force administration of the trust in a certain manner.⁸⁰ Third, many offshore APTs include a so-called duress clause, under which the trustee is directed to ignore any directions received from a settlor or trust protector who is under

75. Cook Islands International Trusts Act § 13B(3)(b).

76. Cook Islands International Trusts Act § 13D.

77. LoPucki, *supra* note 67, at 36.

78. See Howard D. Rosen, *The How's and Why's of Offshore Trusts in Asset Protection Planning*, 21 EST., GIFTS & TR. J. 115, 119-120 (1996).

79. Cf. *Federal Trade Commission v. Affordable Media, LLC*, 179 F.3d 1228, 1241-43 (9th Cir. 1999) (holding trust settlors, who also served as trust protectors, in civil contempt for failing to exercise their powers as protectors to force a repatriation of assets held in a Cook Islands trust).

80. See Rosen, *supra* note 78, at 120 (observing that "[a] court cannot order someone to exercise a veto power until the person over whom the veto power is exercisable (e.g., the offshore trustee) proposes to take action").

duress.⁸¹ Thus, for example, under a duress clause, the trustee of an APT would be required to disregard a direction from the settlor or protector to repatriate trust assets, if the settlor's direction was compelled by a United States court's order. Finally, most offshore APTs also include a "flight" clause, under which the trustee is authorized to change the situs of the trust, change the applicable law, and move the trust assets to a new jurisdiction, if a claim against the trust threatens to be successful.⁸² Flight provisions virtually guarantee that an offshore APT will never be subjected to a creditor's claim.

By all accounts, the efforts of offshore jurisdictions to attract foreign capital have been wildly successful. The British Home Secretary has estimated that offshore APTs may hold as much as \$6 trillion.⁸³ Although most other estimates are more modest,⁸⁴ it is clear that the offshore trust business has grown to become a substantial and thriving industry.

For American property owners, there are at least several potential disadvantages associated with offshore APTs. First, the use of an offshore APT may expose the settlor to the risk of economic and political instability in the offshore jurisdiction,⁸⁵ although the so-called flight clause may afford some protection against this risk.⁸⁶ A second disadvantage is the substantial and onerous reporting requirements imposed on foreign trusts by the Internal Revenue Code.⁸⁷ Third, the death of the settlor may be treated as a sale or exchange of the assets held in the trust, thus triggering capital gains.⁸⁸

81. *See id.*

82. HOWARD D. ROSEN, ASSET PROTECTION PLANNING A-12 to A-13 (1994) (setting forth an example of a flight provision).

83. David Leigh, *Billions Hidden Offshore: Jersey Faces Clampdown*, GUARDIAN (LONDON), Sept. 26, 1998, at 1 (indicating, probably erroneously, that this figure represents a third of the wealth of the world's most wealthy persons).

84. *See* Lischer, *supra* note 3, at 502 & nn.83-89 (summarizing numerous recent estimates).

85. *See* Marty-Nelson, *supra* note 66, at 67; *see also* Paul M. Roder, *American Asset Protection Trusts: Alaska and Delaware Move "Offshore" Trusts Onto the Mainland*, 49 SYRACUSE L. REV. 1253 (1999) (noting the modest risk of military coups in the Caribbean region; also discussing concerns about the business and economic reputation of the trust company). *But see* 1 SCHOENBLUM, *supra* note 67, § 18.23[G][2] (discounting the significance of these risks).

86. *See* 1 SCHOENBLUM, *supra* note 67, § 18.23[G][2].

87. *See* 2 SCHOENBLUM, *supra* note 67, § 22.04[F]. As described by Professor Schoenblum, there are three principal reporting requirements, mandated by I.R.C. § 6048. First, within 90 days of the creation of or transfer of property to a foreign trust, the settlor must notify the Internal Revenue Service. *See id.* § 22.04[F], at 484-85. Second, the person treated as the owner of the trust—which will typically be the settlor, *see* I.R.C. § 679 (1994 & Supp. IV 1998)—must ensure that the trust files a return that includes a complete accounting, the name of the United States "agent" for the trust, and other information required by the Secretary of Treasury. The United States agent must furnish the Secretary with information pertaining to the amounts that should be reported on the

B. Domestic Asset Protection Developments

The last several years have signaled the beginning of a revolution in the American law of trusts. Largely as a measure to attract business for their professional fiduciaries⁸⁷ and beginning with Alaska in 1997,⁸⁸ several states have enacted comprehensive trust law legislation designed to permit self-settled APTs. This portion of the article describes these domestic legislative developments and discusses certain questions concerning their effectiveness in achieving their stated objectives.

settlor's income tax return under the grantor trust rules. See 2 SCHOENBLUM, *supra* note 67, § 22.04[F], at 485. Third, beneficiaries of foreign trusts are required to file returns reporting distributions from the trusts. See *id.* § 22.04[F], at 485-86. Failing to comply with these reporting requirement can subject the taxpayer to severe penalties. See *id.* § 22.04[F], at 486 (discussing I.R.C. § 6677).

88. See 2 SCHOENBLUM, *supra* note 67, § 22.04[B][2] (discussing I.R.C. § 684 but acknowledging, at p. 466, that there are persuasive arguments that section 684 should not apply at the settlor's death).

89. The last several years have also witnessed two other state law developments designed to attract trust business. First, many states recently have abolished the rule against perpetuities, thus permitting settlors to create perpetual trusts, the principal purpose of which is to avoid estate, gift, and generation-skipping transfer taxation as enjoyment of the trust property passes through successive family generations. Marc S. Beckerman & Gerry W. Beyer, *Trusts and Estates Practice into the Next Millennium*, PROB. & PROP., Jan.-Feb. 1999, at 7, 9-10. Second, many states have abolished their state income tax as it applies to trusts (or, in some cases, as it applies to trusts established by non-resident settlors). See Lischer, *supra* note 3, at 515. All four states that now allow the creation of self-settled APTs—Alaska, Delaware, Nevada, and Rhode Island—also exempt such trusts from their state income tax. See *id.* Of these, Alaska, Delaware, and Rhode Island have also repealed their rule against perpetuities. See *id.* at 514. Thus, in these three states it is possible to establish a trust, the assets of which will be sheltered from the claims of creditors of both the settlor and multiple generations of the settlor's family, the income of which will be exempt from state income tax, and the assets of which will avoid estate, gift, and generation-skipping transfer taxation, subject to certain limitations. See I.R.C. §§ 2010(c) (West 2001), 2631 (1994 & Supp. IV. 1998) (limiting the amount that can be sheltered from generation-skipping transfer tax to \$1,000,000 per transferor as of 2001; the exemption increases to \$3,500,000 as of 2009).

90. Followed thus far by Delaware, Nevada, and Rhode Island. See Richard G. Bacon & John A. Terrill, II, *Domestic Asset Protection Trusts Work—Should They?*, 26 EST., GIFTS & TR. J. 123, 125-28 (2001); Boxx, *supra* note 3, at 1204-08. In 1986, the Missouri legislature passed legislation apparently designed to permit self-settled APTs under limited circumstances. See Mo. Rev. Stat. § 456.080(2)(a)-(b) (West 1999 & Supp. 2000). The Missouri scheme has gone largely unnoticed, however, due in part to some unfavorable case law, see *In re Enfield*, 133 B.R. 515, 521 (W.D. Mo. 1991) (stating that the Missouri statute codifies the traditional rule *against* self-settled spendthrift trusts), and in part to fewer promotional efforts by the Missouri estate and financial planning industries, see Lischer, *supra* note 3, at 516 n.149.

(1) *Domestic Legislative Developments*

As of 2001, four states—Alaska, Delaware, Nevada, and Rhode Island—have enacted legislation permitting the use of self-settled APTs.⁹¹ The legislation in two of those states—Alaska and Delaware—has been the most heavily promoted and is the most discussed in the literature;⁹² the article accordingly focuses primarily on the legislation in those two states.

Under the 1997 Alaska legislation,⁹³ if a trust includes a spendthrift provision, the creditors of a trust beneficiary (even if the beneficiary is the trust settlor) cannot reach the beneficiary's interest, as long as the following conditions are satisfied: (1) the transfer to the trust was not intended to hinder, delay, or defraud creditors; (2) the settlor reserves no power to revoke or terminate the trust without the consent of a person with a substantial adverse beneficial interest in the trust;⁹⁴ (3) the trust instrument does not require distributions of income or principal to the settlor; and (4) at the time the trust was established, the settlor was not 30 days or more in default of a child

91. For an excellent tabular summary of the legislation in all four states, see Lischer, *supra* note 3, app. at 592-600.

92. See, e.g., Lischer, *supra* note 3; Sterk, *supra* note 3; Boxx, *supra* note 3; Gingiss, *supra* note 3; Roder, *supra* note 85; Bacon & Terrill, *supra* note 90; Douglas J. Blattmachr & Richard W. Hompesch II, *Heavyweight Competition in New Trust Laws*, PROB. & PROP., Jan.-Feb. 1998, at 30; John E. Sullivan III, *Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes With Offshore Trusts*, 23 DEL. J. CORP. L. 423 (1998); John Paul Parks, *Evaluating the Alaska Trust's Ability to Shield Assets From the Claims of Creditors*, ARIZ. ATT'Y, Nov. 1998, at 28; Ritchie W. Taylor, *Domestic Asset Protection Trusts: The "Estate Planning Tool of the Decade" or a Charlatan?*, 13 B.Y.U. J. PUB. L. 163 (1998); Douglas J. Blattmachr & Jonathan G. Blattmachr, *A New Direction in Estate Planning: North to Alaska*, TR. & EST., Sept. 1997, at 48; Richard W. Nenno, *Delaware Law Offers Asset Protection and Estate Planning Benefits*, EST. PLAN., Jan 1999, at 3; Jonathan G. Blattmachr *et al.*, *New Alaska Trust Act Provides Many Estate Planning Opportunities*, EST. PLAN., Oct. 1997, at 347; Richard W. Hompesch *et al.*, *Does the New Alaska Trusts Act Provide an Alternative to the Foreign Trust?*, J. ASSET PROTECTION, July-Aug. 1997, at 9; Leslie C. Giordani & Duncan E. Osborne, *Will the Alaska Trusts Work?*, J. ASSET PROTECTION, Sept.-Oct. 1997, at 7; Howard D. Rosen & Patricia A. Donlevy-Rosen, *Domestic Asset Protection Trusts: Do They Work?*, 23 EST., GIFTS & TR. J. 211 (1998); John K. Eason, *Home From the Islands: Domestic Asset Protection Trust Alternatives Impact Traditional Estate and Gift Tax Planning Considerations*, 52 FLA. L. REV. 41 (2000).

93. Before 1997, Alaska followed the traditional American rule. See ALASKA STAT. § 34.40.110 (Michie 1962) (repealed 1997). Former section 34.40.110 provided, "[a] deed of gift, a conveyance or a transfer or assignment, verbal or written, of goods and chattels or things in action made in trust for the person making the deed, conveyance, transfer, or assignment is void as against the creditors, existing or subsequent, of the person."

94. The statute does, however, permit the settlor to retain a power to veto distributions or a non-general testamentary power of appointment. See ALASKA STAT. § 34.40.110(b)(2) (Lexis 2000).

support obligation.⁹⁵ Thus, under the Alaska statute, the assets of a self-settled trust that includes a spendthrift provision, and under which the trustee has absolute discretion to distribute income and principal to the settlor, will be sheltered from the claims of the settlor's creditors, unless the settlor's transfer to the trust was fraudulent.⁹⁶

The Alaska legislation also modified its fraudulent transfer rules for purposes of transfers to Alaska APTs. Under the new legislation, a transfer to an APT will be considered fraudulent only if the claimant can prove actual fraud; the statute apparently contemplates no forms of constructive fraud,⁹⁷ a concept recognized under

95. ALASKA STAT. § 34.40.110(a)-(b) (Lexis 2000). Section 34.40.110 provides in pertinent part as follows:

(a) A person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. In this subsection,

- (1) "property" includes real property, personal property, and interests in real or personal property;
- (2) "transfer" means any form of transfer, including deed, conveyance, or assignment.

(b) If a trust contains a transfer restriction allowed under (a) of this section, the transfer restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor, or another person from satisfying a claim out of the beneficiary's interest in the trust, unless the

- (1) transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons under AS 34.40.010;
- (2) trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; in this paragraph, "revoke or terminate" does not include a power to veto a distribution from the trust, a testamentary special power of appointment or similar power, or the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor;
- (3) trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor; or
- (4) at the time of the transfer, the settlor is in default by 30 or more days of making a payment due under a child support judgment or order.

96. An Alaska APT is not effective, however, to shelter assets from an elective share claim by a surviving spouse. Under the Alaska statutes, the assets of an Alaska APT created during the marriage are included in calculating the augmented estate, for purposes of determining the size of the surviving spouse's elective share. See ALASKA STAT. § 13.12.205(2)(A) (Lexis 2000). The spouse's elective share may be satisfied from the Alaska APT only to the extent other assets passing to the surviving spouse are inadequate. Boxx, *supra* note 3, at 1206. For an overview of the augmented estate concept and the operation of elective share statutes, see Robert T. Danforth, *Estate Planning Implications of a Surviving Spouse's Elective Share Rights*, 22 EST., GIFTS & TR. J. 235, 235-37 (1997).

97. See Sterk, *supra* note 3, at 1052.

traditional fraudulent transfer rules.⁹⁸ Moreover, in most cases a fraudulent transfer claim against an Alaska APT will be unsuccessful if brought more than four years after the settlor's transfer to the trust.⁹⁹

Alaska also modified its jurisdictional and choice of law rules to facilitate the creation of Alaska APTs and to ensure their ability to withstand court challenges. Under section 13.36.035(c) of the Alaska statutes, a provision in a trust specifying the application of Alaska law and subjecting the trust to the jurisdiction of Alaska courts is "valid, effective, and conclusive" if (1) some or all of the trust assets are in Alaska, (2) one of the trustees is an Alaska resident, (3) the Alaska trustee has the power to maintain trust records and prepare trust income tax returns, and (4) at least a portion of the administration of the trust occurs in Alaska.¹⁰⁰ Under section 13.36.035(d), a trust that includes a valid Alaska choice of law and jurisdictional provision is governed by Alaska law with respect to all matters concerning administration of the trust and construction of the trust instrument.¹⁰¹ Under section 13.36.310(a) of the Alaska statutes, a trust satisfying the choice of law and jurisdictional requirements of section 13.36.035(c) is immune from attack under most circumstances:

Except as provided in AS 34.40.110 [allowing claims based on actual fraud or delinquent child support payments], a trust that is governed by AS 13.36.035(c) or that is otherwise governed by the

98. See *infra* note 173 and accompanying text.

99. See ALASKA STAT. § 34.40.110(d) (Lexis 2000). Section 34.40.110(d) provides as follows:

A cause of action or claim for relief with respect to a fraudulent transfer under (b)(1) of this section, or under other law, is extinguished unless the action is brought as to a person who

- (1) is a creditor when the trust is created, with the later of (A) four years after the transfer is made; or (B) one year after the transfer is or reasonably could have been discovered by the person; or
- (2) becomes a creditor subsequent to the transfer into trust, within four years after the transfer is made.

100. ALASKA STAT. § 13.36.035(c) (Lexis 2000).

101. ALASKA STAT. § 13.36.035(d) (Lexis 2000). Section 13.36.035(d) provides as follows:

The validity, construction, and administration of a trust with a state jurisdiction provision are determined by the laws of this state, including the

- (1) capacity of the settlor;
- (2) powers, obligations, liabilities, and rights of the trustees and the appointment and removal of the trustees; and
- (3) existence and extent of powers, conferred or retained, including a trustee's discretionary powers, the powers retained by a beneficiary of the trust, and the validity of the exercise of a power.

For purposes of this section, the term "state jurisdictional provision" refers to an Alaska choice of law and jurisdiction provision, as described in section 13.36.035(c). See *Boxx, supra* note 3, at 1205 n.48.

laws of this state . . . is not void, voidable, liable to be set aside, defective in any fashion, or questionable as to the settlor's capacity, on the grounds that the trust or transfer avoids or defeats a right, claim, or interest conferred by law on a person by reason of a personal or business relationship with the settlor or by way of a marital or a similar right.¹⁰²

Moreover, to the extent that a claim falls within one of the exceptions to the statute (that is, if the claim is based on actual fraud or delinquent child support payments), the trust is set aside only to the extent necessary to satisfy the claim.¹⁰³

The Delaware legislation—also passed in 1997—is substantially similar to the Alaska legislation; it was enacted in the hope that the law would allow Delaware to compete with Alaska for the creation of self-settled APTs.¹⁰⁴ The Delaware statute provides that “no action of any kind, including, without limitation, an action to enforce a judgment . . . , shall be brought at law or in equity for an attachment or other provisional remedy against property that is the subject of a qualified disposition or for avoidance of a qualified disposition.”¹⁰⁵ A “qualified disposition” is an irrevocable transfer to a spendthrift¹⁰⁶ trust that (1) limits principal distributions to the settlor to only those made in the discretion of the trustee, (2) includes a provision specifying the application of Delaware law, and (3) has at least one resident trustee (either an individual resident or a bank or trust company authorized to do business in Delaware), who maintains trust records, has custody of trust property, prepares trust income tax returns, or otherwise materially participates in the administration of the trust.¹⁰⁷ The settlor may also retain both a special testamentary power of appointment over the trust¹⁰⁸ and a power to veto trust

102. ALASKA STAT. § 13.36.310(a) (Lexis 2000).

103. ALASKA STAT. § 13.36.310(b) (Lexis 2000).

104. Blattmachr & Hompesch, *supra* note 92, at 32.

105. DEL. CODE ANN. tit. 12, § 3572(a) (Michie 2000 Supp.).

106. To constitute a qualified disposition, the trust instrument must:

[p]rovide[] that the interest of the transferor or other beneficiary in the trust property or the income therefrom may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily, before the qualified trustee or qualified trustees actually distribute the property or income therefrom to the beneficiary, and such provision of the trust instrument shall be deemed to be a restriction on the transfer of the transferor's beneficial interest in the trust that is enforceable under applicable nonbankruptcy law within the meaning of § 541(c)(2) of the Bankruptcy Code . . . or any successor provision thereto.

DEL. CODE ANN. tit. 12, § 3570(10)(c) (Michie 2000 Supp.). Section 541(c)(2) of the Bankruptcy Code states that “[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.”

107. DEL. CODE ANN. tit. 12, §§ 3570(6), (9), (10) (Michie 2000 Supp.).

108. *See* DEL. CODE ANN. tit. 12, § 3570(10)(b)(2) (Michie 2000 Supp.) (providing that the trust will be considered irrevocable notwithstanding that the settlor retains such a

distributions.¹⁰⁹ Unlike the Alaska statute, the Delaware statute grants spendthrift protection to the settlor even if the settlor retains an absolute right to receive income distributions.¹¹⁰

Like the Alaska statute, the Delaware statute permits creditors to reach the assets of an APT if the settlor's transfer to the trust was fraudulent.¹¹¹ Unlike the Alaska statute, the Delaware statute recognizes claims for both actual fraud and constructive fraud;¹¹² in this regard, the Delaware legislation may be considered slightly more creditor friendly than the Alaska legislation.¹¹³ The statute of limitations period is similar to that in the Alaska legislation—in general, a fraudulent transfer claim must be brought within four years after the settlor's transfer to the trust.¹¹⁴ Thus, transfers to the trust cannot be challenged as fraudulent with respect to claims arising more than four years after the trust was established.

Unlike the Alaska statute, the Delaware APT statute expressly exempts from its operation certain types of claims, with respect to which creditors can recover from the APT regardless of when the trust was created and regardless of whether the settlor's transfer was fraudulent. Thus, the statute does not permit settlors to shelter their

power). The statute uses the term "special power of appointment," which presumably refers to a non-general power, that is, a power exercisable in favor of persons other than the settlor, the settlor's creditors, the settlor's estate, and the creditors of the settlor's estate. See RESTATEMENT (SECOND) OF PROPERTY, DONATIVE TRANSFERS § 11.4 (1984) (using the term "non-general" rather than "special").

109. See DEL. CODE ANN. tit. 12, § 3570(10)(b)(1) (Michie 2000 Supp.).

110. See DEL. CODE ANN. tit. 12, § 3570(10)(b)(3) (Michie 2000 Supp.) (providing that the trust instrument will be considered irrevocable notwithstanding that the settlor retains a right to income from the trust). Cf. *id.* § 3570(10)(b)(6) (providing that the trust instrument will be considered irrevocable notwithstanding that the settlor may receive discretionary distributions of principal). Under most circumstances, a settlor would be disinclined to retain an absolute right to income, because the retained right would trigger inclusion of the trust assets in the settlor's estate. See I.R.C. § 2036(a)(1) (1994).

111. See DEL. CODE ANN. tit. 12, § 3572(a) (Michie 2000 Supp.) (providing that a claim against a qualified disposition will be recognized only if successfully asserted under the Delaware version of the Uniform Fraudulent Transfers Act, DEL. CODE ANN. tit. 6, §§ 1304, 1305).

112. Compare ALASKA STAT. § 34.40.110 (Lexis 2000), discussed *supra* at note 95 and accompanying text, with DEL. CODE ANN. tit. 6, § 1304 (Michie 2000 Supp.). See also *infra* note 174 and accompanying text (discussing distinction between actual and constructive fraud).

113. See Sterk, *supra* note 3, at 1055. But see Sullivan, *supra* note 92, at 445-46 n.83 (arguing that the distinction between actual and constructive fraud is more theoretical than practical).

114. DEL. CODE ANN. tit. 12, § 3572(b)(1) (Michie 2000 Supp.) (with respect to claims arising before the trust was funded, incorporating by reference the limitations periods established by Delaware's fraudulent transfer statute, DEL. CODE ANN. tit. 6, § 1309); DEL. CODE ANN. tit. 12, § 3572(b)(2) (Michie 2000 Supp.) (with respect to claims arising concurrent with or after the trust was funded).

assets from claims for alimony or child support, claims for division or distribution of property incident to divorce, or claims for "death, personal injury or property damage," although with respect to the last category of claims the exemption applies only to claims arising before or at the time of the qualified disposition.¹¹⁵

Nevada and Rhode Island both passed APT legislation in 1999. The Rhode Island statute is modeled after the Delaware statute and is similar in all essential respects.¹¹⁶ Like the Alaska statute, the Nevada statute affords creditor protection only to self-settled trusts with respect to which all distributions to the settlor are discretionary.¹¹⁷ To qualify as a Nevada APT, at least one trustee must be a Nevada resident or a bank or trust company authorized to do business in Nevada, and any one of the following must be true: (1) the settlor has his or her domicile in Nevada, (2) all or a portion of the trust property is located in Nevada, (3) the trust was created in Nevada, or (4) the Nevada trustee is authorized to maintain records and prepare income tax returns and all or a portion of the administration is performed in the state.¹¹⁸ Nevada establishes a relatively short statute of limitations for actions "with respect to a transfer of property to a [Nevada APT]": for persons who are creditors at the time of the transfer, within two years of the transfer or (if later) within six months after the creditor discovers or

115. See DEL. CODE ANN. tit. 12, § 3573 (Michie 2000 Supp.). In its original form, the statute also exempted claims by creditors who extended credit to the settlor in reliance on the settlor's representations that the assets of the trust would be available to satisfy the settlor's debt; the statute provided in its original form that the asset-protective features of a qualified disposition

shall not apply in any respect . . . to any creditor who became a creditor in reliance upon an express written statement of the transferor that any property that was the subject of the qualified disposition thereafter remained the property of the transferor and was available to satisfy any debt to such creditor incurred by the transferor.

71 Del. Laws 159, § 1 (1997), amended by 71 Del. Laws 254, § 39 (1997); see also 71 Del. Laws 254, § 36 (1997) (deleting subsection (2) of title 12, section 3573, and renumbering subsection (3) as subsection (2)). The provision was removed in response to criticism that it granted the settlor a retained power that would trigger inclusion of the trust assets in the settlor's estate. See, e.g., Blattmachr & Hompesch, *supra* note 92, at 37.

116. The statute refers to APTs as "qualified dispositions," see R.I. GEN. LAWS § 18-9.2-2 (1999), generally allows for a four-year statute of limitations, see *id.* § 18-9.2-4(b), and exempts claims for alimony and child support, marital property distributions, and tort claims arising before the trust was funded, see *id.* § 18-9.2-5.

117. See NEV. REV. STAT. § 166.040(1)(b) (1999) (the terms of the trust must not "require that any part of the income or principal of the trust be distributed to the settlor"); *id.* § 166.040(2)(b) (stating that a distribution to the settlor is not "required" if the settlor may receive the distribution "only in the discretion of another person"). Cf. *supra* note 110 and accompany text (describing the Delaware legislation, which permits the settlor to retain a mandatory income interest).

118. NEV. REV. STAT. § 166.015 (1999).

reasonably should have discovered the transfer; for persons who become creditors after the transfer, within two years of the transfer.¹¹⁹

(2) *Effectiveness of Domestic Legislation?*

In the years following enactment of the Alaska and Delaware APT legislation, commentators have raised questions about whether courts will enforce domestic self-settled APT arrangements.¹²⁰ Although this article is principally concerned with whether APTs *should* be respected, the importance of that question depends necessarily on whether APTs *will* be respected. Thus, this section of the article summarizes briefly the principal legal questions concerning the effectiveness of domestic APTs. This section of the article also briefly considers some limited information about the extent to which and for what purposes Alaska and Delaware APTs are being implemented.

To place into context the questions concerning the effectiveness of domestic APTs, consider the following hypothetical scenario. A New York settlor creates an Alaska APT with an Alaska trust company as sole trustee. The terms of the trust allow discretionary distributions of income and principal to the settlor and specify Alaska as the governing law. The settlor transfers to the trustee a substantial portion of his assets, primarily marketable securities, and the trustee takes custody of the assets in Alaska. Five years after the settlor's transfer to the trust, the settlor, still a New York resident, negligently injures a fellow New Yorker in a New York automobile accident. The injured person brings a tort action in a New York court and obtains a judgment for money damages against the settlor. The amount of the judgment exceeds the combined value of the settlor's liability insurance coverage and the assets owned by the settlor that were not placed in the trust. Assume that the injured New Yorker—now a judgment creditor—is unsuccessful in asserting that the settlor's transfer to the trust is voidable under the applicable fraudulent transfer statute, either because the transfer was not fraudulent within the meaning of the fraudulent transfer statute or because a fraudulent transfer claim is barred by the statute of limitations.¹²¹ May the judgment creditor nevertheless reach the assets of the Alaska APT?

Suppose the creditor brings an enforcement action in New York, claiming that the assets of the APT should be made available to

119. NEV. REV. STAT. § 166.170 (1999).

120. See Sterk, *supra* note 3, at 1074-1114; Boxx, *supra* note 3, at 1208-41; Duncan E. Osborne et al., *Asset Protection and Jurisdiction Selection*, 33 INST. ON EST. PLAN. ¶ 1404 (1999).

121. See *infra* notes 160-202 and accompanying text.

satisfy the judgment. Would a New York court (or other non-Alaska court) rule on the effectiveness of the Alaska APT? In ruling on the effectiveness of the APT, would a non-Alaska court apply Alaska law or local law? If a non-Alaska court rules that the creditor can reach the trusts assets, must this ruling be respected in a subsequent enforcement action brought in Alaska?

Consider first whether a non-Alaska court would be willing to rule on the effectiveness of the APT, i.e., whether the court would undertake deciding whether the trust assets were available to satisfy the judgment. The resolution of this question would turn on two subsidiary issues—first, does the non-Alaska court view the trustee as a necessary party to this stage of the litigation; second, assuming the court decides that the trustee *is* a necessary party, is the non-Alaska court willing to conclude that it has jurisdiction over the trustee. With respect to the first issue, most courts would likely conclude that the trustee *is* a necessary party.¹²² Moreover, even if a court concluded that the trustee is *not* a necessary party, the court's ruling on the effectiveness of the APT would likely not be binding on the trustee in a subsequent enforcement action.¹²³ With respect to the second issue, a non-Alaska court that properly takes into account constitutional limits on the exercise of personal jurisdiction would likely conclude that it does not have jurisdiction over an Alaska trustee, assuming that the trustee has confined its activities to Alaska.¹²⁴ For several reasons, however, the resolution of this question in a particular case will not be without doubt. First, an Alaska trustee that pursues non-Alaska customers may be deemed to have conducted activities in the forum state, thus subjecting it to personal jurisdiction there.¹²⁵ Second, a court that is particularly outraged by the use of an Alaska trust to evade creditors may be

122. See Boxx, *supra* note 3, at 1216-21 (discussing authority both for and against this proposition and concluding that, under most circumstances, a court would decide that the trustee is a necessary party). *But see* Parks, *supra* note 92, at 29 (observing that an Arizona court may decide an issue pertaining to a non-Arizona trust "if the interests of justice [otherwise] would be seriously impaired" and thus may view the presence of the trustee as not necessary (quoting Ariz. Rev. Stat. § 14-7205(2))); Osborne et al., *supra* note 120, ¶ 1404.2 n.28 (describing the trend in state and federal courts away from characterizing any party not present as "necessary" or "indispensable").

123. See Boxx, *supra* note 3, at 1220-21.

124. See *Hanson v. Denckla*, 357 U.S. 235, 253 (1958) (holding that exercise of personal jurisdiction over a foreign trustee must be based on some act by which the trustee "purposefully avails itself of the privilege of conducting activities within the forum State"); Boxx, *supra* note 3, at 1210-11 (discussing *Hanson*); Sterk, *supra* note 3, at 1089-93 (same); see also *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980) (reaffirming the "purposeful availment" requirement).

125. See Boxx, *supra* note 3, at 1211-12 (noting the extent to which some corporate trustees engage in national marketing).

willing liberally to construe its jurisdictional authority in favor of finding that it has personal jurisdiction over the trustee.¹²⁶ Finally, a court might be influenced by criticisms of traditional constitutional analysis of personal jurisdiction questions and thus willing to exercise personal jurisdiction in situations not contemplated under traditional doctrine.¹²⁷

Consider next the choice of law question: in ruling on the effectiveness of an Alaska APT, would a non-Alaska court apply Alaska trust law or the trust law of the forum? As a general rule, questions concerning the validity and construction of an inter vivos trust are based on the law of the trust situs, not the law of the settlor's domicile, and not the law of the forum.¹²⁸ Moreover, as a general proposition, the law designated in a trust instrument will be controlling with respect to most validity and construction questions.¹²⁹ Thus, both general principles point to applying Alaska law. Both principles are subject, however, to a widely followed exception, under which a court will apply its own law if otherwise applicable foreign law violates its public policy.¹³⁰ Thus, assuming that the action is brought in a jurisdiction that follows the traditional rule concerning creditors' rights in self-settled trusts, the court would likely apply its own law and not Alaska law.¹³¹

126. See *Boxx*, *supra* note 3, at 1212 (noting that the due process analysis under *Denckla* is "fluid").

127. See *Sterk*, *supra* note 3, at 1091-1092 (discussing contemporary criticisms of *Denckla* and *World-Wide Volkswagen* and suggesting that a state court might be willing to exercise personal jurisdiction over a non-resident trustee for the limited purpose of deciding a dispute over creditors' rights to trust assets, even if it would not be willing to exercise personal jurisdiction for all purposes).

128. See *Sterk*, *supra* note 3, at 1082-83 (discussing *Hutchinson v. Ross*, 187 N.E. 65 (N.Y. 1933)).

129. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 268(1) (1971); see also *Boxx*, *supra* note 3, at 1221.

130. See *Sterk*, *supra* note 3, at 1086-89 (citing various cases to that effect). Traditionally, the public policy exception has been applied only to bar claims, not to bar defenses. See EUGENE F. SCOLES ET AL., CONFLICT OF LAWS § 3.15 (4th ed. 2001) (discussing RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 90 (1971) and other authorities). If our hypothetical case were to arise in New York, however, the court would likely apply forum law through application of its basic choice-of-law rules, without relying on the public policy exception. See, e.g., *Hemingway v. McGehee*, 228 N.E.2d 799, 804-06 (N.Y. 1967) (applying New York law to reject a surviving spouse's argument that her rights to property located in Louisiana should be determined under Louisiana community property law, noting that both spouses were domiciled in New York).

131. As with all choice of law issues, the outcome suggested here is far from certain. One source of uncertainty is the question whether the forum court must give full faith and credit to Alaska's legislation authorizing APTs. Respectable authority states that the Full Faith and Credit clause, U.S. CONST. art IV, § 1, limits a court's ability to decline to apply another jurisdiction's laws on public policy grounds. See *Bradford Electric Light Co. v. Clapper*, 286 U.S. 145, 154-63 (1932) (ruling that a federal district court sitting in New

Finally, consider to what extent a ruling by a non-Alaska court would be given effect in an enforcement action brought in Alaska against the Alaska trustee. In this connection, assume first that the non-Alaska court determined that, notwithstanding that the court did not have personal jurisdiction over the trustee,¹³² it nevertheless had the authority to decide whether the trust assets were available to the settlor's creditor (ruling in favor of the creditor on that issue). In a subsequent enforcement action brought in Alaska, the non-Alaska court's ruling would not be binding on the Alaska trustee, because the non-Alaska court would have lacked personal jurisdiction over the trustee.¹³³

Next, assume that the non-Alaska court ruled both that it had personal jurisdiction over the trustee and that the trust assets could be used to satisfy the creditor's judgment. Would the jurisdictional ruling (and thus the underlying substantive ruling) be binding on the trustee in a subsequent enforcement action brought in Alaska? If the Alaska trustee appeared in the non-Alaska litigation, the non-Alaska court's rulings would be binding in a subsequent enforcement action

Hampshire must give effect to Vermont's workmen's compensation law, which purported to provide an exclusive remedy for a Vermont employee injured while working on a project in New Hampshire; the Court stated that the district court, at least in the context of that case, could not on public policy grounds "refuse to give effect to a substantive defense [to an action] under the applicable law of another state"; see also Frederic L. Kirgis, Jr., *The Roles of Due Process and Full Faith and Credit in Choice of Law*, 62 CORNELL L. REV. 94, 119-20 (1976) (articulating standards for applying full faith and credit principles to choice of law questions). A good illustration of this point is *Order of United Commercial Travelers v. Wolfe*, 331 U.S. 586 (1947). *Wolfe* involved a fraternal benefit society incorporated and having its principal office located in Ohio. *Id.* at 588. A significant feature of membership in the society was a death benefit payable to a person designated by the member. *Id.* at 591. The constitution of the society included a provision, valid under Ohio law, that prohibited any action on a death benefit claim brought more than six months after the claim had been disallowed by the society. *Id.* at 588. The case involved a death benefit claim with respect to a member domiciled in South Dakota. *Id.* at 597. After the claim was denied by the society, the claimant waited more than six months before bringing an action to challenge the denial in a South Dakota court. *Id.* at 598. The South Dakota court applied a South Dakota statute invalidating the six month limitations provision contained in the society's constitution. *Id.* at 600. The United States Supreme Court reversed, holding that South Dakota had failed to give full faith and credit to the Ohio law permitting the six month limitations period. *Id.* at 625. Although the situation presented in *Wolfe* is only modestly analogous to the circumstances presented by a claim against an APT, see Kirgis, *supra*, at 116-17 (explaining the Court's rationale), the decision nevertheless raises doubt about whether a court in a non-APT jurisdiction—whose law would allow creditors' claims against self-settled trusts—would be free, on public policy grounds, to ignore a sister state's law prohibiting such claims, at least in those circumstances in which one of the litigants is not domiciled in the forum state. On the other hand, if both litigants were domiciled in the forum state, full faith and credit would likely not preclude the forum state from applying its own law.

132. See *supra* note 124 and accompanying text.

133. See *Boxx, supra* note 3, at 1220-21.

brought in Alaska, regardless of whether the non-Alaska court properly resolved the personal jurisdiction question.¹³⁴ Under the Full Faith and Credit clause of the United States Constitution,¹³⁵ an Alaska court would be bound to give effect to the non-Alaska court's judgment, even if the personal jurisdictional decision by the non-Alaska court were erroneous.¹³⁶ The trustee could not avoid enforcement of the non-Alaska court decision by claiming that the decision violates Alaska's public policy allowing the use of APTs.¹³⁷ On the other hand, if the trustee did not appear in the non-Alaska court litigation, an Alaska court would not be bound by the non-Alaska court's decision.¹³⁸ Because the personal jurisdiction issue would not have been litigated against the trustee, the Alaska court would not be precluded from reconsidering the jurisdictional question if the trustee challenged the constitutionality of the non-Alaska court's assertion of personal jurisdiction over the trustee.¹³⁹ If the Alaska court decided that the non-Alaska court could *not* assert jurisdiction over the trustee, the Alaska court likely would not be bound to give full faith and credit to its sister court's ruling concerning the effectiveness of the APT.¹⁴⁰ On the other hand, if the Alaska court determined that the non-Alaska court did properly assert jurisdiction over the trustee, under those circumstances it would be bound to enforce the foreign judgment.

The obligation of American state courts to give full faith and credit to the judgments of other state courts creates a significant obstacle to the effectiveness of domestic APTs. As described in the immediately preceding paragraphs, a creditor may be able to bring an action in a jurisdiction that does not respect APTs and, assuming that the court can be persuaded to assert personal jurisdiction over the trustee, the court will likely rule that the creditor can reach the assets of the APT. Under many circumstances, the ruling of the court will be entitled to full faith and credit in the home jurisdiction of the trustee.¹⁴¹ In this respect, offshore jurisdictions authorizing APTs

134. See *id.* at 1215 (suggesting that the trustee's best strategy is to refuse to participate in the non-Alaska court litigation).

135. U.S. CONST. art. IV, § 1 (providing that "Full Faith and Credit shall be given in each State to the . . . judicial Proceedings of every other State").

136. See *Boxx*, *supra* note 3, at 1213 n.104 (citing various cases to this effect).

137. *Id.* at 1213-14.

138. *Id.* at 1214.

139. See *id.* at 1215 (discussing *Baker v. General Motors*, 522 U.S. 222 (1998)).

140. Note, however, that whether full faith and credit would bind the Alaska court may depend on whether the trustee was a necessary party to the non-Alaska litigation and whether the trustee might nonetheless be bound by a prior judgment against the settlor based on notions of privity.

141. As described above, factors raising doubt about this outcome include: (i) the court may be unwilling to exercise personal jurisdiction over the trustee and, in the absence of

have a significant advantage—those jurisdictions are not bound by full faith and credit; moreover, most offshore APT legislative schemes specifically provide that the local courts need not recognize the judgments of courts in foreign jurisdictions. Using the Cook Islands legislation as an example, if a United States court ruled that the assets of a Cook Islands trust could be used to satisfy the claim of a United States creditor against a United States debtor, a Cook Islands court would be under no obligation to give effect to that ruling, regardless of whether the United States court asserted personal jurisdiction over the trustee.

Moreover, in the United States, creditor claims may be decided through bankruptcy proceedings, in which a creditor seeking to recover from a domestic APT is afforded several significant advantages. Most importantly, a bankruptcy court has jurisdiction over all of the property of the debtor, wherever located,¹⁴² and it also has jurisdiction to determine whether particular assets (including assets transferred to an APT) constitute property of the debtor.¹⁴³ Furthermore, the district court has national jurisdiction in bankruptcy cases¹⁴⁴ and thus will have personal jurisdiction over any domestic trustee of an APT.¹⁴⁵ With respect to questions concerning the effectiveness of the APT, a bankruptcy court will apply the choice of law rules of the forum state.¹⁴⁶ As suggested earlier, in most circumstances this will result in the court applying the substantive law of the forum state concerning creditors' rights in self-settled APTs. Thus, assuming that the bankruptcy proceeding occurs in a state that does not recognize self-settled APTs, the bankruptcy court will likely declare that the APT assets are part of the bankruptcy estate and that

that jurisdiction, may be unwilling to decide the substantive issue concerning the validity of the APT; (ii) the court may be willing to decide the substantive issue notwithstanding that it lacks personal jurisdiction, but the ruling would then not be entitled to full faith and credit; and (iii) the trustee may decline to participate in the litigation and later succeed in persuading a court in its home jurisdiction that the first court lacked personal jurisdiction.

142. 28 U.S.C. § 1334(d) (1994).

143. See, e.g., *DiBerto v. The Meadows at Madbury, Inc.*, 171 B.R. 461, 475 (Bankr. D.N.H. 1994) (stating that “the Court clearly has jurisdiction to determine what is and what is not property of the estate”); see also Eric Henzy, *Offshore and “Other” Shore Asset Protection Trusts*, 32 VAND. J. TRANSNAT’L L. 739, 746 & n.35 (1999) (citing *DiBerto* and other cases).

144. See 28 U.S.C. § 1334(e) (1994); see also FED. R. BANKR. P. 7004(d).

145. See Henzy, *supra* note 143, at 746 & n.36 (citing cases for the proposition that the constitutional constraints on exercises of personal jurisdiction by state courts do not apply to bankruptcy courts); see also Sterk, *supra* note 3, at 1105-06 (stating that the bankruptcy court will have personal jurisdiction over a defendant as long as the defendant “has the requisite contacts with the United States as a whole, even if the defendant has no contacts with the state in which the bankruptcy court sits”).

146. See Boxx, *supra* note 3, at 1227.

the assets are subject to the claims of the debtor's creditors;¹⁴⁷ moreover, the court will have the authority to compel the APT trustee to comply with any of the court's remedial orders.

To what extent is bankruptcy court a practical alternative for the judgment creditor in our example? If the trust settlor voluntarily petitions a court for relief under the Bankruptcy Code,¹⁴⁸ unless the settlor brings the petition in Alaska or another jurisdiction that respects APTs,¹⁴⁹ as noted above the court will likely apply forum law and thus rule that the trust assets are available to satisfy creditors' claims. But a voluntary petition is just that, so commencing a bankruptcy case in this manner is not something over which a creditor can exercise any control. A bankruptcy proceeding, however, may also be commenced through an involuntary petition.¹⁵⁰ Under section 303 of the Bankruptcy Code, a single creditor may commence an involuntary bankruptcy proceeding only if fewer than twelve creditors hold claims against the debtor; if more than twelve creditors hold claims, at least three of the creditors must join in the petition.¹⁵¹ The primary basis for granting an involuntary petition is that "the debtor is generally not paying [his or her] debts as such debts come due."¹⁵² Many courts are reluctant to grant an involuntary petition in the case of a single creditor, because the debtor's failure to pay a single creditor seems incongruous with the debtor not "generally . . . paying . . . debts as [they] come due."¹⁵³ On the other hand, a court may be more willing to grant a single creditor's petition if the creditor

147. *But see* Bacon & Terrill, *supra* note 90, at 130 (arguing that Bankruptcy Code section 541(c)(2), which excludes from the bankruptcy estate beneficial interests subject to state law transferability restrictions, requires bankruptcy courts to give effect to state APT legislation).

148. *See generally* MICHAEL J. HERBERT, UNDERSTANDING BANKRUPTCY § 6.02 (1995).

149. The debtor may file the petition in any district in which is located the debtor's "domicile, residence, principal place of business in the United States, or principal assets in the United States." 28 U.S.C. § 1408(1) (1994). Venue in a particular district is proper if any one of the four grounds exists during the 180-day period prior to filing, or if during the same period one of the four grounds is satisfied for that district for a longer portion of the time period than for any other district. *See* HERBERT, *supra* note 148, § 6.04, at 93. As a practical matter, the assets held in an APT presumably could not serve as the basis for venue in an APT state, because a debtor taking that position would likely forfeit the opportunity to argue that those assets did not form part of the bankruptcy estate. Thus, for the debtor to bring a voluntary petition in a jurisdiction whose local trust law would respect APTs, the debtor would need to have established some other substantial connection with the jurisdiction (i.e., domicile, residence, or the debtor's "principal assets" not held in the APT).

150. *See* 11 U.S.C. § 303(b) (2000). *See generally* HERBERT, *supra* note 148, § 6.03.

151. *See* 11 U.S.C. § 303(b) (2000); HERBERT, *supra* note 148, § 6.03[D][1], at 86.

152. 11 U.S.C. § 303(h)(1) (2000); *see* HERBERT, *supra* note 148, § 6.03[E], at 88-89.

153. *Boxx, supra* note 3, at 1229; HERBERT, *supra* note 148, § 6.03[E], at 89.

has no other adequate remedy, as may very well be true in the case of a creditor seeking to recover from an APT.¹⁵⁴ An involuntary petition is not without risk for a creditor—dismissal of the petition may result in the creditor being liable for the debtor's costs and attorneys' fees. Moreover, if the creditor acted in bad faith, the court can award the debtor damages, including punitive damages.¹⁵⁵

The foregoing discussion suggests that, notwithstanding APT legislation, creditors may have several avenues of attack to recover self-settled trust assets. Note, however, that a creditor's success will depend on resolving two critical issues in its favor. First, in state court proceedings, the creditor must obtain a judgment from a court having personal jurisdiction over the trustee. Savvy trustees, seeking to protect the assets of their APT clients, will undoubtedly structure their affairs to minimize the risk of subjecting themselves to personal jurisdiction in states that do not recognize APTs. Second, in both state court and federal bankruptcy proceedings, the creditor must persuade the court not to apply the substantive trust law of the APT jurisdiction, but instead to apply the more creditor-friendly law of the forum state. As more states adopt APT and other debtor-friendly legislation, courts in those jurisdictions will become less inclined to find that the foreign state's APT law violates their public policy. Moreover, even in states without APT legislation, courts in those states may recognize the myriad ways in which their own state laws allow non-APT devices (such as limited partnerships and tenancies by the entirety¹⁵⁶) for protecting against creditors' claims and thus be disinclined to find that the foreign APT legislation violates its public policy. In these two significant respects, we can anticipate that recovering from APTs will become increasingly more difficult. Moreover, regardless of the theoretical possibility that courts will not respect APTs, placing assets in APTs will also afford settlors a practical advantage—the risk that the creditors will fail altogether to recover APT assets will create an incentive for creditors to settle claims on a basis favorable to APT trust settlors.

The limited information available to date suggests that many settlors have availed themselves of Alaska and Delaware APTs, despite any concerns about their effectiveness.¹⁵⁷ In Delaware, for

154. See *Boxx*, *supra* note 3, at 1229-30.

155. 11 U.S.C. § 303(b) (2000); *HERBERT*, *supra* note 148, § 6.03[F].

156. See *infra* notes 203-268 and accompanying text.

157. Settlers apparently recognize the uncertainties associated with domestic APTs, but they are willing to tolerate that uncertainty, in part because they believe that placing their assets in an APT will enhance their ability to obtain favorable settlements. Telephone Interview with Douglas J. Blattmachr, President and CEO, Alaska Trust Company (July 12, 2001); Telephone Interview with Richard W. Nenko, Vice President and Trust Counsel, Wilmington Trust Company (July 12, 2001).

example, as of April 2001 over 100 APTs had been established, having an aggregate market value in excess of \$2 billion.¹⁵⁸ In many cases, settlors create a double layer of protection, by first transferring assets to a limited partnership and then placing the partnership assets in an APT.¹⁵⁹

III. The Role of Fraudulent Transfer Laws

Understanding the rights of creditors in self-settled APTs requires an understanding of not only the trust law concepts discussed in Parts I and II, but also the law of fraudulent transfers. Fraudulent transfer laws afford creditors an alternative means of satisfying a judgment from assets transferred to an APT: even if a self-settled APT is respected as an effective device for sheltering assets from a creditor's claim, the creditor can always argue that the settlor's transfer to the APT was fraudulent, and thus voidable, under the fraudulent transfer laws. With a fraudulent transfer claim, the effectiveness of a self-settled APT is essentially irrelevant; if a debtor makes a fraudulent transfer within the meaning of the fraudulent transfer laws, the transfer can be set aside and the transferred assets recovered by a creditor, without regard to the identity of the transferee.¹⁶⁰ If a fraudulent transfer claim is successful, the usual remedy is an order setting the transfer aside.¹⁶¹

Fraudulent transfer laws have existed in some form in England and the United States for centuries. They developed initially through case law and eventually were codified in the 16th century Statute of Elizabeth, which defined fraudulent transfers as those made by debtors with the "purpose and intent . . . to delay, hinder, or defraud creditors."¹⁶² In the United States, most states initially adopted the Statute of Elizabeth.¹⁶³ In 1918, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the

158. Telephone Interview with Richard W. Nenzo, Vice President and Trust Counsel, Wilmington Trust Company (July 12, 2001).

159. Telephone Interview with Douglas J. Blattmachr, President and CEO, Alaska Trust Company (July 12, 2001); *see also infra* notes 231-241 and accompanying text (explaining how limited partnerships can be used to shelter assets from the claims of creditors).

160. Thus, in the context of a fraudulent transfer claim, whether the assets were transferred to an effective APT is irrelevant; if the claim is successful, the transferred assets can be recovered even if the assets were transferred not to a self-settled APT, but to trust for the benefit of persons other than the settlor or outright to a person other than the settlor.

161. *See infra* notes 179-181 and accompanying text.

162. 13 Eliz. ch. 5 (1570), *reprinted in* 1 DUNCAN E. OSBORNE & ELIZABETH MORGAN SCHURIG, *ASSET PROTECTION: DOMESTIC AND INTERNATIONAL LAWS TACTICS* app. 2A, at 2-42 (2001); *see also* SPERO, *supra* note 68, ¶ 3.02[1] (1994).

163. 1 OSBORNE & SCHURIG, *supra* note 162, app. 2B.

Uniform Fraudulent Conveyance Act (UFCA), modeled after the Statute of Elizabeth and embodying the case law thereunder.¹⁶⁴ In 1984, NCCUSL modernized the UFCA by adopting the Uniform Fraudulent Transfers Act (UFTA).¹⁶⁵ Most states have adopted the UFTA;¹⁶⁶ a few states continue to use the UFCA or their own version of the Statute of Elizabeth.¹⁶⁷ The federal Bankruptcy Code has its own fraudulent transfer provisions, which are substantially similar to the state fraudulent transfer laws.¹⁶⁸

Because most states have adopted some version of the UFTA, that statute forms the basis for the discussion in this part of the article. For present and future creditors,¹⁶⁹ the UFTA treats a transfer as fraudulent (and thus voidable by the creditor) under two distinct circumstances. First, the transfer is fraudulent if, under section 4(a)(1), the debtor made the transfer "with actual intent to hinder, delay, or defraud any creditor of the debtor."¹⁷⁰ Because actual fraudulent intent is often difficult to prove, UFTA section 4(b) allows creditors to establish fraudulent intent indirectly by proving the existence of one or more "badges of fraud,"¹⁷¹ which are simply

164. UNIF. FRAUDULENT CONVEYANCES ACT, 7A-2 U.L.A. 2 (1918).

165. UNIF. FRAUDULENT TRANSFERS ACT, 7A-2 U.L.A. 274 (1984) [hereinafter UFTA].

166. As of 2000, 39 states and the District of Columbia had adopted the UFTA. See 7A-2 U.L.A. 16 (Supp 2001).

167. As of 2000, four states and the Virgin Islands had adopted the UFCA. See 7A-2 U.L.A. 1 (Supp 2001). As of 2000, seven states had adopted variations of the Statute of Elizabeth. See 1 OSBORNE & SCHURIG, *supra* note 162, app. 2B.

168. The fraudulent transfer provisions of the Bankruptcy Code, set forth in 11 U.S.C. § 548 (2000), are modeled after the same uniform legislation that forms the basis for most states' laws. See HERBERT, *supra* note 148, § 15.02[A]. Section 548 varies significantly from the state fraudulent transfer laws only with respect to the limitations period; whereas state fraudulent transfer laws generally include a four-year statute of limitations, section 548 applies only to transfers made or obligations incurred within one year before the date of the filing of the bankruptcy petition. 11 U.S.C. § 548 (a)(1). But in a bankruptcy proceeding, the authority of the trustee or debtor in possession to set aside a transfer as fraudulent is not limited to that granted by section 548; under section 544(b), the trustee or debtor in possession may also avoid a transfer that is fraudulent under applicable state law, as long as the transfer could have been set aside by someone who is a creditor in the bankruptcy proceeding. See HERBERT, *supra* note 148, § 15.03.

169. A "future" creditor is one whose claim arose after the fraudulent transfer; a "present" creditor is one whose claim arose before the fraudulent transfer. See UFTA § 4(a).

170. *Id.* § 4(a)(1).

171. UFTA § 4 cmt. 5 (using the term "badges of fraud" and explaining its origin). Section 4(b) provides as follows:

In determining actual intent under subsection (a)(1), consideration may be given, among other factors, to whether:

- (1) the transfer . . . was to an insider;
- (2) the debtor retained possession or control of the property transferred after the transfer;

circumstances recognized by courts as likely indicia of fraudulent intent. The Comments to the UFTA state that proving the existence of one or more badges of fraud is relevant evidence of actual fraud, "but does not create a presumption that the debtor has made a fraudulent transfer."¹⁷²

Second, the transfer is fraudulent if, under UFTA section 4(a)(2)—the so called "constructive fraud" provision¹⁷³—the debtor made the transfer

without receiving a reasonably equivalent value in exchange for the transfer . . . , and the debtor:

- (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
- (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.

The constructive fraud provisions of section 4(a)(2) allow courts to infer fraud under circumstances in which there may be no evidence that the debtor had fraudulent intent but that would appear fraudulent to an objective observer.¹⁷⁴

For present creditors (but not future creditors),¹⁷⁵ UFTA section 5 also treats a transfer as fraudulent under two additional circumstances. First, under section 5(a), a transfer is fraudulent if the debtor, at the time of the transfer, received inadequate consideration

- (3) the transfer . . . was disclosed or concealed;
- (4) before the transfer was made . . . the debtor had been sued or threatened with suit;
- (5) the transfer was of substantially all the debtor's assets;
- (6) the debtor absconded;
- (7) the debtor removed or concealed assets;
- (8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred . . . ;
- (9) the debtor was insolvent or became insolvent shortly after the transfer was made . . . ;
- (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and
- (11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

UFTA § 4(b). Of the eleven factors, courts tend to regard insolvency as the most significant in deciding whether property was transferred with fraudulent intent. See SPERO, *supra* note 68, ¶ 3.04[1][c]. Note that some of the factors militate *against* a finding of fraudulent intent. *Id.* ¶ 3.04[1][b], at 3-20.

172. UFTA § 4 cmt. 5.

173. 1 OSBORNE & SCHURIG, *supra* note 162, § 2:19 & n.1.

174. *Id.*

175. See *supra* note 169 (explaining the distinction).

and either was insolvent or became insolvent as a result of the transfer.¹⁷⁶ Second, under section 5(b), a transfer is fraudulent if the debtor made the transfer to an insider¹⁷⁷ in response to an antecedent debt, the debtor was insolvent as of the time of the transfer, and the insider should have known of the debtor's insolvency.¹⁷⁸ Because relatively few transfers to APTs are likely to render settlors insolvent, it is unlikely that a creditor could successfully bring a UFTA section 5 claim with respect to such a transfer. For this reason, the article considers principally claims arising under section 4(a).

The usual remedy for a fraudulent transfer claim is either to set aside the transfer or to order an attachment of the transferred property.¹⁷⁹ If the creditor has already obtained a judgment against the transferor on the creditor's underlying claim, the creditor may also levy execution on the transferred asset.¹⁸⁰ The UFTA also authorizes courts to grant other equitable remedies as warranted by the circumstances.¹⁸¹ In short, a successful fraudulent transfer claim affords the creditor access to the transferred property for purposes of satisfying the creditor's underlying action.

Section 9 of the UFTA sets forth the relevant limitations periods. For claims asserted under section 4(a)(1), the claim must be brought within four years after the transfer was made or within four years after the transfer was or could reasonably have been discovered by the creditor.¹⁸² For claims asserted under sections 4(a)(2) and 5(a), the claim must be brought within four years after the transfer was made.¹⁸³ The limitations period for claims brought under section 5(b) is only one year after the transfer was made.¹⁸⁴ Although, as noted earlier,¹⁸⁵ most states have adopted the UFTA, a number of jurisdictions have modified the UFTA limitations periods, most commonly by suspending the limitations period indefinitely in actions based on actual fraud under section 4(a)(1).¹⁸⁶

For persons using APTs to shelter their assets from creditors' claims, the statutes of limitation for fraudulent transfer actions afford substantial protection. In most cases, as long as a fraudulent transfer claim arises four years or more after the transfer of assets to an APT,

176. UFTA § 5(a).

177. Section 1 of the UFTA defines "insider" as a relative or close business associate of the debtor. See UFTA § 1(7).

178. UFTA § 5(b).

179. See UFTA § 7(a)(1), (2); see also Boxx, *supra* note 3, at 1224 & n.168.

180. UFTA § 7(b).

181. See UFTA § 7(a)(3)(iii).

182. UFTA § 9(a).

183. UFTA § 9(b).

184. UFTA § 9(c).

185. See *supra* note 166 and accompanying text.

186. SPERO, *supra* note 68, ¶ 3.02[5].

the claim will be barred by the statute of limitations. Only in those cases in which the creditor successfully asserts actual fraud under section 4(a)(1) will a different limitations period potentially apply,¹⁸⁷ but, as discussed below, a future creditor (as opposed to a present creditor) in general will have a difficult burden in establishing actual fraud. Thus, as long as a settlor is planning with respect to future creditors only, with the passage of time the statute of limitations will bar most fraudulent transfer claims.

Under what circumstances will transfers to APTs be deemed fraudulent under the fraudulent transfer laws? More particularly, if a settlor transfers assets to an APT not with a specific creditor in mind, but rather with the general goal of shielding assets from potential future creditors, will the transfer be deemed fraudulent and thus voidable under the UFTA or similar laws? Although the answer to this question is not without doubt, it appears that most courts are unwilling to void transfers whose purpose and effect is to shelter assets from creditors that were unknown at the time of the transfer. Furthermore, the more remote in time the claim of a future creditor, the less likely a court will be to find that an earlier transfer was fraudulent with respect to that creditor. Thus, as long as a person creating an APT does so well in advance of a creditor's claim, and especially if the creditor was unknown and unforeseeable at the time of the transfer to the trust, it is likely that the transfer will not be deemed fraudulent.¹⁸⁸

In an action brought under UFTA section 4(a)(1)—in which the creditor must prove “actual intent to . . . defraud”—a future creditor must typically establish that, as of the time of the transfer, the creditor held “contingent, unliquidated, or unmatured claims,” or that the creditor held “a claim that [could] reasonably [be] foreseen by the transferor.”¹⁸⁹ Professor Peter A. Alces states that, in an action based on actual intent to defraud, a future creditor must “establish a causal link between the fraudulent disposition and the injury suffered.”¹⁹⁰ Regarding this same question Professor Alces further states that “[the] focus on causality provides a means to distinguish between the actions that operate directly to prejudice a particular creditor and those actions that in some remote, not foreseeable way, have after the

187. See *supra* notes 182-184 and accompanying text.

188. See generally PETER A. ALCES, *THE LAW OF FRAUDULENT TRANSACTIONS* ¶ 5.04 (1989 & Supp. 2000) (discussing which creditors have “standing” to bring fraudulent transfer claims); LoPucki, *supra* note 67, at 35 & n.155 (explaining that a transfer by a debtor who lacks the intent to defraud specific creditors, present or future, will not be deemed fraudulent); SPERO, *supra* note 68, ¶¶ 3.04[1], 3.04[2].

189. SPERO, *supra* note 68, ¶¶ 3.04[1], at 3-16 & nn.86-87 (citing cases in support).

190. ALCES, *supra* note 188, ¶ 5.04[1][d] (discussing section 7 of the UFCA, which contains the same “actual intent” requirement as section 4(a)(1) of the UFTA).

passage of considerable time or the occurrence of an intervening cause, compromised a creditor's financial interest."¹⁹¹

Concerning a similar issue,¹⁹² in an often-cited passage the court in *Oberst v. Oberst*¹⁹³ stated:

While the Court finds it very difficult to locate the exact line between bankruptcy planning and hindering creditors, Congress has decided that the key is the intent of the debtor. If the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the discharge. If the debtor is *merely looking to his future wellbeing*, the discharge will be granted. This is an uncomfortable test and does not seem equitable; but it is the law.¹⁹⁴

Thus, the concept of "reasonable foreseeability," the requirement that future creditors establish a "causal link" between the transfer and their claims, and the notion that one may permissibly plan for one's general "future wellbeing" all serve to limit those future creditors who can successfully claim that a transfer was intended to defraud them.¹⁹⁵

What about claims by future creditors brought under UFTA section 4(a)(2), the so-called constructive fraud provision? Under section 4(a)(2), a creditor need not show that the transferor *intended* to defraud creditors; rather, a creditor need only show that the transferor made a transfer for less than consideration of equivalent value and

(i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.¹⁹⁶

The first of these provisions literally seems not to apply to future creditors whose claims arise well after the transfer in question; the

191. *Id.* ¶ 5.04, at 5-112.

192. In this case, whether a person should be denied a bankruptcy discharge because she had transferred property "with intent to . . . defraud a creditor" within the meaning of 11 U.S.C. section 727(a)(2) (2000).

193. 91 B.R. 97 (Bankr. C.D. Cal. 1988); see, e.g., LoPucki, *supra* note 67, at 35 n.155 (citing *Oberst*).

194. 91 B.R. at 101 (emphasis added).

195. See also John E. Sullivan III, *Future Creditors and Fraudulent Transfers: When a Claimant Doesn't Have a Claim, When a Transfer Isn't a Transfer, When Fraud Doesn't Stay Fraudulent, and Other Important Limits to Fraudulent Transfers Law for the Asset Protection Planner*, 22 DEL. J. CORP. L. 955, 971-75, 981-88 (1997) (refuting the proposition that planning one's affairs to shelter assets from creditors' claims is "inherently fraudulent").

196. UFTA § 4(a)(2).

reference to the debtor being “engage[d] or . . . *about to engage*”¹⁹⁷ in a business or transaction suggests that the covered transfers are only those that disadvantage creditors whose claims are reasonably proximate in time. Although the second provision is not, on its face, as easily susceptible to the same interpretation, that, in fact, is how courts have traditionally interpreted both constructive fraud provisions. As is true with a claim based on actual fraud, a claim brought by a future creditor based on constructive fraud typically must show a causal connection between the transfer and the transferor’s failure to satisfy the claim.¹⁹⁸ As one commentator explains:

The requisite causal connection cannot be established merely by showing a chronological relation between the suspect transfer and the debtor’s insolvency. Moreover, creditors are not given the benefit of hindsight in establishing this causal connection. Thus, unforeseen intervening acts that cause or contribute to insolvency break the causal connection between the allegedly fraudulent transfer and the debtor’s subsequent insolvency.¹⁹⁹

Moreover, as the same commentator explains, “the longer the period between the transfer and the claim, the weaker the causal connection.”²⁰⁰

The constructive fraud provisions require a showing that the challenged transfer placed the transferor at an unreasonable risk of being unable to satisfy his or her obligations. Thus, resolving this question in large part depends on whether the transfer rendered the transferor insolvent or nearly so. As a corollary, resolving the question also depends on whether the transferor retained sufficient assets to satisfy creditors whose claims were reasonably foreseeable. If a settlor who transfers assets to an APT reserves sufficient assets to preserve the settlor’s solvency and to ensure that reasonably foreseeable claims can be paid, then a challenge to the transfer based on constructive fraud will be unlikely to succeed.²⁰¹ The adequacy of the transferor’s liability insurance is an important factor in determining whether a transferor has adequately provided for foreseeable future claims.²⁰²

197. UFTA § 4(a)(2)(i) (emphasis added).

198. ALCES, *supra* note 188, ¶ 5.04[1][c].

199. SPERO, *supra* note 68, ¶ 3.04[2], at 3-32; *see also* ALCES, *supra* note 188, ¶ 5.04[1][c] (discussing similar concepts under the constructive fraud provisions of the UFCA).

200. SPERO, *supra* note 68, ¶ 3.04[2], at 3-33.

201. *See* Sullivan, *supra* note 195, at 988-1014 (developing a “rule of reason” for evaluating whether a challenged transfer is constructively fraudulent, based on the degree to which the transferor has preserved his or her long-term solvency).

202. *See id.* at 995-1001; *see also* Sterk, *supra* note 3, at 1047 (suggesting that a settlor who transfers assets to an APT can negate a constructive fraud claim by establishing that

To summarize the conclusions of this part, a settlor who transfers property to an APT will likely succeed in defending fraudulent transfer claims to the extent those claims are brought by future creditors, at least if the obligations to those creditors were not reasonably foreseeable at the time of creating the trust. The settlor will increase the likelihood of success if the transfer to the APT does not leave the settlor unable to satisfy foreseeable obligations. Moreover, the statutes of limitation under most fraudulent transfer statutes provide substantial protection against fraudulent transfer claims that arise more than four years after the APT was created.

IV. Rethinking the Traditional Rule

A. Introduction

This part of the article develops a new approach to evaluating self-settled APTs. It rejects the assumptions on which the traditional rule is based and advocates an approach based on a realistic assessment of the rights and duties of settlors, non-settlor beneficiaries, and trustees. To place the discussion of creditors' rights into perspective, the part begins with an overview of non-APT property management and ownership vehicles that allow persons to shelter property from the claims of creditors.

Throughout the discussion in this part, the article assumes that the transfer of property to an APT cannot be set aside under the relevant fraudulent transfer statute. Thus, the discussion focuses on what remedies a creditor should have based on trust law concerning creditors' rights, without reference to fraudulent transfer laws.

B. Creditor Protection Alternatives

In considering whether and under what circumstances the law should respect APTs, it is helpful to examine the extent to which the law permits property owners to shelter their assets from creditors through non-APT arrangements.

(1) *Tenancies By The Entirety*

A tenancy by the entirety is a form of concurrent ownership of property, between a husband and wife exclusively, in which both concurrent owners hold a right of survivorship²⁰³—that is, upon the death of the first spouse to die, the surviving spouse becomes the sole owner of the property. The concept arose at common law, under which husbands and wives were deemed to constitute a single person

he or she has obtained adequate liability insurance).

203. ROBERT T. DANFORTH, *TAXATION OF JOINTLY OWNED PROPERTY A-2* (1998).

or entity.²⁰⁴ Thus, unlike other concurrent owners of property, tenants by the entirety own the property as a single marital unit, and the individual tenants are deemed not to own any individual share of the whole. The practical consequence of this principle is that, in general, a tenancy by the entirety cannot be severed unilaterally; to sever the tenancy requires the voluntary act of both owners.²⁰⁵ Thus, a tenant by the entirety has no right to convey his or her interest to a third party without the consent of the co-owner. As discussed further below, this characteristic of tenancies by the entirety has the collateral effect of sheltering property held in this form from the claims of one spouse's creditors.

At common law, a tenancy by the entirety was the only concurrent ownership arrangement that could be created between husbands and wives.²⁰⁶ Although other forms of marital property are now permissible, the tenancy by the entirety continues to be recognized in most jurisdictions.²⁰⁷ Thus, for many married couples throughout the United States, the tenancy by the entirety provides a means of sheltering assets from the claims of each spouse's creditors.

In a majority of the jurisdictions that still recognize the tenancy by the entirety, the interest of one spouse in the tenancy is not subject to the claims of his or her creditors during the spouses' joint lives.²⁰⁸ This general rule applies both to encumbrances that could arise voluntarily (e.g., one spouse's attempt to grant a mortgage on real property) and to those that could arise involuntarily as a result of a judgment against one spouse. In most jurisdictions that continue to recognize tenancies by the entirety, the arrangement can be used to own both real and personal property;²⁰⁹ moreover, unlike exempt-property laws,²¹⁰ laws authorizing tenancies by the entirety place no limitations on the value of property that may be held in this form.²¹¹

204. ROGER A. CUNNINGHAM ET AL., *THE LAW OF PROPERTY* § 5.5, at 203 (2d ed. 1993).

205. DANFORTH, *supra* note 203, at A-2.

206. CUNNINGHAM, *supra* note 204, § 5.5, at 203.

207. See RICHARD R. POWELL, 7 *POWELL ON REAL PROPERTY* § 52.01[3], at 52-11 to 52-12 (2000) (indicating that the tenancy by the entirety continues to be recognized in 25 states and the District of Columbia). *But see* JESSE DUKEMINIER & JAMES E. KRIER, *PROPERTY* 323 (4th ed. 1998) (indicating that the tenancy by the entirety exist today in "somewhat less than half the states").

208. See generally DANFORTH, *supra* note 203, at A-6 to A-7 (discussing the particulars and variations of the general rule). Note this important limitation: the assets are sheltered from *individual creditors only*. Tenants by the entirety may join in encumbering their property, and a tenancy by the entirety is subject to the claims of creditors *to whom the spouses are jointly liable*. See CUNNINGHAM, *supra* note 204, § 5.5, at 206.

209. See CUNNINGHAM, *supra* note 204, § 5.5, at 208.

210. See *infra* notes 242-254 and accompanying text.

211. For the relatively wealthy, the federal estate tax constitutes a disincentive to holding a substantial portion of a husband and wife's property as tenants by the entirety.

Also, unlike at common law, under modern law whether property is held as tenants by the entirety is wholly within the control of the spouses. Thus, the tenancy by the entirety is a flexible device for sheltering substantial assets from creditors not available to single

Oversimplifying somewhat, as of 2001 the federal estate tax is imposed on estates worth more than \$675,000. See I.R.C. § 2010(c) (West 2001) (granting a credit against the tax in an amount sufficient to shelter the first \$675,000 worth of property). Property left to a surviving spouse, however, qualifies for the estate tax marital deduction and thus is not subject to estate tax. See I.R.C. § 2056(a) (1994). Married couples who own most of their assets as tenants by the entirety risk subjecting their assets to tax unnecessarily. The point is illustrated by the following example:

Husband (H) and Wife (W) own assets worth \$1,350,000, all of which are held as tenants by the entirety. Each spouse's will leaves all of his or her property to their children. H dies in January 2001, and W dies in December 2001. At H's death all of the assets pass by right of survivorship to W (H's will does not control the disposition of the property). At W's death, her estate is worth \$1,350,000 and is subject to an estate tax of approximately \$270,000. See I.R.C. §§ 2001(c) (1994 & Supp. IV 1998), 2010(c). All of W's assets, less estate tax, pass to H and W's children. If, instead of holding their assets as tenants by the entirety, H and W had held their assets as tenants in common, H's interest would have passed directly to the children estate tax free (an estate worth no more than \$675,000 is not subject to estate tax), as would W's interest; thus, H and W's children would have ended up \$270,000 richer. See I.R.C. §§ 2001(c), 2010(c).

Several years ago, this tax planning problem associated with tenancies by the entirety was alleviated somewhat by the liberalization of the estate tax disclaimer rules, see DANFORTH, *supra* note 203, at A-42 to A-47, under which in most circumstances a surviving tenant by the entirety is authorized to disclaim that tenant's survivorship interest, thereby causing the deceased tenant's interest to pass as if the property were held as tenants in common. Thus, the tax rules now create less of a disincentive to holding property as tenants by the entirety.

A further disincentive to holding substantial portions of a couple's property as tenants by the entirety is that each spouse gives up some of the estate planning benefits of being able to transfer his or her property interests to a revocable trust. See generally JESSE DUKEMINIER & STANLEY M. JOHANSON, *WILLS, TRUSTS, AND ESTATES* 386-96 (6th ed. 2000) (discussing the use of revocable trusts in estate planning). As discussed above, common law principles restrict tenancies by the entirety exclusively to married persons; property owned by a revocable trust is not the same as property owned by the settlor and, thus, transferring property to a revocable trust is inconsistent with holding the property as tenants by the entirety. In an effort to afford the creditor protection attributes of tenancies by the entirety to married persons who also seek the estate planning benefits of revocable trusts, the Virginia legislature has considered a bill that would expressly allow tenancy by the entirety property to be held in both separate and joint revocable trusts. This proposal follows on the heels of recent Virginia legislation designed (i) to clarify that Virginia allows tenancies by the entirety in personal property, not just real property, see J. Rodney Johnson, *Wills, Trusts, and Estates, Annual Survey of Virginia Law*, 33 U. RICH. L. REV. 1075, 1081-82 (1999) (discussing 1999 enactment of section 55-20.1 of the Virginia Code), and (ii) to permit spouses to transfer a tenants-by-the-entirety principal residence to their separate or joint revocable or irrevocable trusts, while retaining "the same immunity from the claims of their separate creditors as [the residence] would if it had remained a tenancy by the entirety," VA. CODE § 55-20.1 (Michie Supp. 2000).

persons nor to spouses residing in jurisdictions that do not recognize that form of ownership.

Moreover, in jurisdictions that recognize the tenancy by the entirety, spouses are afforded a means of creating self-settled trusts, the assets of which will be sheltered from their creditors, thus avoiding the traditional rule rendering such trusts ineffective. Consider, for example, *Bolton Roofing Company Co. v. Hedrick*,²¹² in which a husband and wife transferred property held as tenants by the entirety to a trust for the benefit of themselves and their children. A creditor of the husband sought to satisfy a judgment from the assets of the trust.²¹³ After acknowledging the traditional rule against self-settled spendthrift trusts, the court nevertheless held that the creditor could not reach the trust assets.²¹⁴ Because the property would not have been available to the creditor prior to its transfer to the trust, the court found the usual public policy prohibition against self-settled spendthrift trusts to be inapposite.²¹⁵ The court in *Security Pacific Bank Washington v. Chang*²¹⁶ reached the same conclusion with respect to property held as tenants by the entirety transferred in equal shares to separate spendthrift trusts created by a husband and wife. Thus, notwithstanding that the trusts held the property as tenants in common, the court ruled that the husband's creditor could not reach the assets of his separate trust.²¹⁷ To rule otherwise, the court reasoned, "would not give the . . . creditor justice, it would simply give it a windfall," because a decision adverse to the creditor would not deprive the creditor of an asset that it could have reached before the trust was created.²¹⁸

Tenancy by the entirety rules allow an additional means of avoiding the prohibition against self-settled spendthrift trusts. Consider the following transaction: shortly before the death of his

212. 701 S.W.2d 183 (Mo. Ct. App. 1985).

213. *Id.*

214. *Id.* at 184-85.

215. The court reasoned as follows:

[The creditor's] claim would be valid if the judgment it relies on were against [the spouses], jointly and severally, but it is not. The judgment is against [the husband] as an individual. [The creditor] would not have had any legal right to levy against the real estate owned jointly by [the spouses] prior to the time they conveyed it under the trust agreement. It stands to reason, therefore, that [the creditor] could not have the same real estate, after it had been conveyed to the trustee by [the spouses], as tenants by the entireties, sold to satisfy an individual debt of [the husband's]. . . . The spendthrift clause used here in the trust agreement offends neither statute nor public policy, because it does not deprive [the creditor] of any rights it had before the conveyance in question was made.

Id.

216. 818 F. Supp. 1343 (D. Haw. 1993).

217. *Id.* at 1346.

218. *Id.* at 1346.

wife, an insolvent husband transfers to his wife all of his interest in property held by them as tenants by the entirety. The wife dies, leaving all of the property to a spendthrift trust for the benefit of the husband. May the husband's creditors reach the trust assets in satisfaction of his debts? In *Watterson v. Edgerly*, the court held that they could not.²¹⁹ The court reasoned that, because the trust assets constituted property formerly held as tenants by the entirety, the husband's creditors were not disadvantaged by the creation of the spendthrift trust.²²⁰ Without expressly stating so, a significant factor in the court's decision appears to be that, because the tenancy by the entirety property was not subject to the claims of the husband's creditors, the husband's transfer of the property to his wife, anticipating that the property would soon return to the husband in the form of a spendthrift trust, should not be deemed a fraudulent transfer within the meaning of the fraudulent transfer laws.²²¹

(2) *Retirement Savings*

The Employee Retirement Income Security Act of 1974 (ERISA) requires all retirement plans to include a provision prohibiting alienation of the plan benefits.²²² As interpreted by the United States Supreme Court, the anti-alienation provision in ERISA-qualified plans provides an exclusion²²³ for purposes of section 541(c)(2) of the Bankruptcy Code, which excludes from the debtor's estate a beneficial interest in a trust that is subject to a transfer restriction enforceable under "applicable nonbankruptcy law."²²⁴ ERISA's anti-alienation provisions also protect retirement

219. 388 A.2d 934 (Md. Ct. Spec. App. 1978).

220. *Id.* at 938-39.

221. *See id.* at 938-39.

222. ERISA § 206(d), 29 U.S.C. 1056(d)(1) (2001) (directing that "[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated"). The Internal Revenue Code and Treasury Regulations include a similar requirement for the plan to qualify for tax-exempt status. *See* I.R.C. § 401(a)(13) (West 2001); Treas. Reg. § 401(a)-13(b)(1).

223. Property excluded from the bankruptcy estate under Bankruptcy Code section 541(c)(2) may be distinguished from property that is included in the estate for which either state law or the Bankruptcy Code provides an exemption. The exclusion under section 541(c)(2) applies regardless of whether the debtor elects the state or federal exemption scheme. *See infra* note 243 (noting the interplay of state and federal exemption rules in the bankruptcy context). Moreover, the exclusion is not limited in amount, as is true with some state and federal exemption rules. *See, e.g.*, 11 U.S.C. § 522(d)(10)(E) (2000) (limiting the federal exemption for retirement plans to an amount "reasonably necessary for the support of the debtor and any dependent of the debtor").

224. 11 U.S.C. § 541(c)(2) (2000); *see Patterson v. Shumate*, 504 U.S. 753, 757-66 (1992). Note, however, that a plan for the benefit of a sole shareholder may not qualify for the section 541(c)(2) exclusion, because a plan without a "participant" cannot be an ERISA-qualified plan; the plan may nevertheless be exempt under state law or excludable under

savings from creditors in state court proceedings.²²⁵ At least one court has held that a creditor may not reach a participant's interest in an ERISA-qualified retirement plan even if the participant has the power to demand a lump-sum distribution.²²⁶ State exemption rules may also protect retirement savings in circumstances for which the anti-alienation provisions do not afford protection. For example, in some states retirement savings are excluded from the claims of creditors even after distributions occur, as long as the distributed funds are segregated from other assets of the debtor.²²⁷ In addition, state exemption statutes may protect individual retirement accounts (IRAs), which are not covered by ERISA's anti-alienation rules.²²⁸ IRAs are also protected under the bankruptcy exemption statute,²²⁹ although only to the extent "reasonably necessary" for the support of the debtor and the debtor's dependents.²³⁰

(3) *Family Limited Partnerships*

For approximately the last decade,²³¹ many wealthy individuals have availed themselves of the numerous estate planning advantages

some other principle. See *In re Witwer*, 148 B.R. 930, 934-41 (Bankr. C.D. Cal. 1992) (holding plan not excluded under the *Patterson* ruling because the plan was not subject to ERISA; holding plan nevertheless excluded under the law of the Ninth Circuit, in which retirement accounts with anti-alienation provisions qualify for an exception to the usual rule rendering ineffective self-settled spendthrift trusts).

225. See SPERO, *supra* note 68, ¶ 10.04[1][b]; KATHERINE G. HENKEL, *ESTATE PLANNING AND WEALTH PRESERVATION* ¶ 53.10[3][d][i] (1997).

226. *Tenneco Inc. v. First Virginia Bank of Tidewater*, 698 F.2d 688, 690 (4th Cir. 1983).

227. See SPERO, *supra* note 68, ¶ 10.04[2][a].

228. See SPERO, *supra* note 68, ¶ 10.04[3]; HENKEL, *supra* note 225, ¶ 53.10[3][e]. The laws of many of the most populous states include exemptions for IRAs. See SPERO, *supra*, ¶ 10.04[3], at 10-72 & nn.426-27 (citing authority in California, Florida, Illinois, New York, and Texas).

229. See *Patterson*, 504 U.S. at 763 n.6 (citing cases for the proposition that the federal bankruptcy exemption, 11 U.S.C. § 522(d)(10)(E) (2000), applies to both ERISA plans and non-ERISA plans).

230. See *supra* note 223 and accompanying text.

231. As described below, see *infra* note 232, a substantial incentive for creating family limited partnerships is the valuation discounts that apply to partnership interests for purposes of the estate, gift, and generation-skipping transfer taxes. Although family limited partnerships have long served other estate planning and asset management objectives, a 1993 ruling by the Department of Treasury opened the floodgates to the use of family limited partnerships for so-called valuation discount planning. See Rev. Rul. 93-12, 1993-1 C.B. 202. Before 1993, the government applied a family attribution rule in valuing closely held business interests for transfer tax purposes. In Rev. Rul. 93-12, the government reversed its earlier position, ruling that it would no longer "assum[e] that all voting power held by family members may be aggregated" in valuing transferred interests in the transfer tax context. "Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest." Rev. Rul. 93-12, 1993-1 C.B. 202.

of placing their assets in family limited partnerships.²³² Among those advantages are the limited rights granted by law to the creditors of individual partners. To place this discussion into context, consider the following, fairly typical transaction. A property owner, concerned about potential creditors' claims, forms a limited partnership, to which he transfers investment real estate and marketable securities, and to which her son transfers a relatively small amount of cash. Following the transaction, the mother holds a 98% limited partnership interest and a 1% general partnership interest, and the son holds a 1% general partnership interest. Under the terms of the partnership agreement, distributions of partnership earnings are controlled by the two general partners acting together. Any partnership distributions that do occur must be made to the limited and general partners proportionally.

Some years later the mother is sued and the judgment creditor seeks to satisfy its claim from the mother's partnership interests. Assuming that the mother's transfer to the partnership was not fraudulent within the meaning of the fraudulent transfer laws, to what extent will the creditor be able to satisfy its claim?

232. Perhaps the most significant of these advantages is that the partnership interests qualify for substantial valuation discounts for estate, gift, and generation-skipping transfer tax purposes. See generally BORIS I. BITTKER ET AL., FEDERAL ESTATE AND GIFT TAXATION 662-64, 673-82 (8th ed. 2000) (describing general transfer tax valuation principles and further explaining rationale for discounts attributable to lack of marketability and lack of control). Consider the following example:

A husband and wife own as tenants in common a \$1 million farm, which they transfer to a limited partnership. Each spouse retains a 1% general partnership interest and a 49% limited partnership interest. The spouses intend to make gifts of their limited partnership interests to their children and other descendants in an amount each year that qualifies for the annual gift tax exclusion (as of 2001, up to \$10,000 per donee per calendar year, see I.R.C. § 2503(b) (Supp. IV 1998)). A 1% interest as a tenant in common in the farm would be worth approximately \$10,000. A 1% limited partnership interest, however, should be entitled to a substantial discount for lack of marketability and lack of control. Assume that the taxpayers take a 40% combined discount for lack of marketability and lack of control. See HENKEL, *supra* note 225, ¶ 16.03[1] (describing commonly utilized valuation discounts). If the husband and wife had not created the partnership, each would have been able to transfer only a 1% interest in the farm per donee per year. As a result of creating the limited partnership, however, each spouse can make annual exclusion gifts of a 1.67% interest in the limited partnership [$\$16,667 - 40\% = \$10,000$]. The spouses thus achieve greater transfer tax efficiency in transferring their interests in the farm to their descendants.

Another significant advantage of limited partnership arrangements is that only the general partner has a voice in management decisions. See REVISED UNIFORM LIMITED PARTNERSHIP ACT § 403(a), 6A U.L.A. 177 (1995). Thus, in our example, the husband and wife will continue to control the management of the farm even as they transfer their equity interests to their descendants.

Under the Revised Uniform Limited Partnership Act (RULPA), adopted with slight variations by nearly every state,²³³ the exclusive remedy available to the creditor of an individual partner is a "charging order" against the debtor's partnership interest.²³⁴ In general, a charging order causes a creditor to be treated as an assignee of the partnership interest and thus entitles the creditor to receive the partner's share of partnership distributions until the creditor's claim is satisfied.²³⁵ An assignee is not a partner and thus holds none of the rights exclusive to partners, such as the right to force a dissolution of the partnership under certain circumstances.²³⁶ For several reasons, the right to receive partnership distributions is of limited value to the creditor. First, with many closely held businesses, most profits are simply reinvested in the business; moreover, within certain limitations, the general partners have exclusive control over the timing and amounts of partnership distributions. Thus, distributions to the creditor are likely to occur infrequently, at best. Second, the partnership income tax rules, under which holders of partnership interests are taxed directly on partnership income,²³⁷ may cause the creditor to owe taxes on partnership income that the creditor never receives—so-called phantom taxable income.²³⁸

Although, in general, a charging order entitles the creditor only to receive distributions if and when they occur, under certain circumstances the creditor may also be allowed to "foreclose" the charging order.²³⁹ Foreclosure entitles the creditor to sell the

233. See ROSEN, *supra* note 82, at A-4.

234. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, 4 BROMBERG AND RIBSTEIN ON PARTNERSHIP § 13.07(e) (1998) (describing remedies available under the RULPA).

235. See generally SPERO, *supra* note 68, ¶ 8.02; Kathryn G. Henkel, *How Family Limited Partnerships Can Protect Assets*, EST. PLAN., Feb. 1993, at 3, 3-4.

236. See SPERO, *supra* note 68, ¶ 8.02[1][b], at 8-18.

237. See I.R.C. § 701 (1994).

238. See Rev. Rul. 77-137, 1977-1 C.B. 178; see also ROSEN, *supra* note 82, at A-6 to A-7 (discussing arguments for and against this result); HENKEL, *supra* note 225, ¶ 53.08[9][b] (same).

239. There is some uncertainty concerning the availability of foreclosure as a remedy for the creditor of a limited partner. This uncertainty arises from the fact that the remedial provisions of both the Uniform Partnership Act and the Revised Uniform Partnership Act, which apply to general partnerships as well as to limited partnership to the extent not inconsistent with RULPA, both expressly authorize foreclosure of the debtor partner's interest, see 1 BROMBERG & RIBSTEIN, *supra* note 234, § 3.05(d)(3)(v), while the provisions of the RULPA say nothing about foreclosure. See SPERO, *supra* note 68, ¶ 8.02[1], at 8-12, ¶ 8.02[1][b] (discussing the arguments for and against allowing foreclosure of a charging order). Several courts have ruled that a creditor is entitled to receive partnership distributions only and that foreclosure is not available. ROSEN, *supra* note 82, at A-4 to A-5 (discussing cases). On the other hand, other courts have held that a charging order may be foreclosed if partnership distributions are unlikely to pay off the debt within a reasonable time. See 4 BROMBERG & RIBSTEIN, *supra* note 234, § 13.07(e)(2), at 13:55 & n.50 (citing cases). For the purpose of making their limited

partnership interest and thus immediately realize on the value of the interest, rather than waiting for the value that might be realized from partnership distributions. For several reasons, however, foreclosure is likely to yield little value to the creditor. First, in the context of a family limited partnership, the market for selling the interest will generally be only the family members themselves. Second, under the RULPA, the purchaser at a foreclosure sale becomes not a partner, but a mere assignee and consequently has rights no greater than the creditor holding the charging order.²⁴⁰ These factors will depress the value of the foreclosed interest and likely force the creditor to sell to a family member at a bargain price. A purchaser at a foreclosure sale has no right to force a dissolution of the partnership and thus is unable to recover against the partnership assets.²⁴¹

(4) *Homestead and Other Exemptions*

The laws in virtually every jurisdiction in the United States exempt certain categories of assets from the claims of creditors. The monetary value of the exemptions varies considerably from state to state, ranging from paltry to extraordinarily generous.²⁴² State exemption laws apply both in state court enforcement actions and in federal bankruptcy proceedings.²⁴³ The most important of the state law exemptions are the homestead exemption and the exemption for life insurance.

partnership laws more attractive for protection against creditors' claims, a few states have expressly modified their limited partnership laws to make clear that the foreclosure remedy is not available. *See, e.g.*, ALASKA STAT. § 32.11.340(b) (Lexis 2000) (providing that the charging order is the "exclusive remedy" and that "foreclosure on the . . . partner's partnership interest . . . [is] not available to the judgment creditor . . . and may not be ordered by a court"). In the bankruptcy context, the bankruptcy trustee is not limited to the remedies available under state law. The Bankruptcy Code expressly authorizes the trustee to sell the property of the estate, notwithstanding any state law or partnership provision to the contrary. 11 U.S.C. §§ 363(b)(1), (f) (1994); *see also* SPERO, *supra* note 68, ¶ 8.03[1][b], at 8-24.

240. *See* SPERO, *supra* note 68, ¶ 8.02[1][b], at 8-17 to 8-18.

241. *See* 4 BROMBERG & RIBSTEIN, *supra* note 234, § 13.07(d)(1), at 13:47 (explaining that the purchaser has no right of dissolution in the case of term partnerships, which most limited partnerships are).

242. *See, e.g.*, OSBORNE & SCHURIG, *supra* note 162, §§ 7:01 to 7:53 (summarizing homestead exemption laws of all 50 states and the District of Columbia). *Compare* W. VA. CODE ANN. § 38-9-1 (Michie 1997) (limiting homestead exemption to a value of \$5,000) *with* TEX. PROP. CODE ANN. §§ 41.001, 41.002 (Vernon 2000) (establishing no monetary limitation, and allowing up to 200 acres for a rural homestead and 10 acres for an urban homestead).

243. *See* HERBERT, *supra* note 148, § 11.02 (explaining that, under the Bankruptcy Code, states may "opt out" of the federal exemption rules and allow their residents the state exemptions only; alternatively, states may give their residents a choice between the state exemptions and the federal exemptions).

The homestead exemption is based on a public policy recognizing that even the most impecunious debtor should be able to retain the means to house himself and his family.²⁴⁴ In many states, the size of the homestead exemption is so small that it cannot possibly be effective in achieving its objective—an exemption of only \$5,000, for example, would not permit a debtor to retain his home; instead, it would permit the debtor merely to retain \$5,000 of the sales proceeds.²⁴⁵ Ironically, some homestead exemption laws allow debtors to shelter assets from creditors greatly in excess of that which is needed for maintaining the debtor and the debtor's family. The most notable—or, arguably, notorious²⁴⁶—of those are in Florida and Texas, which exempt homesteads of *unlimited value*.²⁴⁷

The laws of virtually every state also exempt all or a portion of the cash value of unmaturing life insurance policies from the claims of creditors of the owner-insured.²⁴⁸ In most states, there is no restriction on the amount of cash value that can be sheltered in life insurance policies.²⁴⁹ Moreover, many states specifically exempt the cash value of life insurance endowment contracts, the proceeds of which are payable to the insured if he or she survives for the term specified in the contract.²⁵⁰ Thus, it is possible to shelter cash value under life insurance policies even if the proceeds are unlikely to become payable to the insured's dependents.²⁵¹ As is true with other

244. See OSBORNE & SCHURIG, *supra* note 162, § 7:02.

245. See HERBERT, *supra* note 148, § 2.09, at 42.

246. See, e.g., Larry Rohter, *Rich Debtors Finding Shelter Under a Populist Florida Law*, N.Y. TIMES, July 25, 1993, § 1, at 1 (discussing purchases of multimillion dollar homes in Florida); *Protecting Rich Bankrupts*, N.Y. TIMES, Aug. 13, 1999, at A20 (discussing Florida and Texas homestead laws); HERBERT, *supra* note 148, § 11.02, at 186 (stating that critics consider Florida and Texas "as virtual havens for deadbeats"); Laura Jereski, *Home Free*, FORBES, Oct. 27, 1986, at 340 (describing how the Houston real estate developer Melvin Lane Powers protected from creditors his 21-story \$67.5 million duplex penthouse).

247. See FLA. CONST. art. X, § 4 (establishing no monetary limitation, and allowing up to 160 acres for a homestead located outside a municipality and 0.5 acre for a homestead located within a municipality); TEX. PROP. CODE ANN. §§ 41.001, 41.002 (Vernon 2000) (establishing no monetary limitation, and allowing up to 200 acres for a rural homestead and 10 acres for an urban homestead).

248. See generally BUIST M. ANDERSON, ANDERSON ON LIFE INSURANCE § 21.4 (1991); see also William A. Brackney, *Creditors' Rights in Life Insurance*, PROB. & PROP., Mar.-Apr. 1993, at 52, 55-58 (summarizing the law in all 50 states and the District of Columbia).

249. See ANDERSON, *supra* note 248, § 21.4, at 606-07 (noting that a few states exempt only a cash value of a certain amount or an amount that can be purchased with annual premiums of a stated amount).

250. *Id.* § 21.4, at 607.

251. In this respect, laws exempting endowment policies at best only marginally further the principal purpose of life insurance exemption laws—to secure the well-being of the insured's dependents. See STUART SCHWARZSCHILD, RIGHTS OF CREDITORS IN LIFE

exemption laws, state laws exempting life insurance policies apply both in state court and federal bankruptcy proceedings.²⁵² Thus, following a debtor's discharge in bankruptcy, it is possible for the cash value of the exempt life insurance to be available for use by the debtor for non-insurance purposes.²⁵³ Many states' laws also exempt annuity contracts and the income therefrom.²⁵⁴

(5) *Trusts and Non-Trust Transfers for the Benefit of the Settlor's Family*

All property owners, regardless of whether their home jurisdiction recognizes self-settled APTs, have available to them a variety of informal means of implementing arrangements roughly equivalent to APTs. For example, an owner of property for whom asset protection is a paramount concern can transfer the property to a trusted family member, subject to an unenforceable understanding that the property would be used for the benefit of the transferor.²⁵⁵ Assuming that the transfer could not be captured by applicable fraudulent transfer law, the transferred property would be immune

INSURANCE POLICIES 147-52 (1963) (discussing the purposes of insurance exemption laws).

252. See *supra* note 243 and accompanying text.

253. Although there is no statutory prohibition on debtors acquiring exempt assets in anticipation of bankruptcy, an attempt to abuse exemption laws by purchasing exempt property with the intent of selling the property shortly after discharge could prompt a court to deny the exemption or deny the discharge. See ANDERSON, *supra* note 248, § 11.07[C]; SPERO, *supra* note 68, ¶ 10.03[2], at 10-34 & n.202 (citing cases).

For an example of a debtor who was whipsawed by the interplay between state exemption laws and federal bankruptcy law, consider the story of Omar A. Tveten. In anticipation of filing a petition under Chapter 11 of the Bankruptcy Code, Dr. Tveten liquidated almost all of his non-exempt assets and invested the proceeds in life insurance and annuity contracts issued by a fraternal benefit association, protected from creditors' claims under a Minnesota exemption statute. In the bankruptcy proceedings, the court denied a discharge on the grounds that Dr. Tveten's conversion of non-exempt assets into exempt assets constituted a fraudulent transfer. See *Norwest Bank Nebraska, N.A. v. Tveten*, 848 F.2d 871 (8th Cir. 1988) (affirming district court order affirming bankruptcy court's denial of discharge). Ironically, in a related proceeding, the Supreme Court of Minnesota held that the Minnesota statute on which Dr. Tveten relied—which granted an *unlimited* exemption for the life insurance and annuity contracts purchased by Dr. Tveten—violated the Minnesota constitution, under which only a "reasonable amount" of property may be protected from creditors' claims. *In re Tveten*, 402 N.W.2d 551, 556-60 (Minn. 1987). Thus, Dr. Tveten both lost his exemption and failed to receive a discharge.

254. See ANDERSON, *supra* note 248, § 21.7; see also SPERO, *supra* note 68, ¶ 10.09, at 10-100 n.611 (briefly summarizing states' annuity exemption laws).

255. This technique is relatively common with respect to transfers for the benefit of a family member for whom a trust established by the transferor might cause the family member to lose Medicaid eligibility. See, e.g., Sanford J. Schlesinger et al., *Medicaid Planning Ideas: What Works and What Doesn't*, 20 EST. PLAN. 331, 335 (1993). In typical circumstances, the transferor leaves property to one family member, with precatory language that the property is to be used for the benefit of the person for whom outright ownership of the property would disqualify that person for Medicaid benefits.

from the claims of the transferor's creditors.²⁵⁶ This technique is especially effective—and likely most commonly utilized—through transfers from one spouse to another; interspousal transfers are not subject to gift tax,²⁵⁷ and spouses can generally be relied upon to manage and disburse the transferred assets in a manner consistent with the objectives of the transferor.

For the property owner who might be uncomfortable with such an arrangement, other, more formal options are available. The property owner could transfer property to a trust for the benefit of family members, granting a non-general power of appointment²⁵⁸ to a trusted family member, such as a spouse or a child. The power of appointment would grant the trusted family member the power to direct that trust assets be distributed to the settlor. As the donee of a power of appointment, the trusted family member would be free (but could not be compelled) to direct the trustee to distribute trust assets to the settlor as the donee deemed appropriate. No statutory or case law subjects to the settlor's creditors assets with respect to which the settlor is a permissible appointee of a power of appointment. This arrangement has at least one advantage over APTs established in jurisdictions such as Alaska or Delaware: the settlor is unrestricted in his or her choice of trustee.²⁵⁹ The arrangement is also superior to the informal arrangement described in the immediately preceding paragraph, because, unlike assets held outright by a trusted family member, assets held in trust over which a family member holds a non-general power of appointment cannot be reached by the power

256. The risks to the transferor include: (i) the transferee may breach his or her understanding with the transferor and divert the asset to the transferee or others, (ii) the transferee's payment of funds back to the transferor may trigger the imposition of gift taxes, and (iii) the transferred assets may be claimed by the creditors of the transferee. See Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives*, 73 Wash. U. L.Q. 1, 70-71 & n.262 (1995) (discussing transfers to trusted family members for the benefit of persons other than the transferor; also noting the risk that the trusted family member might die unexpectedly).

257. See I.R.C. § 2523 (1994 & Supp. IV 1998) (providing an unlimited gift tax deduction for transfers to a spouse).

258. A power of appointment is a power granted by one person (the "donor" of the power) to another person (the "donee," who is often the beneficiary of a trust), to direct the distribution of assets to persons designated by the donee. A "general" power is a power to direct the distribution of assets to a group of persons that includes the donee, the donee's creditors, the donee's estate, or the creditors of the donee's estate. A "non-general" power is a power to direct the distribution of assets to any person other than the donee, the donee's creditors, the donee's estate, or the creditors of the donee's estate. See DUKEMINIER & JOHANSON, *supra* note 211, at 701-02.

259. Unlike APTs established in Alaska or Delaware, the trust arrangements described in these paragraphs need not have an Alaska or Delaware resident as trustee. See *supra* notes 100-107 and accompanying text.

holder's creditors.²⁶⁰ Thus, the risk that the transferred assets might unintentionally be dissipated is somewhat alleviated. Moreover, the donee of a non-general power cannot appoint the assets to or for the donee's own benefit; thus, this arrangement lessens the risk of the family member diverting the funds in a manner inconsistent with the desires of the settlor. A disadvantage of this arrangement is that, unlike a trustee, a person who holds a power of appointment is not a fiduciary; thus, the donee's decision whether and in what manner to exercise the power is essentially unreviewable.²⁶¹

The risk that the donee of the power will exercise (or fail to exercise) the power in a manner inconsistent with the desires of the settlor can be alleviated somewhat by having the settlor retain control over the ultimate disposition of the trust assets. Consider the following transaction. A property owner transfers assets to a trust for the benefit of his children. The terms of the trust authorize the

260. Under well-established authority, assets subject to a non-general power of appointment cannot be reached by the creditors of the donee of the power. See RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 13.1 (1986); WILLIAM M. MCGOVERN, JR. & SHELDON F. KURTZ, WILLS, TRUSTS AND ESTATES § 10.4, at 403 (2d ed. 2001).

261. The law recognizes a distinction between a power of appointment held by a trustee, whose exercise of the power is subject to the ordinary constraints imposed by the law governing fiduciaries, see RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 cmt. d (1986), and a power held by a non-fiduciary, whose exercise of the power is subject to no such constraints, see *id.* § 11.1 cmt. a, illus. 1. The donee of a power who is not also a trustee has no duty to exercise the power, and the power, if exercised, may be exercised in a wholly arbitrary manner, excluding certain potential appointees in favor of others. See RESTATEMENT (THIRD) OF TRUSTS § 46 cmt. c (donee of power under no duty to exercise power) (Tentative Draft No. 2, 1999); *id.* § 50 cmt. a ("A trustee's discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power."). Professors Eugene F. Scoles and Edward C. Halbach Jr. illustrate the distinction as follows:

A leaves his estate to B Bank in trust to pay the income to C (who is likely to be A's spouse or adult child) for life; on C's death B is to distribute the principal to such of C's issue as C may appoint by will, remainder in default of appointment to C's then living issue by right of representation. C (as "donee") has a testamentary special [non-general] power of appointment. Incidentally, in addition to its managerial powers, B Bank too may have a power over the beneficial interests, most frequently in the form of power to invade principal for C's needs but sometimes in other forms, such as a power to divert income from C and distribute it among other beneficiaries. The power in B is a *fiduciary power*, and B must behave in a "fiduciary manner" with regard to it, as distinct from C's power of appointment that may be exercised arbitrarily, or it may be left unexercised, as long as none but permissible appointees are benefited.

EUGENE F. SCOLES & EDWARD C. HALBACH, JR., PROBLEMS AND MATERIALS ON DECEDENT'S ESTATES AND TRUSTS 330 (5th ed. 1993). See also RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 21.1 cmt. a, illus. 1 (1986) (illustrating that donee of power may exclude one or more permissible appointees in favor of others).

trustee to distribute as much income and principal of the trust as the trustee deems necessary for the children's health, education, and support. The settlor grants to his eldest child a non-general power of appointment, with respect to which the settlor is a permissible appointee. The trust lasts until the settlor's death, at which time the trustee is directed to distribute the remaining assets in equal shares to the settlor's living children and to the descendants of any deceased child, subject, however, to a non-general power of appointment retained by the settlor. The settlor's retained power of appointment allows him, both during his lifetime and at death, to direct the trustee to distribute the trust assets to his children and their descendants in such amounts and shares as the settlor designates. If the settlor fails to exercise his retained power, the trustee will distribute income and principal of the trust according to its terms, which include a direction to distribute the trust assets equally to the settlor's children at the settlor's death. If, however, the settlor exercises his retained power, the trustee will be obliged to distribute the trust assets as the settlor directs. Notice how the settlor's retained power might influence the actions of the settlor's eldest child—if the child fails to exercise the power of appointment in a manner consistent with the settlor's desires, the child risks having the trust assets diverted to her siblings and their descendants at the settlor's death.

The non-general power retained by the settlor in this example will not cause the trust assets to be subject to the claims of the settlor's creditors. Under universally accepted principles, a non-general power retained by the settlor of a trust is not an asset of the settlor for purposes of creditors' claims.²⁶² Moreover, as indicated earlier, the settlor's creditors would have no claim to the trust assets by virtue of the settlor being a permissible appointee of the non-general power granted to the settlor's child.²⁶³ Nor would the *child's creditors* be able to reach the assets subject to the child's power. And finally, the children's beneficial interests in the trust (that is, their right to receive distributions as determined to be necessary by the trustee) can be sheltered from the claims of their creditors by use of a standard spendthrift provision.²⁶⁴

Is there a justification for treating this transaction differently from the manner in which most states would treat APTs? The theoretical distinction between a transaction such as this—in which the donee of a power can appoint trust assets to the settlor—and an

262. See RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS § 13.1 cmt. b (1986) (indicating that assets subject to a non-general power with respect to which the donor is also the donee cannot be reached by the donee's creditors, unless the transfer creating the power was a fraudulent conveyance).

263. See *supra* notes 258-259 and accompanying text.

264. See *supra* note 11 and accompanying text.

APT—in which the trustee has the discretion to distribute trust assets to the settlor—is that, with the latter, the person holding the power is a fiduciary and is thus accountable for his actions both to the settlor and to other trust beneficiaries. Thus, at least theoretically, the settlor of a trust could sue the trustee of a self-settled trust for the trustee's unreasonable failure to make adequate distributions to the settlor. But, as a practical matter, such law suits are unlikely to be successful. Moreover, as we have seen, the theoretical accountability of the trustee may be no more significant than the practical accountability of a child who wishes to conform to the settlor's wishes.

Finally, consider the fact that, in every jurisdiction in the United States, the recipient of a gratuitous transfer of property can, if the transferee wishes, request that the transferor place the property in a spendthrift, discretionary trust for the transferee's benefit. Because the trust would not be self-settled, the assets in the trust would benefit from virtually absolute protection from the transferee's creditors.²⁶⁵ As a practical matter, of course, this option is available only to the relatively wealthy—most persons of moderate means would prefer, if given the choice, to receive gratuitous transfers outright and thus to have absolute control over the transferred assets.²⁶⁶ Anecdotal evidence suggests that transferees make such requests relatively frequently, and the requests are often motivated by a desire to protect the assets from the claims of creditors.²⁶⁷ Consider also that, with proper planning, substantial assets can be left indefinitely in trust, thus protecting the trust assets from the claims of both the life beneficiary's creditors and the creditors of subsequent generations.²⁶⁸

265. See *supra* notes 11-12 and accompanying text (describing the general American rules regarding creditors' rights in spendthrift and discretionary trusts).

266. The wealthy, on the other hand, are more likely to be willing to defer enjoyment of the transferred property or to allow it to be preserved for future generations.

267. Perhaps the most common situation prompting such a request is when an adult child contemplates divorce or remarriage. Although it may be unseemly to characterize spouses and former spouses as "creditors," in the context of divorce claims that is precisely what they are. Having assets in a spendthrift discretionary trust can help to shield inherited assets from such claims.

Another motivation for requesting that inherited or gifted assets be placed in trust is that the trust can be structured to be excluded from the transferee's estate for purposes of the estate tax. As a general rule, if a trust for the transferee's benefit lasts for at least the transferee's lifetime, and if the transferee is granted only limited control over trust distributions, the trust assets will not be included in the transferee's taxable estate. See *DUKEMINIER & JOHANSON, supra* note 211, at 1032-34 (explaining that assets held in trust for life of beneficiary will not be taxed at the beneficiary's death, as long as beneficiary's powers over trust distributions is limited to a non-general power of appointment).

268. See *supra* note 89 (discussing state legislatures' repeal of the rule against

C. Rethinking the Traditional Rule

Bearing in mind the numerous means of sheltering assets from creditors' claims available throughout the United States, how should we approach the topic of APTs? As discussed earlier, the traditional approach to this subject is analytically flawed, because it fails to take into account the relative rights and duties of the trust settlor, beneficiaries other than the settlor, and the trustee. This section of Part IV develops a new conceptual approach to understanding APTs and deciding whether and in what circumstances they should be respected.

To place this discussion into context, consider the follow prototypical APT transaction. A settlor, in a transfer not subject to being set aside under the relevant fraudulent transfer statute, places property into an irrevocable trust. The terms of the trust authorize the trustee to distribute income and principal to the settlor and the settlor's descendants in such amounts and in such shares as the trustee deems appropriate for any purpose. The settlor retains no powers of disposition, whether in the form of a veto power over trust distributions or a non-general power of appointment.²⁶⁹ At the settlor's death, the trust assets pass outright to the settlor's then living descendants, *per stirpes*. The settlor names an independent corporate fiduciary as trustee.

To what extent should the assets of this trust be subject to the claims of the settlor's creditors? Two subsidiary questions bear on the primary question. First, under general principles of trust law, or as a practical matter, is the settlor in this example able to compel distributions to himself? If so, then it seems appropriate that the trust assets would be subject to the claims of his creditors, at least to the extent that such distributions could be compelled. If not, then subjecting the assets to creditors' claims seems less appropriate. Second (and as a corollary to the first question), under general principles of trust law, or as a practical matter, are the settlor's descendants in this example able to limit or prevent distributions to the settlor? If not, then subjecting the trust assets to the claims of the settlor's creditors seems sensible, because no watchdog exists to prevent the trust from serving as the settlor's alter ego. If yes, then subjecting the trust assets to creditors' claims seems less appropriate, because it suggests that the settlor has no control over trust distributions or, at least, that the settlor's access to trust funds is limited by enforceable criteria. As the questions themselves suggest, the proper answers are to be found both in trust law governing the

perpetuities).

²⁶⁹ See *supra* notes 94 and 108-109 and accompanying text (describing how the Alaska and Delaware APT statutes permit settlors to retain such powers).

rights and duties of fiduciaries and their beneficiaries and in the standards of practice to which most fiduciaries adhere.

Determining the proper answer to these questions requires first an examination of the general legal principles governing the discretion of fiduciaries. The first and perhaps most important principle is that a trustee's exercise of discretion is always subject to judicial review, no matter how broadly the trustee's discretion may be described.²⁷⁰ Thus, for example, even if the trust instrument describes the trustee's discretion as "absolute," "unlimited," or "uncontrolled," those terms will not be interpreted so as to relieve the trustee from an obligation to account for its discretionary judgments.²⁷¹ Because a trustee is a fiduciary, it would be inconsistent with the concept of a trust to insulate a trustee's exercise of discretion from all judicial review.²⁷²

The second and next most important principle is that, as a fiduciary, a trustee owes a duty of impartiality to the beneficiaries.²⁷³ Thus, the trustee of our prototypical APT would be bound to treat the settlor and the other beneficiaries impartially, and could be subject to liability for favoring the settlor over either the other current beneficiaries or the future beneficiaries.

Finally and no less important, a trustee's exercise of discretion is subject to a general standard of reasonableness.²⁷⁴ Among other

270. RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. c (Tentative Draft No. 2 1999); RESTATEMENT (SECOND) TRUSTS § 187 cmt. k (1959); GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 560, at 211-12 (rev. 2d ed. 1980).

271. RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. c (Tentative Draft No. 2 1999); 3 SCOTT ON TRUSTS (4th ed.), *supra* note 13, § 187, at 15.

272. See MCGOVERN & KURTZ, *supra* note 260, § 9.5, at 340 (observing that a "trustee" who is not subject to account makes no sense, because a trust connotes some control over the trustee); RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. c (Tentative Draft No. 2 1999) (stating that it is "a contradiction in terms . . . to permit the settlor to relieve a 'trustee' of all accountability").

273. RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. b, at 294 (Tentative Draft No. 2 1999); see also UNIFORM TRUST CODE § 803 (2000) (stating that, "[i]f a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests).

274. RESTATEMENT (THIRD) OF TRUSTS § 50 cmts. b, d (Tentative Draft No. 2 1999).

Whether broadly stated discretionary language, see *supra* text accompanying note 271 (setting forth examples of such language), may relieve a trustee of the requirement that its exercise of discretion be reasonable has been the subject of significant debate. Compare RESTATEMENT (SECOND) TRUSTS § 187 cmt. j (1959) (stating that words of "'absolute' or 'unlimited' or 'uncontrolled' discretion are not interpreted literally but are ordinarily construed as merely dispensing with the standard of reasonableness," and that "[i]n such a case the mere fact that the trustee has acted beyond the bounds of a reasonable judgment is not a sufficient ground for interposition by the court") with RESTATEMENT (THIRD) OF TRUSTS § 50 reporter's note on cmt. c (Tentative Draft No. 2 1999) (observing that cases are difficult to find in which extended discretionary language has been construed to excuse

things, the requirement that a trustee act reasonably means that a trustee can be held liable for failing to exercise its discretion, as when a trustee acts arbitrarily or without giving due consideration to all relevant factors that should affect its decision.²⁷⁵ The point is illustrated by the following example from the Restatement (Second):

A bequeaths \$100,000 to B in trust to apply such part of the income as B should think proper for the maintenance of C and to pay the balance of the income to D. B arbitrarily pays the whole income to D. The court may set aside the payment to D in whole or in part.²⁷⁶

This principle is central to understanding self-settled APTs, because it means that a trustee may not arbitrarily or without good reason pay income or principal to the settlor to the exclusion of other trust beneficiaries, nor may a trustee blindly accede to a settlor's demands for trust distributions.

Consider *In re Osborn*,²⁷⁷ in which a husband and wife established a trust, the terms of which directed the trustee to pay the income to the husband for life, then to the wife for life, and which authorized the trustee to distribute to the husband or the wife such amounts of principal as the trustee "in its judgment [determines to] be necessary for [their] proper support and care."²⁷⁸ Over a period of several years, the trustee permitted the husband to draw checks on a trust account, apparently never inquiring as to the amounts of such checks or the purposes for which they were drawn. Following the husband's death, the remainder beneficiary (later joined by the wife) brought an action for an accounting, claiming that:

in permitting [the husband] to draw such checks, without supervision or restraint by the trustee, the latter surrendered the judgment and discretion confided to it in the trust agreement and became merely passive. The result of these unauthorized expenditures, it is claimed, imperiled the integrity of the trust estate

unreasonable conduct) and BOGERT & BOGERT, *supra* note 270, § 560, at 217-18 (stating that "[t]he authorities do not appear to support the Restatement [Second] position that there is no requirement or reasonableness in the exercise of a power granted in the trustee's absolute discretion"). Note that even the Restatement (Second) demands reasonable conduct of a trustee if the discretionary grant of authority does not include language such as "absolute" or "unlimited." See RESTATEMENT (SECOND) TRUSTS § 187 cmt. e (1959) (stating that, under these circumstances, a court will interfere with a trustee's exercise of power if the trustee "acts beyond the bounds of a reasonable judgment"); see also 3 SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 187, at 14 (same). In light of the fact that a trustee is a fiduciary, the better view is that the trustee's conduct must always be reasonable, regardless of the breadth of discretion granted.

275. See 3 SCOTT ON TRUSTS (4th ed.), *supra* note 14, § 187.3.

276. RESTATEMENT (SECOND) TRUSTS § 187 illus. 5 (1959).

277. 299 N.Y.S. 593 (App. Div. 1937).

278. *Id.* at 597.

and greatly diminished the amount applicable to the support of the widow, the surviving life tenant.²⁷⁹

The court held that the trustee failed properly to exercise its discretion, because it had not exercised its own judgment in determining how much principal should be paid to the husband and had substituted for its judgment that of the husband beneficiary.²⁸⁰

The principle is also illustrated by *Dunkley v. Peoples Bank and Trust Co.*²⁸¹ The terms of the trust in *Dunkley* authorized the trustee to distribute as much of the income and principal of the trust to the settlor's surviving spouse "as the trustee believes desirable . . . for the health, support in reasonable comfort, education, best interests, and welfare of [the surviving spouse]."²⁸² Dissatisfied with the trustee's refusal to comply with his demands for trust principal, the surviving spouse exercised his power to transfer the trust to a new trustee, one which apparently was willing to do the spouse's bidding. The surviving spouse subsequently demanded and eventually received a distribution of all of the assets of the trust. The remainder beneficiary sued the trustee, seeking an accounting and damages for excessive distributions.

The trustee argued that, because the actions of the trustee involved exercises of discretion, the remainder beneficiary must establish "that the trustee acted dishonestly, arbitrarily, from an improper motive, with gross unfaithfulness to the trust or otherwise in bad faith."²⁸³ The court disagreed. Relying in substantial part on the second Restatement, the court indicated that a trustee may be held liable not just for actions involving dishonesty or an improper motive, but also if the trustee "*fails to use his judgment, or acts beyond the bounds of reasonable judgment.*"²⁸⁴ The court further stated that, "even where the trustee is exercising discretionary power, his discretion is not unlimited. He must still act reasonably and as a reasonably prudent trustee would have acted under the same or similar circumstances."²⁸⁵ Moreover, the court observed, a trustee "is under a duty to the successive beneficiaries to act with due regard to their respective interests."²⁸⁶ Based on these principles, the court concluded that the trustee acted improperly when it acceded to the surviving spouse's demands for trust distributions. Most importantly,

279. *Id.* at 599.

280. *See id.* at 600-01.

281. 728 F. Supp. 547 (W.D. Ark. 1989).

282. *Id.* at 551.

283. *Id.* at 556.

284. *Id.* at 557 (quoting, with emphasis added, RESTATEMENT (SECOND) TRUSTS § 187 cmt. e (1959)).

285. *Id.* at 557.

286. *Id.* at 559 (citing RESTATEMENT (SECOND) TRUSTS § 232 (1959)).

by acceding to the surviving spouse's demands, the trustee *failed to exercise its judgment* and instead substituted *the judgment of the surviving spouse*.²⁸⁷ This, the court concluded, constituted "a flagrant breach of the [trustee's] duty to the trust estate and the beneficiaries of the trust."²⁸⁸ The court surcharged the trustee for the wrongful payments to the surviving spouse.²⁸⁹

Other cases similarly hold that a trustee may be held liable for excessive payments to a current beneficiary, notwithstanding broad grants of discretionary authority to make distributions. In *In re Davis' Will*, for example, the trust instrument authorized the trustee to distribute such amounts of the principal to the settlor's surviving spouse "as the trustee may in its absolute and uncontrolled discretion deem . . . advisable for [the spouse's] . . . comfort and happiness."²⁹⁰ The surviving spouse demanded a distribution of the entire principal of the trust, and the trustee sought court approval to comply with the spouse's demand. In refusing to approve the distribution, the court indicated that the trustee could not comply with the spouse's demand without independently investigating whether such a distribution would be appropriate. Even a broad grant of discretion, according to the court, "does not connote inconsiderate action."²⁹¹ The court in *In re Brigg's Estate* reached a similar conclusion with respect to a decision by a trustee to distribute all of the remaining principal to the life beneficiary.²⁹² The court ruled that the decision constituted an abuse of discretion, because the trustee apparently failed to determine whether the distribution was appropriate under the circumstances. Thus, notwithstanding broadly stated discretionary authority to make distributions, the trustee acted "outside the bounds of reasonable judgment."²⁹³ Many other cases similarly hold that a trustee may not indiscriminately accede to a beneficiary's demand for trust assets, both because the trustee must independently exercise its judgment about the appropriateness of the distribution and because the trustee must treat beneficiaries impartially.²⁹⁴

287. *See id.* at 562 (explaining that the trustee had a duty to determine separately and independently each requested distribution).

288. *Id.*

289. *See id.* at 563-64.

290. 88 N.Y.S.2d 192, 193 (Sur. Ct. 1949).

291. *Id.* at 195.

292. 27 A.2d 430 (Pa. Super. Ct. 1942).

293. *Id.* at 433.

294. *See Kemp v. Paterson*, 159 N.E.2d 661 (N.Y. 1959) (notwithstanding broad grant of discretionary authority to make distributions, trustee not permitted to distribute entire principal to life beneficiary, because to do so would disregard the interests of the remainder beneficiaries); *In re Wilkin*, 75 N.E. 1105 (N.Y. 1905) (trustee authorized to distribute income and principal in such amounts as the trustee "may deem best for the interests of the [life beneficiary]"; despite broad grant of authority, trustee liable to

As discussed previously,²⁹⁵ most cases applying the traditional rule regarding creditors' rights in self-settled trusts fail to recognize that the trust settlor, as beneficiary, has no right to demand trust distributions and that a trustee could be held liable for acceding to such a demand. Only a few cases concerning creditors' rights in trusts recognize this important principle. Consider, for example, *Fewell v. Republic National Bank*.²⁹⁶ In *Fewell*, a self-settled spendthrift trust directed the trustee to distribute all income to the settlor and authorized the trustee to distribute to the settlor such amounts of principal as may be necessary for the settlor's "reasonable support, comfort, and health."²⁹⁷ Notwithstanding that the assets of the trust could be reached by the settlor's creditors, the court refused to honor the settlor's request that the trust be terminated and all assets distributed to her without the settlor having obtained the consent of the other trust beneficiaries. To allow otherwise, the court indicated, would defeat the interests of the other beneficiaries.²⁹⁸ Although in one sense the court's reasoning may be suspect,²⁹⁹ the case nevertheless properly recognizes that the trustee's authority to distribute trust assets to the settlor must take into account the interests of other trust beneficiaries.

The foregoing discussion demonstrates that a trustee may not indiscriminately accede to the demands of the trust settlor (or any other beneficiary). Several cases in the transfer tax context properly recognize the important principal that, consistent with its duties as a fiduciary, a trustee should be treated as independent of the trust settlor and thus not the settlor's alter ego. Consider, for example,

remainder beneficiaries for distributing entire principal to the life beneficiary); *In re Murray*, 45 A.2d 636 (Me. 1946) (by acceding to the life beneficiary's request for a distribution of principal, the trustees failed to exercise their discretion, instead substituting their discretion with that of the beneficiary); *Corkery v. Dorsey*, 111 N.E. 795 (Mass. 1916) (trustee abused its discretion in agreeing to distribute entire principal to the life beneficiary); see also *Jennings v. Murdock*, 553 P.2d 846 (Kan. 1976) (trustee properly refused to accede to beneficiaries' demand that the trustee vote corporate stock held in trusts in a manner consistent with the beneficiaries' wishes; "for the best interests of the beneficiary" does not mean "as the beneficiary wishes," *id.* at 869).

295. See *supra* notes 34-53 and accompanying text.

296. 513 S.W.2d 596 (Tex. Civ. App. 1974).

297. See *id.* at 597.

298. See *id.* at 598-99 (observing that the trust included other beneficiaries, both during the settlor's lifetime and at her death).

299. Although the court refused to address the extent of the rights of the settlor's creditors, the traditional rule would provide that the settlor's creditors could reach the maximum amount distributable to the settlor, which arguably in this case would be the entire principal of the trust. Assuming that to be true, refusing to allow the settlor to terminate the trust is illogical, because the settlor could accomplish indirectly (by incurring debt and then relegating her creditors to recovery from the trust) what the court would not allow her to do directly.

Estate of Wall v. Commissioner,³⁰⁰ involving three irrevocable trusts, one for the benefit of each of the settlor's children, in which a corporate trustee was granted the authority to distribute to the child "so much of the income and principal, at such time or times and in such amounts and manner, as the Trustee, in its sole discretion, shall determine."³⁰¹ At issue was whether the settlor's retained power to remove the corporate trustee and replace it with another corporate trustee should cause the trustee's discretionary powers of distribution to be attributed to the settlor, thus triggering estate tax inclusion under sections 2036(a)(2) and 2038(a)(1) of the Internal Revenue Code.³⁰² The theory asserted by the Internal Revenue Service was that, because the settlor could remove and replace trustees at will, the settlor could install a trustee that would do its bidding; thus, the Service argued, the discretionary powers of the trustee should be attributed to the settlor.³⁰³ The Tax Court properly rejected this argument and made the following observations about the relationship between the settlor and the trustee:

[U]nder established principles of the law governing trusts, a trustee would violate its fiduciary duties if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take regarding the beneficial enjoyment of any interest in the trust, or agreed with the settlor, prior to appointment, as to how fiduciary powers should be exercised over the distribution of income and principal. The trustee has a duty to administer the trust in the sole interest of the beneficiary, to act impartially if there are multiple beneficiaries, and to exercise powers exclusively for the benefit of beneficiaries.³⁰⁴

Based on these principles of fiduciary independence, the court declined "to infer any kind of fraudulent side agreement between [the settlor] and [the corporate trustee] as to how the administration of these trusts would be manipulated by [the settlor]."³⁰⁵

A similar conclusion was reached in the context of a gift tax case. In *Estate of Vak v. Commissioner*,³⁰⁶ the settlor created an irrevocable trust for the benefit of himself and several members of his family and

300. 101 T.C. 300 (1993).

301. *Id.* at 303.

302. See I.R.C. §§ 2036(a)(2) (1994) (triggering estate tax inclusion of property transferred by a decedent with respect to which the decedent has retained the "right . . . to designate the persons who shall possess or enjoy the property or the income therefrom"), 2038(a)(1) (1994) (triggering estate tax inclusion of property transferred by a decedent with respect to which at the decedent's death enjoyment thereof was subject to a power held by the decedent "to alter, amend, revoke, or terminate").

303. See 101 T.C. at 305-06, 311.

304. See *id.* at 312.

305. *Id.* at 313.

306. 973 F.2d 1409 (8th Cir. 1992).

transferred to the trust stock in his closely held corporation. The trustees were granted absolute discretion to distribute income and principal to the beneficiaries. The settlor retained a power to remove and replace the trustees, which the settlor relinquished several years later. At issue was when the settlor's transfer became complete for gift tax purposes. The IRS argued, as it did in *Estate of Wall*, that the settlor's power to remove and replace the trustees gave him absolute control over trust distributions, with the consequence that the settlor could direct that all of the income and principal of the trust could be distributed to him. Thus, the IRS argued, the settlor's transfer to the trust remained incomplete until the settlor's removal and replacement power was relinquished. The court rejected the IRS's argument, indicating that the IRS "overstates its position when it contends that 'Mr. Vak had the power to replace the trustees with individuals who would do his bidding.'"³⁰⁷ Both *Estate of Wall* and *Estate of Vak* involved powers held by the settlor to remove and replace the trustee. Notwithstanding that a removal power may afford a settlor some influence over the actions of a trustee, both cases properly recognize that a trustee's duties as a fiduciary compel it to act independently of the settlor and that it is not appropriate to treat the settlor as the trustee's alter ego. A trustee's independence should be even more apparent if the settlor does not hold a removal power.

The United States Tax Court has reached a similar conclusion in the context of the income taxation of trusts. In *Estate of Goodwyn v. Commissioner*,³⁰⁸ at issue was whether the settlor should be taxed on the income of a trust under Internal Revenue Code section 674(a), which subjects a settlor to tax on the income of any trust over which the settlor or any "nonadverse party"³⁰⁹ holds a "power of disposition" affecting "the beneficial enjoyment of the corpus or the income therefrom." Section 674(c) establishes an exception from section 674(a) for a power of disposition held by so-called independent trustees—"trustees, none of whom is the [settlor], and no more than half of whom are related or subordinate parties . . . of the [settlor]." At issue in *Goodwyn* was whether the discretionary

307. *Id.* at 1414 (quoting the Service's brief). The Service has since retreated from the arguments it asserted in *Estate of Wall* and *Estate of Vak*. See Rev. Rul. 95-58 (discussing *Wall* and *Vak*, and holding that a trustee removal power will not trigger estate tax inclusion under sections 2036 or 2038 if replacement trustees do not include related or subordinate parties as described in I.R.C. § 672(c) (1994)).

308. 35 T.C.M. (CCH) 1026 (1976).

309. Defined as any person not having "a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." I.R.C. § 672(a) (1994); see *id.* § 672(b) (1994 & Supp. IV 1998). Thus, generally speaking, a "nonadverse" party is a person who is not a beneficiary of the trust.

powers to distribute income and invest and manage the principal held by the trustees, who were admittedly "independent" of the settlor within the literal meaning of section 674(c), should nevertheless be attributed to the settlor, thus triggering the general rule under section 674(a). The record indicated that "at all times from the establishment of the trusts until [the settlor's] last illness, with the acquiescence of the trustees, the [settlor] made all decisions with respect to the purchase and sale of trust assets and the investment of any proceeds and determined the amounts, if any, to be distributed to the respective beneficiaries."³¹⁰ The settlor's *actual* control over trust investments and distributions, the IRS argued, should trigger section 674(a), despite the fact that the trustees were technically "independent" within the meaning of section 674(c). As the Tax Court described the IRS's position, the IRS argued "that although [the settlor] does not specifically have [the powers of the trustees], his relationship to the trust res through its management and to the administration of the trust generally is such that he should be deemed to be a trustee, in fact, during his life."³¹¹

Notwithstanding the settlor's apparent control over all important trust functions, the Tax Court ruled that the trust income was not taxable to the settlor under section 674(a). In reaching its conclusion, the court emphasized the legal responsibility and independence of the trustees as fiduciaries:

[S]ection 674 uses the term "power" . . . in the legal sense of having an enforceable authority or right to perform some action. The use of this term in this legal sense suggests that the power of a [settlor] upon which he will be taxed is a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes. . . .

In this case, the trustees . . . accepted the rights, duties, and obligations granted them in the trust instruments. Regardless of the fact that they had entrusted to the [settlor] the complete management and control of these trusts, this informal delegation did not discharge them from the legal responsibility they had as the trustees. As a matter of law, the trustees were liable and answerable for the [settlor's] acts on their behalf. . . .

. . . Whatever power [the settlor] exercised over the trust assets, administration or distribution, he did so on the trustee's behalf and not in his own right.³¹²

In other words, because the trustees at all times were legally accountable for the settlor's decisions on their behalf, it was

310. 35 T.C.M. (CCH) at 1038.

311. *Id.* at 1039.

312. *Id.* at 1039-40.

appropriate to treat the trustees as holding the investment and distribution powers, and not the settlor.³¹³ In our prototypical APT, involving a corporate fiduciary that presumably delegates few if any discretionary powers to the settlor, it is even more apparent that the powers of the trustee are legally insulated from the settlor's control.

Several practical considerations further support the notion that the settlor and the trustee of a trust should be treated as independent of one another and that a trustee is unlikely blindly to accede to a settlor's demands for distributions. First, cases holding fiduciaries liable for excessive distributions, whether or not decided correctly, have a chilling effect on fiduciaries (and the lawyers advising them), thus motivating them to decline requests for distributions if another beneficiary is likely to object. Fiduciaries, especially ones engaged in that role as professionals, typically exercise extraordinary caution in making distributions, whenever those distributions might favor one beneficiary over another. Students of tort law will recognize this phenomenon as similar to that associated with judicial expansion of tort liability, one of the "costs" of which is excessive liability-avoiding behavior, such as practicing defensive medicine.³¹⁴ Dean Kenneth B. Davis, Jr., has also observed a similar phenomenon with respect to decisions by trustees concerning transactions in which they may have conflicts of interest. Dean Davis explains that, because of the close scrutiny to which the law subjects trustees, the law creates a risk that a trustee may be sanctioned for engaging in certain self-dealing transactions that are viewed as *per se* opportunistic by the court, notwithstanding that the transactions may have been entered into by the trustee in good faith.³¹⁵ The practical effect of the law's approach is to cause trustees to forgo self-dealing transactions altogether, even ones that might have been in the best interests of the trust beneficiaries.³¹⁶ In sum, the law governing fiduciaries prompts cautious behavior on their part, with the result that professional fiduciaries exhibit a disinclination to comply with beneficiary-settlor demands for trust distributions.

313. See also Treas. Reg. § 1.674(d)-2(a) (powers of independent trustee not attributed to the settlor even if the settlor hold a power to remove and replace the trustee).

314. See, e.g., Gary T. Schwartz, *Reality in the Economic Analysis of Tort Law: Does Tort Law Really Deter?*, 42 UCLA L. REV. 377, 436-38 (1994) (describing costs associated with increased physician malpractice liability); see also PETER W. HUBER, *GALILEO'S REVENGE: JUNK SCIENCE IN THE COURTROOM* 180-85 (1991) (describing costs of large personal injury verdicts).

315. See Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives*, 80 NW. U.L. REV. 1, 42-46 (1985) (describing how the law seeks to avoid all "Type 1" errors—in which fiduciaries' opportunistic transactions are upheld—at the risk of causing "Type 2" errors—in which good faith transactions are invalidated).

316. See *id.*

Second, professional trustees tend to be conservative in making distributions because doing so exposes them to fewer risks. Professor Edward C. Halbach Jr. has described this phenomenon as follows:

In case of doubt a trustee is apt to be conservative in his decisions concerning distributions This conservatism stems from the fact that underpayment, in the absence of such serious abuse or bad faith as to warrant the trustee's removal, would result merely in the present beneficiary's obtaining a court order directing increased distributions from the fund remaining in the hands of the trustee. Overpayment, however, might result in suit by a remainderman long after the distribution, when the funds paid out are no longer recoverable or are recoverable only at considerable inconvenience to the trustee.³¹⁷

Professor Halbach found evidence of this conservatism "by the preponderance of cases that are brought to rectify an alleged underpayment."³¹⁸

Third, professional fiduciaries usually base their fees in substantial part on the size of the trust. Thus, trustees have a financial incentive to be conservative in making distributions.

Finally, in the context of an APT, a trustee will have an added incentive to be conservative in making distributions to the settlor—to the extent discretionary APTs are respected at all, they presumably will be respected only in those cases in which the trustee manages the trust and makes discretionary distributions with clear independence from the settlor. Conversely, creditors will be more likely to succeed in recovering from APTs in cases in which the trust appears to be a sham, that is, when the settlor in effect controls management and distribution decisions. To preserve the integrity of an APT, a professional fiduciary will want to exercise utmost caution in making distributions to the settlor, to avoid any appearance that the trustee has acceded to the settlor's demands or is otherwise acting as the settlor's alter ego. Trustees who wish to compete for APT business, therefore, will wish to establish and preserve their reputations for conservatism and independence.³¹⁹

317. Edward C. Halbach Jr., *Problems of Discretion in Discretionary Trusts*, 61 COLUM. L. REV. 1425, 1427 (1961).

318. *Id.*

319. Douglas J. Blattmachr, President and CEO of the Alaska Trust Company, emphasized this point in a telephone conversation with this writer. He indicated that the Alaska Trust Company is willing to serve as trustee of an Alaska APT only if the settlor expressly recognizes that distributions to the settlor will be in the discretion of the trustee and that the settlor will ordinarily be unable to compel distributions to himself or herself. In the usual case, the Alaska Trust Company will accept contributions to an APT of no more than 1/2 of the settlor's assets, and it recommends that settlors contribute no more than 1/4 or 1/3 of their assets. Mr. Blattmachr expressed his concern that, in cases of greater contributions, settlors may fail to understand the lack of control that they will have over APT distributions. Telephone Interview with Douglas J. Blattmachr, President and

As developed in this section of the article, the laws governing fiduciaries (as well as practical considerations) suggest that, as a general proposition, the settlor of a discretionary APT cannot compel distributions to himself or herself and that other trust beneficiaries under some circumstances may recover from a trustee that makes excessive or ill-considered distributions to the settlor. As a fiduciary, the trustee of an APT is obligated to act independently of the settlor's wishes and to treat all beneficiaries impartially. Thus, in evaluating APTs, and in particular in deciding whether and in what circumstances a settlor's creditors should be able to recover from an APT, one must bear in mind that a settlor who creates an APT *gives up substantial rights to the trust property*. The right to receive discretionary distributions is not the same as absolute ownership of property. This distinction must inform our consideration of APTs and creditors' rights.

As discussed in Part I, the traditional rule concerning creditors' rights in self-settled trusts fails to take this distinction into account—the traditional rule is based on the erroneous assumptions that a settlor who transfers property to a discretionary trust gives up few if any rights to that property and that self-settled trusts involve collusive arrangements between settlors and trustees.³²⁰ Unfortunately, most recent scholarship on APTs reflects a similar misunderstanding. Consider, for example, Professor Karen E. Boxx's excellent article on this subject.³²¹ In countering certain arguments supporting the use of self-settled APTs, Professor Boxx makes the point that, "[a]lthough the trustor must turn irrevocable control over to the independent trustee and pay a fee for such services, there are no legal limitations on the amount the trustee can distribute for the benefit of the grantor."³²² But as the discussion in this Part observes, in fact there are significant theoretical and practical limitations on the trustee's discretion to make distributions to the settlor, and the trustee risks liability to the other trust beneficiaries if it makes distributions in excess of these limitations. Professor Boxx further observes that "the self-settled trust offers such little risk to the grantor, and *allows him to retain so much control*, that it removes the ordinary disincentives to asset protection that existing law has presumed."³²³ While it is

CEO, Alaska Trust Company (July 12, 2001).

320. *See supra* notes 34-53 and accompanying text.

321. Boxx, *supra* note 3.

322. *Id.* at 1256.

323. *Id.* (emphasis added; "ordinary disincentives to asset protection" refers to the limitations inherent in the use of retirement accounts and exemption laws for purposes of sheltering assets from creditors' claims; those limitations, Professor Boxx asserts, are not applicable to APTs).

possible for a settlor to reserve substantial control over an APT,³²⁴ settlor-retained controls are by no means an essential characteristic of APTs. Professor Lynn M. LoPucki similarly describes the domestic development of APT legislation in the follow terms:

[T]he judgment proofing of individuals appears to be in rapid acceleration. *The Death of Liability* [Professor LoPucki's earlier work]³²⁵ describes the decade-old boom in offshore "asset-protection trusts"—devices sited in offshore havens but widely promoted here as an effective means for Americans to render themselves judgment proof. "Asset protection trust" is merely a euphemism for "self-settled spendthrift trust." Self-settled spendthrift trusts are, in essence, private declarations by property owners that they will *retain full use and control of their assets, but that their judgment creditors will not be able to reach them*. Not surprisingly, the law in the United States has long been that self-settled spendthrift trusts are void as against public policy.³²⁶

Professor LoPucki's misunderstanding is fairly typical, though understandable, when one considers the traditional case law analysis of such trusts.³²⁷

To summarize the observations of this section, a thoughtful analysis of creditors' rights in APTs requires a proper understanding of the relative rights and duties of the trust settlor, other beneficiaries, and the trustee. As discussed, trustees are obligated as fiduciaries to exercise their discretion independent of the wishes or demands of the settlor and after considering the competing desires and needs of the other trust beneficiaries. Contrary to a commonly held belief, the settlor of an APT cannot compel the trustee to distribute all amounts that the settlor may desire, and a trustee who acceded to a settlor's unreasonable demands would be liable to the other trust beneficiaries. Thus, a settlor who establishes an APT gives up substantial control over the settlor's assets. Moreover, as a practical matter, trustees—especially trustees of APTs—will act conservatively in making trust distributions.

D. Policy Considerations

Previous sections of this article have offered the following observations about APTs. First, the traditional rule regarding creditors' rights in self-settled trusts is analytically flawed, based on a misunderstanding of the relative rights and duties of the settlor, other

324. See, e.g., ALASKA STAT. § 34.40.110(b)(2) (Lexis 2000) (permitting settlor to retain a power to veto distributions or a non-general testamentary power of appointment).

325. LoPucki, *supra* note 67.

326. Lynn M. LoPucki, *Virtual Judgment Proofing: A Rejoinder*, 107 YALE L.J. 1413, 1415 (1998) (emphasis added).

327. See *supra* notes 34-53 and accompanying text.

beneficiaries, and the trustee. Second, United States law already affords substantial asset-protection alternatives for property owners who are inclined to judgment-proof their assets. Third, the settlor who decides to create an APT necessarily gives up substantial rights in and control over the trust assets. Moreover, the limitations on the settlor's rights are enforceable by other trust beneficiaries.

Bearing these observations in mind, this section of the article poses the following related questions. What policy considerations support the use of APTs? If the law permits APTs, what limitations should be placed on their use? Are the policy objections to APTs sufficiently persuasive that we are willing to treat APT assets (for creditors' rights purposes) as if they were owned by the settlor directly, even in cases in which the trustee acts with clear independence from the settlor? Stating the question another way, do the policy objections persuade us that the rights of the settlor's creditors should be greater than the rights of the settlor himself or herself? The object here is not to answer these questions definitively, but rather to inform our consideration of the questions.

(1) Arguments Favoring APTs

Perhaps the most persuasive argument in favor of APTs is that they allow persons to do for themselves as the law permits them to do for others. As described earlier, wealthy heirs and other recipients of gratuitous transfers are presently afforded the opportunity to opt out of the liability system with respect to inherited or gifted assets, by requesting that those assets be placed in spendthrift trusts.³²⁸ As aptly stated over 50 years ago by Dean Erwin N. Griswold, "[w]e may well question the soundness of a rule which allows a man to hold the bounty of others free from the claims of his creditors, but denies the same immunity to his interest in property which he has accumulated by his own efforts."³²⁹ "A man who earns his own way should have the same opportunity for protection from adversity as the man who takes his support from others."³³⁰ This disparity in treatment is exacerbated by the fact that spendthrift trusts for descendants and others can now be set up to last in perpetuity. As a general proposition, it is the very wealthy who are most able to avail themselves of this planning option. Allowing self-settled APTs would extend this planning tool to person of more modest means, whose assets have been acquired through their own efforts.

An argument advanced by advocates of domestic APTs is that they serve to prevent a substantial exit of capital to offshore

328. See *supra* notes 265-268 and accompanying text.

329. ERWIN N. GRISWOLD, SPENDTHRIFT TRUSTS § 474, at 542-43 (2d ed. 1947).

330. GRISWOLD, *supra* note 329, § 557, at 644.

jurisdictions.³³¹ The domestic developments may also be viewed as a positive alternative to offshore APT laws, which are arguably more abusive.³³² Moreover, this argument goes, APTs encourage investment and savings—as fiduciaries, trustees are required to invest trust assets, and trustees of APTs will naturally be conservative in making distributions.³³³

A further argument in favor of APTs is that they allow all persons to avail themselves of asset protection opportunities available to others. As discussed earlier in this part, there are a myriad of devices for protecting assets from creditors' claims, yet these devices are not available to all persons. For example, not everyone can own property as tenants by the entirety—this form of ownership is not available to unmarried persons, and not all jurisdictions recognize tenancies by the entirety. Not all persons have the opportunity to place substantial assets in retirement accounts; APTs afford those persons the opportunity to save assets for the future in a vehicle sheltered from the claims of creditors.³³⁴ Persons whose assets are

331. See *supra* notes 83-84 and accompanying text (describing amounts held in offshore APTs).

332. See *supra* notes 71-82 and accompanying text.

333. Hirsch, *supra* note 256, at 14-15 (arguing that “a spendthrift trust enforces a regimen of saving over . . . whatever period of years the benefactor selects An economic by-product of this restriction is that it frees up more investment capital and hence tends to promote economic growth.”).

334. In this respect, an APT could serve as a “nest egg”—property set aside to protect the settlor against unforeseen financial contingencies. In connection with this point, consider the argument advanced by Professor George P. Costigan Jr.:

And that brings us, at last, to the problem of the man who realizes that he is a spendthrift and who tries to protect himself from ultimately becoming dependent on charity or on the public for support by creating for himself a spendthrift trust. If there is anything in the argument that the beneficiary's need should affect the attitude of the court, then such a beneficiary's need should be met, provided that there is no fraud on his existing creditors, that is, provided that he keeps out of the trust assets sufficient to discharge his existing debts [T]here seems clearly to be a grave need that society shall protect those persons who are unable to guard themselves against objectionable importunity and against being thrown to the wolves that infest our society.

George P. Costigan, Jr., *Those Protective Trusts Which Are Miscalled “Spendthrift Trusts” Reexamined*, 22 CAL. L. REV. 471, 492 (1934) (further arguing, at 492-93, that the law should require the settlor to give public notice of the trust). With less hyperbole, Professor Adam J. Hirsch has argued convincingly that spendthrift protections available to gratuitous donees should also be available to donors:

[J]ust as a parent might recognize in her child a propensity to overspend or over borrow, so might an individual recognize this same propensity in herself. By creating her own voluntary and involuntary disabling restraints, an individual can deprive herself of the opportunity to overspend or overborrow, and thereby shield herself from financially destructive impulses that she anticipates having to contend with in the future.

Hirsch, *supra* note 256, at 86; see also *id.* at 86-92 (arguing that such “self-paternalism”

substantially invested in closely held businesses can shelter those assets from the claims of their individual creditors through the use of limited partnerships. This same opportunity is not available to owners of passive investment assets. APT laws also afford creditor protection to persons who reside in jurisdictions with less than adequate exemption rules.³³⁵ In some respects, APTs are less objectionable than exempt property rules—with an APT, a settlor cannot both enjoy the property and shelter the property from creditors. As explained by Professor Halbach, any spendthrift protection associated with trusts ends when property is distributed to the beneficiary.³³⁶

From a conceptual perspective, respecting APTs is consistent with the law governing the rights and duties of trust beneficiaries and fiduciaries. Perhaps most importantly, limiting creditors' rights in APTs to no more than the rights of the debtor-settlor serves to protect the rights of other trust beneficiaries. As we have seen,³³⁷ the traditional rule regarding APTs disregards the interests of other beneficiaries by granting the settlor's creditors greater rights than has the settlor himself or herself.

Finally, assuming that a settlor's transfer to an APT is not fraudulent within the meaning of the fraudulent transfer laws, why should creditors be granted greater rights in the APT than they would have in other gratuitously transferred assets, from which the settlor may also continue to benefit through an exercise of discretion by the (non-fiduciary) transferee?³³⁸ In certain respects, APTs are less susceptible to abuse than similar informal arrangements involving trusted family members.³³⁹

may be easier to justify than "parental paternalism" and describing other common examples of self-paternalism in non-trust contexts). For an example of a court approving the use of such a trust, see *Booth v. Chadwick*, 154 S.W.2d 268 (Tex. App. 1941) (allowing prisoner to create self-settled spendthrift trust).

335. *But see* Boxx, *supra* note 3, at 1256 (noting the limitations inherent in exemption rules, such as those governing life insurance and homesteads).

336. Edward C. Halbach, Jr., *Uniform Acts, Restatements, and Trends in American Trust Law at Century's End*, 88 CAL. L. REV. 1877, 1894 (2000).

337. *See supra* notes 18-29 and accompanying text.

338. *See supra* notes 255-268 and accompanying text (describing other trust and non-trust arrangements similar to APTs).

339. *See supra* notes 261-262 and accompanying text (explaining how powers retained by a settlor can be used to influence the donee of a power of appointment); *but see supra* text accompanying notes 264-265 (acknowledging the theoretical distinction that, in the case of an APT, a settlor could sue the trustee for inadequate distributions, while the transferor in the comparable informal arrangement would have no cause of action against a non-fiduciary family member).

(2) *Arguments Against APTs*

The most persuasive argument against APTs is a moral one: “[y]ou should keep your promises and pay your debts because it is the right thing to do.”³⁴⁰ As described by Professor Boxx, “there is something disturbing about a country that would allow debtors to leave their debts unpaid and still enjoy an extravagant lifestyle.”³⁴¹ The principal response to this objection is to suggest that limits be placed on both the amounts that can be sheltered from creditors in a trust and the categories of creditors against whom spendthrift protection is effective.³⁴² Another response is to require settlors to give public notice when APTs are established, although this might do little to protect creditors who routinely extend credit without checking resources (a plumber, for example), and it would do nothing to protect involuntary creditors, such as tort victims.

Another persuasive argument is both moral and economic: allowing potential debtors to shelter their assets from creditors “threatens the system of civil enforcement of obligations” by, among other things, removing the deterrence element associated with our liability system.³⁴³ Allowing persons to shelter their assets in APTs, this argument states, creates a “moral hazard,” by removing the deterrence of having one’s assets exposed to potential claimants. In reply to those who might claim that APTs are a reasonable response to a runaway tort system,³⁴⁴ this argument states that the better response would be remedial tort legislation, not APT legislation.

(3) *Possible APT Limitations*

Despite legitimate concerns about APTs, the legislative trend authorizing APTs will likely continue. In an effort to shape future APT legislation and to prevent abusive APT arrangements, this section of the article suggests some limitations that might be placed on the availability of APTs.

One possible limitation would be a ceiling on APT contributions.³⁴⁵ The ceiling could take the form of an absolute dollar

340. Boxx, *supra* note 3, at 1259.

341. *Id.*

342. *See id.* at 1259-60. *But see* Joseph G. Porter, *Spendthrift Trusts for Settlers*, 68 TR. & EST. 102, 103 (1939) (arguing that the objections against self-settled spendthrift trusts are no different from those against spendthrift trusts for the benefit of others).

343. Boxx, *supra* note 3, at 1260-61.

344. *See Roundtable Discussion, The International Trust*, 32 VAND. J. TRANSNAT'L L. 779, 794 (1999) (comments of Barry Engel).

345. As a practical matter, in many cases the gift tax will function as a ceiling. As a general rule, a transfer to an APT with respect to which the transferor retains no control over distributions will be treated as a completed gift for gift tax purposes. *See* RICHARD B. STEPHENS ET AL., *FEDERAL ESTATE AND GIFT TAXATION* ¶¶ 10.01[4], [6], [7] (7th ed.

amount³⁴⁶ or a percentage of the settlor's assets.³⁴⁷ The latter limitation might be implemented under the applicable fraudulent transfer statute, by creating a presumption that transfers in excess of a certain percentage of a settlor's assets are fraudulent with respect to both present and future creditors. The fraudulent transfer statute could establish a similar presumption in cases of inadequate liability insurance.

Another limitation could involve the identity of the trustee. It seems reasonable to require a certain degree of independence between the settlor and the trustee if the APT arrangement is to be respected. For example, APT legislation could require all distribution decisions to be made by a corporate fiduciary in which the settlor has no ownership or management interest. Even if a legislature places no limits on the identity of the trustee, creditors presumably could "pierce the trust veil" in circumstances in which the trustee has acted as the settlor's alter ego. Legislatures may also wish to limit the powers that a settlor is permitted to retain, such as prohibiting the settlor from retaining a power to veto distributions or prohibiting the retention of a testamentary power of appointment.³⁴⁸

APTs should be respected only in those circumstances in which there are legitimate limitations on the settlor's access to trust assets. To curtail excessive distributions to the settlor, one option would be to place a ceiling on distributions, by reference to a standard—such as one for the settlor's health, support, and education. Another option would be to require that the trust have multiple beneficiaries (both during the settlor's lifetime and after the settlor's death), so that the trustee is accountable to persons other than the settlor, whose interests would be financially adverse to the settlor's interest. To take this concept one step further, APT legislation could require that distributions to the settlor be made by an independent trustee and

1997). As of 2002, a credit against the gift tax permits tax-free transfers of up to \$1,000,000. See I.R.C. § 2505 (1994 & Supp. IV 1998). Completed transfers in excess of this amount trigger gift tax, imposed under a graduated rate schedule that begins at 41%. I.R.C. §§ 2001(c) (West 2001), 2502(a) (1994 & Supp. IV 1998). To avoid the gift tax for transfers in excess of this amount, a settlor creating an APT would need to retain a power of disposition, such as the veto power over distributions or non-general power of appointment authorized under the Alaska statute. But retaining such powers might make a court in a non-APT jurisdiction more inclined to disregard the arrangement and allow the settlor's creditors to reach the trust assets.

346. Determined perhaps by reference to what would produce a reasonable level of income.

347. GRISWOLD, *supra* note 329, § 557, at 645-46 (stating that amounts sheltered in self-settled trusts "should be reasonably limited in amount").

348. One might reasonably surmise that the fewer powers retained by the settlor, the more likely the arrangement would be respected in a non-APT jurisdiction.

also require the consent of a person with a substantial adverse beneficial interest.³⁴⁹

For purposes of protecting voluntary creditors from ill-advisedly extending credit to persons whose assets are held in an APT, the law might impose a public notice requirement for establishing an APT.

Some jurisdictions might place limits on APTs based on the identity of the creditor. The law already recognizes some limitations with respect to spendthrift trusts for the benefit of persons other than settlors. For example, in many jurisdictions, a child seeking delinquent support payments can recover from a spendthrift trust established for someone other than the settlor.³⁵⁰ In most cases, these same limitations would also apply to self-settled trusts. Some jurisdictions might disregard APTs in cases of certain types of tort claims, such as those involving intentional misconduct or gross negligence. This sort of limitation would serve to answer many objections to the use of APTs, because it would remove the "moral hazard" associated with the device.

Conclusion

The traditional rule regarding creditors' rights in self-settled trusts reflects a misunderstanding of how an APT fundamentally changes the nature of the settlor's relationship with his or her property: the settlor both gives up substantial rights in the property and creates rights in others. By permitting the settlor's creditors to reach the trust assets, the traditional rule disregards the otherwise enforceable interests of the other trust beneficiaries. In this and other respects, the traditional rule is theoretically unsound.

Unless Congress acts to prohibit them,³⁵¹ asset protection trusts are here to stay. The purpose of this article is not to defend APTs, but to reshape our conversations about them, and perhaps to direct further APT developments in a manner that is both consistent with fiduciary principles and responsive to the legitimate concerns of APT detractors.

349. See, e.g., *Estate of German v. United States*, 85-1 U.S.T.C. ¶ 13,610 (Ct. Cl. 1985) (finding that, under Maryland law, a self-settled trust could not be reached by the settlor's creditors if distributions to the settlor required the consent of a beneficiary with a substantial adverse interest).

350. See Anne S. Emanuel, *Spendthrift Trusts: It's Time to Codify the Compromise*, 72 NEB. L. REV. 179, 194-95 (1993). This exception applies only to the spendthrift limitation; a discretionary interest in such a trust may still be sheltered from such a claim under the general principles applicable to such interests.

351. See Sterk, *supra* note 3, at 1114-17 (discussing how the law might curtail the use of APTs).