PLANNING WITH DOMESTIC ASSET-PROTECTION TRUSTS: PART I

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Editors' Synopsis: A domestic asset-protection trust ("DAPT") is an irrevocable self-settled spendthrift trust effective against claims brought by creditors. This Article covers reasons for and against DAPTs, fraudulent-transfer rules, and ethical and practical considerations (Part II); discusses the federal income-tax and transfer-tax implications of DAPTs (Parts III and IV); assesses their asset-protection effectiveness (Part V); describes possible uses of these trusts (Part VI); compares DAPTs to offshore asset-protection trusts ("APTs") (Part VII); and discusses how to establish, design, and administer a DAPT (Parts VIII and IX). The appendix contains a sample solvency letter. A second installment, which will appear in the next issue of the Real Property, Probate and Trust Journal, *will summarize and compare the DAPT statutes.*

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* Managing Director and Trust Counsel for Wilmington Trust Company in Wilmington, Delaware. The information in this Article is for information purposes only and is not intended to be an offer or solicitation for the sale of any financial product or service. This article is not designed or intended to provide legal or other professional advice because such advice always requires consideration of individual circumstances. If legal or other professional assistance is needed, the services of an attorney or other professional adviser should be sought.

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I. INTRODUCTION[1]

A. Traditional Rule

All U.S. jurisdictions traditionally declined to extend the protection of their spendthrift trust laws to trusts in which the trustor had retained an interest, at least to the extent of that interest. The traditional rule is set

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[1] For a recent discussion of Delaware and offshore asset-protection trusts, see Robert H. Louis, John F. Meigs, & David J. Way, *Wealth Preservation Trusts: How They Work and When They Should Be Used*, 32 EST. PLAN. 30 (Mar. 2005). For discussions of domestic asset-protection trusts ("DAPTs") by practitioners from states (Florida and Illinois, respectively) that do not recognize their effectiveness, see Thomas O. Wells, *Domestic Asset Protection Trusts—A Viable Estate and Wealth Preservation Alternative*, 77 FLA. B.J. 44 (May 2003); Charles D. Fox, IV, & Michael J. Huft, *Asset Protection and Dynasty Trusts*, 37 REAL PROP. PROB. & TR. J. 287 (2002). For a discussion of such trusts by a law professor who finds utility in them, see Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287 (2002). For a discussion of such trusts by attorneys conversant with the subject, see Richard G. Bacon & John A. Terrill, II, *Domestic Asset Protection Trusts Work—Should They?*, 26 TAX MGMT. EST., GIFTS & TR. J. 123 (2001). For discussions of this subject by law professors who oppose domestic asset-protection trusts on policy grounds, see Henry J. Lischer, Jr., *Domestic Asset Protection Trusts: Pallbearers to Liability?*, 35 REAL PROP. PROB. & TR. J. 479 (2000); Karen E. Boxx, *Gray's Ghost—A Conversation About the Onshore Trust*, 85 IOWA L. REV. 1195 (2000). For a discussion of domestic and foreign asset-protection trusts by offshore trust specialists, see Duncan E. Osborne et al., *Asset-Protection and Jurisdiction Selection*, 33 U. MIAMI INST. ON EST. PLAN. ¶ 1400 (1999). For an analysis of the original version of Delaware's Qualified Dispositions in Trust Act by an Ohio attorney who specializes in debtor-creditor matters, see 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).

forth in section 156(1) of the Second Restatement of Trusts. It reads, "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."[2]

This rule applies even if creation of the trust was not a fraudulent transfer and the trustor did not intend to defraud creditors. The trustor's interest can be reached by existing and by future creditors.[3]

The Scott treatise discussed the traditional rule:

> The owner of property can properly create a trust under which a third person takes a beneficial interest, and the creditors of the settlor cannot reach this interest unless the creation of the trust was a fraudulent conveyance. To the extent to which the settlor himself takes an interest under the trust, however, that interest is subject to the claims of his creditors even though the creation of the trust was not a fraudulent conveyance. It is against public policy to permit the owner of property to create for his own benefit an interest in that property that cannot be reached by his creditors.[4]

The traditional rule has been adopted in the Uniform Trust Code ("UTC")[5] and in the Third Restatement of Trusts.[6] Some state statutes provide that a transfer in trust for the use of the trustor is void against claims of existing or subsequent creditors;[7] others, like the traditional rule, provide that creditors may only reach the trustor's interest in a self-settled trust;[8] still others provide that a court may not order the satisfaction of a

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[2] RESTATEMENT (SECOND) OF TRUSTS § 156(1) (1959). *See* 2A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 156 (4th ed. 1987); GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 223 (rev. 2d ed. 1992).

[3] RESTATEMENT (SECOND) OF TRUSTS § 156 cmt. a (1959).

[4] 2A SCOTT & FRATCHER, *supra* note 2, § 156, at 167–68 (footnotes omitted).

[5] UTC § 505(a)(2) (2004). The current text of the UTC and the jurisdictions that have adopted the UTC are *available at* www.utcproject.org (last visited July 17, 2005).

[6] RESTATEMENT (THIRD) OF TRUSTS § 58(2) (2003); *id.* cmt. e.

[7] *See, e.g.*, IDAHO CODE § 55-905 (2003); KAN. STAT. ANN. § 33-101 (1995); N.J. STAT. ANN. § 25:2-1a (1997); N.Y. EST. POWERS & TRUSTS LAW § 7-3.1(a) (1998); WASH. REV. CODE § 19.36.020 (2005).

[8] *See, e.g.*, ARIZ. REV. STAT. § 14-7705A (2004); CAL. PROB. CODE § 15304(a) (1991); GA. CODE ANN. § 53-12-28(c) (1982); IND. CODE § 30-4-3-2(b) (2000); IOWA CODE § 633.2302 (1964); KY. REV. STAT. ANN. § 381.180(7)(a) (2002); MONT. CODE ANN. § 72-33-305(1) (2004); N.J. STAT. ANN. § 3B:11-1 (1983); OHIO REV. CODE ANN. § 1335.01(A)

judgment from property held in trust for a judgment debtor[9] or from a judgment debtor's interest in a trust[10] unless the judgment debtor created the trust.

The Delaware Court of Chancery held that the trustor of an irrevocable trust who retained a general power of appointment could revoke the trust because the trustor's creditors could reach its assets.[11] More recently, the same court held that a trustor's creditors could reach the trustor's interest in an irrevocable self-settled spendthrift trust created before the enactment of legislation in 1997 that abolished the traditional rule.[12]

B. Effect of Traditional Rule

A few state statutes provide that a self-settled trust is void as to claims of existing and subsequent creditors. In those states, creditors might be able to reach all of the assets of a self-settled trust, regardless of the interest or interests retained by the trustor. If the pertinent statute provides that creditors may only reach the trustor's interest, however, the result is quite different. In those jurisdictions, if the trustor creates a spendthrift trust to pay the income to himself or herself for life, with remainder to his or her issue, creditors may only reach the retained income interest and not the principal of the trust.[13]

Several state statutes provide that even if creditors may reach the trustor's retained interest, the trust otherwise is valid.[14] *Menotte v. Brown* illustrates this point. In *Menotte* the Eleventh Circuit held that the debtor's retained interest in a seven percent charitable-remainder unitrust ("CRUT") was includable in her bankruptcy estate.[15] The court described the impact of its holding:

(2002); OKLA. STAT. ANN. tit. 60, § 175.25H (1999); TEX. PROP. CODE ANN. § 112.035(d) (2001); WIS. STAT. ANN. § 701.06 (2001).

[9] *See, e.g.*, 735 ILL. COMP. STAT. 5/2-1403 (1993).

[10] *See, e.g.*, LA. REV. STAT. ANN. § 9:2004 (1997); TENN. CODE ANN. § 26-4-101 (2000).

[11] Weymouth v. Del. Trust Co., 45 A.2d 427 (Del. Ch. 1946).

[12] Kulp v. Timmons, No. 1946-55 2002 Del. Ch. LEXIS 94, at *21–23 (Del. Ch. July 30, 2002).

[13] RESTATEMENT (SECOND) OF TRUSTS § 156 cmt. a, illus. 1 (1959); RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. e (2001).

[14] *See, e.g.*, ARIZ. REV. STAT. § 14-7705A (1995); CAL. PROB. CODE § 15304(a) (2002); MONT. CODE ANN. § 72-33-305(1) (2003); OHIO REV. CODE ANN. § 1335.01(A) (2002).

[15] 303 F.3d 1261 (11th Cir. 2002).

> When establishing the ICRUA [Irrevocable Charitable Remainder Unitrust Agreement], Appellee made an irrevocable charitable gift of the trust corpus. By including the right to receive income payments for life, Appellee retained a portion of the assets for herself. Whatever interest Appellee retained is her own property, subject to the claims of her creditors. Accordingly, Appellee's right to an income stream is not exempt from her bankruptcy estate and may be reached by her creditors. The corpus of the trust, however, may not be reached by Appellee's creditors.[16]

If the trust gives the trustee discretion to use either income, principal, or both for the trustor, it must be determined how much of the trust assets may be reached by the trustor's creditors. Section 156(2) of the Second Restatement of Trusts provides that, "(2) 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."[17] The UTC[18] and the Third Restatement of Trusts[19] take a comparable approach.

Although the above rules apply only to trust property attributable to contributions by the trustor,[20] it is not entirely clear if the trustor's creditors may reach the maximum amount that the trustee may distribute to the trustor if the trustee can distribute funds to other beneficiaries.[21]

C. DAPT Option

As American society has become increasingly litigious, interest has developed in asset-protection trusts ("APTs")—trusts in which the trustor can retain some potential benefits that cannot be reached by creditors. Until recently, ATPs were available only in foreign jurisdictions. For many Americans, however, an offshore APT is not an attractive option for the reasons set forth in Part VII below (for example, risk of fine or imprisonment, possible application of the foreign trust rules for income-tax purposes, and financial risk if the jurisdiction experiences political

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[16] *Id.* at 1271.

[17] RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959); *id.* cmts. d-e. *See* 2A SCOTT & FRATCHER, *supra* note 2, §§ 156.1–156.2.

[18] UTC § 505(a)(2) (2004).

[19] RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. e, illus. 8 (2001).

[20] UTC § 505(a)(2) (2004).

[21] RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. e; 2A SCOTT & FRATCHER, *supra* note 2, § 156.2 at 176–79; *In re* Frangos, 135 B.R. 272, 274 (Bankr. N.D. Ohio 1992).

change).

A client now may create a domestic asset-protection trust ("DAPT") in Alaska, Delaware, Rhode Island, Nevada, Utah, or South Dakota. Although he or she also might be able to create this type of trust in Oklahoma, Missouri, or Colorado, this discussion will not focus on those states because the statutes in question are either flawed, not fully developed, or both. DAPTs warrant consideration because recent developments have called into question the effectiveness of some long-standing asset-protection techniques. For example, reversing decades of judicial precedent, the U.S. Supreme Court held in 2002 that a spouse's interest in tenancy-by-the-entirety property was subject to the federal tax lien under section 6321 of the Internal Revenue Code of 1986 ("Code").[22] Moreover, 2005 federal legislation affects the bankruptcy law treatment of a retirement plan, a homestead, an individual retirement account ("IRA") and an APT,[23] and courts have found ways to avoid the homestead exemption.[24] Furthermore, in recent cases, trustors of offshore APTs have been fined or jailed for failure to produce documents or repatriate assets when ordered to do so by U.S. courts.[25]

The best candidate for a DAPT is a client who has surplus assets after he or she performs a realistic assessment of his or her existing and foreseeable assets and liabilities. The worst candidate is a client who has (or is about to incur) a large obligation and wants to hide assets to avoid paying it. Nevertheless, if a client must meet a specific debt or claim, he or she may fund a DAPT with assets that are not needed to satisfy that obligation.

II. PRELIMINARY MATTERS

A. Reasons Against Recognizing DAPTs

Although the Scott treatise disapproved of DAPTs, it simply stated that they violate public policy and did not explain its opposition to them.[26] Other commentators have posited reasons for making DAPTs ineffective

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[22] United States v. Craft, 535 U.S. 274 (2002). *See also* Robert T. Danforth, *The Role of Federalism in Administering a National System of Taxation*, 57 TAX LAW. 625, 642–48 (2004).

[23] *See infra* Paragraph F, Part V.

[24] *See* Crews v. Bosonetto (*In re* Bosonetto), 271 B.R. 403 (Bankr. M.D. Fla. 2001) (holding that a debtor's one-half interest in a Florida residence was not exempt because it was owned by a revocable trust, not the debtor).

[25] *See infra* Part VII.

[26] Danforth, *supra* note 1, at 294.

against creditors' claims.

1. One Should Pay One's Debts

The principal objections to recognizing the effectiveness of DAPTs are, "You should keep your promises and pay your debts because it is the right thing to do,"[27] and, "There is something disturbing about a country that would allow debtors to leave their debts unpaid and still enjoy an extravagant lifestyle."[28] It seems, however, that recognizing DAPTs is not inconsistent with these principles, provided that the fraudulent-transfer rules summarized in Paragraph C below continue to apply.

2. Preserve Liability System

Another objection to DAPTs is that allowing debtors to use these trusts to shelter their assets from potential creditors threatens the system of civil enforcement of obligations by undercutting the deterrent effect of our liability system, and the better way to address the excesses of the tort system is through tort reform, not by recognizing DAPTs.[29] Unfortunately, tort reform has been slow, whereas it has been possible to enact APT legislation at home and abroad.

3. DAPTs "Always" Are Fraudulent

The Bogert treatise opposes DAPTs because:

> Creditors have a right that their debtor shall pay their claims before he makes provision for his own support or comfort. Both existing and future creditors may be misled into believing that their debtor's financial situation is sound, because he continues to enjoy the benefits of his property, and perhaps is in actual possession of it, although that property has been conveyed by a secret trust instrument to be held for the debtor. Generally there will be actual fraud, but it may be difficult to prove, and so the law strikes down the transaction as presumed to be fraudulent.[30]

Apparently, the Bogert treatise's assertion that debtors always create DAPTs with evil intent simply is not true. In addition, legal and practical factors exist that prevent DAPTs from being fraudulent:

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[27] Boxx, *supra* note 1, at 1259.
[28] *Id.*
[29] Danforth, *supra* note 1, at 364.
[30] BOGERT & BOGERT, *supra* note 2, § 223, at 448–49 (footnotes omitted).

> [T]rustees 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.[31]

These legal and practical protections might not be available for offshore APTs, however.

B. Reasons for Recognizing DAPTs

Several reasons support recognizing DAPTs.

1. Authorities Do Not Support the Scott Treatise

The cases that the Scott treatise cited in support of the view that DAPTs should not be honored do not justify that position.[32]

2. The United States Is Unique

One commentator reported that, "America stands virtually alone in its rigid and virtually absolute adherence to the rule against self-settled trusts."[33]

He amplified this point and stated that:

> [B]etween the traditional English common law protective trust, the related statutory short form, the English discretionary trust, and the contemporary APT statutes of many other common law nations, much of the world allows self-settled trusts as a way to shelter assets from the settlor's creditors, provided that the settlement did not violate fraudulent transfer laws.[34]

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[31] Danforth, *supra* note 1, at 360.
[32] *See* Danforth, *supra* note 1, at 294–306.
[33] Sullivan, *supra* note 1, at 433 (footnote omitted).
[34] *Id.* at 441.

3. Creditors Are Given More Rights Than Trustors

Permitting creditors to reach the trustor's interest in a DAPT, regardless of the circumstances, might give the creditors greater access to trust funds than trustors, whose receipt of funds might be subject to legal and practical limitations.[35]

4. The Interests of Other Beneficiaries Are Ignored

Giving creditors automatic access to the assets of DAPTs ignores the rights of trust beneficiaries other than the trustor.[36]

5. Continuing Control by the Trustor Is Relevant

Granting creditors automatic access to the assets of DAPTs fails to distinguish between situations in which the trustor maintains control over trust funds and situations in which the trustor does not.[37]

6. Beneficiaries Are Punished for Failure of Benefactors to Plan

Testators and trustors may create irrevocable trusts that will be beyond the reach of creditors of the trust beneficiaries. If they leave assets outright, however, creditor protection is usually unavailable.

7. Clients Who Accumulate Wealth Are Disfavored

Clients who accumulate wealth by success in business, savvy investing, or the receipt of personal-injury awards may not protect assets from creditors' claims. Clients who inherit wealth, however, may have creditor protection if their parents put inheritances in trust.[38]

8. Other Self-Settled Vehicles Are Recognized

Clients may obtain protection from creditors by entering into a variety of other self-settled vehicles. These vehicles include tenancy-by-the-entirety property, retirement plans, family limited partnerships ("FLPs") and limited-liability companies ("LLCs"), homesteads, life insurance policies, annuity contracts, and transfers to, or in trust for, "cooperative" friends or family members.[39] Indeed, a law professor likened the homestead exemption to DAPTs and stated that:

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[35] Danforth, *supra* note 1, at 305.
[36] *Id.*
[37] *Id.* at 305.
[38] *Id.* at 347.
[39] *See generally id.* at 333–47.

> [T]he limited nature of the congressional response to homestead exemption planning—in light of the significant commentary long accompanying consideration of that issue—provides a potent frame of reference for those who argue that there is absolutely nothing objectionable about a solvent individual setting aside a "nest egg" in a self-settled asset-protection trust where no creditors are looming on the horizon. A belief that individuals concerned about liability exposure would equate the two planning opportunities is anything but tenuous.[40]

9. Clients Want DAPTs

Even though self-settled trusts generally are ineffective against trustors' creditors, clients continue to create them and one cannot assume that they do so because their attorneys are uninformed. Over 100 self-settled trust cases are cited in the annotations under section 156 of the Second Restatement of Trusts, and, in my experience, clients create such trusts even when they know they might not work. For example, parents often persuade children to create self-settled trusts with inheritances received at age twenty-one, and clients sometimes create these trusts when they are concerned about creditors or greedy family members.

10. Preserve United States Business

If DAPTs are not respected, trustors will continue to place assets in offshore APTs that are beyond the reach of U.S. creditors and taxing authorities.

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[40] *See* John K. Eason, *Developing the Asset Protection Dynamic: A Legacy of Federal Concern*, 31 HOFSTRA L. REV. 23, 70 (2002) (footnotes omitted).

C. Fraudulent-Transfer Rules[41]

1. Introduction

All United States jurisdictions permit creditors to set aside fraudulent transfers. At present, forty-one states and the District of Columbia follow the 1984 Uniform Fraudulent Transfer Act ("UFTA"),[42] three states follow the 1918 Uniform Fraudulent Conveyance Act, and six states follow the sixteenth century Statute of Elizabeth.[43]

For present creditors, section 5(a) of the UFTA provides in pertinent part that, "A transfer made . . . by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made . . . if the debtor made the transfer . . . and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer . . . ."[44]

For present and future creditors, section 4(a) of the UTFA provides in pertinent part:

> A transfer made . . . by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made . . . , if the debtor made the transfer . . . :
> (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
> (2) 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

[41] *See generally* Richard W. Nenno & John E. Sullivan, III, *Delaware Asset Protection Trusts: Avoiding Fraudulent Transfers and Attorney Liability*, 32 EST. PLAN. 22 (2005); Henry J. Lischer, Jr., *Professional Responsibility Issues Associated with Asset Protection Trusts*, 39 REAL PROP. PROB. & TR. J. 561, 571–76 (2004); Peter Spero & David Rice, *New Developments Affect the Statute of Limitations for Fraudulent Transfers*, 30 EST. PLAN. 384 (2003); Fox & Huft, *supra* note 1, at 303–07; Danforth, *supra* note 1, at 326–33; 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 Transfer Law for the Asset Protection Planner*, 22 DEL. J. CORP. L. 955 (1997).

[42] *See* The National Conference of Commissioners on Uniform State Laws, UFTA *at* www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ufta.asp for jurisdictions that have adopted the UFTA (last visited July 17, 2005).

[43] 1 Duncan E. Osborne & Elizabeth M. Schurig, *Asset Protection: Domestic and International Law and Tactics* app. 2B at 2-53 to 2-54 (May 2004).

[44] UFTA § 5(a), 7A pt. 2 U.L.A. 330 (1999).

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.[45]

A claim under section 4(a)(1) of the UFTA often is referred to as a claim for "actual fraud;" a claim under UFTA section 4(a)(2) often is referred to as a claim for "constructive fraud." Section 4(b) of the UFTA[46] provides eleven badges of fraud that a creditor may use to establish actual intent under section 4(a)(1). For fraudulent-transfer purposes, a claim arises when the underlying action takes place. Thus, a malpractice claim against a surgeon arises when he or she botches an operation, not when the patient discovers the mistake or files suit.[47]

There are four possible classes of UFTA violations: present actual fraud, present constructive fraud, future constructive fraud, and future actual fraud. Fortunately, three of the four classes are relatively easy to handle. Present fraud, whether actual or constructive, is resolved merely by paying just debts when they come due, thereby satisfying present creditors. Constructive fraud, whether present or future, is resolved by planning a transaction so that the transferor either receives reasonably equivalent value in exchange for the transfer, or alternatively, remains solvent after a transfer. Consequently, the most difficult problems arise in connection with future actual fraud.[48]

If a creditor is able to demonstrate that a transaction was a fraudulent transfer, then:

> [T]he 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. If a fraudulent transfer claim is success-

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[45] *Id.* § 4(a).

[46] *Id.* § 4(b).

[47] John E. Sullivan, III, Remarks During Panel Discussion on Tax and Asset Protection Issues Involved in Bankruptcy at the American Bar Association's 2004 Joint Tax Section and Real Property, Probate and Trust Law Section Fall CLE Meeting in Boston (Oct. 1, 2004).

[48] John E. Sullivan, III, *The Often Overlooked Role of Disclosure in Asset Protection Planning*, *in* ASSET PROTECTION STRATEGIES: PLANNING WITH DOMESTIC AND OFFSHORE ENTITIES 367, 370 (Alexander A. Bove, Jr. ed., 2002).

ful, the usual remedy is an order setting the transfer aside.[49]

2. Claims by Future Creditors

Three commentators explained that not all future creditors may use the fraudulent-transfer rules to reach transferred assets.

According to the first commentator:

> [M]any future plaintiffs do not have "claims," and do not even amount to "creditors" under UFTA. UFTA also imposes a "rule of reason" that requires transferors to protect against reasonably foreseeable claims, as recognized by today's law. The statute does not require transferors to protect against claims that are not reasonably foreseeable, and this limitation fully conforms with many other areas of law. In this country, transferors who intentionally create reserves to protect their legitimate creditors, and who restrict their asset protection planning to their surplus assets, are intentionally protecting their creditors. This negates any fraudulent intent, even when good faith mistakes in calculations or financial assumptions are later discovered.
>
> There are also many other key technical or legal concerns that limit UTFA's reach. For instance, passage of time is recognized as a valid defense.[50]

The second commentator stated:

> 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 credi-

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[49] Danforth, *supra* note 1, at 326 (footnotes omitted).
[50] Sullivan, *supra* note 41, at 1049.

> tor'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.[51]

The last commentator stated:

> There must be a causal connection between the alleged fraud and the injury claimed by the plaintiff-creditor in order to find that the creditor may prosecute the fraud action. This 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 passage of considerable time or the occurrence of an intervening cause, compromised a creditor's financial interest.[52]

A common misconception is that a transaction that is entered into exclusively for asset protection automatically is a fraudulent transfer. A commentator refuted that misconception and stated:

> There's a broad school of thought to that effect, but I think that school of thought is incorrect. It's absolutely permissible to shelter assets in advance of a problem, and I think the case law supports that. If your sole purpose is asset-protection planning but you do it at a time when the coast is clear, you're on very firm footing because you've got a right to do that.[53]

3. Impact of Statutes of Limitations

Section 9 of the UFTA[54] provides statutes of limitations for the bringing of fraudulent-transfer claims. Thus, a cause of action under section 4(a)(1) is extinguished unless an action is brought within four years after the transfer was made, or if later, within one year after the transfer was or could reasonably have been discovered by the claimant. A cause of action under section 4(a)(2) or section 5(a) is extinguished unless an action is brought within four years after the transfer was made.

A commentator has described the effect that should result from the above statutes of limitations for DAPTs and stated:

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[51] Danforth, *supra* note 1, at 330 (footnote omitted).

[52] PETER A. ALCES, THE LAW OF FRAUDULENT TRANSACTIONS § 5:79 at 5-176 (2002) (footnotes omitted).

[53] Sullivan, *supra* note 47.

[54] UFTA § 9, 7A pt. 2 U.L.A. 359 (1999).

> 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, 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, but, . . . 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.[55]

4. Recent Cases

Four recent cases illustrate the application of the fraudulent-transfer rules.

In *United States v. Engh*, the Seventh Circuit considered whether a 1983 residence transfer by a tax protestor and his wife to an Illinois land trust was subject to the federal tax lien.[56] The court held that the residence was subject to the lien and mentioned several badges of fraud: the transfer was without consideration, the protestor continued to occupy the property and pay taxes and expenses, the transfer was to family members, and there was a clear intent to avoid the Internal Revenue Service ("Service").[57] The court concluded that, "We could go on and on, but that's unnecessary, for this isn't even a close case. The circumstances overwhelmingly demonstrate that Engh transferred his interest in the Marstonmoor property to the trust in furtherance of a scheme to put his assets out of the reach of the IRS."[58]

The second case is *Nastro v. D'Onofrio*, in which the plaintiff sought to enforce a $550,000 California judgment against the defendant by attaching the defendant's assets.[59] The plaintiff first sought to avoid the transfer of $650,000 of stock in four Connecticut corporations to a Jersey, Channel Islands, trust for the defendant's wife and children. The defendant was not a beneficiary and the transfer was made two weeks after the Cali-

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[55] Danforth, *supra* note 1, at 329–30.
[56] *See* 330 F.3d 954 (7th Cir. 2003).
[57] *Id.* at 956–57.
[58] *Id.* at 957.
[59] *See* 263 F. Supp. 2d 446 (D. Conn. 2003).

fornia judgment was rendered. The court granted the plaintiff's request for a preliminary injunction and held:

> There is evidence in the record in support of Nastro's claim that D'Onofrio transferred his interest in the Connecticut companies without consideration and was thereby rendered insolvent. As previously noted, D'Onofrio testified that he has no assets to satisfy Nastro's judgment. Also, according to Nastro's testimony and statement to the Internal Revenue Service ("IRS"), his transfer of his interest in the Connecticut companies to the trustee was without consideration and gratuitous. Further, D'Onofrio stated to the IRS that he transferred his interest in the Connecticut companies just fourteen days after the California Superior Court rendered judgment in Nastro's favor. At the very least, Nastro has established a strong prima facie case of constructive fraud under the UFTA.[60]

In *Sumpter v. United States*, a Michigan federal district court held that a debtor's 1988 transfers to a trust for his minor children made at about the same time the Service began to pursue him for delinquent taxes were acts of actual fraud.[61] As a result, the transfers were set aside sixteen years after the debtor made them, long after the trust had terminated.

In a recent Pennsylvania case, a creditor obtained a judgment against the debtor in March of 2001.[62] Subsequently, the debtor's wife died, and he disclaimed his intestate share of her estate at a time when he was insolvent.[63] The Superior Court affirmed the lower court and held that the creditor could set the disclaimer aside as a fraudulent transfer.[64]

Pertinent recent cases have been decided in other jurisdictions.[65]

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[60] *Id.* at 460 (citations omitted).

[61] *See* 302 F. Supp. 2d 707, 724 (E.D. Mich. 2004).

[62] *See* Gallaher *ex rel.* Rockwood Cas. Ins. Co. v. Riddle, 850 A.2d 748, 750 (Pa. Super. Ct. 2004).

[63] *See id.*

[64] *See id.* at 750–51.

[65] *See* United States v. Verduchi, No. 03-139-T, 2005 U.S. Dist. LEXIS 7938 (D.R.I. Apr. 25, 2005); United States v. Dawes, 344 F. Supp. 2d 715 (D. Kan. 2004); United States v. Mazzeo, 306 F. Supp. 2d 294 (E.D.N.Y. 2004); Osherow v. Porras (*In re* Porras), 312 B.R. 81 (Bankr. W.D. Tex. 2004); Fischer v. Brancato, 147 S.W.3d 794 (Mo. Ct. App. 2004); Gill v. Stern (*In re* Stern), 345 F.3d 1036, 1042–45 (9th Cir. 2003). For an analysis of *Fischer*, see Jay Adkisson, *Fischer—Civil Conspiracy, Fraudulent Transfer—Even Absent Actual Transfer*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. # 52 (Sept. 9, 2004), *at* www.leimbergservices.com.

5. Applicable Law

One commentator discussed the choice of law used to determine whether the transfer in the case of *James v. Powell* was fraudulent.[66]

> The trust instrument's choice of law designation is irrelevant to this question because the issue of fraudulent conveyance is not an issue of the contract between the trustor and trustee . . . . If the choice of law clause in the trust agreement applied to a fraudulent conveyance question, then any debtor could control the choice of law by entering into a contract with the transferee and making the contract subject to the law of a state with a more favorable fraudulent conveyance law. The location of the assets before or after the transfer, consequently, does not affect the choice of law. In *James v. Powell*, for example, a New York court considered whether a transfer of land in Puerto Rico was fraudulent as to the transferor's New York judgment creditor. The court held that Puerto Rican law applied to answer that question, citing the Restatement sections setting forth choice of law rules applicable to real property. However, the court commented in a footnote that:
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>> Of course, if, in exploring the law of Puerto Rico, it were to be found that it was specifically designed to thwart the public policy of other states—for example, by denying a remedy to all judgment creditors in the plaintiff's circumstances in order to attract foreign investment in its real estate—the courts of this State would be privileged to apply the law of New York rather than that of Puerto Rico.[67]

Because all DAPT states have fraudulent-transfer rules (Delaware, Nevada, Rhode Island, Utah, and South Dakota have the UFTA; Alaska follows the Statute of Elizabeth), a court should apply the law that governs a DAPT to determine whether creation of the trust was fraudulent. A creditor should be able to reach assets that were the subject of an improper transfer. Thus, DAPTs that do not run afoul of the fraudulent-transfer rules should be effective.

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[66] *See* 225 N.E.2d 741 (N.Y. 1967).
[67] Boxx, *supra* note 1, at 1222 (footnotes omitted).

D. Ethical Principles

In each case, attorneys should assess whether they will be acting ethically if they assist—or decline to assist—a client in creating a DAPT.[68] As with any engagement, attorneys must be mindful of the need to protect confidential information and avoid conflicts of interest. Attorneys also should make sure that they are competent to carry out the engagement.

As of March 1999, forty states and the District of Columbia had adopted versions of the Model Rules of Professional Conduct ("Model Rules").[69] The Model Rules were adopted by the American Bar Association in 1983.[70] In 2002, however, the American Bar Association adopted substantial amendments to the Model Rules, which were based on recommendations of its Commission on Evaluation of the Rules of Professional Conduct (the Ethics 2000 Commission).[71]

No provision of the Model Rules specifically addresses the propriety of asset-protection planning, but the provision of most concern is Rule 1.2(d), which was not amended in the 2002 revision. Rule 1.2(d) provides:

> A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.[72]

For purposes of the Model Rules, "fraud" and "fraudulent" mean "conduct that is fraudulent under the substantive or procedural law of the applicable jurisdiction and has a purpose to deceive."[73]

The other ten states[74] follow the American Bar Association's Model Code of Professional Responsibility ("Model Code"). The Model Code

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[68] *See* Gideon Rothschild & Daniel S. Rubin, *Asset-Protection Planning: Ethical? Legal? Obligatory?*, TR. & EST., Sept. 2003, at 42; *see also* 1 Osborne & Schurig, *supra* note 43, §§ 4:07–4:17 at 4-10 to 4-29.

[69] *See* ACTEC COMMENTARIES ON THE MODEL RULES OF PROF'L CONDUCT 14–15 (3d ed. 1999).

[70] *See* MODEL RULES OF PROF'L CONDUCT (2002). *See also* Lischer, *supra* note 41, at 602–07, 615–17.

[71] The Ethics 2000 Commission was chaired by Chief Justice E. Norman Veasey of the Delaware Supreme Court.

[72] *Id.* R. 1.2(d).

[73] *Id.* R. 1.0(d).

[74] *See* Rothschild & Rubin, *supra* note 68, at 43.

was issued in 1980.[75] No provision of the Model Code covers the propriety of asset-protection planning, but the Model Code does forbid a lawyer to "[e]ngage in conduct involving dishonesty, fraud, deceit, or misrepresentation"[76] or to "counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent."[77] In New York and other Model Code states, an attorney should not automatically face disciplinary action for assisting a client in making a transfer that is later adjudged a fraudulent conveyance.[78]

Cases and ethics opinions involving the propriety of asset-protection planning have been issued in California, Connecticut, Florida, New York, Oregon, and South Carolina.[79] Offshore APT specialists contend that the cases show that an attorney might be engaging in an ethical violation if the attorney helps a client to defraud known or foreseeable creditors, but there should be no ethical violation if the planning involves unknown and unforeseeable creditors.[80] In addition, an outspoken critic of domestic and offshore APTs concedes that an attorney in a non-DAPT jurisdiction can avoid ethical concerns by referring a client to counsel in a DAPT jurisdiction to discuss an APT, and the DAPT attorney has no ethical concerns because his or her jurisdiction recognizes APTs.[81]

Attorneys cannot assume that they will escape ethical problems simply by choosing not to participate in asset-protection planning because the Model Rules[82] and the Model Code[83] require attorneys to represent their client zealously. Commentators have cautioned attorneys and stated that:

> So far there are no reported ethics decisions or malpractice cases addressing whether a lawyer is obligated to promote a client's lawful asset protection plan. But it is only a matter of time before such claims begin to be heard. Therefore, professionals should not shrink from asset protection. Handled responsibly, it should be as ethically and legally innocuous as any other type of

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[75] *See* MODEL CODE OF PROF'L RESPONSIBILITY (1980). *See also* Lischer, *supra* note 41, at 599–602, 614–15.

[76] MODEL CODE OF PROF'L RESPONSIBILITY DR 1-102(A)(4).

[77] *Id.* DR 7-102(A)(7).

[78] *See* Rothschild & Rubin, *supra* note 68, at 43.

[79] *See* Lischer, *supra* note 41, at 599–607; Rothschild & Rubin, *supra* note 68, at 43–44.

[80] *See* Rothschild & Rubin, *supra* note 68, at 43–44.

[81] *See* Lischer, *supra* note 41, at 625.

[82] *See* MODEL RULES OF PROF'L CONDUCT R. 1.3 cmt. 1 (1983).

[83] *See* MODEL CODE OF PROF'L RESPONSIBILITY DR 7-101 (1980).

> planning. Certainly, to protect themselves, professional advisors must do their due diligence. At a minimum, they should follow established "know your client" procedures, conduct or obtain a solvency analysis of the client, review the client's circumstances—and always document that due diligence.[84]

E. Potential Liability for Attorneys

In each case, attorneys should assess the likelihood that they will be sued, held liable, or both if they assist—or decline to assist—a client in creating a DAPT. Four recent cases are instructive.

In *Morganroth & Morganroth v. Norris, McLaughlin & Marcus, P.C.*, the Third Circuit held that a Michigan law firm could pursue a claim for damages against a New Jersey law firm in connection with the Michigan firm's attempt to enforce a $6 million judgment for counsel fees against John DeLorean.[85] The New Jersey firm allegedly prepared false documents and helped the debtor conceal assets.

In *Nastro v. D'Onofrio*, however, the federal district court in Connecticut dismissed the plaintiff's claim for damages against the defendant's attorney and his law firm for participating in the creation of an offshore spendthrift trust even though the court permitted the plaintiff to pursue a fraudulent-transfer claim against the defendant.[86]

Similarly, two Alaska attorneys were joined in an action to reach the assets of an offshore APT, the creation of which allegedly was a fraudulent conveyance. Although the attorneys did not pay damages when the case was settled, they were required to defend the suit.[87]

Finally, early in 2004, the Florida Supreme Court held in *Freeman v. First Union National Bank* that Florida's UFTA does not create a cause of action for damages for a creditor against an aider or abettor to a fraudulent transaction.[88]

Attorneys' potential exposure should be minimal if they always follow a screening procedure (including the preparation of a solvency analysis) to ensure that they are not participating in a fraudulent transfer. Conversely,

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[84] Rothschild & Rubin, *supra* note 68, at 45 (footnotes omitted).

[85] *See* 331 F.3d 406 (3d Cir. 2003). *See* Lischer, *supra* note 41, at 621–22.

[86] *See* 263 F. Supp. 2d at 459.

[87] *See* David G. Shaftel, *Allvest—Validity of Domestic Self-Settled Discretionary Spendthrift Trusts*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #29 (Apr. 23, 2003), *at* www.leimbergservices.com.

[88] *See* 865 So. 2d 1272 (Fla. 2004); *cf.* Fischer, 147 S.W.3d at 794.

clients (particularly wealthy clients) are very interested in protecting their assets,[89] and attorneys might face exposure if they do not advise the client to create a DAPT and creditors later reach the client's assets. In addition, the Delaware, Alaska, South Dakota, and Utah APT statutes include protections for trustees, advisers, and attorneys who participate in the creation of APTs.[90]

III. FEDERAL INCOME-TAX CONSEQUENCES[91]

If the trustor of a DAPT retains the right to receive discretionary income and principal distributions, the trust will be a grantor trust with respect to its ordinary income and capital gains, unless distributions to the trustor must be approved by an adverse party (such as a child who will receive assets that are not distributed to the trustor).[92] Consequently, if the trustor wants the trust to be a grantor trust, the trustor does not need to include one of the powers that typically is provided to obtain grantor trust treatment (such as a power to add charitable beneficiaries or to reacquire trust property in a nonfiduciary capacity). Grantor-trust treatment might be desirable from an estate-planning perspective because the trust will not be diminished by federal income taxes, but the trustor might be taxed on income that the trustor does not actually receive. In all situations of this type, the planner should make sure that the trustor is ready to assume this burden.

Only the Delaware APT statute specifically permits the trust instrument to authorize or direct the trustee to reimburse the trustor for income taxes attributable to the trust. Except in Delaware, inclusion of a reimbursement provision might jeopardize the asset-protection objectives of the trust. The trustor might be reimbursed for these taxes in the exercise of discretion, but if the trustor is reimbursed too often, the Service and creditors might contend that the trustor and the trustee had agreed when the trust was created that these distributions would be made. Under the Delaware, Alaska, and South Dakota APT statutes, the trustor retains no rights except those expressly provided by the trust instrument.[93]

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[89] *See* Russ Alan Prince & Richard L. Harris, *Shelter from the Storm: T & E Exclusive: Survey Charts the Rising Importance of Asset-Protection Planning*, TR. & EST., Sept. 2003, at 38.

[90] *See* DEL. CODE ANN. tit. 12, § 3572(d)–(e) (2001); ALASKA STAT. § 34.40.110(e) (2004); S. 93, 2005 Leg., 80th Sess. (S.D. 2005); UTAH CODE ANN. § 25-6-14(4) (1998).

[91] *See* Fox & Huft, *supra* note 1, at 336.

[92] *See* I.R.C. § 677(a) (2000).

[93] *See* DEL. CODE ANN. tit. 12, § 3571 (2001); ALASKA STAT. § 34.40.110(i) (2004);

Part VI of this Article discusses how DAPTs can be used to avoid state and local income taxes and state intangible tax. In states (such as Massachusetts, New Jersey, and New York) where income tax is based on taxable income as determined for federal purposes, it will be possible to avoid tax on the income of a DAPT only if the trust is a nongrantor trust.

The Service has confirmed in two private letter rulings that a Delaware APT may be a nongrantor trust if the trustor involves adverse parties.[94] In the first ruling, the trustor proposed to create an irrevocable inter vivos trust. During the trustor's lifetime, the trustee would make distributions to the trustor, his wife, and his parents' descendants as directed by the two-member Distribution Committee or by one member of the Distribution Committee with the trustor's written consent. At all times, the Distribution Committee would consist of adverse parties—the two eldest adult and competent trust beneficiaries other than the trustor and his wife. On the trustor's death, the trustee would distribute the remaining trust property in favor of the trust beneficiaries other than the trustor as he appointed by his will. In default of appointment, the remaining trust assets would be distributed in favor of the trustor's descendants.[95]

Late in 2004, the Service ruled that a self-settled trust established in an unspecified state could be a nongrantor trust.[96]

IV. FEDERAL TRANSFER-TAX CONSEQUENCES[97]

A. Introduction

The trustor of a DAPT can prevent the creation of the trust from being a completed gift by retaining a special testamentary power of appointment. This trust, from which the trustor may receive distributions only on the exercise of discretion, may possibly be structured to be a completed gift for federal gift-tax purposes and be excluded from the trustor's gross estate for federal estate-tax purposes.

B. Gift Tax

The trustor's retention of a special testamentary power of appointment

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S. 93, 2005 Leg., 80th Sess. (S.D. 2005).

[94] *See* Priv. Ltr. Rul. 200247013 (Aug. 14, 2002); Priv. Ltr. Rul. 200148028 (Aug. 27, 2001).

[95] Priv. Ltr. Rul. 200148028 (Aug. 27, 2001).

[96] Priv. Ltr. Rul. 200502014 (Sept. 17, 2004).

[97] *See* Danforth, *supra* note 22, at 636–38, 657–58; Fox & Huft, *supra* note 1, at 329–36.

over a DAPT will prevent the trustor from making a completed gift,[98] unless distributions actually are made.[99] If the trustor does not keep this special power of appointment, however, the trustor will make a completed gift when the trustor parts with dominion and control over the property put in the trust.[100] If the trustor cannot take action after creating a trust that enables a creditor to reach trust assets, then the trustor will have parted with dominion and control and the gift will be complete. Conversely, if the trustor can take action following creation of a trust that enables a creditor to reach its assets, then the trustor will have dominion and control and the gift will be incomplete. The ability of a trustor of a DAPT to enable creditors to reach trust assets is discussed in Paragraph D.

C. Estate Tax

To determine if a DAPT is includable in the trustor's gross estate for federal estate-tax purposes, the planner must consider Code sections 2038(a)(1), 2036(a)(1), and 2036(a)(2).

1. Code Section 2038(a)(1)

The trust will be included in the trustor's gross estate under Code section 2038(a)(1) if, at death, the trustor has a power to alter, amend, revoke, or terminate the trust.[101] Whether or not Code section 2038(a)(1) prevents estate-tax exclusion will depend on whether the trustor retains enough power to enable creditors to reach trust assets.

2. Code Section 2036(a)(1)

A trust will be included in the trustor's gross estate if, at death, the trustor has "the possession or enjoyment of, or the right to the income from, the property" within the meaning of Code section 2036(a)(1).[102] If the trustor of a Delaware APT retains the right to receive current income distributions (this option is not available under the other statutes), the trust will be included in the trustor's gross estate under this section. If the trustor of a DAPT can receive distributions only upon the exercise of absolute discretion, however, the issue is whether or not this trust provi-

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[98] *See* Treas. Reg. § 25.2511-2(b) (1996). *See also* Priv. Ltr. Rul. 200502014 (Sept. 17, 2004); Priv. Ltr. Rul. 200247013 (Aug. 14, 2002); Priv. Ltr. Rul. 200148028 (Aug. 27, 2001).
[99] *See* Treas. Reg. § 25.2511-2(f) (1996).
[100] *See* Treas. Reg. § 25.2511-2(b) (1996).
[101] *See* I.R.C. § 2038(a)(1) (2000).
[102] *See* I.R.C. § 2036(a)(1) (2000).

sion is enough, by itself, to cause estate-tax inclusion. Cases and rulings support the view that it is not.[103]

Shortly after the Alaska APT statute became law in 1997, a publication commented on its transfer-tax implications and stated that, "If the grantor's retained interest is discretionary, his creditors cannot reach the trust property, except as provided in the statute. Thus, under existing estate tax authority, the trust property would not be includible in the grantor's gross estate."[104]

Another authority commented on the same issue:

> Suppose *A* creates a trust, naming an independent trustee, income to be paid to *A* or accumulated in the trustee's discretion during *A*'s lifetime, remainder to *C*, and suppose further that up to the date of *A*'s death *A* has received, but irregularly, 40% of the income from the trust. The general rule in such a case, with exceptions to be described below, is that nothing is includible in *A*'s gross estate under § 2036(a)(1), not even 40% of the corpus.[105]

In discussing this issue, other commentators concluded that, "[I]f some meaning is to be accorded the word 'retained,' some showing of an arrangement, more than the fact that income was paid to the decedent, should be required."[106] An interest or right is treated as retained or reserved if, at the time of the transfer, an express or implied understanding existed that distributions would be made.[107] If a pattern of distributions can be established, it is likely an arrangement will be inferred.[108] As noted previously, the Delaware, Alaska, and South Dakota APT statutes expressly provide that a distribution understanding is invalid.[109]

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[103] *See In re* Estate of Uhl, 241 F.2d 867 (7th Cir. 1957); Estate of German v. United States, 55 A.F.T.R.2d 85-1577 (Cl. Ct. 1985); Estate of Wells v. Commissioner, 42 T.C.M. 1305 (1981); Priv. Ltr. Rul. 9837007 (June 10, 1998); Priv. Ltr. Rul. 9332006 (Aug. 20, 1992); Priv. Ltr. Rul. 8037116 (June 23, 1980).

[104] *See* Richard B. Covey & Dan T. Hastings, *Discretionary Trust with Grantor as Beneficiary; Ability of Creditors of Grantor to Reach Trust Property; Alaska Law*, PRAC. DRAFTING 4889, 4891 (July 1997).

[105] *See* Joseph M. Dodge, 50-5th T.M., *Transfers with Retained Interests and Powers* at A-23.

[106] RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 4.08[4][c] at 4-154 (8th ed. 2002) (footnote omitted).

[107] *See* Treas. Reg. § 20.2036-1(a) (2004).

[108] *See* Estate of Skinner v. United States, 197 F. Supp. 726, 730 (E.D. Pa. 1961), *aff'd*, 316 F.2d 517 (3d Cir. 1963).

[109] *See* DEL. CODE ANN. tit. 12, § 3571 (2001); ALASKA STAT. § 34.40.110(i) (2004);

3. Code Section 2036(a)(2)

A trust will be included in the trustor's gross estate if, at death, the trustor has "the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom" within the meaning of Code section 2036(a)(2).[110] The issue under this section is whether the trustor has retained too much power to enable creditors to reach trust assets.

D. Rights of Creditors

Whether the creation of a DAPT will be a completed gift and whether the trust will be subject to estate tax at the trustor's death under Code section 2038(a)(1) or section 2036(a)(2) turns on the ability of the trustor to enable creditors to reach trust assets.

All pertinent cases and rulings provide that the trustor will not make a completed gift and will not obtain estate-tax exclusion if the trustor retains the powers to incur debt and to relegate creditors to trust assets.[111] By making self-settled spendthrift trusts enforceable, the DAPT laws prevent creditors from reaching trust assets to satisfy the trustor's debts and thereby should make it possible for the trustor to make a completed gift and to exclude the trust assets from the trustor's estate.

Instances, called acts of independent significance, exist in which actions by a trustor might enable creditors to reach trust assets but will not produce an adverse transfer-tax result. In these situations, authorities recognize that trustors do not act to regain control over trust property. Acts of independent significance include divorce,[112] failure to support a spouse,[113] the ability to have or adopt children,[114] and the ability to terminate employment.[115] Similarly, Treasury Regulation section 1.664-3

S. 93, 2005 Leg., 80th Sess. (S.D. 2005).

[110] I.R.C. § 2036(a)(2) (2002).

[111] *See* Vander Weele v. Commissioner, 27 T.C. 340 (1956), *aff'd*, 254 F.2d 895 (6th Cir. 1958); Estate of Paxton v. Commissioner, 86 T.C. 785 (1986); Outwin v. Commissioner, 76 T.C. 153 (1981); Paolozzi v. Commissioner, 23 T.C. 182 (1954); *German*, 55 A.F.T.R. 1577; Rev. Rul. 77-378, 1977-2 C.B. 347; Rev. Rul. 76-103, 1976-1 C.B. 293; Tech. Adv. Mem. 199917001 (Jan. 15, 1999); Priv. Ltr. Rul. 9332006 (Aug. 20, 1992); Priv. Ltr. Rul. 8037116 (June 23, 1980); Gen. Couns. Mem. 35112 (Nov. 13, 1972). For summaries of most of these cases and rulings, see Fox & Huft, *supra* note 1, at 331–35.

[112] *See* Estate of Tully, 528 F.2d 1401 (Cl. Ct. 1976); Outwin v. Commissioner, 76 T.C. 153; Tech. Adv. Mem. 8819001 (Jan. 6, 1988).

[113] *See* Ellis v. Commissioner, 51 T.C. 182 (1968), *aff'd*, 437 F.2d 442 (9th Cir. 1971).

[114] *See* Rev. Rul. 80-255, 1980-2 C.B. 272.

[115] *See* Landorf v. United States, 408 F.2d 461 (Cl. Ct. 1969); Estate of Smead v.

provides that the divorce of the beneficiary of a CRUT is an "event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons" and that this type of divorce is a triggering event permitting an income-only CRUT to "flip" to a standard CRUT.[116] The provisions of the Delaware, Utah, and South Dakota APT statutes that permit a trust to be reached to pay alimony, child support, and other obligations fall clearly within the scope of this exception and should not prevent trustors from achieving desired gift- and estate-tax results.

E. DAPT Developments

In 1998, the Service ruled that a transfer to an Alaska APT was a completed gift but refused to rule on whether assets in the trust at the trustor's death would be subject to estate tax.[117] A few months later, the Service confirmed that transfers to seven irrevocable California self-settled trusts were not completed gifts and that the trusts were includable in the trustor's gross estate because California did not recognize self-settled trusts.[118] Late in 1999, the Service declined to rule on whether a transfer to a Delaware APT was a completed gift or excludable from the trustor's gross estate.

A 2004 revenue ruling sheds light on the transfer-tax consequences of DAPTs.[119] In it, the Service considered the gift- and estate-tax treatment of trusts that are treated as grantor trusts for income-tax purposes. With respect to the second situation considered by the ruling, the Service held that discretion given to an independent trustee to reimburse the trustor for income taxes attributable to the trust will not cause estate-tax inclusion, except that "applicable local law subjecting the trust assets to the claims of A's creditors" might cause inclusion.[120] The quoted language indicates that trust assets will not be taxed if state law, such as that of a DAPT state, does not subject trust assets to the claims of the trustor's creditors.

A trustor who creates a DAPT that is designed to be a completed gift and excludable from the gross estate should report the transfer on a timely gift-tax return. Adequate disclosure of the transfer as a taxable gift on the return will commence the running of the period of limitations for assess-

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Commissioner, 78 T.C. 43 (1982); Estate of Beauregard v. Commissioner, 74 T.C. 603 (1980); Rev. Rul. 72-307, 1972-1 C.B. 307.

[116] *See* Treas. Reg. § 1.664-3(a)(1) (2004).

[117] Priv. Ltr. Rul. 9837007 (June 10, 1998).

[118] Tech. Adv. Mem. 199917001 (Jan. 15, 1999).

[119] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[120] *Id.* at 9.

ment of gift tax on the transfer even if the transfer is ultimately determined to be an incomplete gift. Thus, if an incomplete gift is reported as a completed gift on the gift-tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed. Once the period of assessment for the gift tax expires, the transfer will be subject to inclusion in the trustor's gross estate for estate-tax purposes only to the extent that a completed gift would be included.[121]

F. GST Tax

The trustor's allocation of GST exemption to transfers to a DAPT will not be effective as long as the trust is subject to an estate-tax inclusion period, that is, as long as the trust is includable in the trustor's gross estate.[122]

The estate-tax inclusion period issue may not be resolved conclusively until after the trustor's death (when the Service, with hindsight as to patterns of distribution and claims of creditors, may establish estate-tax inclusion). Consequently, the trustor might want to fund a trust to which GST exemption is to be allocated with assets that the trustor will not need and in which the trustor reserves no interest. The trustor might then place the balance of the assets to be protected in a DAPT that is not structured to be a completed gift or excludable from the gross estate.

V. ASSET-PROTECTION EFFECTIVENESS

A. Introduction

Critics of DAPTs—both offshore APT proponents and APT opponents—contend that because U.S. constitutional strictures, such as the Full Faith and Credit Clause, the Due Process Clause, and the Supremacy Clause, apply to DAPTs, one or more of these strictures will fatally compromise a DAPT's ability to protect assets. Specifically, critics argue that a court in a U.S. jurisdiction that does not recognize DAPTs ("non-DAPT court") will easily obtain jurisdiction over the DAPT or its trustee, readily conclude that enforcing the DAPT would violate a strong public policy of its jurisdiction, and order the DAPT's trustee to pay the creditor. Critics also argue that a court in a jurisdiction that does recognize DAPTs ("DAPT court") must give full faith and credit to the judgment of the non-

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[121] *See* Treas. Reg. § 301.6501(c)-1(f)(5) (2004). I am aware of two instances in which a trustor reported the creation of a Delaware APT as a completed gift, the trustor then died, and the Service did not seek to include the trust in the gross estate before issuing its closing letter.

[122] *See* Treas. Reg. § 26.2632-1(c) (2004).

DAPT court, and that the creditor will be able to reach the assets of the DAPT if the controversy is adjudicated in bankruptcy. Nonetheless, Gideon Rothschild, Esquire, of Moses & Singer in New York City, points out that a resident of a DAPT state should create a DAPT in his or her state of residence rather than in another U.S. jurisdiction or abroad because these constitutional issues will be inapplicable. In addition, a resident of a non-DAPT jurisdiction should consider a DAPT because DAPT critics offer too facile an analysis of the situation.

The applicability of the Full Faith and Credit Clause—as well as questions of jurisdiction and choice of law—will be relevant when:

(1) A creditor obtains a judgment against the trustor of a DAPT in a non-DAPT court and tries to enforce it against the DAPT in a DAPT court, or
(2) A creditor seeks to obtain a judgment against a DAPT or a trustee of a DAPT in a non-DAPT court.

Part V considers provisions of the United States Constitution and related principles that are relevant in assessing the asset-protection effectiveness of DAPTs.

B. Non-DAPT Court Might Lack Jurisdiction

1. Introduction

Comment a to section 104 of the Second Restatement of Conflict of Laws provides in relevant part as follows:

> Due process forbids the rendition of a judgment within the United States unless the State of rendition has judicial jurisdiction. . . . A judgment rendered in violation of these requirements is void in the State of rendition itself, and due process forbids the recognition and enforcement of such a judgment in sister States. . . .[123]

Hence, if a creditor tries to obtain a judgment against a DAPT in a non-DAPT court, that court first must determine if it has jurisdiction to enter the judgment. Jurisdiction might be based on in rem jurisdiction over trust assets or personal jurisdiction over a trustee.

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[123] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 104 cmt. a (1971). *See* Estate of Waitzman, 507 So. 2d 24, 25 (Miss. 1987).

2. In Rem Jurisdiction

The non-DAPT court will have in rem jurisdiction over the trust if some trust assets are held in the court's jurisdiction. For example, in *Bank of America v. Weese*, a Maryland court had jurisdiction over a Cook Islands trust because the trust was funded with Maryland real estate.[124] To prevent a non-DAPT court from having in rem jurisdiction over a DAPT, the trustee should hold all assets in the jurisdiction where the trust is created.

3. Personal Jurisdiction

a. Introduction

A non-DAPT court might be able to adjudicate a creditor's claim if it has personal jurisdiction over a trustee. Consequently, trustors should avoid appointing co-trustees outside DAPT jurisdictions. Even if the non-DAPT court's long-arm statute appears to confer jurisdiction over the trustee of a DAPT, it may exercise jurisdiction only if the trustee has enough contacts with the court's jurisdiction to prevent the exercise of jurisdiction from being unconstitutional.

b. Hanson v. Denckla

The leading case in this area is *Hanson v. Denckla*, which involved a controversy concerning the right to part of the principal of a trust established in Delaware by a Pennsylvania trustor who subsequently moved to Florida.[125] The U.S. Supreme Court held that a Delaware court was under no obligation to give full faith and credit to a judgment of a Florida court that lacked jurisdiction over the trust's assets and the trustee. The court discussed the jurisdictional issues:

> Appellees' stronger argument is for *in personam* jurisdiction over the Delaware trustee. They urge that the circumstances of this case amount to sufficient affiliation with the State of Florida to empower its courts to exercise personal jurisdiction over this nonresident defendant. Principal reliance is placed upon *McGee v. International Life Ins. Co.* In *McGee* the Court noted the trend of expanding personal jurisdiction over nonresidents. As technologi-

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[124] No. 03-C-01-01892 (Md. Cir. Ct. Baltimore County, August 3, 2001), *available at* http://www.mddailyrecord.com/pub/2_28_friday/businessnews/48370-1.html.

[125] *See* 357 U.S. 235 (1958).

cal progress has increased the flow of commerce between States, the need for jurisdiction over nonresidents has undergone a similar increase. At the same time, progress in communications and transportation has made the defense of a suit in a foreign tribunal less burdensome. In response to these changes, the requirements for personal jurisdiction over nonresidents have evolved from the rigid rule of *Pennoyer v. Neff*, to the flexible standard of *International Shoe Co. v. Washington*. But it is a mistake to assume that this trend heralds the eventual demise of all restrictions on the personal jurisdiction of state courts. Those restrictions are more than a guarantee of immunity from inconvenient or distant litigation. They are a consequence of territorial limitations on the power of the respective States. However minimal the burden of defending in a foreign tribunal, a defendant may not be called upon to do so unless he has had the "minimal contacts" with that State that are a prerequisite to its exercise of power over him.

We fail to find such contacts in the circumstances of this case. The defendant trust company has no office in Florida, and transacts no business there. None of the trust assets has ever been held or administered in Florida, and the record discloses no solicitation of business in that State either in person or by mail.

The cause of action in this case is not one that arises out of an act done or transaction consummated in the forum State. In that respect, it differs from *McGee v. International Life Ins. Co.* and the cases there cited. In *McGee*, the nonresident defendant solicited a reinsurance agreement with a resident of California. The offer was accepted in that State, and the insurance premiums were mailed from there until the insured's death. Noting the interest California has in providing effective redress for its residents when nonresident insurers refuse to pay claims on insurance they have solicited in that State, the Court upheld jurisdiction because the suit "was based on a contract which had substantial connection with that State." In contrast, this action involves the validity of an agreement that was entered without any connection with the forum State. The agreement was executed in Delaware by a trust company incorporated in that State and a settlor domiciled in Pennsylvania. The first relationship Florida had to the agreement was years later when the settlor became domiciled there, and the trustee remitted the trust income to her in that State. From Florida Mrs. Donner carried on several bits of trust administration that

> may be compared to the mailing of premiums in *McGee*. But the record discloses no instance in which the *trustee* performed any acts in Florida that bear the same relationship to the agreement as the solicitation in *McGee*. Consequently, this suit cannot be said to be one to enforce an obligation that arose from a privilege the defendant exercised in Florida. This case is also different from *McGee* in that there the State had enacted special legislation (Unauthorized Insurers Process Act) to exercise what *McGee* called its "manifest interest" in providing effective redress for citizens who had been injured by nonresidents engaged in an activity that the State treats as exceptional and subjects to special regulation.
>
> The execution in Florida of the powers of appointment under which the beneficiaries and appointees claim does not give Florida a substantial connection with the contract on which this suit is based. It is the validity of the trust agreement, not the appointment, that is at issue here. For the purpose of applying its rule that the validity of a trust is determined by the law of the State of its creation, Florida ruled that the appointment amounted to a "republication" of the original trust instrument in Florida. For choice-of-law purposes such a ruling may be justified, but we think it an insubstantial connection with the trust agreement for purposes of determining the question of personal jurisdiction over a nonresident defendant. The unilateral activity of those who claim some relationship with a nonresident defendant cannot satisfy the requirement of contact with the forum State. The application of that rule will vary with the quality and nature of the defendant's activity, but it is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws. The settlor's execution in Florida of her power of appointment cannot remedy the absence of such an act in this case.[126]

*c. Post-*Hanson *Cases*

The continued vitality of *Hanson* has been confirmed in recent years. In 1990, the Supreme Court of Montana considered whether Montana

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[126] *Id.* at 250–54 (citations and footnotes omitted).

courts had jurisdiction over a Nevada corporate trustee in a dispute involving the will of a Montana decedent in *In re* Estate of Ducey.[127] In concluding that the Montana courts lacked personal jurisdiction over the trustee, the court noted that:

> Like the trustee in *Hanson*, FIBN did not conduct any business in the forum state availing itself of the benefits and protections of Montana's laws. FIBN made some payments of trust income to Mrs. Ducey in Montana. FIBN allegedly responded to requests made by Mrs. Ducey and allegedly participated in negotiations initiated by and at the request of Mrs. Ducey. From Montana, Mrs. Ducey carried on several bits of trust administration that may be compared to the mailing of premiums in *McGee*. However, the record does not indicate that FIBN as trustee performed any acts in Montana that bear the same relationship to the trust agreement as the solicitation of re-insurance in *McGee*.[128]

In *Frumkin v. First Union Nat'l Bank of Florida (In re* Frumkin), a Tennessee resident, who was the beneficiary of a Florida trust, brought suit in Tennessee to replace the corporate trustee and to move the trust's situs from Florida to Tennessee.[129] The court quoted extensively from *Hanson* and held that the trustee had insufficient contacts with Tennessee (some checks and correspondence were mailed to the beneficiary in Tennessee) to give the court jurisdiction over it.[130]

In *Dreher v. Smithson (In re* George M. Naylor Revocable Ins. Tr.), the Oregon Court of Appeals dismissed, for lack of personal jurisdiction, a proceeding brought by an Oregon resident to remove the two individual trustees of a Massachusetts trust of which she was a beneficiary.[131] The court held that the trustees' contacts with Oregon (the trustees accepted their appointment as successor trustees with knowledge that the plaintiff lived in Oregon) were insufficient to satisfy the demands of due process.[132]

Similarly, in *Rose v. Firstar Bank*, the Rhode Island Supreme Court considered whether Rhode Island courts could adjudicate a lawsuit

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[127] *See* 787 P.2d 749 (Mont. 1990).
[128] *Id.* at 752.
[129] *See* 874 S.W.2d 40 (Tenn. Ct. App. 1993).
[130] *See id.* at 41–43.
[131] *See* 986 P.2d 721 (Or. Ct. App. 1999).
[132] *See id.* at 725.

brought by Rhode Island beneficiaries against an Ohio corporate trustee.[133] The court found the facts of the case to be similar to those of *Hanson* and dismissed the case for lack of personal jurisdiction. The court reasoned:

> This argument, however, stumbles on the principle that "the unilateral activity of those who claim some relationship with a nonresident defendant cannot satisfy the requirement of contact with the forum State." We hold that the bank has not purposefully availed itself of the benefits of Rhode Island law merely by agreeing to and continuing to serve as the trustee for this trust after one of the trust's beneficiaries had moved her residence to this jurisdiction and then continued to reside here with her children.
>
> Further, merely by sending trust statements, by mailing trust-related checks, and by making occasional trust-related telephone calls to the trust beneficiaries who resided in this state, the bank did not thereby purposely avail itself of the privilege of doing business here. Simply put, these communications were not the purposeful availment of doing business in Rhode Island.[134]

A commentator described the implications of *Rose*.

> With the consolidation of the banking industry and the resulting mega-banks conducting business in many states, the likelihood is greater that at least the larger banks will find themselves amenable to process in many states. However, as long as a corporate trustee does not initiate any activity to establish a presence in a jurisdiction other than the site of its administrative offices, the Due Process clause will continue to shield corporate trustees from being sued by disgruntled beneficiaries in the beneficiaries' domiciliary states.[135]

In *Nastro v. D'Onofrio*, the federal district court in Connecticut, relying on *Hanson*, held that it lacked personal jurisdiction over the trustee of a Jersey, Channel Islands, trust because the trustee's contacts with Connecticut (the trustor's unilateral act of settling a trust with stock in Connecticut corporations) were insufficient to justify the exercise of

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[133] *See* 819 A.2d 1247 (R.I. 2003).

[134] *Id.* at 1255 (alteration in original) (citations omitted).

[135] Ronald R. Volkmer, *New Fiduciary Decisions: Jurisdiction Over Out-of-State Bank Trustee*, 30 EST. PLAN. 463, 466 (2003).

jurisdiction under the Due Process Clause.[136]

In *Walker v. West Michigan National Bank and Trust,* the court dismissed an action by a Delaware resident to rescind a 1988 transfer to an irrevocable trust of which a Michigan bank was the successor trustee.[137] The court held that there were insufficient contacts with Delaware (the filing of income-tax returns for the trust) to justify its exercise of personal jurisdiction.[138] In *Walker v. Northern Trust Company*, a different judge of the same court dismissed an action against the corporate trustee of another trust for the same beneficiary because the court lacked personal jurisdiction.[139]

A 1995 Florida case is a cautionary tale for corporate trustees that wish to limit the jurisdictions in which they are subject to personal jurisdiction.[140] In the case, the beneficiaries of an offshore (Cayman Islands) trust sought to have the successor trustee (an Isle of Man corporation) account in Florida for its administration of the trust. Although it appeared that the successor trustee had no Florida contacts, the court denied its motion to dismiss the complaint for lack of personal jurisdiction because it was not clear whether the trustee's Florida attorney, over which the court had jurisdiction, was acting solely as the trustee's legal counsel or as its managing agent.[141]

d. Federal Court Jurisdiction

The circumstances in which a federal district court in a non-DAPT jurisdiction can assert personal jurisdiction over the trustee of a DAPT under federal-question jurisdiction[142] or diversity jurisdiction[143] often will be as described above.[144] The Tenth Circuit has described the limits on a district court's exercise of jurisdiction.

> Unless Congress specifically indicates otherwise, there are two limits on a federal court's ability to assert personal jurisdic-

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[136] *See* Nastro, 263 F. Supp. 2d at 453.
[137] *See* 324 F. Supp. 2d 529 (D. Del. 2004).
[138] *See id.* at 534.
[139] *See* No. 03-795-KAJ, 2004 U.S. Dist. LEXIS 15012 (D. Del. 2004).
[140] *See* Beaubien v. Cambridge Consol. Ltd., 652 So. 2d 936 (Fla. Dist. Ct. App. 1995).
[141] *See id.* at 940.
[142] *See* 28 U.S.C. § 1331 (2000).
[143] *See* 28 U.S.C. § 1332 (2000).
[144] *See* Fed. R. Civ. P. 4(k)(1)(A).

> tion. First, a federal district court may only exercise personal jurisdiction over a defendant "who could be subjected to the jurisdiction of a court of general jurisdiction in the state in which the district court is located." Second, in addition to satisfying this state law requirement, the exercise of personal jurisdiction must "not offend the due process clause of the Fourteenth Amendment."[145]

4. *Implications*

A court will have jurisdiction if the trustee of a DAPT has extensive contacts in the non-DAPT court's jurisdiction, but if all trustees and trust assets are located in the state where the trust was established and if the trustees have insufficient contacts in the non-DAPT jurisdiction, the non-DAPT court will not have jurisdiction over the trust. Trustors and their advisers should keep this in mind in choosing trustees. If a trustee believes that a non-DAPT court lacks jurisdiction, the trustee's best strategy might be to have the trustor litigate the determination of jurisdiction and not participate in that proceeding itself.[146]

If a non-DAPT court lacks jurisdiction over a DAPT and a creditor seeks to enforce a judgment of the non-DAPT court against the trustor in the DAPT state, the creditor will be unable to reach the assets of the trust unless the claim falls within one of the limited exceptions in the relevant DAPT law. If a non-DAPT court does have jurisdiction over the DAPT or its trustee, however, the court's analysis is only beginning.

C. Non-DAPT Court Should/Must Decline Jurisdiction

1. *Introduction*

Section 267 of the Second Restatement of Conflict of Laws provides, "The administration of a trust of interests in movables is usually supervised by the court, if any, in which the trustee has qualified as trustee or by the courts of the state in which the trust is to be administered."[147]

If the trustee of a DAPT has qualified in a DAPT court or if it has not so qualified but the trust is to be administered in a DAPT state, the courts

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[145] United States v. Botefuhr, 309 F.3d 1263, 1271 (10th Cir. 2002) (citations omitted).

[146] *See* Boxx, *supra* note 1, at 1215–16.

[147] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 267 (1971). The comparable provision for inter vivos trusts that hold interests in real property is RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 276 (1971). *See* 5A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 571 at 178–79 (4th ed. 1989).

of the DAPT state will have primary supervision over the administration of the trust and have and will exercise jurisdiction as to all questions that may arise in the administration of the trust.[148] Hence, if a DAPT is created with a trust company as trustee and that trustee is organized and does business in the DAPT state, the courts of the DAPT state will exercise jurisdiction over the administration of the trust.[149]

If a non-DAPT court has jurisdiction over the trustee or the trust, a comment to section 267 suggests that it should defer to the court of primary supervision.

> A court of a state other than that of the testator's domicil or that in which the trust is to be administered will not exercise jurisdiction if to do so would be an undue interference with the supervision of the trust by the court which has primary supervision. Whether there is such interference depends on the relief sought. Thus, if a court acquires jurisdiction over the trustee it may entertain a suit to compel him to redress a breach of trust, even though the trustee has qualified as trustee in a court of another state or the administration of the trust is in another state. It may compel the trustee to render an accounting or it may even remove the trustee. On the other hand, it will ordinarily decline to deal with questions of construction or validity or administration of the trust, leaving these matters to be dealt with by the court of primary supervision. Thus, it will not ordinarily give instructions to the trustee as to his powers and duties.[150]

The Scott treatise also summarized the applicable principles:

> The administration of a trust is ordinarily governed by the law of the state of primary supervision, and the rights of the parties should not be dependent on the fact that a court of some other state happens to have acquired jurisdiction. That court may give a judgment based upon the application of its own local law, or it may attempt to apply the law of the state of primary supervision but mistake that law.[151]

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[148] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 267 cmt. e (1971).
[149] *See id.*
[150] *Id.*
[151] See SCOTT & FRATCHER, *supra* note 147, § 573, at 190.

2. UPC Approach

Section 7-203 of the Uniform Probate Code ("UPC") provides:

> The Court will not, over the objection of a party, entertain proceedings under Section 7-201 involving a trust registered or having its principal place of administration in another state, unless (1) when all appropriate parties could not be bound by litigation in the courts of the state where the trust is registered or has its principal place of administration or (2) when the interests of justice otherwise would seriously be impaired.[152]

At present, section 7-203 is in effect in the above form in ten states.[153] The Florida version, which does not contain the interests of justice exception, reads:

> Over the objection of a party, the court shall not entertain proceedings under § 737.201 for a trust registered, or having its principal place of administration, in another state unless all interested parties could not be bound by litigation in the courts of the state where the trust is registered or has its principal place of administration. The court may condition a stay or dismissal of a proceeding under this section on the consent of any party to jurisdiction of the state where the trust is registered or has its principal place of business, or the court may grant a continuance or enter any other appropriate order.[154]

3. Case Law

In *Bartlett v. Dumaine*, the Supreme Court of New Hampshire held that the courts of New Hampshire should defer to the courts of Massachusetts on the duty of the trustees of a Massachusetts trust to account to its beneficiaries. The court required deference even though the New Hampshire court had personal jurisdiction over all interested parties.[155] The Scott treatise cited cases in California, Illinois, Massachu-

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[152] UPC § 7-203 (1974).

[153] *See* ALASKA STAT. § 13.36.045 (1962); ARIZ. REV. STAT. § 14-7205 (2004); COLO. REV. STAT. § 15-16-203 (2003); HAW. REV. STAT. § 560:7-203 (1999); IDAHO CODE § 15-7-203 (2003); MICH. COMP. LAWS § 700.7203 (2002); N.C. GEN. STAT. § 36A-25.1 (2003); N.D. CENT. CODE § 30.1-33-03 (1996); S.C. CODE ANN. § 62-7-203 (1987); UTAH CODE ANN. § 75-7-204 (1993).

[154] *See* FLA. STAT. § 737.203 (1974).

[155] *See* 523 A.2d 1, 14–15 (N.H. 1986).

setts, New Jersey, New York, Pennsylvania, and Texas that reached comparable results.[156]

D. Non-DAPT Court Should Apply DAPT Law

1. Rules for DAPTs

Section 270 of the Second Restatement of Conflict of Laws provides in relevant part:

> An inter vivos trust of interests in movables is valid if valid (a) under the local law of the state designated by the settlor to govern the validity of the trust, provided that this state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6 . . . .[157]

Questions involving the "validity" of trust provisions relate to whether the trust violates the rule against perpetuities or a rule against accumulations.[158] Section 270 permits a court to consider the strong public policy of the jurisdiction with which a trust has its most significant relationship (which might or might not be the law designated by the trust instrument) in assessing the validity of a trust. According to the authorities, the strong-public-policy issues that justify departure from section 270's general rule involve those trust provisions designed to defeat a surviving spouse's right of election and those that violate a jurisdiction's restrictions on testamentary gifts to charity.[159] Jurisdictional differences in the rule against perpetuities do not justify departure.[160]

The comments to the Second Restatement of Conflict of Laws, the Scott treatise, and the Bogert treatise do not address whether the recogni-

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[156] *See* SCOTT & FRATCHER, *supra* note 147, § 570, at 176 n.29.

[157] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 270 (1971). *See* SCOTT & FRATCHER, *supra* note 147, §§ 555, 587, 597–603; BOGERT & BOGERT, *supra* note 2, § 297. For the rules that apply to inter vivos trusts that hold interests in real property, see RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 278 (1971); SCOTT & FRATCHER, *supra* note 147, §§ 643, 652; BOGERT & BOGERT, *supra* note 2, § 297.

[158] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 269 cmt. d (1971); BOGERT & BOGERT, *supra* note 2, § 293, at 253–54.

[159] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 269 cmts. c, i, § 270 cmts. b, e (1971); SCOTT & FRATCHER, *supra* note 147, § 601; BOGERT & BOGERT, *supra* note 2, § 294, at 268–70, § 297, at 298–99, § 301, at 330.

[160] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 269 cmt. i (1971).

tion of self-settled trusts by one state violates a strong public policy of another state, and apparently no cases or rulings address this point. There are apparently only four instances in which a court or the Service considered whether or not self-settled trusts violated a state's strong public policy in other contexts. In *State v. Henneberry*, the Connecticut Superior Court held that the use of a court-created self-settled trust to qualify the recipient of a personal-injury award for public assistance would violate a strong public policy of Connecticut.[161] Moreover, the Tax Court held, in *Outwin v. Commissioner*, that the strong public policy of Massachusetts prevented the creation of self-settled trusts from being completed gifts (so that the trusts were includable in the trustor's gross estates),[162] and, in comparable circumstances, the Service reached the same result under California law.[163] In *Estate of German v. United States*, though, the Claims Court, in similar circumstances, held that there was not a strong public policy against self-settled trusts under Maryland law.[164] If differences between rules against perpetuities do not amount to differences in strong public policy, differences as to the recognition of self-settled trusts should not either.

Nevertheless, the "validity" of a DAPT should not be in question because trustors create valid self-settled trusts, such as revocable trusts and charitable-remainder trusts ("CRTs"), all the time. The pertinent inquiry concerns the extent, if any, to which creditors can reach the assets of a DAPT. For trusts that hold personal property, section 273—not section 270—of the Second Restatement of Conflict of Laws is the starting point for this analysis.[165] It provides:

> Whether the interest of a beneficiary of a trust of movables is assignable by him and can be reached by his creditors is determined
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> (b) in the case of an inter vivos trust, by the local law of the state . . . in which the settlor has manifested an intention that the

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[161] *See* No. CV0200986675, 2003 Conn. Super. LEXIS 3464 (Conn. Super. Ct. 2003).

[162] *See* 76 T.C. at 166 (1981).

[163] *See* Tech. Adv. Mem. 199917001 (Jan. 15, 1999).

[164] *See* 55 A.F.T.R.2d 1577 (Cl. Ct. 1985).

[165] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 273 (1971). *See also* SCOTT & FRATCHER, *supra* note 147, §§ 625–28; BOGERT & BOGERT, *supra* note 2, § 293, at 260–61. For the rules that apply to inter vivos trusts that hold interests in real property, see RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 280 (1971); SCOTT & FRATCHER, *supra* note 147, § 660; BOGERT & BOGERT, *supra* note 2, § 293, at 260–61.

> trust is to be administered . . . .[166]

Unlike section 270, section 273 and its comments do not contemplate that a different rule might apply if the law of the trust's situs violates a strong public policy of another state. Consequently, the law that governs a DAPT should be determinative with respect to the ability of creditors to reach trust assets.

The Scott treatise suggested that there might be a strong-public-policy exception to the rule in section 273.

> If the settlor creates a trust to be administered in a state other than that of his domicil, the law of the state of the place of administration, rather than that of his domicil, ordinarily is applicable. Thus, a settlor domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state. In that case the law of that state will be applicable as to the rights of creditors to reach the beneficiary's interest.
>
> This permits a person who is domiciled in a state in which restraints on alienation are not permitted, to create an inter vivos trust in another state where they are permitted and thereby take advantage of the law of the latter state. It would seem, however, that there is nothing objectionable in this, at least if there is no strong public policy forbidding it in the state of his domicil.[167]

However, the treatise takes the position that a difference in the effectiveness of spendthrift clauses should not justify a departure from the general rule.

> It would seem that the policy of a state, whether it be to restrain alienation in order to protect the beneficiary, or to permit alienation in order to protect creditors and assignees, is not so strong as to preclude the application of the law to the contrary prevailing in another state.[168]

The Scott treatise criticized dictum in *Erdheim v. Mabee*, which suggested that the forum court should have more latitude,[169] and stated, "If

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[166] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 273 (1971).
[167] SCOTT & FRATCHER, *supra* note 147, § 626, at 419 (footnote omitted).
[168] *Id.* at 414 (footnote omitted).
[169] *See* 113 N.E.2d 433 (N.Y. 1953).

this means that any court that acquires jurisdiction over the trust property can properly apply its own law as to the rights of creditors to reach the trust property, regardless of the law of the situs of the trust, it is submitted that this dictum cannot be supported."[170]

The Scott treatise summarized:

> There are conflicting policies in the various states as to the rights of creditors of a beneficiary of a trust of movables to reach his interest and as to the rights of assignees of his interest. There is a policy in some states to protect the beneficiary; there is a policy in other states to protect the creditors and assignees; and in some states there is a policy that, within limits, protects them both. Where more than one state is involved, the question is which state's law will be applied.
>
> Although the matter is not entirely clear, it is submitted that the applicable law should, ordinarily at least, be the law of the state of the situs of the trust. To the extent that under that law a beneficiary's interest cannot be reached by creditors or assignees, it cannot be reached in any state . . . .
>
> If under the law of the state of the situs of the trust a beneficiary's interest cannot be reached, it should be immaterial in what state the proceeding to reach it is brought; the law of the forum, merely because it is the law of the forum, should not be applied. It should be immaterial in what state the beneficiary was domiciled, in what state his creditor or assignee was domiciled, or in what state the debt was incurred or the assignment made.[171]

When the Scott treatise was written, some U.S. jurisdictions did not respect spendthrift trusts at all, whereas others did so to one degree or another. The treatise suggested that differences between laws did not constitute differences of strong public policy. Today, every U.S. jurisdiction respects some form of third-party spendthrift trust and the asset-protection effectiveness of a variety of self-settled vehicles. Recognition of self-settled trusts should not justify departure from the general rule.

Section 505(a)(2) of the UTC[172] does not give effect to self-settled spendthrift trusts, and UTC section 105(b)(5)[173] does not permit a govern-

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[170] SCOTT & FRATCHER, *supra* note 147, § 626, at 417 (footnote omitted).
[171] *Id.* § 628, at 434.
[172] *See* UTC § 505(a)(2) (2004).
[173] *See id.* § 105(b)(5).

ing instrument to depart from that rule. This does not necessarily mean that a trustor who lives in a state that has adopted the UTC may not create an effective DAPT because section 107(1) of the UTC permits a trustor to choose the law to govern the meaning and effect of the terms of the trust, unless the law is contrary to a strong public policy of the jurisdiction that has the most significant relationship to the matter at issue.[174] The UTC does not specify the strong public policies that will invalidate the choice of law. It appears, however, that section 105(b)(5) does not trump section 107(1).[175]

2. Rules for Offshore APTs

In three recent cases (all of which probably involved fraudulent transfers) U.S. courts applied U.S. laws, rather than the foreign laws designated in the trust instruments, to determine whether creditors could reach trust assets.

The first case was *Marine Midland Bank v. Portnoy (In re* Portnoy), which involved the plaintiff's attempts to collect its $1 million loan to the debtor's company that was guaranteed by the debtor.[176] When the company began to encounter financial difficulties, the debtor transferred his assets to a Jersey, Channel Islands, trust. The court denied the debtor's motion for summary judgment, and held that New York law, rather than Jersey law, determined whether the trust was valid.[177]

The second case was *Sattin v. Brooks*, in which the debtor transferred personal property to his wife who then transferred it to Jersey, Channel Islands, and Bermuda trusts shortly before he filed for bankruptcy.[178] The court granted the plaintiff's motion for summary judgment, found that the trusts were part of the bankruptcy estate, and held that Connecticut law was determinative.[179]

The third case involved the notorious Stephan Jay Lawrence. The Eleventh Circuit summarized the background of the case.

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[174] *See id.* § 107(1).

[175] Richard B. Covey & Dan T. Hastings, *The Uniform Trust Code—Part I*, Prac. Drafting 7420, 7425 (Oct. 2003).

[176] *See* 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

[177] *See id.* at 698–701.

[178] *See* 217 B.R. 98 (Bankr. D. Conn. 1998).

[179] *See id.* at 101–02. For discussions of *Portnoy* and *Brooks*, see Lischer, *supra* note 41, at 593–96; Gideon Rothschild et al., *Self-Settled Spendthrift Trusts: Should A Few Bad Apples Spoil the Bunch?*, 32 VAND. J. TRANSNAT'L L. 763 (1999).

> In January 1991, Lawrence settled an offshore Trust, with an estimated value of $7 million dollars. According to the Trust, Lawrence had the sole power to appoint Trustees. Two months later, an arbitration judgment was issued against him in the amount of $20.4 million dollars. Over time, several amendments were made to the Trust. In February 1991, a spendthrift provision was added. In January 1993, the Trust was amended so that settlor's powers could not be executed under duress or coercion and his life interest would terminate in the event of his bankruptcy. In March 1995, an amendment was added declaring Lawrence to be an "excluded person" under the Trust, thus proscribing his ever becoming a beneficiary of the Trust. Finally, in 1999, the Trustees issued a "Declaration of Intent" stating that the excluded person status was irrevocable.[180]

Previously, the bankruptcy court had concluded that Florida law rather than Mauritian law determined the effectiveness of the trust.

> When in bankruptcy, debtors may claim exempt property, and they may engage in pre-bankruptcy "exemption planning." Indeed, debtors will not be penalized for making "full use" of available exemptions. Exemption planning, however, is a far cry from the type of hide-the-ball, "catch me if you can" conduct evidenced by the Debtor in this case. Unfortunately, he is apparently not alone in his belief that this conduct is acceptable. There is a growing body of case law surrounding debtors who have secreted their assets in distant jurisdictions with laws which would make the stereotypical Swiss banker proud. For example, in *In re* Portnoy, a case with strikingly similar facts, the court held that to apply the law of the chosen offshore trust situs, in that case the Jersey Channel Islands, would "offend strong [state] and Federal bankruptcy policies if applied."
>
> The *Portnoy* court further stated that "while under normal circumstances parties are free to designate what state's or nation's law will govern their rights and duties, where another state or nation has a dominant interest in the transaction at issue, and the designated law offends a fundamental policy of that dominant

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[180] Lawrence v. Goldberg (*In re* Lawrence), 279 F.3d 1294, 1296 (11th Cir. 2002) (footnote omitted).

> state, the court may refuse to apply the foreign law." The court held that equity would not countenance a debtor's unilaterally removing "the characterization of property as his simply by incorporating a favorable choice of law provision into a self settled trust of which he is the primary beneficiary."[181]

Elsewhere, the bankruptcy court said, "Candidly, it appears the Debtor would have set the trust up on Mars if he could have."[182]

In *Walker v. Weese*, the debtors allegedly transferred assets to a Cook Islands trust after they incurred $24 million in debts (including a $16 million debt to Bank of America).[183] The federal district court in Maryland rejected their claim for a jury trial and remanded the case to the bankruptcy court to determine, inter alia, whether Maryland or Cook Islands law applied,[184] but the case was settled before this issue was resolved.

3. Why the Rules are Different

For conflict-of-laws purposes, the law designated in a DAPT should be respected, whereas the law designated in an offshore APT often should not. Section 10 of the Second Restatement of Conflict of Laws contemplates this distinction and provides that:

> The rules in the Restatement of this Subject apply to cases with elements in one or more States of the United States and are generally applicable to cases with elements in one or more foreign nations. There may, however, be factors in a particular international case which call for a result different from that which would be reached in an interstate case.[185]

Comment d to section 10 amplifies the distinction.

> (2) Within the United States, there are safeguards under the Constitution of the United States, such as the due process clause of the Fourteenth Amendment, which give a large measure of legal assurance of fairness of official action within each State. The lack of such safeguards in an international conflicts case

181 Goldberg v. Lawrence (*In re* Lawrence), 227 B.R. 907, 917 (Bankr. S.D. Fla. 1998) (alteration in original) (citations and footnote omitted).
182 *Id.* at 912 n.11.
183 *See* 286 B.R. 294 (D. Md. 2002).
184 *See id.* at 300 n.6.
185 RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 10 (1971).

> may call for closer scrutiny or different treatment. (3) Within the United States, there are authoritative constitutional rules . . . which do not bind courts of other nations and which may not apply to an international conflicts case in the United States. A court in the United States, in any event, should be guided by the policies of fairness and equality embodied in these constitutional rules in deciding an international case to which these rules are not strictly applicable.[186]

Although the DAPT and offshore APT statutes give effect to self-settled trusts, offshore trusts, unlike DAPTs, openly flout the U.S. judicial system. Thus, unlike DAPTs, they frustrate the setting aside of fraudulent transfers, the enforcement of judgments obtained elsewhere, and the engagement of local counsel.

E. DAPT Court Might Not Need to Give Full Faith and Credit to Judgment of Non-DAPT Court

1. *Introduction*

In this country, "Full Faith and Credit shall be given in each State to the public Acts, Records, and Judicial Proceedings of every other State."[187]

2. *Respect Due Statutes*

a. *The* Hyatt *Case*

The Full Faith and Credit Clause applies to the statutes as well as to the judgments of another state, but it does not operate in the same manner with respect to them. A recent U.S. Supreme Court case that illustrates the application of the Full Faith and Credit Clause to state statutes is *Franchise Tax Board v. Hyatt*. In *Hyatt* the Court had to decide whether the Nevada Supreme Court's refusal to extend full faith and credit to a California statute that immunized a California tax-collection agency from suit violated the Full Faith and Credit Clause.[188] In contrasting the application of the Full Faith and Credit Clause to statutes and to judgments, Justice O'Connor, speaking for a unanimous Court, wrote:

> "[O]ur precedent differentiates the credit owed to laws (legislative measures and common law) and to judgments." Whereas the Full

[186] *Id.* cmt. d.
[187] U.S. CONST. art. IV, § 1.
[188] *See* 538 U.S. 488 (2003).

> Faith and Credit command "is exacting" with respect to "[a] final judgment . . . rendered by a court with adjudicatory authority over the subject matter and persons governed by the judgment," it is less demanding with respect to choice of laws. We have held that the Full Faith and Credit Clause does not compel "'a state to substitute the statutes of other states for its own statutes dealing with a subject matter concerning which it is competent to legislate'."[189]

The court concluded that Nevada need not give full faith and credit to the California statute and Justice O'Connor declared:

> States' sovereignty interests are not foreign to the Full Faith and Credit command. But we are not presented here with a case in which a State has exhibited a "policy of hostility to the public Acts" of a sister State. The Nevada Supreme Court sensitively applied principles of comity with a healthy regard for California's sovereign status, relying on the contours of Nevada's own sovereign immunity from suit as a benchmark for its analysis.
>
> In short, we heed the lessons learned as a result of *Bradford Elec. Light Co. v. Clapper* and its progeny. Without a rudder to steer us, we decline to embark on the constitutional course of balancing coordinate States' competing sovereign interests to resolve conflicts of laws under the Full Faith and Credit Clause.[190]

The decision in *Hyatt* is consistent with comment d to section 145 of the Second Restatement of Conflict of Laws, which provides that "subject only to rare exceptions, the local law of the state where conduct and injury occurred will be applied to determine whether the actor satisfied minimum standards of acceptable conduct and whether the interest affected by the actor's conduct was entitled to legal protection."[191]

The Full Faith and Credit Clause does not compel a court in one state to adopt a statute of another state, but a court may not simply ignore another state's law. Whether, and to what extent, a state court may apply its own law to the exclusion of another state's law that, at least as a matter of argument, is more applicable is often a close question.

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[189] *Id.* at 494 (alteration in original) (citations omitted).
[190] *Id.* at 499 (citations omitted).
[191] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 145 cmt. d (1971).

b. The Phillips Petroleum *Case*

The U.S. Supreme Court did not permit a state court to ignore statutes of other states in *Phillips Petroleum Co. v. Shutts*.[192] In *Phillips*, which was a class action brought by investors in Phillips Petroleum, a Kansas court entered judgment for the class and applied the Kansas law to the claims of all class members because no compelling reason had been shown for applying any other law.[193] The Court reversed in part and held that, although Kansas was not necessarily required to substitute the law of another state for its own, under the Due Process Clause and Full Faith and Credit Clause, Kansas could not apply its own law merely because it had jurisdiction over the parties who, besides being members of the class, had no relationship to Kansas.[194] In reaching its decision, the Court confirmed that "for a State's substantive law to be selected in a constitutionally permissible manner, that State must have a significant contact or significant aggregation of contacts, creating state interests, such that choice of its law is neither arbitrary nor fundamentally unfair."[195]

The decisions in *Hyatt* and *Phillips Petroleum* demonstrate that a court has some latitude under the Full Faith and Credit Clause in giving effect to the statutes of other states. A court may not reject another state's laws without reason, however, and the Supreme Court, as self-described "final arbiter" of exceptions to the Full Faith and Credit Clause, will determine the extent of any exceptions to that Clause.[196]

c. The Warner *Case*

One should not assume that a court will apply the law of the forum in every case, even if it might be able to do so. For example, in *Warner v. Florida Bank & Trust Co.*, the Fifth Circuit applied Minnesota law to a trust created under Minnesota law even though the parties were in the process of moving to Florida, where the trust was presumptively void.[197] The court declared that only when a contract right under another state's laws is "obnoxious" to the law of the forum would the forum court with-

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[192] *See* 472 U.S. 797 (1985).
[193] *See id.* at 799, 803.
[194] *See id.* at 821–22.
[195] *Id.* at 818 (citation omitted).
[196] *See* Magnolia Petroleum Co. v. Hunt, 320 U.S. 430 (1943), *overruled* on other grounds by Thomas v. Wash. Gas Light Co., 448 U.S. 261 (1980).
[197] *See* 160 F.2d 766 (5th Cir. 1947).

hold aid in enforcement of that other state's laws.[198] The *Warner* court based its decision on choice of law principles rather than on the Full Faith and Credit Clause, and this is significant because application of the Full Faith and Credit Clause tends to involve issues of jurisdiction and choice of law. The cases concerning the application of another state's statute by the forum state and the willingness of the forum court to apply another state's statutes illustrate that the court's decision will be affected by all of these factors.

d. Implications

Although the forum court will often have discretion in applying a sister state's statute, the facts before the court in some cases will strongly suggest, or perhaps even require, as in *Phillips Petroleum*, the application of a state's law other than the law of the forum. On the one hand, a court of the state in which the defendant resides may have a strong argument for the imposition of the law of the forum because of the defendant's residence and because the plaintiff, whatever his or her residence, must have chosen the forum. On the other hand, the factors that support the choice of the law of the forum are weaker when jurisdiction over the defendant (and, in the case of a DAPT, the trustee) has been acquired through some "long-arm" process.

Thus, for choice-of-law issues, the Full Faith and Credit Clause may prove to be more of a benefit than a burden to a DAPT because it requires full faith and credit for the statutes of each state. Although a court in the United States may simply ignore the legislation of the Cook Islands, the court is required to respect the legislative acts of a sister state that has adopted APT legislation even if the court ultimately concludes that it may constitutionally apply the law of the forum. To protect a Delaware APT from vulnerability under the Full Faith and Credit Clause, Delaware law provides that the trustee of a Delaware APT will cease to act if a court decides that Delaware law does not govern the validity, construction, or administration of the trust or the effect of its spendthrift clause.[199]

3. Respect Due Judgments

As noted above, the U.S. Supreme Court declared in *Franchise Tax Board v. Hyatt* that "the full faith and credit command 'is exacting' with

[198] *Id.* at 772.
[199] *See* DEL. CODE ANN. tit. 12, § 3572(g) (Supp. 2004).

respect to '[a] final judgment . . . rendered by a court with adjudicatory authority over the subject matter and persons governed by the judgment.'"[200] Nevertheless, the Court also stated in *Baker ex rel. Thomas v. General Motors Corp.*:

> Full faith and credit, however, does not mean that States must adopt the practices of other States regarding the time, manner, and mechanisms for enforcing judgments. Enforcement measures do not travel with the sister state judgment as preclusive effects do; such measures remain subject to the evenhanded control of forum law.[201]

The Alaska, Delaware, Rhode Island, Nevada, South Dakota, and Utah APT statutes anticipate an attack based on the Full Faith and Credit Clause. For example, the Delaware statute is intended to operate upon actions, rather than mere claims, and to bar all actions, including actions to enforce judgments, unless brought within the appropriate periods allowed by Delaware law.[202]

Substantial authority exists for the validity of the approach taken in the Alaska, Delaware, Rhode Island, Nevada, South Dakota, and Utah statutes. In *Matanuska Valley Lines, Inc. v. Molitor*, the Ninth Circuit held that statutes limiting the time in which actions to enforce judgments may be brought are procedural, and that a time limitation on such actions does not violate the Full Faith and Credit Clause.[203]

In *Watkins v. Conway*, the U.S. Supreme Court upheld a Georgia statute that denied enforcement of a Florida judgment.[204] The Supreme Court upheld the Georgia statute even though it applied only to judgments of other states because it found that the judgment had also expired and could no longer be revived in Florida. In dictum appearing in a footnote, however, the Court remarked that it would have faced a different question if the judgment could have been revived in Florida.[205]

The implication of the Court's footnote in *Watkins* is that Georgia would not have been permitted to deny enforcement of the Florida judgment if it was enforceable, or could have been made enforceable, in

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[200] 538 U.S. at 494 (2003) (alteration in original) (citation omitted).
[201] 522 U.S. 222, 235 (1998).
[202] *See* DEL. CODE ANN. tit. 12, § 3572(a) (2001).
[203] 365 F.2d 358, 360 (9th Cir. 1966).
[204] *See* 385 U.S. 188 (1966).
[205] *See id.* at 191 n.4.

Florida. Georgia could not refuse to enforce a valid Florida judgment of a given date, when at the same time it would enforce a Georgia judgment of the same date, without affording the foreign judgment less credit than its own and apparently violating the Full Faith and Credit Clause.

The Delaware statute makes no distinction between its own judgments and those of other states. No action to enforce any judgment, Delaware or otherwise, may proceed unless brought within the appropriate periods prescribed by the Delaware statute. To this extent, the Delaware statute fits squarely within the "evenhanded control of forum law" test set forth by the Court in *Baker*.[206] Unless the Full Faith and Credit Clause is later held to stand for the proposition that a state is required to operate its judicial system with multiple procedures, one for its own citizens and others to match the procedures available in other jurisdictions, the provisions of the Delaware statute should not be found to violate the Full Faith and Credit Clause. The Alaska, Rhode Island, Nevada, South Dakota, and Utah approaches to this critical issue seem similar to that of Delaware.

The proposition that DAPT statutes may set limitations periods for the enforcement of judgments obtained in other jurisdictions is supported by comment f to section 142 of the Second Restatement of Conflict of Laws.

Opponents of DAPTs, including creditors of the trustors of such trusts, must take into account that the Full Faith and Credit Clause is more likely to protect such trusts than to be useful in setting them aside. The laws of foreign countries receive no respect under the Full Faith and Credit Clause.

4. *Improper Interference With Important Interests of DAPT State*

a. *Introduction*

A DAPT court might not be required to give full faith and credit to a judgment rendered by a non-DAPT court. Section 103 of the Second Restatement of Conflict of Laws provides:

> A judgment rendered in one State of the United States need not be recognized or enforced in a sister State if such recognition or enforcement is not required by the national policy of Full Faith and Credit because it would involve an improper interference with important interests of the sister State.[207]

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[206] *Baker*, 522 U.S. at 235.
[207] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 103 (1988).

Section 103's comments emphasize that it has an extremely narrow scope of application.[208] Nevertheless, authorities indicate that section 103 might apply if a DAPT court is asked to give full faith and credit to a judgment rendered by a non-DAPT court.

b. Scott Treatise Analysis

The Scott treatise addressed the issue:

> In some situations, however, the court that has primary supervision over the administration of the trust may regard the judgment as an undue interference with its power to control the administration. It may take the position that the court in rendering the judgment applied its local law, whereas it should have applied the law of the state of primary supervision, or that, if it had attempted to apply the law of the state of primary supervision, it had mistaken that law. The question then is whether the court of primary supervision is bound to give Full Faith and Credit to the judgment. The final determination of this question rests, of course, with the Supreme Court of the United States.[209]

The Supreme Court held in *Hanson v. Denckla* that the courts of Delaware were not required to give full faith and credit to a judgment of a Florida court that lacked jurisdiction over the trustee and the trust property.[210] The Scott treatise stated, "It seems clear that the Florida court in applying its local law and in holding that the Delaware trust and the exercise of the power of appointment thereunder were invalid was unduly interfering with the administration of the trust by the Delaware courts."[211]

The Scott treatise described the implications of the above observation:

> Since the Delaware court could properly regard the judgment of the Florida court as an undue interference with the administration of the trust that was fixed in Delaware, it should not be bound by that judgment although the Florida court had jurisdiction over some or all of the beneficiaries. Indeed, it may well be argued that the Delaware court would not be bound by the Florida judgment even though the Florida court had jurisdiction over the trustee

[208] *Id.* cmts. a–b.
[209] SCOTT & FRATCHER, *supra* note 147, § 573, at 191.
[210] *See supra* text accompanying notes 121–22.
[211] SCOTT & FRATCHER, *supra* note 147, § 573, at 193.

> also. A court might acquire jurisdiction over an individual trustee who happened to be in the state or over a corporate trustee that happened to have such connection with the state as to give the state jurisdiction over it, or the trustee might appear in the action. It is submitted that the judgment would nevertheless be an undue interference with the administration of the trust by the Delaware courts.
>
> It might, indeed, be held that not only would the Delaware courts not be bound to give Full Faith and Credit to the Florida judgment but that the Florida judgment would be such an interference with the administration of the trust that it would be invalid as a denial of due process of law.[212]

The Scott treatise suggested that the same principle should apply in other contexts:

> In *Hanson v. Denckla* the issue was as to the validity of the disposition of the trust property. A similar question may arise as to the effect of a judgment rendered by a court other than the court that has primary supervision, giving instructions to the trustee as to his powers and duties or authorizing or directing the trustee to deviate from the terms of the trust. These matters are certainly ordinarily for the determination by the court that has primary supervision over the administration of the trust. Certainly in most cases the courts of other states would decline to exercise jurisdiction even though they happened to acquire jurisdiction over the trustee or some of the beneficiaries. If, however, such a court does exercise jurisdiction, the Supreme Court might well hold that the court of primary supervision is not bound to give full faith and credit to the judgment. Indeed, it might hold the judgment to be invalid even in the state that rendered it on the ground that it is an undue interference with the administration of the trust and a denial of due process of law.[213]

c. *Lewis v. Hanson*

In *Lewis v. Hanson*, the Supreme Court of Delaware unequivocally stated that the Delaware courts would not have been required to give full

[212] *Id.* at 194 (footnote omitted).
[213] *Id.* at 195.

faith and credit to a Florida judgment even if the Florida courts had jurisdiction over the trustee, the trust property, or both.[214] The court declared:

> [W]e think the public policy of Delaware precludes its courts from giving any effect at all to the Florida judgment of invalidity of the 1935 trust. We are dealing with a Delaware trust. The trust *res* and trustee are located in Delaware. The entire administration of the trust has been in Delaware. The attack on the validity of this trust raises a question of first impression in Delaware and one of great importance in our law of trusts. To give effect to the Florida judgment would be to permit a sister state to subject a Delaware trust and a Delaware trustee to a rule of law diametrically opposed to the Delaware law. It is our duty to apply Delaware law to controversies involving property located in Delaware, and not to relinquish that duty to the courts of a state having at best only a shadowy pretense of jurisdiction.[215]

d. Bartlett v. Dumaine

The Supreme Court of New Hampshire applied the above principles in *Bartlett v. Dumaine*.[216] In *Bartlett* the beneficiaries of a New Hampshire trust (the Dumaine Trust) and a Massachusetts trust (the Dexter Trust) brought claims against the trustees of the two trusts.[217] The court affirmed the master's and the lower court's findings that the claims against the trustees of the New Hampshire trust were meritless. The court cited section 103 of the Second Restatement of Conflict of Laws and sections of an earlier edition of the Scott treatise and dismissed the request for an accounting for the Massachusetts trust. The court dismissed the request even though it had personal jurisdiction over all interested parties and stated:

> In determining whether the superior court should have exercised or declined to exercise its jurisdiction in this case, we consider the relationships which New Hampshire and Massachusetts have with the Dexter Trust. New Hampshire's interest in the proper administration of Dexter is substantial because Dumaines, a New Hampshire trust, has the vested remainder interest in Dex-

[214] *See* 128 A.2d 819 (Del. 1957).
[215] *Id.* at 835 (citation omitted).
[216] *See* 523 A.2d 1.
[217] *See id.* at 4.

> ter. Nevertheless, we cannot help but conclude that Massachusetts' interest in the administration of Dexter is greater. Both the petitioners and the respondents acknowledge that Dexter is a Massachusetts trust which is administered in Massachusetts, and which is governed by the trust law of that commonwealth. The question we are asked to decide is whether the Dexter trustees need only account to the Dumaines' trustees under the Massachusetts general rule that in matters involving the trust and the outside world the trustees represent the beneficiaries, or whether the Dexter trustees must account directly to the Dumaines' beneficiaries under exceptions to the general rule which govern when certain conflicts of interest exist. It is our conclusion that the Massachusetts courts and not those of New Hampshire, are the courts of "primary supervision" over the Dexter Trust and the satellite trusts, and that this question should be left to a Massachusetts court to decide.
>
> Both New Hampshire and Massachusetts jealously seek to preserve jurisdiction over their own trusts. Both states also willingly decline jurisdiction over another state's trust. Both practices are sound. Although there is a strong policy favoring an end to litigation, there is an equally strong policy favoring the orderly administration of trusts.[218]

The court concluded its discussion and stated:

> A final consideration stays our hand from divining the law of Massachusetts in this area, namely, what effect that Commonwealth is likely to give any judgment we might render. "A judgment rendered in one State of the United States need not be recognized or enforced in a sister State if such recognition or enforcement is not required by the national policy of Full Faith and Credit because it would involve an improper interference with important interests of the sister State." There is ample evidence that the Massachusetts Supreme Judicial Court would consider a decision by this court regarding the Dexter trustees duty to account, as improper interference with the Commonwealth's important interests.[219]

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[218] *Id.* at 14–15 (citations omitted).
[219] *Id.* at 15 (citations omitted).

F. DAPT Should Survive Bankruptcy

1. Introduction

If a creditor attempts to reach the assets of a DAPT to satisfy a claim, the debtor's other assets probably are minimal, and the creditor's ability to reach the debtor's trust interest might be determined in bankruptcy court. A debtor may file a voluntary petition for bankruptcy[220] or creditors may file an involuntary petition against the debtor.[221]

In bankruptcy, the creditor will not need to establish in rem jurisdiction over trust assets or personal jurisdiction over a trustee because the applicable federal district court has exclusive jurisdiction over all of the debtor's assets, wherever located,[222] and because of nationwide service of process in bankruptcy proceedings.[223] Nonetheless, this might not really be a victory for the creditor.[224]

2. The Trust Exclusion

Under section 541(a)(1) of the Bankruptcy Code, a debtor's bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[225] Under section 541(c)(1) of the Bankruptcy Code, the debtor's interest in property "becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law."[226] Nevertheless, section 541(c)(2) of the Bankruptcy Code provides, "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."[227] Courts have held that bankruptcy trustees do not succeed to beneficiaries' interests in discretionary spendthrift trusts created by third parties.[228]

It might appear that section 541(c)(2) is limited to traditional spend-

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[220] *See* 11 U.S.C. § 301 (2000).
[221] *See* 11 U.S.C. § 303 (2000).
[222] *See* 28 U.S.C. § 1334(e) (2000).
[223] *See* 11 U.S.C. § 7004(d) (2000).
[224] *See* David G. Shaftel & David H. Bundy, *Domestic Asset Protection Trusts and the Bankruptcy Challenge*, 32 EST. PLAN. 14 (2005).
[225] 11 U.S.C. § 541(a)(1) (2000).
[226] 11 U.S.C. § 541(c)(1) (2000).
[227] 11 U.S.C. § 541(c)(2) (2000).
[228] *See* First Northwestern Trust Co. v. IRS, 622 F.2d 387 (8th Cir. 1980); Mann v. Kreiss (*In re* Kreiss), 72 B.R. 933, 942 (Bankr. E.D.N.Y. 1987).

thrift trusts, but the U.S. Supreme Court held in *Patterson v. Shumate* that a debtor's interest in an ERISA-qualified plan was excludable from his bankruptcy estate.[229] The Court concluded that, "The natural reading of the provision entitles a debtor to exclude from property of the estate any interest in a plan or trust that contains a transfer restriction enforceable under any relevant nonbankruptcy law."[230]

Although the Supreme Court said in *Patterson* that the clarity of section 541(c)(2) obviated the need to consider the section's legislative history,[231] the Court also declared that:

> These meager excerpts reflect at best congressional intent to *include* state spendthrift trust law within the meaning of "applicable nonbankruptcy law." By no means do they provide a sufficient basis for concluding, in derogation of the statute's clear language, that Congress intended to *exclude* other state and federal law from the provision's scope.[232]

Following *Patterson*, courts have held that bankruptcy estates do not include a debtor's beneficial interest in assets held by the trustees of a municipal employees' retirement plan,[233] a retirement plan that might no longer qualify under ERISA,[234] a 401(k) plan in which the Service sought to secure a claim,[235] a Keogh Plan,[236] a 403(b) plan,[237] or an IRA.[238]

The Alaska, Delaware, South Dakota, and Utah APT statutes (but not the Rhode Island and Nevada statutes) specifically provide that the spendthrift clause in an APT is to be considered a restriction described in section 541(c)(2).[239] The Sixth Circuit held, "An inquiry under section 541(c)(2)

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[229] *See* 504 U.S. 753 (1992). *See* Yates v. Hendon, 541 U.S. 1 (2004); Rupp v. Kunz (*In re* Kunz), 2005 U.S. App. LEXIS 1282 (10th Cir. 2005); *Gill*, 345 F.3d at 1040–41; Ostrander v. Lalchandani (*In re* Lalchandani), 279 B.R. 880 (B.A.P. 1st Cir. 2002); Johnston v. Mayer (*In re* Johnston), 218 B.R. 813 (Bankr. E.D. Va. 1998).

[230] *Id.* at 758.

[231] *See id.* at 761.

[232] *Id.* at 762.

[233] *See* Taunt v. Gen. Ret. Sys. (*In re* Wilcox), 233 F.3d 899 (6th Cir. 2000).

[234] *See* Traina v. Sewell (*In re* Sewell), 180 F.3d 707 (5th Cir. 1999).

[235] *See* IRS v. Wingfield (*In re* Wingfield), 284 B.R. 787 (E.D. Va. 2002).

[236] *See* Ehrenberg v. Southern Cal. Permanente Med. Group (*In re* Moses), 167 F.3d 470 (9th Cir. 1999).

[237] Skiba v. Gould (*In re* Gould), 322 B.R. 741 (Bankr. W.D. Pa. 2005).

[238] *See* Orr v. Yuhas (*In re* Yuhas), 104 F.3d 612 (3d Cir. 1997); Meehan v. Wallace (*In re* Meehan), 102 F.3d 1209 (11th Cir. 1997).

[239] *See* ALASKA STAT. § 34.40.110(a) (2004); DEL. CODE ANN. tit. 12, § 3570(10)(c)

normally has three parts: First, does the debtor have a beneficial interest in a trust? Second, is there a restriction on the transfer of that interest? Third, is the restriction enforceable under nonbankruptcy law?"[240] The trustor's interest in a DAPT will meet the first two requirements because the trustor will have a beneficial interest in the trust and because, to qualify under the relevant statute, the trust must contain a spendthrift clause. Whether or not the spendthrift clause is enforceable under applicable nonbankruptcy law requires more analysis.

3. *Applicable Nonbankruptcy Law*

A creditor might try to convince a court that "applicable nonbankruptcy law" for section 541(c)(2) purposes is the law of the debtor's domicile (which might not recognize DAPTs), and not the law of the trust. The Scott treatise suggested that the creditor's contention would be unsuccessful:

> We have seen that ordinarily the law of the state of the place of administration . . . determines whether the interest of a beneficiary is assignable by him and whether it can be reached by his creditors. Hence it is the law of that state which determines whether it can be reached by his trustee in bankruptcy.[241]

All fifteen cases that I have found have held that the law of the state that governs the trust applies (rather than the law of the trustor's domicile):

(1) In *Spindle v. Shreve*, the U.S. Supreme Court held that Illinois (not Kentucky) law determined whether a Kentucky resident's interest in an Illinois spendthrift trust was includable in his bankruptcy estate;[242]

(2) In *In re* Newman, the Seventh Circuit held that Missouri (not Illinois) law applied in determining whether principal and income distributions from a Missouri spendthrift trust were excludable from the debtor's bankruptcy estate;[243]

(3) In *In re* Hecht, a federal bankruptcy court in New York held

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(1974); S. 93, 2005 Leg., 80th Sess. (S.D. 2005); UTAH CODE ANN. § 25-6-14(1)(a) (Supp. 2004).

[240] *Taunt*, 233 F.3d at 904.

[241] SCOTT & FRATCHER, *supra* note 147, § 626(3) at 422.

[242] *See* 111 U.S. 542, 547–48 (1884).

[243] *See* 903 F.2d 1150, 1152 n.2 (7th Cir. 1990).

that Maryland (not New York) law applied in determining the extent to which the income of two Maryland spendthrift trusts was excludable from the bankruptcy estate;[244]

(4) In *Heidkamp v. Galliher*, a federal bankruptcy court in Florida held that New York (not Florida) law determined the extent to which a New York spendthrift trust and the income therefrom were excludable from the bankruptcy estate;[245]

(5) In *In re* Hunter, a federal bankruptcy court in Florida held that Missouri (not Florida) law applied in determining the extent to which the income of a Missouri spendthrift trust was excludable from the bankruptcy estate;[246]

(6) In *Schwen v. Ramette (In re* Schwen), a federal bankruptcy court in Minnesota held that Florida (not Minnesota) law determined whether the debtor's interest in a Florida spendthrift trust, of which she was a co-trustee and a beneficiary, was excludable from her bankruptcy estate;[247]

(7) In *Dzikowski v. Edmonds (In re* Cameron), a federal bankruptcy court in Florida held, without discussion, that New York (not Florida) law determined whether a New York self-settled spendthrift trust was excludable from the bankruptcy estate;[248]

(8) In *In re* Gower, a federal bankruptcy court in Florida held that Colorado (not Florida) law applied in determining the extent to which the income from a Colorado spendthrift trust was excludable from the bankruptcy estate;[249]

(9) In *In re* Herzig, a federal bankruptcy court in Massachusetts held that New York (not Massachusetts) law determined whether a debtor's interest in a trust was excludable;[250]

(10) In *McCauley v. Hersloff (In re* Hersloff), a federal bankruptcy court in Florida held that Maryland (not Florida) law determined whether a Maryland spendthrift trust was excludable from the bankruptcy estate; [251]

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[244] *See* 54 B.R. 379, 382–83 (Bankr. S.D.N.Y. 1985), *aff'd sub nom.* Togut v. Hecht, 69 B.R. 290, 291 (S.D.N.Y. 1987).

[245] *See* 272 B.R. 792, 795 (Bankr. M.D. Fla. 2002).

[246] *See* 261 B.R. 789, 791 (Bankr. M.D. Fla. 2001).

[247] *See* 240 B.R. 754, 757 (Bankr. D. Minn. 1999).

[248] *See* 223 B.R. 20, 24 (Bankr. S.D. Fla. 1998).

[249] *See* 184 B.R. 163, 165 (Bankr. M.D. Fla. 1995).

[250] *See* 167 B.R. 707, 709 (Bankr. D. Mass. 1994).

[251] *See* 147 B.R. 262, 264 (Bankr. M.D. Fla. 1992).

(11) In *In re* Graham, a federal bankruptcy court in Vermont held that New York (not Vermont) law applied in determining the extent to which the debtor's interests in a New York spendthrift trust were includable in the bankruptcy estate;[252]

(12) In *In re* Sanders, a federal bankruptcy court in Georgia held that California (not Georgia) law applied in determining the extent to which two California retirement plans were excludable from the bankruptcy estate;[253]

(13) In *In re* Kragness, a federal bankruptcy court in Oregon held, without discussion, that Hawaii (not Oregon) law applied in determining whether interests in two Hawaii testamentary trusts were excludable from the bankruptcy estate;[254]

(14) In *In re* Hall, a federal bankruptcy court in Florida held that Ohio (not Florida) law determined whether a self-settled Ohio trust was excludable from the bankruptcy estate;[255] and

(15) In *In re* Remington, a federal bankruptcy court in New Jersey held that Pennsylvania (not New Jersey) law applied in determining whether the debtor's interests in two Pennsylvania spendthrift trusts were includable in the bankruptcy estate.[256]

In *In re* Hecht, the bankruptcy trustee contended that New York law was the "applicable nonbankruptcy law." The trustee made this claim because, under New York law, the bankruptcy estate would have included 10% of all future income and any portion of the remaining 90% that exceeded the debtor's reasonable living requirements but, under Maryland law, the bankruptcy estate would have included only the income received by the debtor in the 180 days following filing of the bankruptcy petition.[257] The *Hecht* court reasoned:

> Even though the wills specifically indicate that Maryland law is to be applied, the Trustee argues that New York law is applicable because (a) the debtor is domiciled in New York; (b) the Chapter 7 petition was filed in New York; (c) the Trustee is domiciled in New York; (d) 39 of the 55 scheduled creditors are lo-

[252] *See* No. 88-00099, 1989 Bankr. LEXIS 1283, at *6 (Bankr. D. Vt. May 25, 1989).
[253] *See* 89 B.R. 266, 269 (Bankr. S.D. Ga. 1988).
[254] *See* 58 B.R. 939 (Bankr. D. Or. 1986).
[255] *See* 22 B.R. 942, 943 (Bankr. M.D. Fla. 1982).
[256] *See* 14 B.R. 496, 502 (Bankr. D.N.J. 1981).
[257] *See* 54 B.R. at 382.

> cated in New York; (e) nearly 90% of the debt is owed to creditors in New York; and (f) at the time Hecht filed her petition, five creditors had commenced actions against her in New York state courts. The Trustee has amply demonstrated that the *petition* itself was properly filed in New York. The trusts, however, were created in Maryland by Maryland settlors, with a Maryland trustee and with a res located in Maryland. The trusts are also administered in Maryland. Even if Maryland law had not been designated as the law to be applied to questions of validity and construction, this Court would nonetheless have applied Maryland law.[258]

In the other fourteen cases, it does not appear that anyone even asserted that the law of the debtor's domicile should apply.

The Supreme Court noted in *Patterson* that a word is presumed to have the same meaning in all subsections of the Bankruptcy Code.[259] The phrase "applicable nonbankruptcy law" also appears in section 522(b)(2)(B), which relates to the exemption of property held as tenants by the entirety (another self-settled vehicle that affords protection from creditors) or joint tenants.[260] There are seven cases in which the issue of the applicable law has been contested and, without exception, the court held that the phrase refers to an asset's location, rather than to the law of the debtor's domicile.[261] For example, in *McNeilly v. Geremia*, the First Circuit Bankruptcy Appellate Panel held the "applicable nonbankruptcy law" that determined whether funds that the debtor and his wife held as tenants by the entirety were exempt from the bankruptcy estate was the law of Vermont, where the bank account was located, not the law of Rhode Island, where they lived.[262] The court held that the bank account was exempt from the debtor's bankruptcy estate, and the result would have been different if the law of the debtor's domicile had applied.

There is no case in which a bankruptcy judge has considered whether

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[258] *Id.* at 383 n.2 (citations omitted).

[259] *See Patterson*, 504 U.S. at 758.

[260] *See* 11 U.S.C. § 522(b)(2)(B) (2000).

[261] *See In re* Nelms, 2005 Bankr. LEXIS 138 (Bankr. E.D. Mich. 2005); McNeilly v. Geremia (*In re* McNeilly), 249 B.R. 576, 580–81 (B.A.P. 1st Cir. 2000); *In re* Wiza, 248 B.R. 470, 473–74 (Bankr. D.N.H. 2000); *In re* Gillette, 248 B.R. 845, 849–50 (Bankr. M.D. Fla. 1999); *In re* Cochrane, 178 B.R. 1011, 1020 (Bankr. D. Minn. 1995); *In re* Anselmi, 52 B.R. 479, 490 (Bankr. D. Wyo. 1985); *In re* Hayden, 41 B.R. 21, 23 (Bankr. E.D. Ky. 1983).

[262] *See* 249 B.R. at 580–81.

section 541(c)(2) applies to a DAPT. Nevertheless, courts that have held that section 541(c)(2) did not extend to self-settled spendthrift trusts because applicable state law did not recognize them, have suggested that they would have reached a contrary result if the applicable law had been different.[263] In particular, the courts recognized that "applicable non-bankruptcy law" includes both state and federal law[264] and that "state law other than spendthrift trust law can serve as 'enforceable nonbankruptcy law' under section 541(c)(2)."[265] Some commentators believe that a DAPT would be excluded from the bankruptcy estate.[266]

During a nationally televised program conducted on November 5, 2002, Chief Bankruptcy Judge Mahoney of the U.S. Bankruptcy Court for the Southern District of Alabama was asked if U.S. courts will honor the DAPT statutes.[267] She responded:

> The full faith and credit issue is going to be a really tough one for courts, and it's really hard to say we're not going to recognize a Delaware trust, we're not going to recognize another state's valid law even though it's offensive to our law. I can think of situations like that right now in different arenas where something that's a hotly contested or emotional issue in one state is dealt with differently in another state but we still recognize it and so I see some really interesting cases coming up.[268]

Bankruptcy Judge Hyman of the U.S. Bankruptcy Court for the Southern District of Florida was asked the same question, and he responded:

> Other than [Section] 707, 727, or 548, the bankruptcy court looks

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[263] *See Menotte*, 303 F.3d at 1265–70; Shurley v. Tex. Commerce Bank-Austin, N.A. (*In re* Shurley), 115 F.3d 333, 337–42 (5th Cir. 1997); Lindquist v. Mack (*In re* Mack), 269 B.R. 392 (Bankr. D. Minn. 2001); Aylward v. Landry (*In re* Landry), 226 B.R. 507, 512 (Bankr. D. Mass. 1998).

[264] *See Ehrenberg*, 167 F.3d at 475; *see also In re* Mack, 269 B.R. at 399.

[265] *See Taunt*, 233 F.3d at 905.

[266] *See* Bacon & Terrill, *supra* note 1, at 130–31; Jonathan G. Blattmachr & Madeline Rivlin, *A New Paradigm in Estate Planning: The Non-Estate Tax Aspects of Estate Planning*, TR. & EST., Mar. 2001, at 38, 38–39; Gregory M. McCoskey, *Death and Debtors: What Every Probate Lawyer Should Know About Bankruptcy*, 34 REAL PROP. PROB. & TR. J. 669, 691 (2000).

[267] *See* Honorable Margaret A. Mahoney, Remarks at ALI-ABA, *Asset Protection Planning*, Live Nationwide via Satellite on the American Law Network (Nov. 5, 2002).

[268] *Id.*

> to state law and is bound by state law. Before this legislation, we were asked to look at other types of trusts where the debtor was the settlor and beneficiary of a trust. We didn't look to federal law to determine whether the creditors could reach the assets. We looked to state law and the state where the trust is domiciled generally. So, this would be no different.[269]

When asked if the Supremacy Clause would change the result, Judge Hyman expressed his opinion: "Frankly, I don't understand that argument because . . . if there was a valid spendthrift clause and state law said creditors could not get to the assets, then the courts had to follow that state law."[270]

4. Implications for Offshore APTs

Under *Patterson* and subsequent cases, section 541(c)(2) of the Bankruptcy Code excludes a trust interest from the debtor's bankruptcy estate if the interest is subject to a transfer restriction that is enforceable under state or federal law. Although courts might extend the application of section 541(c)(2) to offshore trusts, no court has yet done so, and the section has not been available to debtors who have sought to exclude offshore APTs from their bankruptcy estates.[271]

5. 2005 Bankruptcy Act

On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("2005 Bankruptcy Act"), which addresses the treatment of self-settled trusts in bankruptcy.[272]

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[269] Honorable Paul G. Hyman, Jr., Remarks During Panel Discussion on Tax and Asset Protection Issues Involved in Bankruptcy at the American Bar Association's Joint Tax Section and Real Property, Probate and Trust Law Section Fall CLE Meeting in Boston (Oct. 1, 2004).

[270] *Id.*

[271] *See Goldberg*, 227 B.R. at 917; *Sattin*, 217 B.R. at 104; *Portnoy*, 201 B.R. at 701.

[272] S. Res. 256, 109th Cong. (2005) (enacted). For summaries of the 2005 Bankruptcy Act, *see* Natalie B. Choate, *Bankruptcy Law Impact on IRAs and Qualified Retirement Plans*, STEVE LEIMBERG'S EMPLOYEE BENEFITS AND RETIREMENT PLAN. EMAIL NEWSL. #304 (Apr. 26, 2005), at www.leimbergservices.com; Jonathan E. Gopman, Robert L. Lancaster, & Pierre Vogelbacher, *New Bankruptcy Act—What Planners Really Need to Know*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #64 (Apr. 21, 2005), at www.leimbergservices.com; Alan S. Gassman & Jonathan Alper, *New Bankruptcy Bill—Who Pays It?*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #62 (Mar. 14, 2005), at www.leimbergservices.com.

Specifically, section 1402(4) of the 2005 Bankruptcy Act adds section 548(e) to the Bankruptcy Code. The addition empowers a bankruptcy trustee to avoid a transfer to a "self-settled trust or similar device" made on or within 10 years before the date of the filing of a bankruptcy petition if the transfer was made "with actual intent to hinder, delay, or defraud" any creditor to which the debtor was or became indebted on or after the date that such transfer was made. New section 548(e)(2) specifies that the provision applies to federal and state securities law violations and to fraud, deceit, or manipulation involving the purchase or sale of registered securities.[273]

Because the provision was drafted and passed at the last minute, its application is unclear. For example, a "self-settled trust or similar device" might include a retirement plan, an IRA, a homestead, a limited partnership, a limited-liability company, or tenancy-by-the-entirety property as well as a DAPT or an offshore APT. In addition, the provision might cover just the securities-law violations mentioned above, not all transfers.

Bankruptcy courts could interpret the "actual intent" language any number of ways. At least one court has explained that:

> 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 well-being, the discharge will be granted.[274]

If courts adopt the above approach, a transfer of surplus assets to a DAPT for nonasset-protection purposes (for example, estate or charitable planning or state income-tax avoidance) well before the filing of a bankruptcy petition and after the completion of a thorough solvency analysis, should not be vulnerable under section 548(e). If courts interpret the "actual intent" language to cover a transfer in which asset protection is at

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[273] For discussions of section 548(e), *see* John E. Sullivan, III, *New Rules, Old Game,* TR. & EST., June 2005, at 59; Duncan E. Osborne & Michael W. Johnson, *Potential Effects of Bankruptcy Abuse Prevention and Consumer Protection Act on Asset Protection Planning*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #67 (May 17, 2005), at www.leimbergservices.com; Henry J. Lischer, Jr., *Asset Protection Trusts: A Difference of Opinion*, 107 TAX NOTES 921 (May 16, 2005); Jay Adkisson & Christopher Riser, *Bankruptcy Act Impact On Life Insurance and Domestic Asset Protection Trusts*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #66 (May 3, 2005), at www.leimbergservices.com; Gideon Rothschild, *Did Bankruptcy Reform Act Close the "Loophole" for the Wealthy?*, 107 TAX NOTES 492 (Apr. 25, 2005).

[274] *In re* Oberst, 91 B.R. 97, 101 (Bankr. C.D. Cal. 1988).

all implicated, then DAPTs and offshore APTs will be vulnerable in bankruptcy.

Although clients might be tempted to create offshore APTs rather than DAPTs in light of the new provision because bankruptcy trustees find it harder to reach trust assets abroad than in the United States, bankruptcy courts might deny discharges if they determine that offshore APTs are being misused and/or fine or imprison trustors of such trusts in egregious cases.

The 2005 Bankruptcy Act generally becomes effective on October 17, 2005,[275] but section 548(e) is effective for bankruptcy cases commenced on or after April 20, 2005.[276]

6. *Post-Petition Distributions*

a. *Introduction*

If a trustor's interest in a DAPT is excluded from the bankruptcy estate under section 541(c)(2), a court must determine if any trust distributions to the trustor after the filing of the bankruptcy petition will become part of the bankruptcy estate. The inclusion issue will arise if the trustor receives a discretionary or mandatory distribution of income or principal from the DAPT.

The relevant Bankruptcy Code provision is section 541(a)(5), which provides:

> Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date—
>
> (A) by bequest, devise, or inheritance.[277]

b. *The Rule*

To be included in the bankruptcy estate under section 541(a)(5)(A), a DAPT distribution must meet two requirements. First, it must be received by the debtor within 180 days after the filing of the bankruptcy petition (not at all times thereafter). Second, it must result from a "bequest, devise, or inheritance."[278]

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[275] 2005 Bankruptcy Act § 1501.
[276] *Id.* § 1406.
[277] 11 U.S.C. § 541(a)(5) (2000).
[278] *Id.*

Because the Bankruptcy Code does not define "bequest," "devise," or "inheritance," the courts that have considered section 541(a)(5)(A) have looked to applicable state law and, in the absence thereof, to *Black's Law Dictionary*, which states that a "bequest" is "[t]he act of giving property (usually personal property) by will,"[279] a "devise" is "[t]he act of giving property by will,"[280] and an "inheritance" is "[p]roperty received from an ancestor under the laws of intestacy."[281]

It is hard to see how an interest in a DAPT could fall into any of the above categories.

c. Applicable Cases

In *In re* Newman, the court held that income distributions received by the debtor from two irrevocable inter vivos spendthrift trusts within 180 days after the filing of the bankruptcy petition were not includable in his bankruptcy estate.[282] The court reasoned:

> The spendthrift trusts are valid under the law of Missouri. Congress clearly exempted the corpus of spendthrift trusts that are valid under state law from the reach of creditors in bankruptcy proceedings. Congress did not include income payments of *inter vivos* spendthrift trusts within the 180-day post-filing period provision.[283]

In *In re* Kragness, the court considered whether income payments received by the debtor from two testamentary trusts within 180 days of the filing of the bankruptcy petition were includable in the bankruptcy estate.[284] That is significant because the bankruptcy trustee did not even attempt to reach the debtor's income interest in an irrevocable inter vivos trust.

As is evident from two recent cases, *Zimmerman v. Spencer (In re* Spencer)[285] and *In re* Roth,[286] the result is the same for principal distributions to the debtor within the 180 day period. In both cases, the court held

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[279] BLACK'S LAW DICTIONARY 168 (8th ed. 2004).
[280] *Id.* at 483.
[281] *Id.* at 799.
[282] *See* 903 F.2d 1150.
[283] *Id.* at 1154.
[284] *See* 58 B.R. at 944.
[285] *See* 306 B.R. 328, 333–36 (Bankr. C.D. Cal. 2004).
[286] *See* 289 B.R. 161, 169 (Bankr. D. Kan. 2003).

that principal that became payable to a debtor from an inter vivos trust due to the death of a parent within 180 days after the filing of a bankruptcy petition did not come into the bankruptcy estate.

G. Contracts Clause Should Not Apply

In the United States, each state is prohibited from enacting a "Law impairing the Obligation of Contracts."[287] Some commentators suggest that the DAPT acts are vulnerable to attack under this provision.[288] Other commentators believe that the Contracts Clause rarely will be implicated because it covers existing contracts, which usually will not be affected by DAPT acts.[289] The Contracts Clause also is inapplicable to tort claims.

H. Assessment

No court has upheld the effectiveness of a DAPT. The absence of authority does not mean that an attorney should not discuss this option with clients. Attorneys face the risk of being held liable for failure to raise the DAPT option if clients' assets are needlessly reached by creditors. If nothing else, putting assets in a DAPT will improve a client's negotiating position if creditor concerns arise.[290]

Before the 2005 Bankruptcy Act, a commentator discussed creditors' prospects for success in challenging DAPTs:

> 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

[287] U.S. CONST. art. I, § 10, cl. 1.

[288] *See* Osborne et al., *supra* note 1, ¶ 1404.5 at 14-26 to 14-27.

[289] *See* Bacon & Terrill, *supra* note 1, at 130; Boxx, *supra* note 1, at 1230–41.

[290] Early in 2003, a rumor circulated that an Alaska APT had been breached. The case in question involved a transfer, which likely was a fraudulent transfer, by an Alaska resident to a foreign (Nevis) APT that was to be administered in Alaska. For a summary of the case, see Shaftel, *supra* note 87.

> 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 entirety) 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.[291]

VI. POSSIBLE USES

A. Employ Tax Benefits

1. General

Although a client is likely to get more certain tax results if the client cuts all ties with specific assets, some clients might not be willing to do so. Some clients might be more inclined to create a trust that exhausts the gift-tax exemption or GST exemption, an irrevocable life-insurance trust, a charitable-lead trust, a CRT, a grantor-retained annuity trust ("GRAT"), or a qualified personal-residence trust ("QPRT") if the client knows that funds in the trust might be available in an emergency.

2. Make Taxable Gifts to Reduce Federal Transfer Tax

A client can save a significant amount of federal transfer tax if he or she makes a gift that incurs gift tax, lives at least three years after making the gift, and dies when the federal estate tax exists. The client might be more inclined to use this strategy if the client structures the taxable gift as a transfer to a DAPT because the client might be able to get funds back

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[291] Danforth, *supra* note 1, at 325 (footnote omitted).

from the trust if they are needed.

3. *Make Taxable Gifts to Avoid State Death Tax*

Because the federal state death tax credit has been phased out, many states have enacted their own death taxes. A client might be able to avoid the state death tax by making a gift before death.[292] The client should consider taking advantage of this strategy by making a taxable gift to a DAPT because of the possibility of getting funds back in the event of need.

4. *Assure Favorable Tax Treatment for Grantor Trusts*

In Revenue Ruling 2004-64, the Service concluded, inter alia, that a trustor's payment of income taxes attributable to a grantor trust is not a taxable gift, and that inclusion in a grantor trust of a provision that gives the trustee discretion to reimburse the trustor for such taxes will not, by itself, cause the trust to be included in the gross estate under Code section 2036(a)(1).[293] Commentators explained that trustors should consider establishing certain grantor trusts in DAPT states:

> Situation 3 also indicates that the mere existence of applicable state law authorizing the grantor's creditors to attach trust assets, by reason of the trustee's discretion to reimburse the grantor for income tax payments, may be sufficient to warrant inclusion of the trust assets in the grantor's estate under Section 2036. This may be reason (perhaps, in addition to others) for grantors, who do not wish to prohibit reimbursement for income taxes, to consider creating grantor trusts in jurisdictions (e.g., Alaska or Delaware) that do not subject the trust assets to the claims of creditors.[294]

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[292] *See* William S. Forsberg & Darren M. Wallace, *Planning for Property Interests in More Than One State After the Demise of the State Death Tax Credit*, PROB. & PROP. Sept./Oct. 2004, at 46; Richard B. Covey & Dan T. Hastings, *The Estate Planner's Toolbox—Part I*, PRAC. DRAFTING 7720, 7747–48 (July 2004); Debra L. Stetter, *Deathbed Gifts: A Savings Opportunity for Residents of Decoupled States*, 31 EST. PLAN. 270 (2004).

[293] *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[294] Mitchell M. Gans, Stephanie E. Heilborn, & Jonathan G. Blattmachr, *Some Good News About Grantor Trusts: Rev. Rul. 2004-64*, 31 EST. PLAN. 467, 472 (2004). *See also* William S. Forsberg & James C. Worthington, *Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts—When to Use Them and When Not To*, PROB. & PROP. May/June 2005, at 36; Alan Halperin & Andrea Levine Sanft, *2004-64 Sparks Applause But Leaves Questions*, TR. & EST., Sept. 2004, at 22.

B. Obtain Asset Protection

1. General

Clients who have no foreseeable creditor claims might want to create DAPTs to protect some of their assets from future creditor claims, with or without attempting to make completed gifts, or to remove assets from their estates.

2. Protect Gifts and Inheritances

Clients might want to create DAPTs to shield gifts or inheritances that they receive outright rather than in trust. For example, in *In re* Johannes Trust, a state agency provided services to a developmentally disabled individual for whom a court had created a trust to receive an inheritance.[295] The Michigan Court of Appeals held that the agency could be reimbursed for its services from the trust because Michigan does not honor self-settled spendthrift trusts, but the opinion suggests that the trust might have been protected if Michigan law were different.[296]

3. Protect Young Adults' Assets

Parents might want to encourage their children to put assets that they receive at majority into DAPTs. Although the children may obtain trust funds, they do not have the unlimited ability to dissipate those funds.

4. Protect Officers and Directors

Because the activities of corporate officers and directors now receive increased scrutiny, they might want to insulate some of their assets by putting them into DAPTs. [297]

5. Protect Assets From Future Ventures

A client might want to create a DAPT upon the sale of a business to protect the proceeds from claims arising from future ventures.

6. Protect Vulnerable Persons

DAPTs might be used to protect the assets of clients who are mentally,

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[295] *See* 479 N.W.2d 25 (Mich. Ct. App. 1991).

[296] *See id.* at 29.

[297] *See* Edmond M. Ianni, *Blind Trusts Offer Clients Customized Wealth Planning*, 30 EST. PLAN. 319 (2003); Edmond M. Ianni, *Remove Temptation*, TR. & EST., June 2003, at 42.

physically, or financially vulnerable.

In *Hanson v. Minette*, a trustor claimed (although the court did not believe him) that he had created an irrevocable self-settled spendthrift trust to help him to control his extravagant spending.[298] Because Iowa law did not honor this type of trust, he was unable to prevent creditors from reaching the trust assets.

Similarly, the Michigan Supreme Court held in *Coleman v. Department of Mental Health (In re* Hertsberg Inter Vivos Trust) that a state agency could be reimbursed for services that it provided to the handicapped beneficiary of a trust that was created with funds received in a judicial proceeding against her guardian/mother. The court reimbursed the agency because Michigan does not recognize self-settled trusts.[299]

Moreover, a federal district court in Iowa found in *Harrison v. City National Bank* that a self-settled trust that a chronic alcoholic created to protect his assets was ineffective in part because Iowa does not respect this type of trusts.[300]

7. Provide Premarital Planning

Because Delaware, Alaska, Rhode Island, Nevada, Utah, and South Dakota APTs are immune from spousal claims in various circumstances, clients might use DAPTs to shield assets from spousal claims without providing the financial disclosure that is required to implement effective prenuptial agreements.

8. Protect Personal-Injury Awards

Trusts created by courts from personal-injury awards are often self-settled and therefore potentially subject to creditor claims.

The Ninth Circuit held in *Herrin v. Jordan (In re* Jordan) that the fund established for a debtor under a structured settlement agreement that he entered into with his employer to resolve a personal-injury claim was not excludable from his wife's and his bankruptcy estate under section 541(c)(2).[301] The court found that the fund was a self-settled spendthrift trust and that it was not effective under Washington law.

Similarly, the Bankruptcy Court for the Northern District of Ohio held in *In re* Myers that the payments received by a minor under a settlement

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[298] *See* 461 N.W.2d 592 (Iowa 1990).
[299] *See* 578 N.W.2d 289 (Mich. 1998).
[300] *See* 210 F. Supp. 362 (S.D. Iowa 1962).
[301] *See* 914 F.2d 197, 200 (9th Cir. 1990).

agreement that his mother entered into for him with her automobile insurance carrier to settle a personal-injury claim were not excludable from his bankruptcy estate under section 541(c)(2).[302] The court found that the payments constituted a self-settled trust and that it was not effective under Ohio law.

In addition, the Supreme Court of South Dakota held in *Farmers State Bank v. Janish* that a trust created with funds received as a personal injury award was self-settled and therefore ineffective against the trustor's creditors in South Dakota.[303]

C. Protect CRTs and Other Estate-Planning Vehicles

Several common estate-planning vehicles, such as CRTs, GRATs, QPRTs, and grantor-retained income trusts, are self-settled trusts and therefore are vulnerable to creditor claims.

In *Lindquist v. Mack (In re* Mack), a bankruptcy court in Minnesota held that the debtor's retained rights to receive payments from a 7% CRUT, to select the trustees, and to amend the CRUT to preserve its tax qualification were includable in his bankruptcy estate because neither Minnesota common law or statutory law nor Code section 664 or the regulations under it provided an effective anti-alienation provision.[304] In *Lindquist*, the debtor funded the CRUT in 1997 with stock (which had a $10,000 basis) in a successful family company. The value of the remainder interest was only $21,263. Shortly after the debtor created the CRUT, the trustees sold the stock for $1,655,189 and invested part of the proceeds in a new venture, the failure of which forced him into bankruptcy in 2001.[305]

Similarly, in *Menotte v. Brown*, the Eleventh Circuit held that the interest of a debtor, an alcoholic, in a 7% CRUT, which she created before she became insolvent and with no intent to defraud creditors, was includable in her bankruptcy estate because self-settled spendthrift trusts could be reached by creditors under applicable Florida law.[306]

The Delaware, Alaska, Utah, South Dakota acts (but not the other statutes) extend protection to CRTs and other self-settled arrangements.

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[302] *See* 200 B.R. 155, 159 (Bankr. N.D. Ohio 1996).

[303] *See* 410 N.W.2d 188, 189 (S.D. 1987).

[304] 269 B.R. at 412–13.

[305] *See* Robert E. Madden & Lisa H.R. Hayes, *Current Tax Developments: Beneficiary of Self-Settled CRUT Can't Avoid Creditors*, 29 EST. PLAN. 123, 125 (2002).

[306] *See* 303 F.3d at 1266–70.

D. Avoid State Income or Intangible Tax

A client might try to use a DAPT to avoid income tax on undistributed ordinary income and capital gains imposed by a state that has not adopted the federal grantor-trust rules (such as Alabama or Pennsylvania). A client willing to subject distributions to the approval of an adverse party might also attempt to use a DAPT to avoid income tax on undistributed income and capital gains imposed by a state that has adopted the federal grantor-trust rules (such as Massachusetts, New Jersey, or New York). The Service has ruled twice that a Delaware APT may qualify as a nongrantor trust if distributions to the trustor must be approved by adverse parties.[307] A DAPT also might be used to avoid the tax imposed by a state (such as Florida) on the value of intangible personal property. In summation, the trustor might be able to receive tax-free distributions of the untaxed income in later years.

E. Provide Pre-Immigration Planning

Nonresident aliens may create trusts with intangible property free of gift and GST tax. Before emigrating to the United States, individuals may create Delaware APTs to remove assets from their estates, but retain the ability to get funds back if needed.

F. Provide Protection for Trusts Moved From Offshore or Other Domestic Jurisdictions

As mentioned in Part II above, people create self-settled spendthrift trusts for a variety of purposes in domestic jurisdictions that do not provide protection from creditors. To protect clients and themselves, attorneys should explore moving such trusts to domestic jurisdictions where the trusts will be effective. Before moving a trust, however, the attorney should consider whether the change will cause the trustor/beneficiary to make a completed gift. Similarly, for a variety of reasons, it might be appropriate to relocate an offshore APT to a DAPT jurisdiction.

G. Enable Officers and Directors to Comply with Securities Laws

Corporate officers and directors might want to use "blind" DAPTs to comply with securities law restrictions while keeping the ability to benefit

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[307] *See* Priv. Ltr. Rul. 200247013 (Aug. 14, 2002); Priv. Ltr. Rul. 200148028 (Aug. 27, 2001). *See also* Priv. Ltr. Rul. 200502014 (Sept. 17, 2004).

from trust assets.[308]

VII. A COMPARISON OF OFFSHORE APTS AND DAPTS[309]

A. Introduction

Although they are described as APTs, DAPTs serve additional purposes. DAPTs may be used to reduce federal transfer tax, to protect self-settled estate-planning vehicles, to avoid state income or intangible tax, or to enable corporate officers and directors to satisfy securities law requirements. None of these ends requires an offshore APT. Even when asset protection is the sole objective, DAPTs offer advantages over offshore APTs.

B. Advantages of Offshore APTs[310]

1. Offer Protective Features

Like DAPTs, offshore APTs are governed by the laws of jurisdictions that provide creditor protection for self-settled spendthrift trusts, but the similarity of the two vehicles stops here. Offshore APTs usually provide protective features that DAPTs cannot offer. These features include:

(1) Narrow definitions of fraudulent-transfer claims that may defeat the APT;
(2) Very short limitations periods for bringing such claims;
(3) Very high burdens of proof (such as "beyond a reasonable doubt") for proving fraudulent-transfer claims;
(4) No recognition of U.S. judgments so that a creditor may not levy on trust assets to enforce the judgment, but must relitigate the claim;
(5) Trust provisions (flight clauses) that permit the trustee or protector to change the governing law or to move the trust assets if the trustor encounters creditor claims;
(6) Trust provisions (duress clauses) that instruct the trustee or protector to ignore orders of the trustor or U.S. courts if the trustor develops creditor problems;
(7) Difficulty for U.S. creditors to engage local counsel;
(8) Inability of U.S. courts to obtain personal jurisdiction over the

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[308] *See* Ianni, *supra* note 297.

[309] For general descriptions of offshore APTs, see Lischer, *supra* note 41, at 567–69; Fox & Huft, *supra* note 1, at 297–303; Danforth, *supra* note 1, at 306-10.

[310] *See* Alexander A. Bove, Jr., *Drafting Offshore Trusts*, TR. & EST., July 2004, at 44.

trustee; and

(9) Involvement of a protector in distribution and administrative duties.

2. *Might Be Superior*

Offshore APTs are not always impregnable. The trustor's asset-protection objectives might be thwarted if the trustor appoints a U.S. trustee over which a U.S. court has personal jurisdiction,[311] if the trust is funded with real property in the United States,[312] or if the trust is funded with securities that are subject to the court's control.[313] In addition, the trustor might risk fine or imprisonment for creating an offshore APT, and the trustor's attorney might face disciplinary action and personal liability for participating in the transaction. Nevertheless, if a client and his or her attorney are willing to assume these risks, a well designed and implemented offshore APT can offer effective protection from creditor claims.

3. *Full Faith and Credit Not Due U.S. Judgments*

Unlike courts in DAPT states, courts of foreign jurisdictions are not required to give full faith and credit to judgments of U.S. courts. Nevertheless, the mere invocation of the Full Faith and Credit Clause does not, *ipso facto*, mean that the trustee of a DAPT must pay a creditor's claim. Because other constitutional factors favor DAPTs, the trustee might successfully defend the creditor's challenge or negotiate a favorable settlement.

C. Advantages of DAPTs

1. *Constitutional Issues Might Favor*

As discussed in Part V, the Full Faith and Credit Clause and section 541(c)(2) of the Bankruptcy Code are likely to favor DAPTs.

2. *Less Financial Risk for Trustor and Beneficiaries*

The same factors that make the assets of an offshore APT hard to reach by creditors also render them difficult to reach by the trustor and beneficiaries in the event of political change or the misconduct or insol-

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[311] *See* Shaftel, *supra* note 87.

[312] *See* Bank of Am. v. Weese, No. 03-C-01-01892; *Estate of Waitzman*, 507 So. 2d at 24–25.

[313] *See Nastro*, 263 F. Supp. 2d 446.

vency of the offshore trustee.

Beaubien v. Cambridge illustrates the potential perils faced by U.S. beneficiaries of offshore APTs.[314] In *Beaubien* the beneficiaries attempted to obtain an accounting from an Isle of Man corporation, as successor trustee of a Cayman Islands trust that originally was funded with $500,000 in 1984. By the time of the litigation the beneficiaries were without recourse in the Cayman Islands. Their last-ditch attempt was to try to convince a Florida court to compel the trustee's Florida attorney to account on the ground that he was the trustee's managing agent.

3. Tax Treatment More Favorable

Unlike a DAPT, an offshore APT risks being classified as a foreign trust for U.S. federal income-tax purposes. A foreign-trust classification will subject the trust to special U.S. tax rules[315] and onerous reporting and penalty provisions.[316] In particular, Code section 684 treats a domestic trust that becomes a foreign trust as if the domestic trust transferred its assets to the foreign trust immediately before the change. Although many offshore APTs begin as domestic trusts because they are treated as grantor trusts for federal income-tax purposes, they may become foreign trusts upon the death of the grantor. The assets of this type of trust will receive a stepped-up basis at the trustor's death only if the basis of the trust's assets is determined under Code section 1014(a) (for example, if they are included in the trustor's gross estate).[317] These special tax rules and reporting requirements do not apply to a DAPT.

4. Less Expensive

A DAPT is usually less expensive to establish and administer than an offshore APT.

5. Less Risk of Fine or Imprisonment

a. Introduction

Courts have fined or imprisoned trustors of offshore APTs in four notorious cases.

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[314] *See* 652 So. 2d 936.

[315] *See* Brian R. Basset, *New Regs. on the Tax Effects of Funding 'Outbound' Foreign Trusts*, 29 EST. PLAN. 113 (2002).

[316] *See* I.R.C. §§ 6048, 6677 (West 2002).

[317] *See* Treas. Reg. § 1.684-3(c), 1.684-3(g), Exs. 2–3 (2005).

b. The Anderson *Case*

The first case was *FTC v. Affordable Media, LLC* (commonly known as the Anderson case), in which the FTC sought to recover funds that Denyse and Michael Anderson had raised through a fraudulent telemarketing scheme.[318] The Ninth Circuit affirmed the district court, found the Andersons in civil contempt for their failure to repatriate assets in a Cook Islands trust, and ordered that they be incarcerated.

The Ninth Circuit noted that:

> The standard for finding a party in civil contempt is well settled:
>
> > The moving party has the burden of showing by clear and convincing evidence that the contemnors violated a specific and definite order of the court. The burden then shifts to the contemnors to demonstrate why they were unable to comply.[319]

The Andersons conceded that they had not complied with the district court's order to repatriate the assets of the Cook Islands trust, but contended that it was impossible for them to comply because the trustee would not return the assets to the United States. The court continued:

> With foreign laws designed to frustrate the operation of domestic courts and foreign trustees acting in concert with domestic persons to thwart the United States courts, the domestic courts will have to be especially chary of accepting a defendant's assertions that repatriation or other compliance with a court's order concerning a foreign trust is impossible. Consequently, the burden on the defendant of proving impossibility as a defense to a contempt charge will be especially high.[320]

The Ninth Circuit agreed with the district court that it was not impossible for the Andersons to repatriate the trust assets because they still had control of the trust. The Ninth Circuit noted that the Andersons were protectors of the trust and had obtained a distribution to pay their taxes. The court summarized:

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[318] *See* 179 F.3d 1228 (9th Cir. 1999). *See also* Lischer, *supra* note 41, at 577–87.
[319] *Affordable Media*, 179 F.3d at 1239 (citation omitted).
[320] *Id.* at 1241.

> The Andersons claim that they have "demonstrated to the district court 'categorically and in detail' that they can not comply with the repatriation section of the preliminary injunction." The district court was not convinced and neither are we. While it is possible that a rational person would send millions of dollars overseas and retain absolutely no control over the assets, we share the district court's skepticism.[321]

The court suggested that the Andersons might have been in control of the trust even if they weren't the protectors and stated that:

> Although we have concentrated on the Andersons' capacity as protectors of the trust to support the district court's finding that the Andersons remain in control of the trust, we have not considered whether other facts might support the Andersons' continuing control over the trust, regardless of who is the protector of the trust. The Andersons attempted to resign their position as protectors and that attempt appears to have failed. If the Andersons have in fact resigned their position as protectors, they may still remain in control of the trust. We have not resolved this issue at the time because the Andersons have conceded that they are the protectors of the trust.[322]

The Andersons contended that their inability to repatriate the assets of the Cook Islands trust would be a complete defense to civil contempt. The Ninth Circuit addressed this assertion and stated that:

> Given that these offshore trusts operate by means of frustrating domestic courts' jurisdiction, we are unsure that we would find that the Andersons' inability to comply with the district court's order is a defense to a civil contempt charge. We leave for another day the resolution of this more difficult question because we find that the Andersons have not satisfied their burden of proving that compliance with the district court's repatriation order was impossible.[323]

The Andersons spent several months in jail, and the trustee ultimately turned over $1.2 million to the FTC.

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[321] *Id.* (citation omitted).
[322] *Id.* at 1243 n.11.
[323] *Id.* at 1240.

c. The Lawrence *Case*

The second case was *Lawrence v. Goldberg (In re* Lawrence).[324] In *Lawrence*, the Eleventh Circuit affirmed the finding of the bankruptcy court and the district court and found Lawrence in civil contempt for failing to repatriate the assets of a Mauritian trust that he had created two months before a $20.4 million arbitration judgment was issued against him. The Eleventh Circuit ordered imprisonment until Lawrence purged his contempt. The court agreed with the lower courts that Lawrence had retained control of the trust (he could remove and appoint trustees and add and exclude beneficiaries) and affirmed their rejection of his impossibility defense. The court noted that:

> Even if we were to find that Lawrence had set forth sufficient evidence of impossibility, we must agree with the trial court that Lawrence's claimed defense is invalid because the asserted impossibility was self-created. We previously have held that, "where the person charged with contempt is responsible for the inability to comply, impossibility is not a defense to the contempt proceedings." Lawrence insists that his impossibility is distinguishable from other cases finding that self-created impossibility is not a defense because his actions, if any, creating the impossibility occurred prior to the instant action. This contention clearly lacks merit. We agree with the district court that Lawrence created this Trust in an obvious attempt to shelter his funds from an expected adverse arbitration award.[325]

Lawrence was imprisoned in September 2000, and he has not yet been released.

d. The Bilzerian *Case*

The third case was *SEC v. Bilzerian*.[326] The federal district court for the District of Columbia summarized the case's history:

> In 1991, the Court found Bilzerian liable for securities fraud. In connection with that liability, the Court ordered Bilzerian to disgorge $33,140,787.07 in profits from the fraud on January 28,

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[324] *See* 279 F.3d 1294. *See also* Lischer, *supra* note 41, at 587–91; Wendy Davis, *Asset Protection's Bad Boy*, TR. & EST., July 2004, at 50.

[325] *Lawrence*, 279 F.3d at 1300 (footnotes omitted).

[326] *See* 131 F. Supp. 2d 10 (D.D.C. 2001).

> 1993, and on June 23, 1993, ordered him to disgorge an additional $29,196,812.46 in prejudgment interest. . . . The SEC did not seek to enforce the roughly $62 million disgorgement judgment for over five years due to protracted litigation over the possible dischargeability of the judgment in a bankruptcy proceeding in Florida. In 1998, the Eleventh Circuit affirmed the ruling of the United States District Court for the Middle District of Florida that the disgorgement judgment against Bilzerian was not dischargeable in bankruptcy.
>
> In November 1998, the SEC moved this Court to hold Bilzerian in civil contempt of the 1993 disgorgement orders because he had not made any payments on the $62 million judgment. Bilzerian argued that he was unable to comply with the disgorgement orders essentially because he had no financial resources. On August 21, 2000, after receiving substantial briefing from the parties and holding a hearing, the Court found Bilzerian in contempt of its 1993 disgorgement orders. The Court found that (1) Bilzerian had not demonstrated his financial inability to comply "categorically and in detail" as required by case law; (2) Bilzerian had not made all reasonable efforts to comply with the orders; and (3) any financial inability to comply was self-created because Bilzerian had separated his assets from himself and funneled them to shell companies, partnerships, and trust entities . . . through outright transfers as well as payment arrangements made with his employer, Cimetrix. The Court set a number of conditions which Bilzerian had to meet in order to purge the contempt. These purgation conditions were set without prejudice and were only temporary because Bilzerian had not complied with the Court's order for a full accounting of his assets; without the accounting of his assets, the Court could not ascertain the precise amount of the $62 million judgment Bilzerian is capable of paying. These temporary conditions required Bilzerian to (1) pay $5,000 on the first day of each month until further order of the Court, and (2) submit an additional accounting by October 2, 2000 as detailed in ¶¶ 1-10 of the August 21 Order.[327]

The court found that Bilzerian had failed to purge its temporary contempt order because he did not provide documentation for trusts and other

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[327] *Id.* at 12–13 (footnote and citation omitted).

entities and details of his personal finances. The court was particularly troubled by his failure to provide information for the trust he had created in the Cook Islands in 1995 because that trust was "at the apex of the structure comprising the Bilzerian-related entities, and—directly or indirectly—holds almost every other asset described in the Court's August 21 Opinion."[328]

As a result, the court held, "Given Bilzerian's facially deficient accounting, the only remedy is to incarcerate Bilzerian until he provides the information covered by the Court's order or, at a minimum, until he demonstrates a credible and good faith effort to do so."[329] The resolution of the case has been described by a commentator:

> Corporate raider Paul Bilzerian recently was reported to have given up half his assets, including a home owned by his wife that should have been protected under Florida law, after spending several months in prison. Mr. Bilzerian was quoted as follows in the *St. Petersburg Times* of 2/5/02: "People don't understand how awful those places are. There were weeks upon weeks that I wasn't able to see the sunlight or brush my teeth."[330]

e. The Eulich *Case*

The most recent case is *Eulich v. United States*. In *Eulich* the court considered the government's motion to hold Eulich in civil contempt for failure to provide documents from a Bahamian trust (worth $75–$100 million) in connection with the Service's review of the trustor and his wife's 1995, 1996, and 1997 income tax returns.[331] The court held:

> For the reasons previously stated, the court determines that clear and convincing evidence establishes that John F. Eulich failed to comply with the court's Order of Enforcement dated September 17, 2002, and did not make all reasonable efforts to comply with

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[328] *Id.* at 16.

[329] *Id.* at 18.

[330] Alan S. Gassman, *Common Mistakes Planners Make Regarding Asset Protection*, 29 EST. PLAN. 518, 523 (2002).

[331] *See* No. CIV. A. 3:99-CV-1842-L, 2004 U.S. Dist. LEXIS 16285 (N.D. Tex. Aug. 18, 2004). *See also* Jonathan E. Gopman, *Eulich Revisited—Asset Protection Through Foreign Trusts Alive and Well*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #54 (Sept. 29, 2004), *at* www.leimbergservices.com; Jay D. Adkisson, *Eulich—Impossibility Defense Fails*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #50 (Aug. 27, 2004), *at* www.leimbergservices.com.

> it. Accordingly, court hereby holds John F. Eulich in civil contempt of court and, to obtain compliance with its enforcement order, the court imposes a civil fine in the amount of $5,000 per day for the first 30 days from the entry date of this order. If John F. Eulich has not complied by the 31st day, the fine is hereby increased to $10,000 per day until he produces, or causes to be produced, the documents of the Mallion Trust Fund No. 16 to IRS representative(s), or the court orders otherwise. If by the 45th day after entry of this order, Eulich has not complied with the enforcement order, the attorney for the Government shall notify the court of his noncompliance. If the court receives such notice, it will set the matter for a hearing to determine whether Eulich is in compliance and, if he is not, whether the daily fine should be increased or whether Eulich should be incarcerated to obtain compliance with the enforcement order.[332]

The trustor contended that efforts to obtain the documents would be unavailing because they would be thwarted by the confidentiality rules of Bahamian law. The court responded:

> Eulich made a conscious decision to set up the Trust in the Bahamas. He thus created the present dilemma regarding the disclosure or nondisclosure of the documents in question. Therefore, even if Bahamian law would prevent disclosure of the requested documents by the new members of the Advisory Committee, which is in dispute, Eulich cannot benefit from a situation that he himself created.[333]

The court's skepticism regarding the trustor's inability to provide the documents requested by the Service was born out by subsequent events. Shortly after the court entered its contempt order, the trustor produced four boxes of photocopied documents.[334]

f. Implications

Although some debtors willingly pay large fines or endure incarcera-

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[332] *Eulich*, 2004 U.S. Dist. LEXIS 16285, at *20-21.

[333] *Id.* at *10.

[334] Jay D. Adkisson, *Eulich Revisited—Again!*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #56 (Dec. 1, 2004), *at* www.leimbergservices.com. *See also* Gideon Rothschild & Daniel S. Rubin, *Putting Eulich in Perspective*, STEVE LEIMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #57 (Dec. 6, 2004), *at* www.leimbergservices.com.

tion to protect their assets, others will find the risks unacceptable. Attorneys who recommend offshore APTs contend that the imposition of sanctions resulted from poor trust design in the cases in question, but a U.S. court might be tempted to employ the sanctions when a trustor has placed assets beyond the court's reach. The trustor of an offshore APT will have a hard time convincing a U.S. court that the trustor does not retain control over trust assets. For example, the following provision of the law of the Cook Islands, an often recommended offshore jurisdiction, clearly contemplates that the trustor may have or acquire rights over trust assets:

> 13C. 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 of the trust or instrument either solely or together with others.[335]

The trustor's task of proving no retained control is even more difficult if, as often is the case, other beneficiaries of the trust cannot engage local counsel to enforce their interests. The risk of fine or incarceration should be lower in the case of a DAPT because the controversy will be adjudicated in the U.S. legal system.

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[335] Cook Islands Int'l Trust Act § 13C (1984), *available at* http://www.assetprotectioncorp.com/cookislandstrustact (last visited July 17, 2005).

6. Less Risk of Professional Discipline

The disciplinary perils for an attorney in the United States are greater for an offshore APT than for a DAPT. An attorney in a non-DAPT jurisdiction may escape ethical concerns by referring a client to counsel in a DAPT state who may discuss DAPTs without ethical concerns.[336] In the case of an offshore APT, an attorney cannot defer to any other attorney who will be without ethical concerns.

VIII. ESTABLISHING A DAPT

A. Introduction

Establishing a DAPT is a multistep process, but is not very different from creating other kinds of domestic trusts. The attorney and the trustee must perform due diligence, the client must choose assets to fund the trust, the client and attorney must decide whether to engage local counsel, and the trust must be drafted and funded.[337]

B. Due Diligence

1. As discussed in Part II above, the attorney and the trustee must satisfy themselves that creation of the trust will not be a fraudulent transfer. Consequently, there should be no rush to create a DAPT, and, if the client insists on haste, the attorney and the trustee should decline the engagement.
2. The attorney and the trustee should insist that the client provide a solvency analysis in connection with the creation of a DAPT. The Alaska APT statute requires the client to prepare a solvency affidavit.[338] Although the other statutes do not require a solvency affidavit, the attorney and the trustee should require the client to furnish written proof of solvency and should not proceed if the client refuses. A sample solvency letter is included in the Appendix.
3. The attorney and the trustee also should follow their usual "know your client" procedures.
4. If claims or obligations are revealed by the due-diligence process,

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[336] *See* Lischer, *supra* note 41, at 625.

[337] *See* F. Peter Conaty, Jr., & William H. Lunger, *Practical Considerations in Drafting a Delaware Asset Protection Trust*, 30 TAX MGMT. EST., GIFTS & TR. J. 117 (2005).

[338] *See* ALASKA STAT. § 34.40.110(j) (2004).

the attorney and the trustee should make sure that the client will retain sufficient funds to meet them.

C. Involvement of Local Counsel

If a client is not represented by an attorney who is licensed in the jurisdiction where the trust is to be created, the client should engage local counsel. The local counsel should either draft the trust instrument for approval by the client and the existing attorney or approve the trust prepared by the existing attorney. Because local counsel's role is limited, the existing attorney-client relationship will not be jeopardized.

D. Asset Selection

1. The client should not fund the trust with assets (such as real estate in a state that does not honor DAPTs) over which a court might obtain in rem jurisdiction or over which a court might take action that could defeat the trust.
2. To bolster the asset-protection effectiveness of the trust and, if appropriate, its transfer-tax treatment, the client should fund it with assets from which the client never expects to need distributions.
3. To provide an extra layer of asset protection, attorneys often advise clients to fund DAPTs with interests in FLPs or LLCs. If FLP or LLC interests are used, the client must not control the entity[339] and the documentation for the entity must be drafted with care.[340] The entity probably should be created in a jurisdiction in which a creditor's sole remedy is to obtain a charging order over the interest.[341]

E. Trustee Selection

1. As discussed in Part V above, the asset-protection effectiveness of

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[339] *See In re* Albright, 291 B.R. 538 (Bankr. D. Colo. 2003).

[340] *See* Movitz v. Fiesta Invs. LLC (*In re* Ehmann), 319 B.R. 200 (Bankr. D. Ariz. 2005); Jay D. Adkisson & Christopher M. Riser, *Ehmann—Bankruptcy Trustee Gets Debtor's Non-Economic Rights*, STEVE LEMBERG'S ASSET PROTECTION PLAN. EMAIL NEWSL. #59 (Feb. 9, 2005), at www.leimbergservices.com.

[341] *See* Daniel S. Kleinberger, Carter G. Bishop, & Thomas Earl Geu, *Charging Orders, and the New Uniform Limited Partnership Act: Dispelling Rumors of Disaster*, PROB. & PROP. July/Aug. 2004, at 30; Elizabeth M. Schurig & Amy P. Jetel, *A Charging Order Is the Exclusive Remedy Against a Partnership Interest: Fact or Fiction?*, PROB. & PROP. Nov./Dec. 2003, at 57.

a DAPT might be compromised if a court outside the jurisdiction where the trust is created has personal jurisdiction over a trustee.

2. Although a client might name a co-trustee outside the DAPT jurisdiction with the expectation that the co-trustee will resign if creditor problems develop, there is no guarantee that the trustee will resign in time.
3. The client should choose a trustee that has a realistic chance of defeating personal jurisdiction because of the trustee's minimal contacts with the jurisdiction of the client's domicile.
4. The client should be reluctant to appoint advisers or protectors outside the jurisdiction in which the trust is created because a court might order them to perform duties that would defeat the trust.
5. An institutional trustee that does business as a single entity in multiple jurisdictions might not be a good candidate to be the trustee of a DAPT.

F. Drafting the DAPT

1. Including beneficiaries in addition to the trustor during the trustor's lifetime will increase the chances that the DAPT will work if creditor problems develop.
2. The trust should be drafted conservatively. Thus, the trust should only contain provisions that are explicitly permitted by the pertinent statute.
3. The terms following the trustor's death should be integrated with the trustor's other estate-planning documents. If the trustor retains a special testamentary power of appointment, the trustor can modify those terms as appropriate.
4. With the help of local counsel, the client's attorney should make sure that all provisions required by the pertinent statute are included.
5. Although the pertinent statute might permit the trustor to retain a variety of powers, the trust should not include powers (such as the right to replace the trustee) that might jeopardize the trust's asset-protection effectiveness.

G. Funding and Administering the DAPT

1. The trust should be funded correctly and promptly.
2. In the administration of the trust, the trustee must follow customary procedures for processing requests for discretionary distribu-

tions and avoid the appearance that the trustor may use the trust as a checking account.

H. Cost of Establishing and Administering the DAPT

1. The client must pay the existing and local attorneys for their services in connection with establishing a DAPT.
2. The trustee in the DAPT state probably will charge for administering the trust. Typically, a corporate trustee's fees for administering a DAPT are the same as for administering other trusts.

IX. PROPER DESIGN AND ADMINISTRATION OF A DAPT

A. Introduction

Some practitioners question whether a DAPT ever will provide protection against creditor claims or be excludable from the trustor's gross estate under Code section 2036(a)(1). The practitioners recognize the theoretical reasons that support the effectiveness of DAPTs but raise practical concerns. Specifically, they argue that the trustor and trustee of a DAPT always will have an "understanding" that the trustee will distribute funds whenever the trustor asks for them. They argue that a trustee who denies a distribution request will be fired or never receive more business from the trustor or members of the trustor's family. There are legal and practical responses to the practitioners concerns.

B. *The* Finch *Case*

In *Finch v. Wachovia Bank & Trust Co., N.A.*,[342] a recent North Carolina case, a widow asked the trustee of a marital trust to invade principal for funds to make gifts to her family and charities. After requesting and obtaining a statement of the widow's expenses, the trustee concluded that the will did not authorize the distribution of funds for the stated purpose and denied her request.

The widow filed a declaratory judgment action against the trustee and the remainder beneficiaries. The trial court held that the trustee had abused its discretion and ordered the trustee to exercise its discretion by determining a reasonable annual amount to distribute for gift-giving purposes.

The North Carolina Court of Appeals held:

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[342] *See* 577 S.E.2d 306 (N.C. Ct. App. 2003). A similar recent case is *In re* Ware, 814 A.2d 725 (Pa. Super. Ct. 2002).

> We affirm that portion of the trial court's order concluding that Wachovia abused its discretion by failing to consider plaintiff's gift requests in determining her reasonable needs. We vacate that portion of the trial court's decree ordering Wachovia to distribute an annual amount to plaintiff for gifting purposes. We remand for entry of an order consistent with this opinion, to include a provision that Wachovia has the sole discretion whether to disburse any funds from the corpus to meet plaintiff's gifting desires.[343]

C. Comments

The trustee in *Finch* had a dilemma. The trustee could have accommodated the widow's request, but she might later have sued if trust funds ran out. The remainder beneficiaries might also have sued the trustee following the widow's death to recover improper distributions. In either event, the trustee might have faced surcharge, removal, or reduced compensation. On the other hand, the trustee was sued because it turned down the widow's request. The trustee's job was more difficult because it dealt with a fractious family—the widow and one child had challenged the will following the decedent's death and one child had supported her mother, whereas another child had opposed his mother in the controversy. In the end, the court confirmed that the trustee had the final say.

D. Recommendations

There are at least six ways to mitigate the concerns mentioned in Paragraph A above:

1. Avoid Misunderstanding at Beginning

If the trustor really wants the trust to work, the attorney and the trustee should make it clear at the outset (preferably in writing) that the trustor will not be able to use the trust as a checking account. The trustor must understand that the trustor may receive funds only in accordance with the terms of the trust instrument and by following the trustee's procedure for processing discretionary distribution requests.

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[343] *Finch*, 577 S.E.2d at 310. *See* RESTATEMENT (THIRD) OF TRUSTS § 50 (2001); RESTATEMENT (SECOND) OF TRUSTS § 187 (1959); 3 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 187 (4th ed. 1988).

2. *Fund With Nest Egg*

The trustor should fund the trust with a portion of the trustor's assets that the trustor never expects to need, and, if possible, trust funds never should be distributed to the trustor. One attorney suggested that the trust be funded with assets the trustor might have formerly distributed as taxable gifts.

3. *Choose Proper Law*

The trustor should consider creating the trust in Delaware, Alaska, or South Dakota because the laws of those states specifically provide that the trustor only has the rights set forth in the trust instrument and that outside understandings are invalid.[344]

4. *Choose Proper Trustee*

The trustor should appoint as trustee an institution or individual that has written procedures for processing discretionary payment requests from trusts (self-settled or otherwise) and that scrupulously follows the written procedures. The trustor should avoid giving control of discretionary distributions to individual trustees, advisers, or protectors who lack safeguards. The *Finch* case illustrates how correct trust administration can prevent improper distributions.

5. *Name Other Beneficiaries*

The trustor should name other beneficiaries who might object if the trustee makes improper distributions. The *Finch* case illustrates how the involvement of other beneficiaries can focus the trustee's attention.

6. *Create DAPT*

The trustor should create the trust in a jurisdiction where other beneficiaries have an opportunity to bring their claims in court. Each of the six DAPT states should meet this requirement. A purported "advantage" of offshore APTs is that they are created in jurisdictions where creditors are unable to engage local counsel to pursue claims. Beneficiaries seeking to prevent trustees of offshore APTs from acting improperly are similarly disadvantaged.

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[344] *See* DEL. CODE ANN. tit. 12, § 3571 (2001); ALASKA STAT. § 34.40.110(i) (2004); S. 93, 2005 Leg., 80th Sess. (S.D. 2005).

APPENDIX

Solvency Letter

_______________, 200_

Attention:
Re:
Ladies and Gentlemen:

This letter is written to you in connection with my creation of the above-captioned trust (the "Trust"), which I will create after delivery of this letter.

I am aware that under certain circumstances assets held in the Trust may not be reached by my personal creditors. I have been advised by you that a personal creditor of mine could reach assets held in the Trust if the creditor could prove that my transfer of assets to the Trust was a fraudulent transfer.[1] I also understand that no assurance can be given that the law of Delaware would apply to the determination as to whether a transfer of assets to the Trust is a fraudulent transfer. Accordingly, I have, to the extent I deem advisable, consulted with counsel in Delaware and in other states including my state of residence, regarding the laws pertaining to fraudulent transfers in those states. You have not advised me in any manner with respect to the fraudulent transfer laws, or law of similar import, in any state.

I have no intent to hinder, delay or defraud any creditor of mine in connection with the transfer of assets to the Trust or otherwise.

I am not now engaged in, nor do I have any intent or plan to engage in, any business or transaction for which my assets remaining after the completion of my intended transfer of assets to the Trust would be unreasonably small in relation to the business or transaction.

I do not intend to incur, nor do I have any belief or reason to believe that I will incur, debts beyond my ability to pay when due.

I am not presently involved in, nor am I aware of, any pending or threatened litigation in which any person is directly or indirectly seeking damages against me [, except for those matters or court actions identified

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[1] Under Delaware law, a transfer is fraudulent if (i) made by the debtor with actual intent to hinder, delay or defraud a creditor, (ii) the debtor engages in a business or transaction for which his assets remaining thereafter are unreasonably small in relation to the business or transaction, or (iii) the debtor intended or should have known that he would incur debts beyond his ability to pay when due. *See* DEL. CODE ANN. § 1304(a) (1999). The fraudulent transfer laws of other states may be more or less restrictive.

in Exhibit “A”]. I am not involved in any administrative proceeding under the jurisdiction of a federal, state or municipal government as of this date [, except as set forth in Exhibit “A”].

Upon the completion of my intended transfer of assets to the Trust, I will not have made a transfer to the Trust of substantially all of my assets.

[Except as described in Exhibit “B”, to] OR [To] the best of my knowledge, I am not liable for, or indebted to, any person who suffered death, personal injury or property damage on or before the date upon which I create and fund the Trust, whose death, personal injury or property damage may be determined at any time to have been caused in whole or in part either by my act or omission or by the act or omission of another person for whom I am vicariously liable.

[Except as described in Exhibit “C”,] I am not presently in arrears on account of any agreement or court order for the payment of support or alimony in favor of my spouse, my former spouse, or my children, nor have I failed to comply with any agreement or court order providing for the division of property in favor of my spouse or former spouse.

I have no intent to abscond.

No part of my intent in creating the Trust is to conceal assets.

I am not currently insolvent, nor have I incurred debts I am unable to pay when due. I do not currently contemplate filing for relief under the provisions of the U.S. Bankruptcy Code, nor am I involved in any situation that I reasonably anticipate would cause me to file for relief thereunder in the future.

Following the completion of my intended transfer of assets to the Trust, I will remain solvent and the value of my assets will substantially exceed my debts. To the best of my knowledge, I will remain able to pay my debts as they come due.

When I state that my assets will exceed my debts, I am referring to all of my property that is not encumbered by a valid lien except to the extent it is generally exempt under nonbankruptcy law, and except for property held in tenancies by the entirety when it is not subject to process by a creditor holding a claim against only one tenant.

I am not about to incur substantial debt, nor have I already incurred a substantial debt in relation to the value of my assets.

I have full right, title, and authority to make the intended transfer of assets to the Trust. None of the assets that I intend to transfer to the Trust have been pledged or otherwise promised in satisfaction of any debt nor are any of those assets subject to any lien, encumbrance, or security interest of any type.

The assets intended to be transferred to the Trust were not derived from unlawful activities.

Whenever in this letter I refer to my "creditors" or my "debts," I mean to include both my direct creditors and direct debts and those creditors to whom, and those debts for which, I am, or may be, jointly and severally liable or indirectly liable such as, for example, those creditors to whom, and debts for which, I am, or may be, liable on account of my status as a general partner in a partnership or guarantor of the debt of another.

I intend that each person now or hereafter serving as Trustee or Advisor for the Trust may rely upon this letter in agreeing to act as a fiduciary of the Trust. You, along with any other Trustee of the Trust, may rely upon it for any purpose including assisting in any defense in any legal proceeding that may be brought against you in your corporate or fiduciary capacity.

Very truly yours,

SUBSCRIBED AND SWORN to before me
This ____ day of _______________, 200_

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Notary Public