ASSET PROTECTION AND DYNASTY TRUSTS
Author(s): Charles D. Fox IV and Michael J. Huft
Source: *Real Property, Probate and Trust Journal*, Vol. 37, No. 2 (Summer 2002), pp. 287-361
Published by: American Bar Association
Stable URL: http://www.jstor.org/stable/20782272
Accessed: 25-01-2018 10:36 UTC

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact support@jstor.org.

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at http://about.jstor.org/terms

JSTOR

American Bar Association is collaborating with JSTOR to digitize, preserve and extend access to *Real Property, Probate and Trust Journal*

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

ASSET PROTECTION AND DYNASTY TRUSTS

Charles D. Fox IV*
Michael J. Huft**

Editors' Synopsis: Historically, settlors of trusts were not permitted to remain trust beneficiaries while obtaining spendthrift protection from creditors; however, recent legislation in several states has purportedly permitted this result. This Article examines domestic protection trusts permitted under Alaska, Delaware, Nevada, and Rhode Island. Additionally, this Article examines the possibility of creating perpetual dynasty trusts under the law of several states that have abolished the rule against perpetuities or permit trusts to opt out of the rule.

I. INTRODUCTION ... 291
II. TRADITIONAL ASSET PROTECTION METHODS ... 294
  A. Outright Gifts of Property ... 294
  B. Transfer in Trust ... 294
  C. Co-ownership ... 294
  D. Exempt Assets ... 294
  E. Trusts for Disabled Beneficiaries ... 295
III. SOPHISTICATED TECHNIQUES FOR ASSET PROTECTION ... 296
  A. Limited Partnerships ... 296
  B. Limited Liability Companies ... 296
  C. Offshore Protection Trusts ... 297
    1. *Creditor Protection Benefits* ... 298
    2. *Other Advantages* ... 298
    3. *Popularity* ... 298
    4. *Provisions of Offshore Protection Trusts* ... 299
    5. *Confidentiality* ... 301
    6. *Offshore Trust Subject to Claims of Creditors* ... 301

---

* Partner, Schiff Hardin & Waite, Chicago, Illinois. A.B., Princeton University, 1975; M.A., Yale University, 1977; J.D., University of Virginia, 1980. This Article, in part, is based on an outline prepared by Charles D. Fox IV and John A. Terrill, entitled *Perpetual Trusts and Creditor Protection: Looking At New Possibilities*, which was presented at the ACTEC Annual Meeting in Orlando, Florida on February 25 to March 1, 1998. The authors wish to thank their summer associate, Emma Sobol, for her assistance and hard work.

** Associate, Schiff Hardin & Waite, Chicago, Illinois. B.S., University of Notre Dame, 1971; Ph.D., University of Michigan, 1979; J.D., Northwestern University, 1995.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

7. A Final Word of Caution . . . 303
IV. FRAUDULENT CONVEYANCES . . . 303
A. Fraudulent Conveyances as to Existing Creditors . . . 304
B. Fraudulent Conveyances as to Future Creditors . . . 304
C. Determination of Actual Intent—Badges of Fraud . . 305
D. Solvency . . . 306
E. Remedies . . . 306
F. Reducing the Risk of a Fraudulent Conveyance Attack . . . 306
V. ETHICAL AND OTHER CONSIDERATIONS FOR ATTORNEYS . . . 307
A. Threshold Question . . . 307
B. Personal Liability for Assisting Clients in Defrauding Creditors . . . 308
C. Potential Liability for Failing to Counsel Asset Protection Planning . . . 308
VI. ABOLITION OF THE RULE AGAINST PERPETUITIES . . . 309
A. Repeal Legislation . . . 309
B. Delaware Partial Repeal Legislation . . . 310
C. Opt-Out Legislation . . . 310
1. Illinois Opt-Out Legislation . . . 311
2. Maine and Maryland Opt-Out Legislation . . . 311
3. Ohio Opt-Out Legislation . . . 312
4. Arizona Opt-Out Legislation . . . 312
5. Colorado Opt-Out Legislation . . . 313
6. Missouri Opt-Out Legislation . . . 313
7. Virginia Opt-Out Legislation . . . 314
8. Prospective Nevada Opt-Out Legislation . . . 314
D. Income Tax Considerations . . . 314
E. Summary . . . 315
VII. DOMESTIC PROTECTION TRUSTS . . . 320
A. Missouri Domestic Protection Trusts . . . 320
B. Alaska, Delaware, Nevada, and Rhode Island Domestic Protection Trusts—History and Common Concerns . . . 321
C. Alaska Trusts . . . 322

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

1. Rule Against Perpetuities 323
2. Creditor Protection 323
3. Limitations 323
4. Applicability of Alaska Act 324
D. Delaware Trusts 324
1. Creditor Protection 324
2. Limitations 325
3. Applicability of Delaware Act 325
4. Rule Against Perpetuities 325
E. Nevada Trusts 326
1. Creditor Protection 326
2. Limitations 326
3. Applicability of Nevada Act 327
F. Rhode Island Trusts 327
1. Creditor Protection 327
2. Limitations 327
3. Applicability of Rhode Island Act 328
4. Rule Against Perpetuities 328
G. State Income Tax Considerations 328
H. Estate and Gift Tax Consequences of Domestic Asset Protection Trusts 329
1. Gift Tax Concerns 329
2. Estate Tax Concerns 330
3. Arguments for Estate Tax Inclusion 335
4. Conclusions 335
I. Federal Income Tax Consequences of Domestic Asset Protection Trusts 336
VIII. CONFLICT-OF-LAWS PRINCIPLES RELATING TO PERPETUITIES AND ASSET PROTECTION TRUSTS 337
A. Potential Conflict of Laws 337
B. Alaska, Delaware, Nevada, and Rhode Island Choice-of-Law Provisions 337
1. Alaska 337
2. Delaware 338
3. Nevada 338
4. Rhode Island 339

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

C. Conflict-of-Laws Principles Governing Trusts Under the Second Conflict of Laws Restatement . . . 339
1. Distinctions . . . 339
a. Real Property vs. Personal Property . . . 340
b. Secondary Distinctions . . . 340
2. Issues Relating to Validity . . . 340
a. Real Property Trusts . . . 340
b. Personal Property Trusts . . . 340
3. Issues Arising Under Trust Administration . . . 342
a. Real Property Trusts . . . 342
b. Personal Property Trusts . . . 342
4. Issues Relating to Trust Construction . . . 343
5. Conflict-of-Laws Principles Governing Anti Alienation Clauses . . . 343
a. Real Property Trusts . . . 343
b. Personal Property Trusts . . . 343
D. Application of Conflict-of-Laws Principles to Claims That Asset Transfer Was Fraudulent . . . 344
1. Enforceability of Settlors' Choice-of-Law . . . 344
2. Resolution of Conflict-of-Laws Issue . . . 344
E. Application of Conflict-of-Laws Principles to Claims That Spendthrift Trust Is Invalid . . . 345
1. Real Property Trusts . . . 345
2. Personal Property Trusts . . . 346
a. Substantial Relation to the Trust . . . 346
b. Violation of Strong Public Policy . . . 347
IX. PRACTICAL PROBLEMS WITH RESPECT TO DOMESTIC ASSET PROTECTION TRUSTS . . . 347
A. Enforceability of Foreign Judgments . . . 347
1. Enforcement of Judgment in Original Forum . . . 348
2. Enforcement in Jurisdiction Where the Trust Has Its Situs . . . 349
B. Judgment Against Trust and Not Settlor . . . 349
X. ATTACK ON SPENDTHRIFT PROTECTION FOR THIRD PARTY BENEFICIARIES . . . 350
XI. CONCLUSION . . . 360

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

I. INTRODUCTION

Asset protection in some respects has been a part of estate planning for as long as an estate planning discipline has existed. After all, people create trusts for family members in most instances to preserve and protect property for the future use and benefit of the family members. From this perspective, asset protection is really just an integral part of the primary goal of the estate planner—to provide a structure to pass property, either during life or at death, to a client's designated beneficiaries, while reducing transfer taxes and avoiding other costs and delays.

In today's increasingly litigious environment, however, asset protection planning is becoming increasingly significant as a separate area of focus within the field of estate planning. The essence of asset protection planning is the use of advanced planning techniques to place assets beyond the reach of future potential creditors.[1] In this way, the client can preserve the assets to pass to family members or other beneficiaries through traditional estate planning techniques.

Creditor and liability problems can arise from a variety of sources:

(1) *Contract Creditors*

Creditor threats can arise from contractual relationships such as consumer debt, bank debt, guaranties, and partnership liabilities.

(2) *Tort Creditors*

The amount of tort litigation in the United States has increased tremendously in recent years.[2] Moreover, the potential costs to a party found liable may be dangerously severe. In 1999, for example, the top ten jury awards in United States alone totaled $9.6 billion.[3] In addition, annual litigation-related costs in the United States have been estimated at $300 billion.[4]

Insurance has often been viewed as a shield against tort judgments. Today, however, individuals with perceived deep pockets, such as doctors, lawyers, and other professionals, may find themselves paying judgments, in part, out of their own assets, because insurance is no longer adequate to cover many of the judgments rendered. Moreover, questions are arising

---

[1] *See* Howard D. Rosen, *Asset Protection Planning*, TAX MGMT. PORTFOLIO NO. 810 (1994), A-1.

[2] *See, e.g.*, *A Rising Tide of Torts?*, 71 N.Y. ST. B.J., April, 1999, at 40.

[3] *See* Dana B. Taschner, *The Appeal of Big Jury Awards*, L.A. LAW, Oct. 2000, at 68.

[4] *See* Spencer Abraham, *Litigation Tariff: The Federalist Case for National Tort Reform*, POLICY REVIEW, Summer 1995, at 77, 78.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

about the stability of the insurance industry in general and the survivability of certain insurance companies in particular.[5]

(3) *Regulatory Liability*

Government has imposed liability on various groups to achieve desirable social goals. One of the best examples of this practice is the liability imposed for the cost of cleaning up environmentally damaged property by the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA" or "Superfund"),[6] as well as other federal and state environmental statutes. CERCLA, for example, gives the Environmental Protection Agency ("EPA") broad powers in the identification and cleanup of contaminated sites and in the recovery of cleanup and related costs from private parties.

Subject to certain limited defenses, liability is imposed without regard to fault on any or all of the liable parties. The liability is not necessarily based on the degree to which the party contributed to the problem, if at all. The potential costs to a party on whom liability is imposed are staggering. As of August 2001, the EPA counted a total of 1,235 Superfund sites,[7] and the average Superfund cleanup has been estimated to cost more than $20 million.[8] Significantly, general liability policies commonly exclude environmental liability.

(4) *Divorce*

Divorce claims are far more prevalent today than during any previous period. Furthermore, premarital agreements offer only limited protection in the event of divorce. Courts often overturn such agreements if the rigorous formalities are not met. Premarital agreements do not cover the various types of interspousal tort claims that can be made, such as the intentional infliction of emotional distress.[9] Finally, many couples, for numerous real or imaginary reasons, fail to enter into premarital agreements.

---

[5] *See generally* Duncan Osborne, *New Age Estate Planning: Offshore Trusts*, 27 U. OF MIAMI INST. ON ESTATE PLANNING PROC. ¶ 1700, 17-1 to 17-74 (1993), (discussing the insurance industry further).

[6] *See* 42 U.S.C. §§ 9601-9675 (Supp. III 1997).

[7] *See* http://cfpub.epa.gov/superapps/index.cfm/fuseaction/faqs.viewAnswer/question_id/64/category_id/15/faqanswr.cfm, last visited Aug. 6, 2002.

[8] *See* Charles Openchowski, *Superfund in the 106th Congress*, 30 ENVTL. L. REP. 10648, n.16 (Aug. 2000).

[9] *See* Osborne, *supra* note 5, at ¶ 1700.2.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

(5) *Disabled Beneficiaries*

A growing topic of concern for many clients with a disabled parent, spouse, or child is how to create a trust to provide for the needs of that disabled relative, without having the trust assets included among the disabled beneficiary's assets for the purpose of determining whether the beneficiary is eligible for Medicaid or other public assistance.[10]

Historically, trusts have been one of the most important, regularly used and accepted asset protection tools available to an individual who seeks to make assets available to a third person beneficiary, but wishes to protect those transfers from the beneficiary's creditors. With respect to the transferor's creditors, for reasons set forth below, trusts have until very recently not been viewed as a useful technique for creditor protection. Several developments have changed this environment and have encouraged the use of trusts for protecting assets from the transferor's creditors while, in certain cases, perhaps, retaining for the transferor the use of the transferred assets. Until recently, the attention had been on offshore protection trusts. However, in 1997, both Alaska and Delaware enacted legislation permitting so-called domestic protection trusts. Since then, Nevada and Rhode Island have enacted similar legislation. This Article first takes a brief look at traditional asset protection methods, then briefly reviews offshore protection trusts. The primary focus of this Article, however, is an examination of the domestic protection trusts permitted under Alaska, Delaware, Nevada, and Rhode Island law, as well as the possibility of creating perpetual dynasty trusts under the laws of several states that have recently either abolished the rule against perpetuities or allow a trust to opt out of the rule. Of particular concern is whether a settlor who is not a resident of a state that allows either perpetual trusts or self-settled asset protection trusts can choose to have a trust governed by the laws of that state, and whether a court in a state the laws of which have not been chosen to govern the trust would apply the laws of the chosen state to issues governing trust validity, the validity of transfer of property to the trust, the availability of trust assets to satisfy the settlor's creditors, and to issues relating to perpetuities. This Article examines choice-of-law provisions and conflict-of-laws principles as they relate to these provisions of trusts.

---

[10] *See generally* Clifton B. Kruse, Jr., *Discretionary Trusts: Insulating Discretionary Trust Assets for Elders and Incapacitated Persons from Consideration by Medicaid and Other Public Support Providers*, 17 AM. C. OF TR. AND EST. COUNS. 26, 26-65 (Summer 1991) (providing a comprehensive overview of this subject).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

II. Traditional Asset Protection Methods

A. Outright Gifts of Property

Outright gifts are a simple way for a client to protect assets from the claims of creditors. Assets that the client gives away are no longer subject to seizure by the client's creditors. However, if the client is insolvent, or would become insolvent by making the gift, the Fraudulent Conveyance statutes, discussed in Part IV of this Article, may impose consequences.

B. Transfer in Trust

Trusts may be the most important, regularly used, and accepted asset protection tool available. For transfer of property by gift, using a trust can alleviate the client's concerns about the beneficiary's imprudent use of the property. In the case of a transfer to a spouse, a trust will provide some protection in case of later divorce. Of even greater importance is the creditor protection that a trust provides to the trust beneficiaries. In most states, a beneficiary's creditors cannot reach trust assets if the trustee's power to distribute trust assets is subject to the trustee's discretion, and the trust has been created, in good faith, by, or the fund so held in trust has proceeded from, a person other than the beneficiary. In many states, the statutory protection from creditors provided by a trust created by another is automatic. In other cases, the trust agreement must specifically prohibit attachment by, or assignment to, a beneficiary's creditors. A spendthrift provision is ineffective in most states where the settlor is also a beneficiary of the trust. In general, the settlor's creditors can reach the trust assets to the extent that the trustee could make permissible distributions to the settlor, whether or not the settlor has the power to compel the distribution.

C. Co-ownership

Different forms of co-ownership, such as tenancy by the entirety, joint tenancy with right of survivorship, and tenancy in common, may provide some protection against creditors.

D. Exempt Assets

Certain assets are partially or entirely exempt from the reach of creditors under either federal or state law. To the extent feasible, an individual can protect wealth from creditors by concentrating that wealth in exempt assets. For example, most states have a homestead exemption that allows an individual always to retain a certain amount of equity in the individual's residence. Many states exempt the proceeds as well as cash

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

value of life insurance and annuity contract from the reach of creditors. In some states, such as Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other dependent.[11] Both the Employee Retirement Income Security Act ("ERISA")[12] and the laws of many states protect qualified retirement plans from creditors. Individual retirement accounts are not subject to the ERISA protections, but are protected under the laws of some states, such as Texas.[13]

E. Trusts for Disabled Beneficiaries

The most likely potential creditor of a disabled beneficiary is the federal, state, or local agency that provides public assistance to that beneficiary. Over the past ten to fifteen years, public agencies have become more aggressive in seeking reimbursement for the cost of caring for disabled persons. Many states have passed laws that permit government agencies to seek such reimbursement and define the assets available to such agencies. An estate planner must carefully consider these statutes when drafting a trust that is designed to provide supplemental benefits to a disabled person to improve the quality of the person's life without having the entire trust subject to confiscation by a government agency.

State case law is not consistent in defining the standard of distribution that will cause trust assets to be chargeable for a disabled beneficiary's care. Many states treat a trust that allows the trustee to make distributions for the "support and maintenance" of a beneficiary as an asset of the beneficiary for the purpose of determining eligibility for public aid. However, in other cases, states have been unable to obtain reimbursement for public aid when the trust instrument allowed the trustee to use principal for the beneficiary's support and maintenance, especially in cases in which the trust instrument evidenced the testator's intent that trust assets merely supplement support from other sources. Many state legislatures are now attempting to provide statutory guidelines for when trust assets will be considered available to the beneficiary for the purpose of qualifying the beneficiary for public assistance or allowing the state to seek reimbursement from trust assets.

---

[11] 735 ILL. COMP. STAT. 5/12-1001(f) (West 1992 & Supp. 2002).

[12] *See* 29 U.S.C. §§ 1001-1461 (1994).

[13] *See* TEX. PROP. CODE ANN. § 42.0021 (West 1990) (exempting pension plans from attachment).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

III. SOPHISTICATED TECHNIQUES FOR ASSET PROTECTION

A. Limited Partnerships

The family owned partnership has become a popular vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. The family partnership provides a number of benefits, both tax and nontax, including valuation discounts, transfers of value without relinquishing control, and restrictions on further transfer of limited partnership interests.

With respect to asset protection planning, a limited partner's personal exposure for the debts of the partnership generally is limited to his or her investment in the partnership. This limited exposure prevents a creditor of the partnership from reaching the personal assets of a limited partner to satisfy debts owed by the partnership.

A limited partnership also can provide a modest level of protection against creditors of a partner who are seeking assets to satisfy a debt or judgment. Almost every state has enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"). RULPA helps protect the interests of limited partners from the claims of their creditors by mandating an unattractive remedy for the creditors.[14]

Usually, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides that "a court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest." Under section 702 of RULPA, the assignee judgment creditor is entitled to receive only those distributions to which the debtor partner would have been entitled, unless the partnership agreement provides otherwise. The effect of the charging order is that a partner's creditor will only receive those partnership distributions which, absent the charging order, would have been distributed to the debtor partner.

B. Limited Liability Companies

The limited liability company ("LLC") is emerging as a possible viable alternative to the use of a limited partnership. The LLC first became

---

[14] *See* REVISED UNIF. LTD. P'SHIP ACT § 703 (amended 1985), 6A U.L.A. 235 (1995).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

available in Wyoming in 1977 and now is available in almost every state. The LLC provides the limited liability of a corporation, but preserves the flow- through treatment of taxable income or loss of a partnership. The LLC can provide an attractive alternative to a general or limited partnership, especially when limiting the personal liability of the family members in relation to the activities of the entity is desired. The LLC, however, has not found widespread use among estate planners as a substitute for the family limited partnership because of concerns about the availability of valuation discounts for transfers of member interests.

With respect to asset protection issues, many state LLC statutes contain charging order sections similar to that found in RULPA. Also, LLC statutes generally contain provisions that provide protection quite similar to that afforded by a limited partnership, such as:

(1) a member's interest in an LLC is personal property but not an interest in specific assets of the LLC;
(2) an assignee must have the unanimous consent of the other members to become a member of the LLC; and
(3) an assignee who is not a member may receive the share of profits and income to which the assignor was entitled, but may not participate in the management of the LLC.[15]

The use of the LLC in asset protection planning is likely to be restricted until a uniform statute is adopted in most, if not all, states.[16] Otherwise, the amount of protection will be uncertain, especially if property is held in different states.[17]

C. Offshore Protection Trusts

Offshore protection trusts have become one of the most talked about estate planning techniques in recent years. They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions permit a settlor to create a spendthrift trust for the settlor's own benefit. These barriers often insulate the property entirely from creditors or encourage creditors to agree to inexpensive settlements.

---

[15] *See* Rosen, *supra* note 1, at A-9.
[16] *See id.* at A-10.
[17] *See id.*

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

1. *Creditor Protection Benefits*

An offshore protection trust can present geographic, legal, procedural, and financial hurdles to a creditor interested in reaching its assets. The mere fact that a trust is a foreign trust may deter creditors from pursuing the trust. This deterrence is particularly likely if the trust is funded with assets from the foreign jurisdiction. The cost of pursuing a claim against a foreign trust can be high, especially in foreign jurisdictions that prohibit contingent fee litigation or require significant deposits to commence a proceeding. Some jurisdictions, such as the Cook Islands, do not recognize foreign judgments.[18] Thus, an action first brought in a United States court may need to be tried a second time in a foreign jurisdiction. As mentioned, many foreign jurisdictions have favorable spendthrift trust provisions that protect the interests of a settlor-beneficiary. Such provisions are in contrast to the dominant rule in the United States that one may not create a spendthrift trust for one's own benefit.

2. *Other Advantages*

In addition to the creditor protection benefits of an offshore protection trust, such a trust may offer an individual other advantages:

(1) economic diversification;
(2) a "low profile" or anonymity with respect to wealth;
(3) premarital and marital planning;
(4) preparation for the contingency of changing one's citizenship;
(5) participation in investments not otherwise available to U.S. investors;
(6) planning in anticipation of currency controls or fluctuations; and
(7) liability protection, tax planning, or strategic advantage with respect to an active trade or business.[19]

3. *Popularity*

Offshore protection trusts are now quite popular among wealthy families, investment managers, and professionals, such as doctors, lawyers, and accountants, as ways to shield their assets from malpractice claims. Current estimates indicate that $1 trillion worth of assets are held in

---

[18] *See* International Trusts Act of 1984, § 13D (1996) (Cook Islands).

[19] DUNCAN D. OSBORNE, ASSET PROTECTION: DOMESTIC & INTERNATIONAL LAW AND TACTICS, § 19.03 (1996).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

offshore protection trusts.[20] How much of that figure consists of U.S. source assets, however, has not been estimated.

4. Provisions of Offshore Protection Trusts

The basic provisions of an offshore protection trust generally include the following:

(1) *Governing Law*. The trust is created and governed under the laws of one of several foreign jurisdictions that have laws favorable to offshore protection trusts. These include, among others, the Cook Islands; the Cayman Islands; Gibraltar; the Isle of Man; the Bahamas; Belize; the Turk and Caicos Islands; and Cyprus.

(2) *Irrevocability*. The trust is irrevocable; however, as described below, a third party usually possesses a substantial power of amendment.

(3) *Term*. The trust may have a term for a set number of years or last for the life of the settlor or one or more beneficiaries.

(4) *Beneficiaries*. The beneficiaries normally include the settlor and one or more family members.

(5) *Trustees*. A trustee located in the jurisdiction almost always is required. Typically, this trustee is a foreign corporation with trust powers. One or more U.S. cotrustees possibly may serve, but this increases the risk of attachment by creditors because a U.S. trustee potentially is within the jurisdiction of U.S. courts.

(6) *Distributions*. A foreign trustee usually has unfettered and absolute discretion over the distribution of income and principal.

(7) *Control*. The settlor often retains some degree of control over the trust through the following: (i) membership in or designation of a committee of advisors, with powers similar to those of a "trust protector," described below; (ii) retention of limited authority to take steps such as removing trustees and appointing new trustees; or (iii) designation of a trust protector with authority to make more substantial changes to the trust, such as moving the trust to another jurisdiction, or terminating a beneficiary's interests. Some experts recommend that the trust protector be unrelated to the settlor and the settlor's family. One commentator, for example, reports that a member of his firm serves as the trust protector for the first years of the trust. This, according to the commentator, insures proper

[20] *See* Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It Too*, 47 RUTGERS L. REV. 11, 14 (Fall 1994).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

recordkeeping and U.S. tax reporting during the formative years of the trust and also provides time to train a successor.[21]

Typically, the degree of control that a settlor retains bears an inverse relationship to the amount of creditor protection that the trust provides. In other words, the more control that a settlor is willing to relinquish, the greater asset protection the settlor generally will achieve. Conversely, if a settlor retains too much control, the settlor runs the risk of having the entire arrangement overturned by a court as a "sham transaction."[22]

Additional provisions are frequently included in offshore protection trusts to increase their effectiveness against potential creditors. These provisions include the following:

(1) *Ability of Foreign Trustee or Other Fiduciary to Change Situs of Trust Assets*. The trustee or trust protector can be given the power to change the situs of the trust assets to another jurisdiction, which can be employed if an action is threatened against the trust in its original jurisdiction. This power increases the costs to the creditor of making its claim and, consequently, acts as a deterrent to any such claim.

(2) *Letter of Wishes*. The settlor of the trust can provide nonbinding written guidelines to the trustee. These guidelines cover the settlor's intent with respect to the investment of the assets and the making of distributions to family members. The guidelines can be changed as circumstances or the desires of the settlor change.

(3) *Duress Clause*. A duress clause directs a foreign trustee to ignore the advice, order, or instruction of a U.S. trustee if such advice, order, or instruction is given under duress, which should be defined in the trust instrument to include court compulsion.

(4) *No Benefits Term*. The trust might include a provision that provides for a term during which the beneficiaries are solely persons other than the trust settlor. This term may correspond with the limitations period applicable to claims of creditors in the foreign jurisdiction governing the trust.

(5) *Restrictions on Beneficial Interests*. The trust can provide that the settlor is only one of several permissible beneficiaries with the trustee having the power to choose among them and to remove one

---

[21] *See* Larry W. Gibbs & Mark Schwartzarann, *Tips on International Planning for the U.S. Citizen*, 234 TR. & EST., July 1995, at 37, 38.

[22] *See* Osborne, *supra* note 19 at §§ 20:08-20:09.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

or more of them. The trust can also provide that upon the occurrence of a certain event (e.g., a judgment against the settlor), the settlor's beneficial interest in the trust (and any fiduciary powers held by the settlor) either may be terminated or held in abeyance for a specified period of time.

5. *Confidentiality*

Early in the planning stages for an offshore protection trust, confidentiality should be stressed to the potential settlor and all related parties. Although information regarding the trust may not be protected from the Internal Revenue Service ("Service") or trust beneficiaries, it can, in many cases, be hidden from third parties who might later become creditors. The planner should strive for confidentiality with respect to the trust's existence, its terms and provisions, its value, the nature and location of its assets, the trustees, and, if applicable, the trust protector's identity and activities, the settlor's and beneficiaries' identities, and the nature, name, and role of any ancillary entities associated with the trust.[23]

6. *Offshore Trust Subject to Claims of Creditors*

Taxpayers who have established offshore trusts are beginning to discover that those trusts do not always provide the level of creditor protection advertised. The fundamental problem is that a U.S. resident who moves assets to an offshore trust is still personally subject to the jurisdiction of U.S. courts. As in a recent Florida bankruptcy case, *In re Lawrence*,[24] the court may have little sympathy for someone who has, in its view, "stashed" funds offshore.

On January 8, 1991, Stephen Lawrence established an offshore trust in the Jersey Channel Islands with an initial contribution of $7 million. This trust was established two months prior to the conclusion of a forty-two month arbitration dispute with Bear Stearns & Co. Inc. that resulted in a $20.4 million award in favor of Bear Stearns. On February 7, 1991, the trust was amended to add specific spendthrift language and to move the property to Mauritius.[25] On January 23, 1993, the trust was amended so that the settlor's powers could not be exercised under duress or coercion

---

[23] *See id.* at § 20:10.
[24] *See* 251 B.R. 630 (Bankr. S.D. Fla. 2000), *aff'd*, 279 F.3d 1294 (11th Cir. 2002).
[25] *See id.* at 635.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

and that Lawrence's life interest would terminate if Lawrence became bankrupt.[26]

Lawrence subsequently declared bankruptcy. On August 26, 1999, the bankruptcy court ordered Lawrence to turn over the trust assets to satisfy in part a judgment obtained by Bear Stearns.[27] On September 8, 1999, the bankruptcy court held Lawrence in contempt for failing to turn over the assets, and ordered him to be jailed.[28] The court said that because the trust was his own creation, the debtor could not avail himself of the impossibility defense. The court also stated that why Lawrence would transfer $7 million to a trust and release all control "tortured reason and abandoned common sense." Lawrence appealed to the district court.[29]

The district court supported the bankruptcy court's conclusion that Lawrence had set up the trust for his own benefit. Moreover, it found that Lawrence "effectively had dominion over the property on the Trust, and that the spendthrift provisions [were] not enforceable as a shield against creditors."[30] It found that Lawrence's attempt to use an offshore trust contravened "the clear public policy against allowing a debtor to shield money placed in a trust for his or her own benefit from creditors, defied common sense, and was undermined by language in the trust that gave Lawrence the power to remove and appoint trustees."[31]

Upon review, the district court upheld the order of incarceration for Lawrence.[32] The district court cited the Ninth Circuit's holding in *Federal Trade Commission v. Affordable Media, LLC.*[33] *Affordable Media* involved an attempt by a couple, the Andersons, to hide money in an offshore trust based in the Cook Islands. Under the terms of that trust, if an event of duress occurred, the Andersons were removed as cotrustees and the Cook Island trustee was prohibited from repatriating assets.[34] In a contempt proceeding at the district court level, the Andersons argued that they could not comply with the court order to repatriate the assets because to do so

[26] *See id.* at 635-36.
[27] *See id.* at 637.
[28] *See id.* at 638.
[29] *See id.* at 638, n.5.
[30] *Id.* at 644.
[31] *Id.* at 645.
[32] *See id.* at 653.
[33] *See* 179 F.3d 1228 (9th Cir. 1999).
[34] *See id.* at 1232.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

was impossible. The district court was not impressed and held the Andersons in contempt. The Ninth Circuit upheld the contempt finding.[35]

Lawrence and *Affordable Media* do not spell the end of offshore asset protection trusts or the domestic protection trusts currently available in Alaska, Delaware, Nevada, and Rhode Island. However, they do reveal some limitations. The Andersons and Lawrence appear to have been involved in fraudulent schemes. U.S. law generally voids a transfer in fraud of actual or foreseeable creditors. Courts are inclined to retain this approach with offshore asset protection trusts even if local law governing the trust is different. Moreover, both the Andersons and Lawrence appear to have retained too much control. In the case of the Andersons, they acted as both trustees and trust protectors for their trust. Lawrence had the power to remove and appoint the trustee. Both the Andersons and Lawrence failed to follow the general rule that the less the amount of control retained, the greater the protection afforded by an asset protection trust.

7. A Final Word of Caution

A client should not expect that an offshore protection trust will provide perfect protection against the claims of creditors. If the creditor has a skilled lawyer, the existence of the foreign trust usually will become known. A litigious and determined creditor can make life very difficult for a debtor who has offshore assets and refuses to settle in some manner with the creditor. The creditor, for example, can force the debtor into involuntary bankruptcy and persuade the court to refuse to discharge the debtor until the debtor gives up some of the assets in the offshore trust. As related by a colleague, this situation apparently happened to a Texas man who had an offshore trust. The judge kept the man in bankruptcy and ordered that he obtain court approval for any expenditure he planned to make, including, for example, buying groceries, so the court could determine the source of the funds and whether any portion could be given to the creditor. Moreover, some local courts may interpret their laws narrowly to minimize the possibility of their jurisdiction being viewed as a rogue country vis-à-vis the international community.

IV. FRAUDULENT CONVEYANCES

The most effective means for a creditor to attack an asset protection plan is use of the fraudulent conveyance laws. Fraudulent conveyance

---

[35] *See* 179 F.3d at 1233.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

provisions exist under both the federal Bankruptcy Code and state law. Most states have adopted a version of the Uniform Fraudulent Transfer Act ("UFTA").[36] One must consider these provisions when engaging in any asset protection planning that involves transferring property to a third person, including the trustee of an offshore protection trust.

A. Fraudulent Conveyances as to Existing Creditors

Under UFTA, a transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if:

(1) the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor was insolvent at that time, or the debtor became insolvent as a result of the transfer or obligation;[37] or

(2) the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.[38]

B. Fraudulent Conveyances as to Future Creditors

A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose after the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation either:

(1) with the actual intent to hinder, delay, or defraud any creditor of the debtor;[39] or

(2) without receiving reasonably equivalent value in exchange for the transfer or obligation and the debtor:
   (a) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
   (b) intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond the ability to pay as they became due.[40]

---

[36] *See* UNIF. FRAUDULENT TRANSFER ACT 7A PART II U.L.A. 266 (1999).
[37] *See* UNIF. FRAUDULENT TRANSFER ACT § 5(a), 7A Part II U.L.A. 330.
[38] *See* UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A Part II U.L.A. 330.
[39] *See* UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1), 7A Part II U.L.A. 301 (1999).
[40] *See* UNIF. FRAUDULENT TRANSFER ACT § 4(a)(2), 7A Part II U.L.A. 301 (1999).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Although UFTA does not distinguish between different classes of future creditors, courts have created a distinction between future creditors that the debtor can reasonably foresee and those that the debtor cannot reasonably foresee. Under this distinction, actual intent to defraud can exist as to the former but not as to the latter. For example, a Florida court held that a physician who had transferred assets to his wife following the cancellation of his insurance policy had no actual intent to defraud a patient because the patient was not a reasonably foreseeable creditor of the physician at the time the assets were transferred.[41] As a result, individuals against whom no pending or threatened claims exist, "and who otherwise do not intend to embark on some course of conduct or to proceed with [their] affairs with reckless regard for the rights of others," can legitimately proceed with asset protection planning, including the creation of offshore protection trusts.[42]

C. Determination of Actual Intent—Badges of Fraud

In determining whether a debtor had actual intent to defraud creditors and therefore made a fraudulent conveyance as to foreseeable future creditors, the so-called "badges of fraud" are to be assessed. The badges of fraud, with respect to a transfer, include whether:

(1) the transfer or obligation was to an insider;[43]
(2) the debtor retained possession or control of the property transferred after the transfer;
(3) the transfer or obligation was disclosed or concealed;
(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
(5) the transfer was of substantially all the debtor's assets;
(6) the debtor absconded;
(7) the debtor removed or concealed assets;
(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

---

[41] *See* Hulbert v. Shackleton, 560 So. 2d 1276, 1280 (Fla. Dist. Ct. App. 1990).

[42] Barry S. Engel, *Sole Purpose Asset Protection Planning*, 28 OFFSHORE INVESTMENT J. INVESTMENTS 48, 50 (July/August 1992).

[43] Examples of an insider include a relative of the debtor, UNIF. FRAUDULENT TRANSFER ACT § 1(7)(ii)(A), 7A Part II U.L.A. 275 (1999), or a corporation in which the debtor is the person in control, UNIF. FRAUDULENT TRANSFER ACT § 1(7)(ii)(D).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and
(11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.[44]

D. Solvency

The debtor's solvency before and after a transfer is probably the most important factor in determining whether the transfer was fraudulent. Usually, absent actual intent to defraud, a transfer is not considered fraudulent if, following a transfer, the debtor retained sufficient nonexempt assets to satisfy the claims of creditors. For this reason, a transfer of all of one's assets to an offshore trust or other asset protection device runs a high risk of being ineffective.

E. Remedies

In an action brought under UFTA, a creditor may obtain any of the following remedies:
(1) setting aside of the transfer to the extent necessary to satisfy the creditor's claim;
(2) attachment of the transferred asset or other property of the transferee;
(3) an injunction against further disposition by the debtor, a transferee, or both, of the asset transferred or of other property;
(4) appointment of a receiver to take charge of the transferred asset or other property of the transferee; or
(5) any other relief the circumstances may require.[45]

The federal Bankruptcy Code allows, under certain circumstances, for a creditor to have a debtor's transfer voided if the creditor files a petition with the federal bankruptcy court within one year of the transfer.[46]

F. Reducing the Risk of a Fraudulent Conveyance Attack

If one can show legitimate reasons for the creation of the trust other than to prevent creditors' claims, one can overcome some of the concerns with respect to avoiding a fraudulent conveyance attack against the creation

---

[44] UNIF. FRAUDULENT TRANSFER ACT § 4(b), 7A Part II U.L.A. 275 (1999).
[45] *See* UNIF. FRAUDULENT TRANSFER ACT § 7, 7A Part II U.L.A. 339 (1999).
[46] *See* 11 U.S.C. § 548(a) (1994 & Supp. V 1999).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

and funding of an offshore protection trust. To be able to demonstrate legitimate reasons for the creation of an offshore protection trust and therefore to avoid the impact of UFTA, an attorney should consider having the client provide an affidavit indicating the reasons for the transfer, stating the client's financial condition, and indicating the client's ability, after the transfer, to pay reasonably anticipated debts as they come due.

V. ETHICAL AND OTHER CONSIDERATIONS FOR ATTORNEYS

A. Threshold Question

Is counseling clients regarding asset protection planning (and assisting clients in the creation of asset protection vehicles) ethical? Obviously, no single answer is correct for all situations, and an attorney must assess each situation separately with regard to federal and state ethical rules. The primary sources of federal rules are the American Bar Association's Model Code of Professional Responsibility (the "Model Code") and Model Rules of Professional Conduct (the "Model Rules"). The primary sources of state rules are each state's code of professional conduct.

Generally, as long as the client's asset protection activity about which the lawyer is counseling is not fraudulent or otherwise unlawful, the lawyer remains within the ethical canons. However, the realities are often far murkier. First, a lawyer may not in every case have all the facts from a client to know whether a client's asset protection activity is fraudulent or otherwise unlawful. Second, even when the lawyer has all the facts, the line between advising a client about the legality of an activity and furthering an illegal activity is not always clear. The drafters of the Model Rules and some state bar ethics committees have sought to set forth rules for the hard cases.

Section 1.2(d) of the Model Rules 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 the client and may counsel or assist the client to make a good faith effort to determine the validity, scope, meaning or application of the law."[47]

In South Carolina, an attorney proposed to assist a client in transferring property to his spouse for the sole purpose of preventing the possibility of a future creditor recovering against the property. The South Carolina Bar Ethics Advisory Committee held that the proposed transfer was not

[47] MODEL RULES OF PROF'L CONDUCT R.1.2(d) (1983, as amended 2001).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

improper as long as there was no "immediate reasonable prospect of a judgment being entered against the client."[48]

The ultimate issue thus seems to be whether the lawyer knows, or could reasonably anticipate, that a particular conveyance is fraudulent. As a result, prior to counseling a client with respect to asset protection, a lawyer should exercise due diligence to "accurately characterize and evaluate the client's circumstances and motivation."[49]

B. Personal Liability for Assisting Clients in Defrauding Creditors

Courts have imposed liability on attorneys who assisted their clients in defrauding creditors. For example, an Arizona court concluded that a judgment creditor had a valid claim for damages against an attorney who engaged in a conspiracy to hinder and fraudulently delay the creditor from collecting a judgment.[50] In California, a court suspended an attorney from the practice of law for three years because he knowingly advised his client to convey away certain of her real property for the purpose of delaying and defrauding her creditors.[51]

C. Potential Liability for Failing to Counsel Asset Protection Planning

Commentators have suggested that a malpractice claim may arise if an attorney fails to suggest some forms of asset protection planning. One commentator gave the example of a wealthy client who consults his attorney regarding a comprehensive estate plan. During the course of his analysis, the attorney becomes aware of the client's significant securities portfolio, which the lawyer recommends be transferred to the revocable trust he is drafting for the client. Three years after the estate plan is implemented, the client is sued for a matter which arose two years after he met with the estate planner. The client suffers a financially catastrophic judgment and is required to liquidate his revocable trust in order to satisfy the claim. The client then sues the attorney for failing to have discussed asset protection with him.[52]

---

[48] S.C. Ethical Advisory Comm., Opinion 84-02 (1984).

[49] Osborne, *supra* note 19, § 4.10.

[50] McElhanon v. Hing, 728 P.2d 256 (Ariz. Ct. App. 1986), *aff'd in part and vacated in part*, 728 P.2d 273 (Ariz. 1986).

[51] *See* Townsend v. State Bar of California, 197 P.2d 326, 329 (Cal. 1948).

[52] *See* Rosen, *supra* note 1, at A-3.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

VI. ABOLITION OF THE RULE AGAINST PERPETUITIES

The common law Rule Against Perpetuities (the "Rule") provides that no interest is good unless it vests or fails within a life in being plus twenty-one years.[53] Currently, fifteen states effectively have abolished the Rule, and six states have repealed it outright. A seventh, Delaware, has repealed the Rule with respect to interests in personal property. An additional eight states have preserved the Rule, but have granted trust settlors the authority to opt out of it by including specified provisions in their trust instruments. In addition, the Nevada legislature has passed opt-out legislation that will become effective as of December 1, 2002, if it is approved by the voters in the 2002 general election. In 2000 Florida extended the perpetuities period to 360 years,[54] and in 2001 Washington State extended it to 150 years.[55]

A. Repeal Legislation

Statutory provisions in Alaska, Idaho, New Jersey, Rhode Island, South Dakota, and Wisconsin provide that the Rule is not in force in these states.[56] Statutes in effect in Idaho, South Dakota, and Wisconsin provide that the repeal of the Rule applies retroactively.[57] By contrast, New

[53] *See* Angela M. Vallario, *Death by a Thousand Cuts: The Rule Against Perpetuities*, 25 J. LEGIS. 141 & n.1 (1999) (citing JOHN CHIPMAN GRAY, THE RULE AGAINST PERPETUITIES 191 (4th ed. 1942)).

[54] *See* FLA. STAT. ANN. § 689.225(2)(f) (West Supp. 2002). This provision is valid for all trusts created after December 31, 2000. For older trusts, the previous perpetuities period of 90 years remains effective.

[55] *See* WASH. REV. CODE § 11.98.130 (West Supp. 2002). This provision is applicable to any irrevocable trust with an effective date on or after January 1, 2002. Unless the trust instrument otherwise provides, this provision does not apply to any irrevocable trust with an earlier effective date or any revocable or testamentary trust with an effective date on or after January 1, 2002, if at all times after the date of enactment the creator of the trust was not competent to revoke, amend, or modify the will or trust instrument.

[56] *See* ALASKA STAT. § 34.27.075 (West 2000) ("The common law rule against perpetuities does not apply in this state."); IDAHO CODE § 55-111 (2000) ("[T]here shall be no rule against perpetuities applicable to real or personal property. . . ."); N.J. STAT. ANN. § 46:2F-9 (West Supp. 2001) ("No interest created in real or personal property shall be void by reason of any rule against perpetuities, whether the common law rule or otherwise. The common law rule against perpetuities shall not be in force in this State."); R.I. GEN. LAWS § 34-11-38 (West 2000) ("The common law rule against perpetuities shall no longer be deemed to be in force and/or of any effect in this state. . . ."); S.D. CODIFIED LAWS § 43-5-8 (West 2000) ("The common-law rule against perpetuities is not in force in this state."); WIS. STAT. ANN. § 700.16(5) (West 2000) ("The common-law rule against perpetuities is not in force in this state.").

[57] Idaho's statute provides that "no trust heretofore or hereafter created, either

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Jersey's statute provides that it shall not be applied retroactively.[58] It is unclear whether the repeal of the Rule in Alaska or Rhode Island applies retroactively.[59]

B. Delaware Partial Repeal Legislation

Delaware has repealed the Rule only with respect to interests in personal property,[60] but replaced the common law Rule with a perpetuities period of 110 years for real property held in trust.[61] Whether either of these provisions applies retroactively to existing trusts is unclear.

C. Opt-Out Legislation

The remaining eight states that have effectively abolished the Rule have done so by providing settlors with the power to opt out of its application to their trusts. These states include Illinois, Maine, Maryland,

---

testamentary or inter vivos, shall be declared void [under the Rule]." IDAHO CODE § 55-111 (2000). South Dakota's statute provides: "If no action or proceeding has been instituted by July 1, 1984, to declare void any instrument which existed prior to July 1, 1983 under the provisions of this chapter as it existed prior to July 1, 1983, then all such instruments shall be interpreted under this chapter 43-5." S.D. CODIFIED LAWS § 43-5-9 (West 2000). Wisconsin's statute provides that it "applies to interests in property in existence on July 1, 1971, and to interests in property created after such date." WIS. STAT. ANN. § 700.25 (West 2000).

[58] New Jersey's statute provides that the abolishment legislation applies to future property interests or powers of appointment created on or after July 9, 1999 or created before July 9, 1999 pursuant to the laws of a state that does not enforce the Rule and to which, after July 9, 1999, New Jersey law is made applicable by such means as a transfer of the trust situs to New Jersey or a change in the law governing a trust instrument to New Jersey law. *See* N.J. STAT. ANN. § 46:2F-11(a) (West Supp. 2001).

[59] Alaska's recently amended statute provides that the statutory rule against perpetuities contained in Alaska Statutes § 34.27.051 applies to trust instruments executed on or after April 2, 1997 if the trust instrument creates a nonvested property interest subject to the exercise of a power of appointment that creates a new or successive power of appointment. *See* ALASKA STAT. § 34.27.070 (West 2000). Neither § 34.27.051 nor § 37.27.070 of Alaska's Statutes discusses nonvested property interests that are not subject to such powers of appointment. Therefore, whether the repeal of the Rule applies retroactively to all nonvested property interests is unclear. Rhode Island's statute provides that the Rule is no longer in force provided that "the provisions of this section shall not be construed to invalidate or modify the terms of any interest which would have been valid prior to the effective date of this act [1999]." R.I. GEN. LAWS § 34-11-38 (West 2000).

[60] *See* DEL. CODE ANN. tit. 25, § 503(a) (West Supp. 2000) ("No interest created in real property held in trust shall be void by reason of the common law rule against perpetuities and no interest created in personal property held in trust shall be void by reason of any rule against perpetuities, whether the common law rule or otherwise.").

[61] *See id.* § 503(b).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Ohio, Arizona, Colorado, Missouri, and Virginia. If Nevada voters approve legislation passed by the Nevada legislature, that state will be added to the list.

1. Illinois Opt-Out Legislation

Illinois' opt-out statute preserves the common law Rule.[62] However, the statute provides that the Rule will not apply to "qualified perpetual trusts."[63] A qualified perpetual trust is defined as any trust created by any written instrument executed on or after January 1, 1998, including an amendment to an instrument in existence prior to that date.[64] A qualified perpetual trust also includes the exercise of a power of appointment granted by an instrument executed or amended on or after January 1, 1998, if:

(a) by the specific terms governing the trust, the Rule does not apply; and

(b) the power of the trustee, or other person to whom the power is properly granted or delegated, to sell trust property extends beyond the period of the Rule.[65]

2. Maine and Maryland Opt-Out Legislation

The opt-out legislation of Maine and Maryland is very similar to that of Illinois. Both Maine and Maryland preserve the Rule but provide specific opt-out provisions.[66] While Maine's opt-out provisions apply prospectively,[67] it is unclear whether Maryland's opt-out provisions apply prospectively or retrospectively. The statutes of both states provide that the Rule does not apply to a trust when:

(a) the governing instrument states that the Rule does not apply to the trust; and

---

[62] *See* 765 ILL. COMP. STAT. ANN. 305/2 (West 2000) (stating that the common law Rule will remain in full force and effect, except as modified by statutes in force by September 22, 1969).

[63] *See id.* § 305/4(a)(8).

[64] *See id.* § 305/3(a-5).

[65] *See id.* § 305/3(a-5).

[66] *See* ME. REV. STAT. ANN. tit. 33, §§ 101, 101-A (West Supp. 2001); MD. CODE ANN., EST. & TRUSTS §§ 11-102, 11-102(e) (West Supp. 2000).

[67] *See* ME. REV. STAT. ANN. tit. 33, §101-A (West Supp. 2001) (stating that exemptions from the Rule apply to trusts created after 1999).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

(b) the trustee, or other person to whom the power is properly granted or delegated, has the power to sell, mortgage, or lease property beyond the period of the Rule.[68]

3. Ohio Opt-Out Legislation

Ohio also preserves the Rule,[69] but many of its opt-out provisions, which apply prospectively,[70] differ from those in place in Illinois, Maine, and Maryland. To trigger the opt-out provisions in Ohio, the trust instrument must specifically state that the Rule shall not apply to the trust.[71] Furthermore, either the trustee must have an unlimited power to sell all trust assets, or one or more persons, one of whom may be the trustee, must have the unlimited power to terminate the entire trust.[72] In addition, one or more of the following conditions must be satisfied:[73]

(a) the trust is executed in Ohio;
(b) the sole trustee or one of the trustees is domiciled in Ohio;
(c) the trust is administered in Ohio, or the situs of a substantial portion of the assets subject to the testamentary portion of the trust is in Ohio, even though some part or all of those assets are physically deposited for safekeeping in a state other than Ohio; or
(d) the instrument creating the trust states that Ohio law is to apply.

4. Arizona Opt-Out Legislation

Arizona's opt-out statute also preserves the Rule, but validates a nonvested property interest in trust that meets specified criteria.[74] The Arizona statute does not require the trust instrument to state specifically that the Rule does not apply, but rather validates any nonvested property interest under a trust the trustee of which has the expressed or implied power to sell the trust assets. Additionally, at one or more times after the creation of the interest, one or more persons who are living when the trust

---

[68] *See id.*; MD. CODE ANN., EST. & TRUSTS § 11-102(e) (West Supp. 2000).

[69] *See* OHIO REV. CODE ANN. § 2131.08(A) (Anderson 2002).

[70] *See id.* § 2131.09(B)(3) (providing that opt-out provisions apply to an interest in property in trust created either by wills of decedents dying on or after March 22, 1999 by a trust instrument executed on or after March 22, 1999 or by the exercise of a general power of appointment on or after March 22, 1999).

[71] *Id.* § 2131.09(B)(1).

[72] *See id.*

[73] *See id.* § 2131.09(B)(2).

[74] *See* ARIZ. REV. STAT. ANN. § 14-2901(A) (West 1995 & Supp. 2001).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

is created must have an unlimited power to terminate the interest.[75] Arizona's statute does not apply retroactively to existing trusts.[76]

5. *Colorado Opt-Out Legislation*

As in Arizona, the Colorado opt-out statute does not require the trust instrument to state specifically that the Rule does not apply. Prior to the amendment of 2001, the Colorado perpetuities statute stated that a nonvested property interest is invalid unless:

(a) when the interest is created, it is certain to vest or terminate no later than twenty-one years after the death of an individual then alive; or
(b) the interest either vests or terminates within ninety years after its creation.[77]

The amendment added the following as a third situation in which a nonvested property is not invalid:

(c) the interest is in trust, and all or part of the income or principal of the trust may be distributed, in the discretion of the trustee, to a person who is living when the trust is created.[78]

This amendment effectively removes from the applicability of the Rule most transfers in trust for estate planning purposes. Only nondiscretionary trusts remain subject to the Rule. The amendment became effective June 1, 2001. However, whether the amendment applies to trusts created or amended before that date is not clear.

6. *Missouri Opt-Out Legislation*

Missouri's opt-out statute provides that the Rule does not apply to a trust if the trustee, or other person or persons to whom the power is delegated, has the power pursuant to the terms of the trust or applicable law to sell the trust property during the period in which the trust continues beyond the period of the Rule that would otherwise apply to the trust.[79] The opt-out statute applies to (i) trusts created by a will or inter vivos agreement, or pursuant to the exercise of a nongeneral power of appoint-

---

[75] *See id.* § 14-2901(A)(3).

[76] *See id.* § 14-2905(A) (providing that opt-out provisions apply to nonvested property interests created on or after December 31, 1994).

[77] *See* COL. REV. STAT. § 15-11-1102(1) (2001).

[78] *See id.* § 15-11-1102(1)(c).

[79] *See* MO. ANN. STAT. § 456.236(1) (West Supp. 2002) (providing also that any rule prohibiting unreasonable restraints on or suspension of the power of alienation is also not violated by such a trust).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

ment granted under a will or inter vivos agreement, executed or amended on or after August 28, 2001, (ii) trusts created pursuant to the exercise of a general power of appointment exercised in an instrument executed or amended on or after August 28, 2001, or (iii) any such trust created before August 28, 2001, if the laws of Missouri become applicable to the trust after such date and under the laws of the state applicable to the trust prior to such date, the trust was not subject to the Rule.[80]

7. *Virginia Opt-Out Legislation*

Virginia's recent opt-out statute provides that the Rule will not apply to interests in personal property held in a trust if the trust instrument, by its terms, provides that the Rule will not apply to such trust.[81] Whether the opt-out provision is retroactive is not clear.[82]

8. *Prospective Nevada Opt-Out Legislation*

The amendment to the Nevada Uniform Statutory Rule Against Perpetuities Act provides that the Rule will not apply to a nonvested property interest in, or a power of appointment with respect to, a trust if:

(a) the trustee has unlimited power to sell the trust assets, or at least one person, including the trustee, has the power to terminate the trust;

(b) the trust instrument states that the Rule does not apply to the trust; and

(c) the trust is executed in Nevada, has at least one trustee domiciled in Nevada, is administered in Nevada, and has assets of which a substantial portion is located in Nevada.[83]

D. Income Tax Considerations

In selecting a state in which to establish a perpetuities-free trust, one should also consider the extent to which the income of the trust will be

---

[80] *See id.* § 456.236(3).

[81] VA. CODE ANN. § 55-13.3(C) (Michie Supp. 2001) (stating that: "The rule against perpetuities shall not apply to any trust or any interest created in personal property held in such trust, or to any power of appointment over personal property held in such trust, or to any power of appointment over personal property granted under such trust, when the trust instrument, by its terms, provides that the rule against perpetuities shall not apply to such trust.").

[82] *See generally* J. Rodney Johnson, *Wills, Trusts, and Estates*, 34 U. RICH. L. REV. 1069, 1069 (2000) (discussing the Virginia opt-out legislation).

[83] *See* NEV. REV. STAT. ANN.§ 111.1037(7) (Michie 1998 & Supp. 2001).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

subject to state income tax. Three of the perpetuities-free states—Alaska, Nevada, and South Dakota—do not have an income tax. In addition, Ohio does not tax the income of trusts. Although nearly all states having an income tax will tax trust income that is derived from sources within that state, typically from real estate or business conducted within the state, most will tax the remaining trust income (and thus treat the trust as a "resident trust") only if certain conditions are met, which vary dramatically from state to state. Such conditions may include the residence of the grantor when a trust becomes irrevocable (Illinois, Missouri, New Jersey, Wisconsin), the place where the trust is administered (Colorado, Maine, Maryland, Virginia), or the residence of one or more fiduciaries (Delaware, Rhode Island). Even if the trust meets the requirements for taxation within a state, some (Delaware, Rhode Island) will exclude from taxation any income attributable to a nonresident beneficiary.

E. Summary

The following tables summarize the provisions, including the factors that make a trust resident for income tax purposes, of those states which have effectively abolished the Rule. The state income tax provisions for determining the residence of a trust are often too complex to be set forth fully in this table, and these provisions should be examined carefully before selecting a state based on its taxation of trust income.

REPEAL JURISDICTIONS

State	***Perpetuities Provision***	***State Income Taxation of Trust*** **(Factors that cause income to be taxed in the state, regardless of the source of the income)**	***State Treats Real Property and Personal Property Differently?***
Alaska	Complete repeal of common law Rule.	None.	No

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

State	***Perpetuities Provision***	***State Income Taxation of Trust*** **(Factors that cause income to be taxed in the state, regardless of the source of the income)**	***State Treats Real Property and Personal Property Differently?***
Delaware	Complete repeal of common law Rule, but creation of 110 year perpetuities period for trust holding real property.	1. Created by resident; 2. Sole trustee is resident or has office in state; 3. Corporate trustee has office in state; 4. All trustees are individuals and at least half are residents. No tax on income allocable to nonresident beneficiaries.	Yes
Idaho	Complete repeal of common law Rule. Applies retroactively to existing trusts.	Income of trust is taxed if at least three of the following: Resident grantor; Trust created in state; Trust property in state; Resident trustees; or Administration in state.	No
New Jersey	Complete repeal of common law Rule. Does not apply retroactively.	Grantor of trust or portion of trust must be resident at time trust became irrevocable.	No
Rhode Island	Complete repeal of common law Rule.	Revocable trust that becomes irrevocable upon any event (including death) that terminates a resident's power to revoke; or Irrevocable trust created by resident, but only while creator continues as resident or after death if a resident at death. No tax on income allocable to nonresident beneficiaries.	No
South Dakota	Complete repeal of common law Rule. Applies retroactively to existing trusts.	None.	No

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

State	***Perpetuities Provision***	***State Income Taxation of Trust*** **(Factors that cause income to be taxed in the state, regardless of the source of the income)**	***State Treats Real Property and Personal Property Differently?***
Wisconsin	Complete repeal of common law Rule. Applies retroactively to existing trusts.	Grantor of trust or portion of trust must be resident at time trust became irrevocable.	No

OPT-OUT JURISDICTIONS

State	***Perpetuities Provision***	***State Income Taxation of Trust*** **(Factors that cause income to be taxed in the state, regardless of the source of the income)**	***State Treats Real Property and Personal Property Differently?***
Arizona	Preserves Rule, but validates nonvested property interest under trust (i) the trustee of which has power to sell trust assets; and (ii) at one or more times after creation of the interest one or more persons living when trust is created have unlimited power to terminate interest. Opt-out provision does not apply retroactively.	All fiduciaries are resident; or All beneficiaries are resident; or If beneficiaries and settlor are nonresident, and some, but not all, fiduciaries are resident, non-Arizona source income taxed in proportion to number of resident fiduciaries; or If fiduciary(ies) and settlor are nonresident, and some, but not all beneficiaries are resident, non-Arizona source income taxed in proportion to interests of resident beneficiaries.	No
Colorado	Preserves Rule, but provides exception for trusts for which all or part of the principal may be distributed in the discretion of the trustee to a person who is living when the trust is created.	Trust administered in Colorado.	No

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

State	***Perpetuities Provision***	***State Income Taxation of Trust*** **(Factors that cause income to be taxed in the state, regardless of the source of the income)**	***State Treats Real Property and Personal Property Differently?***
Illinois	Preserves common law Rule, but provides exception for "qualified perpetual trusts." A qualified perpetual trust is a trust (i) created by written instrument executed on or after January 1, 1998 (including amendment to existing trust and exercise of power of appointment granted by existing trust); (ii) to which, by specific terms governing trust, Rule does not apply; and (iii) power of trustee (or other qualified person) to sell trust property extends beyond period of Rule. Opt-out provision does not apply retroactively.	Grantor of trust resident at time trust became irrevocable.	No
Maine	Preserves Rule, but provides exception for trust if (i) trust instrument states Rule does not apply; and (ii) trustee (or other qualified person) has power to sell, mortgage, or lease trust property beyond the period of the Rule. Opt-out provision does not apply retroactively.	Irrevocable trust created by resident at time of funding; or Revocable trust during period when settlor is resident; or The trust is registered with Probate Court.	No
Maryland	Preserves Rule, but provides exception for trust if (i) trust instrument states Rule does not apply; and (ii) trustee (or other qualified person) has power to sell, mortgage, or lease trust property beyond the period of the Rule.	Grantor is a current resident; or Trust is principally administered in the state.	No

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

State	***Perpetuities Provision***	***State Income Taxation of Trust*** **(Factors that cause income to be taxed in the state, regardless of the source of the income)**	***State Treats Real Property and Personal Property Differently?***
Missouri	Preserves Rule, but provides exception for trust created after August 28, 2001, if the trustee or a delegatee has the power to sell trust property after the period of the Rule that would otherwise apply.	Grantor resident in Missouri at time trust becomes irrevocable and at least one income beneficiary resident in Missouri on last day of tax year.	No
Nevada	Preserves Rule, but provides exception, if the voters in the 2002 general election approve, for trust if (i) trust instrument states that Rule does not apply; (ii) trustee has unlimited power to sell all trust assets or one or more persons (including the trustee) have unlimited power to terminate entire trust; and (iii) trust is executed in Nevada, a trustee is domiciled in Nevada, the trust is administered in Nevada, and situs of substantial portion of assets is in Nevada.	None.	No

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

State	*Perpetuities Provision*	*State Income Taxation of Trust* (Factors that cause income to be taxed in the state, regardless of the source of the income)	*State Treats Real Property and Personal Property Differently?*
Ohio	Preserves Rule, but provides exception for trust if: (i) trust is created after March 22, 1999; (ii) trust instrument states that Rule does not apply; (iii) trustee has unlimited power to sell all trust assets or one or more persons (one of whom may be trustee) have unlimited power to terminate entire trust; and (iv) trust is executed in Ohio, a trustee is domiciled in Ohio, the trust is administered in Ohio or situs of substantial portion of assets subject to testamentary portion of trust is in Ohio, or trust instrument states that Ohio law is to apply. Opt-out provision does not apply retroactively.	None.	No
Virginia	Preserves Rule, but provides exception for interests created in personal property held in trust if trust instrument states that Rule does not apply.	Trust created by resident; Trust administered by resident; Trust under supervision of Virginia court.	Yes

VII. DOMESTIC PROTECTION TRUSTS

A. Missouri Domestic Protection Trusts

In 1986, Missouri amended its spendthrift statute to become the first state to permit settlors of trusts to obtain spendthrift protection if the transfers to the trust were not fraudulent.[84] As currently amended, the statute provides that the settlor's creditors may satisfy claims from the trust assets to the extent of the settlor's beneficial interest if at the time the trust was established or amended the settlor was either:

[84] *See* MO. ANN. STAT. § 456.080.3(1) (West 2000).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

(1) the sole beneficiary of the trust or retained the power to revoke or amend the trust; or

(2) one of a class of beneficiaries and retained a right to receive a specific portion of the trust's income or principal.[85]

Attorneys in Missouri and other states quietly took advantage of this provision. However, at least one court has declared that the Missouri statute did not change the existing rule that prohibited self-settled spendthrift trusts.[86]

B. Alaska, Delaware, Nevada, and Rhode Island Domestic Protection Trusts—History and Common Concerns

In 1997, Alaska and Delaware enacted legislation to permit the settlor of a trust to remain a trust beneficiary, but still obtain spendthrift protection.[87] Proponents of the Alaska and Delaware statutes assert that the statutes offer the same opportunity to protect one's assets from creditors that otherwise is available only with offshore trusts created in certain debtor-friendly jurisdictions. Determining the truth of this assertion will take some time. In 1999, Nevada and Rhode Island enacted similar legislation.[88] In almost every other state, settlors of trusts are denied spendthrift protection. This denial is derived from the English "Statute of Elizabeth," which is embodied in The Restatement (Second) of Trusts (the "Second Trust Restatement"):

§ 156. Where the Settlor is a Beneficiary.

a. 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.

b. 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.[89]

---

[85] *See id.* § 456.080.3(2).

[86] *See In re Enfield*, 133 B.R. 515, 519 (Bankr. W.D. Mo. 1991).

[87] *See* ALASKA STAT. § 13.06.050 (Lexis 2000); DEL. CODE ANN. tit. 12, § 3536 (West Supp. 2000).

[88] *See* NEV. REV. STAT. ANN. § 166.015 (Michie Supp. 2001); R.I. GEN. LAWS § 18-9.1-1 (2000). On February 2, 1999, a house bill was introduced in the Texas legislature that is substantially similar to the Alaska Act discussed above. *See* H.R. 1553, 1999 Leg., 76th Sess. (Tex. 1999).

[89] RESTATEMENT (SECOND) OF TRUSTS § 156 (1959).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

This provision of the Second Trust Restatement has been applied in many reported cases and appears to be the view commonly held by estate planning professionals throughout the United States. The commonly-held view may not apply universally, however, and a number of exceptions to the rule may exist.[90] However, clearly most practitioners advise their clients that a self-settled trust cannot insulate assets from the claims of the settlor's creditors as long as the settlor retains any interest in the trust.

One practical effect of this rule is that the rights of creditors to reach a discretionary self-settled trust in which the settlor retains an interest causes any gift made by the settlor to the trust to be incomplete for federal gift tax purposes. For a transfer to be a completed gift under section 2511 of the Internal Revenue Code (the "Code"), the donor must have "so parted with dominion and control as to leave in him no power to change its disposition."[91] The Service has ruled that "[t]he transfer of property to an irrevocable inter vivos trust created in, and administered under the laws of, a state in which the trust is deemed a 'discretionary trust' whose assets are subject to claims of the grantor's creditors, does not constitute a completed gift."[92] The Service went on to state:

> If and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in section 25.2511-2 of the regulations.[93]

A further consequence of a creditor's ability to reach the settlor's interest in a self-settled trust is that the assets in the trust will continue to be part of the settlor's gross estate for federal estate tax purposes under one or both of Code sections 2036 and 2038.

C. Alaska Trusts

In apparent response to the high profile discussion of offshore trusts in the asset protection arena and the reticence of many American practitioners and their clients to adopt the laws of an unfamiliar foreign country, Alaska's legislature enacted the Alaska Trust Act (the "Alaska Act") which became effective April 2, 1997.[94]

---

[90] *See, e.g.*, Robert L. Manley, *Estate Planning with Self Settled Spendthrift Trusts: Steering Clear of Debts and Taxes*, SD36 A.L.I.-A.B.A. 91, 95-96 (1999).

[91] 26 C.F.R. § 25.2511-2(b) (2001).

[92] Rev. Rul. 76-103, 1976-1 C.B. 293.

[93] *Id.* at 294.

[94] *See* ALASKA STAT. §§ 13.36.105-13.36.220 (Lexis 2000).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

1. Rule Against Perpetuities

The Alaska Act effectively eliminates the Rule.

2. Creditor Protection

The Alaska Act allows a person to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The Alaska Act provides that, outside of some specific situations discussed below, the assets of a trust governed by the Act are not subject to the claims of the settlor's creditors.[95] This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income.[96] If the trust has beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the right to veto distributions to other trust beneficiaries or the right to direct where trust property passes at the settlor's death.[97]

3. Limitations

The Alaska Act has limitations. A creditor under section 34.40.110, as amended by the Alaska Act, is able to reach the trust assets to the extent necessary to pay the creditor's claim if:

(1) [the] transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons under AS § 34.40.010;[98]

(2) [the] trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust;

(3) [the] trust requires that all or part of the trust's income or principal, or both, must be distributed to the settlor; or

---

[95] *See* ALASKA STAT. § 34.40.110(b)(1) (West 2000).

[96] *See id.* § 34.40.110(b)(3).

[97] *See id.* § 34.40.110(b)(2).

[98] *Id.* § 34.40.110(2)(b)(1). Estate planning professionals and their clients should note that the statute of limitations for actions against transfers in fraud of creditors extinguishes an action unless the action is brought by

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

Id. § 34.40.110(d).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

(4) at the time of transfer, the settlor is in default by [thirty] or more days of making a payment due under a child support judgment or order.[99]

4. *Applicability of Alaska Act*

To qualify a trust under the Alaska Act, some or all of the trust assets must be deposited in Alaska,[100] part or all of the trust administration must take place in Alaska,[101] and the settlor must use an Alaska resident or an Alaska-headquartered bank or trust company as trustee or cotrustee.[102] The Alaskan trustee must have certain duties, including selecting the trust tax return preparer and maintaining certain trust records.[103]

D. Delaware Trusts

Delaware, long known as a trust-friendly jurisdiction based on a variety of other tax and legal rules, quickly responded to the Alaska legislation. On July 9, 1997, Delaware Governor Carper signed into law the Qualified Dispositions in Trust Act (the "Delaware Act"). The Delaware Act provides creditor protection and estate planning opportunities similar to those in the Alaska statute described above.[104]

1. *Creditor Protection*

As in the Alaska Act, the Delaware Act allows an individual to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The Delaware Act defines the creation of a "qualified disposition" as the creation of an irrevocable trust with the appropriate trustee, which contains a spendthrift provision and incorporates the laws of Delaware.[105] Outside of some specific situations discussed below, the assets in trust are not subject to the claims of the settlor's creditors in the courts of Delaware.[106] This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income. If the trust has beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the right to veto distributions to other trust beneficiaries or the right to direct where trust

[99] *Id.* § 34.40.110(2)(b)(2)-(4).
[100] *See id.* § 13.36.035(c)(1).
[101] *See id.* § 13.36.035(c)(4).
[102] *See id.* §§ 13.36.035(c)(2), 13.36.390(1).
[103] *See id.* § 13.36.035(c)(3).
[104] *See* DEL. CODE ANN. tit. 12, §§ 3570-3576 (2001).
[105] *See* DEL. CODE ANN. tit. 12, § 3570(6), (10) (2001).
[106] *See id.* § 3572(a).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

property passes at the settlor's death.[107] The Delaware Act differs from other self-settled spendthrift statutes in that it permits the settlor to retain the right to receive trust income.[108]

2. *Limitations*

The Delaware Act has limitations. Creditors under sections 3572, 3573, and 3574 are able to reach the trust assets to the extent necessary to pay the creditor's claims and related costs, including attorneys' fees, if:

(1) the transfer was to defraud creditors;[109]
(2) the claim resulted from an agreement or a court order providing for alimony, child support, or property division; or
(3) before the date of the transfer, the creditor suffers death, personal injury, or property damage as a result of action by the settlor, directly or indirectly, for which the transferor is liable.[110]

3. *Applicability of Delaware Act*

To qualify a trust under the Delaware Act, the settlor must use a Delaware resident or a corporate trustee authorized by Delaware law to act as a trustee and "whose activities are subject to supervision by the Bank Commissioner of [Delaware], the Federal Deposit Insurance Corporation, the Comptroller of the Currency, or the Office of Thrift Supervision."[111] Furthermore, the trustee must "materially participate" in trust administration.[112]

4. *Rule Against Perpetuities*

Delaware had previously effectively eliminated the Rule except for real property interests.[113] Accordingly, the Delaware Act did not need a provision such as was contained in the Alaska Act.

---

[107] *See id.* § 3570(10)(b).

[108] *See id.* § 3570(1)(b)(3) (noting that the Delaware Act does not deem a trust instrument revocable on account of its inclusion of the settlor's "potential or actual receipt of income, including rights to such income retained in the trust instrument. . .").

[109] *See id.* § 3572. The Delaware Act's statute of limitations is identical to the Alaska Act. *See id.* § 3572(b); DEL. CODE ANN. tit. 6, § 1309 (2001). *See also* DEL. CODE ANN. tit. 6, §§ 1304, 1305 (2001) (defining a transfer in fraud of creditors).

[110] *See* DEL. CODE ANN. tit. 12, §§ 3536(a), 3573, 3574(a) (2001).

[111] *Id.* § 3570(9).

[112] *Id.*

[113] *See* DEL. CODE ANN. tit. 25, § 503(a) (2001).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

E. Nevada Trusts

On October 1, 1999, Nevada enacted the Spendthrift Trust Act of Nevada (the "Nevada Act").[114] The Nevada Act provides creditor protection and estate planning opportunities similar to those in the Alaska and Delaware Acts.

1. Creditor Protection

The Nevada Act, as the Alaska Act and the Delaware Act, enables a person to establish a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The Nevada Act provides that, except in certain circumstances, the assets of a trust governed by the statute are not subject to the claims of the settlor's creditors. This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income.[115] If the trust has beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the right to veto distributions to other trust beneficiaries or the right to direct where trust property passes on the settlor's death.[116]

2. Limitations

The Nevada Act has limitations. A creditor is able to reach the trust assets to the extent necessary to pay the creditor's claim if:

(1) the transfer was intended to hinder, delay, or defraud known creditors;[117]

(2) the trust is revocable; or

(3) the trust requires that any part of the trust's income or principal must be distributed to the settlor.[118]

---

[114] *See* NEV. REV. STAT. ANN. §§ 166.010-166.180 (Michie 1993 & Supp. 2001).

[115] *See* NEV. REV. STAT. ANN. § 166.040.1(b) (Supp. 2001).

[116] *See id.* § 166.040.2(a).

[117] The statute of limitations for actions against transfers in fraud of creditors provides:

> A person may not bring an action with respect to a transfer of property to a spendthrift trust: (1) If he is a creditor when the transfer is made, unless the action is commenced within: (a) Two years after the transfer is made; or (b) Six months after he discovers or reasonably should have discovered the transfer, whichever is later. (2) If he becomes a creditor after the transfer is made, unless the action is commenced within two years after the transfer is made.

Id. § 1166.170.

[118] *See id.* § 166.040.1(b).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

3. *Applicability of Nevada Act*

To qualify a trust under the Nevada Act, all or part of the trust property must be located and administered in Nevada, and the settlor must use as trustee or cotrustee a Nevada resident, or a bank or trust company that maintains an office in Nevada for the transaction of business.[119] This trustee must have certain powers including preparing income tax returns for the trust and maintaining trust records.[120]

F. Rhode Island Trusts

In 1999, Rhode Island enacted the Qualified Dispositions in Trust Act (the "Rhode Island Act"), which provides creditor protection and estate planning opportunities almost identical to those in the Delaware Act.

1. *Creditor Protection*

As does the Delaware Act, the Rhode Island Act allows an individual to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The Rhode Island Act defines a "qualified disposition" as the creation of an irrevocable trust with the appropriate trustee, which contains a spendthrift provision and incorporates the laws of Rhode Island.[121] Except for some specific situations discussed below, the assets in trust are not subject to the claims of the settlor's creditors in the courts of Rhode Island. This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income.[122] If the trust has beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the right to veto distributions to other trust beneficiaries or the right to direct where trust property passes on the settlor's death.[123] Unlike the Delaware Act, however, the Rhode Island Act does not permit the settlor to retain the right to receive trust income.[124]

2. *Limitations*

The Rhode Island Act has limitations. Creditors are able to reach the trust assets to the extent necessary to pay their claims and related costs, including attorneys' fees, if:

---

[119] *See id.* § 166.015.
[120] *See id.* § 166.015.1(d).
[121] *See* R.I. GEN. LAWS § 18-9.2-2(6), (9) (2000).
[122] *See id.* § 18-9.2-3.
[123] *See id.* § 18-9.2-2(9)(A).
[124] *See id.*

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

(1) the transfer was to defraud creditors;[125]
(2) the claim resulted from an agreement or a court order providing for alimony, child support, or property division; or
(3) the creditor suffers death before the date of the transfer, personal injury, or property damage as a result of action by the settlor, directly or indirectly, for which the transferor is liable.[126]

3. Applicability of Rhode Island Act

To qualify a trust under the Rhode Island Act, the settlor must use a Rhode Island resident or a corporate trustee authorized under Rhode Island law to act as a trustee and "whose activities are subject to supervision by the Department of Business Regulation of [Rhode Island], The Federal Deposit Insurance Corporation, the Comptroller of the Currency, or the Office of Thrift Supervision."[127] Furthermore, the trustee must materially participate in trust administration.[128]

4. Rule Against Perpetuities

Rhode Island abolished the Rule in 1983.[129]

G. State Income Tax Considerations

As with perpetuities trusts, the selection of a state in which to establish an asset protection trust may depend, in part, on how that state taxes trust income. The income tax provisions for three of the asset protection states, Alaska, Delaware, and Rhode Island, are summarized in the table at the end of section VI. The provisions in the remaining two asset protection states are as follows:

a. *Nevada* does not tax income.[130]
b. *Missouri* taxes the income of a trust that was created by, or consists of property contributed by, a person domiciled in Missouri on the date the trust became irrevocable if, on the last day of the taxable year, at least one income beneficiary of the trust is a resident of Missouri.[131]

---

[125] The Rhode Island Act's statute of limitations is identical to that of the Alaska Act. *See* R.I. GEN. LAWS § 18-9.2-4(b) (2000).
[126] *See id.* §§ 18-9.2-6(a), 18-9.2.4(a), 18-9.2-5.
[127] *Id.* § 18-9.2-2(8)(i).
[128] *See id.* § 18-9.2-2(8)(ii).
[129] *See* R.I. GEN. LAWS § 34-11-38 (Supp. 2001).
[130] *See* NEV. REV. STAT. § 164.330 (1993).
[131] *See* MO. REV. STAT. § 469.405 (West 1992).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

H. Estate and Gift Tax Consequences of Domestic Asset Protection Trusts

Several commentators have taken the position that if creditors cannot reach the trust property, which will be the case if the Alaska, Delaware, Nevada, and Rhode Island Acts prove effective, the trust property will not be includible in the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust.[132] Instead, a completed gift will occur upon the transfer of the property to the domestic asset protection trust. The result would be a freeze transaction. The settlor would incur gift tax upon funding of the trust and would continue to enjoy the property as a discretionary beneficiary of the trust; however, the trust would not be taxed in the settlor's estate under Code sections 2036(a)(1) or 2038.

For example, A creates a domestic protection trust in Alaska in 2000 and funds it with $5 million. A and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, and therefore, the gift is complete, A pays gift taxes of $2.5 million (assuming a 50% rate and previous use of unified credit). A dies in 2009 when the assets in the trust are worth $10 million. Up until the time of his death, A was a discretionary beneficiary and received distributions from the trust. By using a domestic protection trust, according to its proponents, A will avoid estate taxation on the $5 million of appreciation after funding of the trust.

1. Gift Tax Concerns

To obtain this favorable tax treatment, a gift must first be completed for purposes of Code section 2511. To have a completed gift, the settlor's creditors should not be able to look to the settlor's domestic protection trust for payment of debts.[133] A gift should become complete when the period specified under the law of the jurisdiction for a creditor to reach the property in the trust ends.[134]

In a 1993 private letter ruling involving an offshore trust, the Service found that neither the settlor nor the settlor's creditors could compel distribution of the trust assets.[135] Therefore, the gift was complete and the

---

[132] *See* Richard Covey, ed. PRACTICAL DRAFTING, 4889, 4891 (1997); Douglas J. Blattmachr & Jonathan G. Blattmachr, *Discretionary Trust with Grantor as Beneficiary; Ability of Creditors of Grantor to Reach Trust Property; Alaska Law, A New Direction in Estate Planning: North to Alaska*, 136 TRUSTS & ESTATES, Sept. 1997 at 48, 50.

[133] *See* Outwin v. Comm'r, 76 T.C. 153, 168 (1981); Estate of Paxton v. Comm'r, 86 T.C. 785, 818-19 (1986).

[134] *See* Comm'r v. Vander Weekle, 254 F.2d 895, 897 (6th Cir. 1958).

[135] *See* Priv. Ltr. Rul. 93-32-006 (Aug. 20, 1992).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

trust was not subject to estate tax. Later, in 1998, the Service ruled that a transfer to an Alaskan domestic protection trust in which the settlor was a discretionary beneficiary was a completed gift.[136]

If a taxable gift occurs upon creation of the domestic protection trust, one question is the amount of the taxable gift. If other family members are beneficiaries, under Code section 2702, the settlor's possibility of receiving trust distributions is not a qualified interest and is valued at zero. Thus, the gift to the family is the entire amount of the property transferred. In a situation in which the trustee can make distributions to both the settlor and nonfamily members, the Service would likely determine that the taxable gift is all of the property transferred to the trust.[137]

In some situations, a settlor may not want to pay gift tax, while still insulating the trust from creditors. Under the treasury regulations, the settlor could retain a special testamentary power of appointment to descendants, provided that the trustee's discretionary powers are broad and are not limited by an ascertainable standard.[138] In such a case, discretionary distributions to other beneficiaries should be treated as completed taxable gifts in the year in which made, and should qualify for the gift tax annual exclusion.[139] Each statute envisions the settlor retaining such interests, while still accomplishing the creditor protector goal.

2. *Estate Tax Concerns*

Both sections 2036 and 2038 of the Code deal with retained powers and enjoyment of the trust assets. These retained powers or enjoyment will exist when a creditor can reach the assets in a trust.[140] However, the settlor will relinquish the powers and enjoyment when the gift is complete, assuming that the gift to a domestic protection trust is ever complete. This, in the eyes of many commentators, should keep the assets out of the settlor's estate.[141]

---

[136] *See* Priv. Ltr. Rul. 98-37-007 (June 10, 1998).

[137] *See, e.g.*, Rev. Rul. 76-491, 1976-2 C.B. 301 (determining under Code section 2512 that the full value of property conveyed to a trust in exchange for an annuity is a gift when the the donor's adult child had a power of appointment, exercisable at any time, over the trust property, and the trustee could not look to any property other than trust property for payment of the annuity and had no liability if trust property was insufficient to make an annuity payment. Under these circumstances the annuity had no fair market value).

[138] *See* 26 C.F.R. § 25.2511-2(b) (2001).

[139] *See* 26 C.F.R. § 25.2511-2(f) (2001).

[140] *See* 26 C.F.R. § 20.2036-1(b)(2) (2001); *In re* Uhl's Estate, 241 F.2d 867, 869 (7th Cir. 1957); Estate of Paxton, 86 T.C. at 818-19.

[141] *See, e.g.*, Joseph Kartiganer, *et al.*, *Completed Gifts to Offshore Trusts and the Three-Year Rule*, J. ASSET PROTECTION 19, 21 (March/April 1996).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Several cases and rulings appear to support the estate tax result as shown in the following chart. The commentary, which is partially based on the thoughts of Professor Pennell, presents some criticisms of the rulings and cases, which might, if applied, eliminate the present favorable tax consequences.

Case or Ruling[142]	**Decision**	**Comments**[143]
1. Rev. Rul. 77-378, 1977-2 C.B. 348.	Settlor transferred half of his income-producing assets to an irrevocable trust with a corporate trustee who could pay income and principal in his absolute discretion to the settlor during his lifetime. The Service ruled that the transfer was incomplete for gift tax purposes.	Reaches expected result since creditors can reach the property.
Case or Ruling	**Decision**	**Comments**
2. Rev. Rul. 76-103, 1976-1 C.B. 293.	Settlor created a trust for the benefit of himself and his family. Trustee had absolute discretion to distribute income to the settlor and to change the trust situs. The Service ruled that a gift is complete for federal estate tax purposes when creditors cannot reach the trust assets. In dicta the Service said that Code section 2038 would apply if settlor dies before gift becomes complete.	Examined gift tax consequences but was not focused on estate tax consequences. Estate tax discussion of Code section 2038 is dicta and there is no discussion of inclusion under Code section 2036 because settlor had access to income only.

[142] *See* Jonathan G. Blattmachr & Howard M. Zaritsky, *North to Alaska—Estate Planning Under the New Alaska Trust Act*, 32D ANNUAL PHILIP E. HECKERLING INSTITUTE ON ESTATE PLANNING, SPECIAL SESSION MATERIALS II (1998). This source is kept on file with the authors.

[143] *See* Jeffrey N. Pennell, *Recent Wealth Transfer Tax Developments*, Appendix at p.98, A.L.I.-A.B.A. Continuing Legal Education Course of Study, Sept. 10, 1998. [SD17 ALI-AA 45, *88].

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Case or Ruling	Decision	Comments
3. *Paolozzi v. Commissioner*, 22 T.C. 182 (1954), *acq*. 1962-2 C.B. 5.	Settlor created an irrevocable Massachusetts trust to pay as much of net income as the trustee, in its absolute discretion, deemed best. The Service argued for a completed gift. The court held that right of settlor's creditors to reach the income of the trust made the gift incomplete.	This is a gift tax case and not an estate tax case. It does not address inclusion under Code section 2038(a)(1) when no creditors' rights exist.
4. *Outwin v. Commissioner*, 76 T.C. 153 (1981), *acq*. 1981-2 C.B. 1.	Transfer to trust in which the trustee, with the approval of an adverse party, could distribute income and principal was not a completed gift because settlor's creditors could reach the trust funds. Court discussed, in a footnote, the possibility that creditors' ability to reach assets could cause inclusion under either Code sections 2036(a)(1) or 2038.	This is a gift tax case and not an estate tax case. Estate tax inclusion only addressed in a footnote.
5. *Estate of German v. United States*, 7 Ct. Cl. 641 (Ct. Cl. 1985).	Settlor created irrevocable trusts under Maryland law and named himself a discretionary beneficiary of income and principal, with the consent of an adverse party. No gift tax was paid upon creation, and the trust was not included on the settlor's estate tax return. The court denied the government's summary judgment motion that the assets should be included in the estate.	This is a gift tax case and not an estate tax case. Government failed to establish whether creditors could reach the settlor's interest. Settlor's estate conceded that it owed gift tax on creation. Does not address issue of inclusion if creditors cannot reach the assets in the trust.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Case or Ruling	Decision	Comments
6. *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986).	Settlor transferred all his assets to a "constitutional trust" on which no gift tax was paid upon creation and no estate tax was paid at settlor's death. Court held that the trust property was included in the settlor's gross estate, under Code section 2036(a)(1), because of (1) an implied understanding that the settlor could receive income or principal upon request and (2) the ability of the settlor's creditors to compel distributions.	Code section 2036(a)(1) does not apply to a retained right to corpus. Case could have been argued under Code section 2038 as a power to terminate trust by relegating it to creditors. Does not address issue of inclusion if creditors cannot reach the trust.
7. *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941).	Second Circuit held that creditors could not reach assets under a precursor of Code section 2036(a)(1) when settlor was an income beneficiary with wife and, after wife's death, with his children. This was because of multiple beneficiaries and trustee's discretion.	New York law changed after this decision, meaning that it may no longer be reliable as precedent.
8. *Uhl v. United States*, 241 F.2d 867 (7th Cir. 1957).	In an Indiana trust, the settlor received right to $100 per month and additional amounts in the trustee's discretion. Court held that a trust was not includible in the settlor's gross estate beyond the amount necessary to produce $100 per month because creditors, under Indiana law, could not reach those additional funds. Gift tax was paid on excess principal.	Accepts idea that estate tax and gift tax should be consistent (which most courts reject). Government failed to prove rights of creditors under Indiana law. Court failed to equate rights of creditors with enjoyment of the property by the settlor, who could argue for inclusion.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Case or Ruling	Decision	Comments
9. *Estate of Wells v. Commissioner*, T.C.M. (P-H) 781-574 (1981).	Settlor could receive income and principal of an irrevocable trust in the trustee's absolute discretion. No income was actually paid. Court excluded the assets from the settlor's estate because the taxpayer was able to show that no understanding that the trustee would actually pay the income to the settlor existed. Thus, no inclusion under Code section 2036 because the settlor had not retained a right.	Never addressed the creditors' rights issue. Decedent used the $30,000 lifetime exemption to avoid gift tax. Government failed to argue that the decedent retained all of the income for life and thereby cause inclusion under Code section 2036(a)(1). Mere receipt of all income does not show retention which is shown by an agreement.
10. *Vander Weele v. Commissioner*, 27 T.C. 340 (1956), *acq*. 1962-2 C.B. 5.	Settlor created an irrevocable trust in Michigan and authorized payment of as much of the income and principal as trustees deemed appropriate for the settlor's comfort. The court held that the transfer was incomplete for gift tax purposes because creditors could reach the assets.	This is a gift tax case and did not discuss estate tax inclusion.
11. Priv. Ltr. Rul. 93-32-006 (Aug. 20, 1992).	Relying on Revenue Ruling 76-103, the Service held that, in an off-shore trust, the trustee's ability to make discretionary distributions to the settlor and other family members was a completed gift and not a retained interest because, under the law governing the trust, creditors could not attack the trust assets.	May carry holding of Revenue Ruling 76-103 too far because that ruling did not conclude that Code section 2036 did not apply and the discussion of Code section 2038 is dicta. Government may have wanted to impose gift tax because of risk of inability to collect estate tax from offshore trust.
12. Priv. Ltr. Rul. 80-37-116 (June 23, 1980).	Nonresident alien created irrevocable trust with discretionary income and principal provisions. Relied on *Uhl* and *Herzog* to conclude that Code section 2036 (a)(1) was not applicable.	Unclear whether *Uhl* and *Herzog* are good precedent.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Case or Ruling	Decision	Comments
13. Priv. Ltr. Rul. 98-37-007 (June 10, 1998).	Transfer to Alaskan trust in which settlor is a discretionary beneficiary is a completed gift. However, the Service specifically declined to rule if the trust property would be excluded from the testator's estate.	The Service obviously does not want to address estate exclusion issue.

3. *Arguments for Estate Tax Inclusion*

If one assumes that creditors cannot reach the trust, will the mere right of the settlor to receive discretionary distributions of income and principal cause inclusion under Code section 2036 (a)(1)? Pennell believes that the creditor's rights test may now lack validity because of the enactment of the Alaska and Delaware Acts, as well as the Nevada and Rhode Island Acts.[144]

The estate tax and the gift tax do not always interrelate. Even if a gift tax is paid, property in a trust possibly will be included in a settlor's estate because of a retained interest at later date, subject to a credit for any gift tax paid under Code section 2012. Code sections 2035 and 2038 may require inclusion of the trust assets in the settlor's gross estate for a period of three years after the statutory period during which creditors can reach the assets of an Alaska trust.[145] This assumes that subsequent creditors can reach the property under either Alaska or Delaware law. If a creditor with a right arising after the creation of the trust has the right extinguished when the statute of limitations expires, then the situation could be the same as a settlor's releasing a retained right over the trust. This threshold is probably difficult to cross. This assumes that any Code sections 2036 and 2038 rights extinguish when the rights of creditors to reach trust assets end.[146]

4. *Conclusions*

The use of an estate freeze may be possible under Alaska, Delaware, Nevada, and Rhode Island law. A great deal of uncertainty surrounds this proposition, however, and any attempt to do a freeze will certainly invite the Service's scrutiny. Moreover, if the Service loses in court, it may seek remedial legislation, which would permit Code section 2036 inclusion

[144] Pennell, *supra* note 143.

[145] *See* Kartiganer, *supra* note 141, at 21 (discussing this topic in an offshore context).

[146] *See* White v. United States, 881 F. Supp. 688 (D. Mass. 1995); Priv. Ltr. Rul. 91-27-008.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

merely if a settlor were a discretionary beneficiary of the trust. Of course, those settlors who establish domestic protection trusts prior to the date of any such remedial legislation presumably would be grandfathered.

Clients who are comfortable with risk may find the freeze technique appropriate. The client must be comfortable with gift tax liability and loss of basis step up for appreciated assets transferred to the trust. One could minimize exposure to tax by (i) using the applicable credit, or (ii) using Crummey powers to qualify gifts to the trust for the annual exclusion.

If an estate freeze is possible, one presumably could establish an irrevocable perpetuities trust under Alaska or Delaware law with a perpetual life and have the settlor be a discretionary beneficiary. Very wealthy clients will likely not consider the right to be a discretionary beneficiary of great importance. They can make gifts without worrying about future access to the property. This technique works best for those moderately wealthy clients who can afford to make gifts and who would like to get property out of the hands of creditors, but still have possible access to the property in the future.

I. Federal Income Tax Consequences of Domestic Asset Protection Trusts

For income tax purposes, under Code section 677, a domestic asset protection trust should be treated as a grantor trust, if either the grantor or spouse is a discretionary beneficiary of income. Code section 677(a) states that a grantor owns for income tax purposes any portion of a trust that can be distributed to the grantor, regardless of whether it actually is distributed. If the grantor does not want to be taxed on income the grantor does not receive, the trust could require consent of a beneficiary with a substantial adverse interest in the payment of the income, such as a vested remainder person. Payment of the income tax by way of a deliberately defective grantor trust is actually a way to make additional gifts to the beneficiaries of the trust.[147]

[147] The Service has ruled that a settlor's payment of taxes owed on a grantor retained income trust represented a gift to the remainder beneficiaries. *See* Priv. Ltr. Rul. 94-44-033 (Aug. 5, 1994). Later, however, the Service, without explanation, withdrew the entire paragraph holding that the payment of income tax by the settlor to satisfy legal obligations under Code section 677(a) was a gift. *See* Priv. Ltr. Rul. 95-43-049 (Aug. 5, 1994).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

VIII. CONFLICT-OF-LAWS PRINCIPLES RELATING TO PERPETUITIES AND ASSET PROTECTION TRUSTS

A. Potential Conflict of Laws

Because most states do not permit self-settled spendthrift trusts, a potential conflict-of-laws issue exists when a settlor from one of these states creates a self-settled spendthrift trust in a state that does authorize such trusts. A conflict of laws exists when the application of the laws of different jurisdictions would not result in the same resolution.[148] When a settlor transfers assets into a self-settled spendthrift trust, and a creditor later seeks to reach those funds, two basic conflict-of-laws issues may arise. First is the question of which state's law should be applied to determine whether the asset transfer was fraudulent. Then, assuming the asset transfer was not fraudulent, the second question is which state's law should be applied to determine whether the spendthrift trust itself is valid.[149]

B. Alaska, Delaware, Nevada, and Rhode Island Choice-of-Law Provisions

Each state with an asset protection statute seeks to compel the application of that state's law to any creditors' challenges to self-settled spendthrift trusts.

1. Alaska

Alaska's asset protection statute allows a settlor to provide in the trust agreement that Alaska law will govern the validity, construction, and administration of the trust, provided the trust meets certain conditions.[150] A settlor's choice-of-law clause is valid, effective, and conclusive for the trust if (i) some or all of the trust assets are deposited in Alaska; (ii) a trustee is an Alaska resident or an Alaska-headquartered bank or trust company; (iii) the powers of the trustee include maintaining trust records

---

[148] *See* Meaghan R. Hogan, *Once More unto the Breach: Planning for a Conflict of Laws with Alaska and Delaware Self-Settled Spendthrift Trusts*, PROB. & PROP., March-April 2000, at 27, 28.

[149] *See* Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1075 (2000); Karen Gebbia-Pinetti, *As Certain as Debt and Taxes: Estate Planning, Asset-Protection Trusts, and Conflicting State Law*, SC60 A.L.I.-A.B.A. 179, 237 (1998).

[150] *See* ALASKA STAT. § 13.36.035(a), (c), (d) (Michie 2000).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

and preparing, or arranging for the preparation of, the trust's income tax return; and (iv) part or all of trust administration occurs in Alaska.[151]

2. *Delaware*

Delaware's asset protection statute contains choice-of-law provisions similar to those of Alaska's asset protection statute. However, while a choice-of-law clause is optional in an Alaska asset protection trust, the clause is mandatory in a Delaware asset protection trust. For a transfer of assets to satisfy the requirements of a qualified disposition under Delaware law, the trust instrument must expressly incorporate Delaware law to govern the validity, construction, and administration of the trust.[152] Delaware law governs not only these internal affairs of a trust but also governs whether a particular asset transfer into such a trust was fraudulent,[153] if the trust contains a choice-of-law clause and satisfies the other requirements of a qualified disposition.[154]

3. *Nevada*

The choice-of-law provisions of Nevada's asset protection statute are not as extensive or protective of settlors as those of Alaska and Delaware. Nevada's statute provides that, unless the trust instrument declares otherwise, and if certain conditions are met[155], then Nevada law governs the construction, operation, and enforcement in Nevada of all spendthrift trusts created in or outside Nevada. Nevada's asset protection statute further provides that, unless the trust instrument declares otherwise, Nevada law governs the construction, operation, and enforcement outside of Nevada of

---

[151] *See id.* §§ 13.36.035(c)(1)-(4), 13.360.390(1).

[152] *See* DEL. CODE ANN. tit. 12, § 3570(10)(a) (2001).

[153] *See id.* § 3572(a) (stating that no party shall bring an action of any kind for an attachment or other provisional remedy against property that is the subject of a qualified disposition or for avoidance of a qualified disposition unless such action is brought pursuant to Delaware's fraudulent transfer law).

[154] The other requirements of a qualified disposition are that: (i) the trust is irrevocable; (ii) the trust contains a spendthrift clause; (iii) the settlor uses a Delaware resident or a corporate trustee authorized by Delaware law to act as a trustee and whose activities are subject to supervision by the Bank Commissioner of Delaware, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, or the Office of Thrift Supervision; and (iv) this trustee materially participates in trust administration. *See id.* §§ 3570(6), (9)-(10).

[155] *See* NEV. REV. STAT. §§ 166.015.1, 166.015.2 (2000) (stating that the conditions are that: (i) all or part of the trust property is located and administered in Nevada; and (ii) the settlor uses as trustee or co-trustee a Nevada resident or a bank or trust company that maintains an office in Nevada for the transaction of business).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

all spendthrift trusts created in Nevada, except "so far as prohibited by valid laws of other states."[156]

4. *Rhode Island*

Rhode Island's asset protection statute resembles Delaware's asset protection statute in that it requires settlors of self-settled spendthrift trusts to incorporate Rhode Island law expressly to govern the validity, construction, and administration of the trust.[157] Rhode Island's trust laws further provide that Rhode Island law governs the validity, construction, effect, and administration of all trusts holding personal property if the trust instrument contains a Rhode Island choice-of-law clause, and either (i) the personal property is located in Rhode Island when the trust is created and the trust is administered in Rhode Island; (ii) a trustee is a Rhode Island resident or a domestic corporation or national bank located in Rhode Island and authorized to act as trustee and the trust is administered in Rhode Island; or (iii) the trust is created by a Rhode Island resident.[158]

C. Conflict-of-Laws Principles Governing Trusts Under the Second Conflict of Laws Restatement

Most states have adopted the Restatement (Second) of Conflict of Laws (the "Restatement").[159] The general rules contained in the Restatement focus on the significance of a state's contacts to the trust and on the settlor's intention concerning the law that should govern the trust. Chapter 10 of the Restatement contains conflict-of-laws principles relating to trusts. The introductory note to Chapter10 states that

> [t]he chief purpose of making decisions as to the applicable law is to carry out the intention of the [settlor].... It is important that his intention . . . not be defeated, unless this is required by the policy of a state which has such an interest in defeating his intention, as to the particular issue involved, that its local law should be applied.[160]

1. *Distinctions*

The Restatement makes several distinctions in applying conflict-of-laws principles that must be kept in mind when determining which state's law a court would apply to any particular issue. Those issues are:

---

[156] *Id.* § 166.015.3.
[157] *See* R.I. GEN. LAWS §§ 18-9.2-2(6), (9)(a) (2000).
[158] *See id.* §§ 18-1-1 to -3.
[159] *See* Hogan, *supra* note 148, at 30.
[160] RESTATEMENT (SECOND) OF CONFLICT OF LAWS ch. 10 (1971).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

a. Real Property vs. Personal Property

The primary distinction is between interests in real property and interests in personal property, which the Restatement refers to as "movables" and which includes chattels, rights embodied in documents, such as bonds or shares of stock, or rights not so embodied. As discussed more fully below, the state in which real property is located (the "situs" of the property) often is treated as having a sufficient interest in issues relating to the property that the law of the situs is applied to such issues. Such considerations are much less important in determining which state's laws to apply to interests in movables.

b. Secondary Distinctions

Within each of the primary categories of interests in land and interests in movables, the Restatement separately discusses conflict-of-laws principles applicable to (i) the validity of a trust, (ii) issues arising under the administration of a trust, (iii) construction of a trust instrument, and (iv) restraints on alienation of a beneficiary's interest under a trust.

2. Issues Relating to Validity

a. Real Property Trusts

The law that the courts of the situs would apply determines the validity of a trust of an interest in land.[161] In most situations the courts of the state of the situs will apply local law.[162]

b. Personal Property Trusts

An inter vivos trust holding movables is valid if:

(1) it is valid under the local law of the state that the settlor designates 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; or

(2) if there is no such effective designation, under the local law of the state with which, as to the matter at issue, the trust has its most significant relationship.[163]

---

[161] *See id.* § 278.
[162] *See id.* § 278 cmt. a.
[163] *Id.* § 270.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

A state has a substantial relation to a trust when any of the following is true:

(i) "[I]t is the state, if any, which the settlor designated as [the state] in which the trust is to be administered;"

(ii) It is the state in which the trustee at the time of the creation of the trust has its domicile or its place of business;

(iii) It is the state in which the trust assets are located at the time of the creation of the trust;

(iv) It is the state of domicile of the settlor at the time of the creation of the trust; or

(v) It is the state of domicile of the trustees.[164]

The commentary under section 270 of the Restatement states that as to most grounds for invalidity, the trust will be upheld if it is valid under the local law of the state of the place of administration.[165] However, when the purpose of the settlor in creating an inter vivos trust is to avoid claims of the settlor's spouse or family (for example, under the state's forced share statute), the trust will be held invalid if it is invalid under the local law of the settlor's domicile.[166] Although no reported cases on this issue relating to domestic self-settled spendthrift trusts exist, a court might extend this principle to apply to the claims of the settlor's creditors. However, an estate planner should keep in mind the following observations:

(1) Transfers to a trust to avoid claims by a surviving spouse or family, or creditor's claims, are not themselves ordinarily issues of trust validity. Thus, if a trust is valid under the laws of the settlor's domicile, a court in that state should find the trust valid, even if it finds that transfers have been made for purposes which are improper under that state's laws.

(2) Even if a court extends the principle of this section to apply to the claims of the settlor's creditors, the fraudulent conveyance statutes are not significantly different in the states permitting self-settled asset protection trusts from those in other states. Thus, if a settlor makes a transfer to an asset protection trust in Alaska, Delaware, Nevada, or Rhode Island that does not violate the fraudulent conveyance statute in that state, such a conveyance probably would not violate the fraudulent conveyance statute in the state of the settlor's domicile. A court in the state of the settlor's domicile,

---

[164] *Id.* § 270 cmt. b.

[165] *See id.* § 270 cmt. c.

[166] *See id.* § 270 cmt. b.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

therefore, should find that such a transfer would not apply that state's laws to issues of trust validity.

The rule of section 270 of the Restatement is applicable to questions involving the Rule Against Perpetuities. As to this issue "the trust will be upheld if the settlor has manifested an intention that it should be administered in a particular state, and if under the local law of that state the trust would be valid, even though the settlor was domiciled in a state in which it would be invalid."[167]

3. *Issues Arising Under Trust Administration*

Issues arising under trust administration include matters relating to the execution and carrying out of the trust, such as the duties and powers (including the exercise of discretionary powers) of the trustee. On the other hand, questions relating to the identity of beneficiaries and the extent of their interests are matters of construction, which are treated in the following section.

a. *Real Property Trusts*

The administration of a trust of an interest in land is determined by the law that would be applied by the courts of the situs as long as the land remains subject to the trust.[168] In most situations, the courts of the state of the situs will apply local law. But if the settlor provides that the local law of some other state will be applied to govern the administration of the trust, or certain issues of administration, the courts of the situs would apply the designated law as to issues which can be controlled by the terms of the trust.[169]

b. *Personal Property Trusts*

The administration of a trust of an interest in movables is governed as to matters which can be controlled by the terms of the trust:

(1) by the local law of the state designated by the settlor to govern the administration of the trust, or

(2) if there is no such designation, by the local law of the state to which the administration of the trust is most substantially related.[170]

---

[167] *Id.* § 270 cmt. d.
[168] *See id.* § 279.
[169] *See id.* § 279 cmt. b.
[170] *Id.* § 272.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

4. Issues Relating to Trust Construction

An instrument creating an interest in property, whether of land or of movables, is construed in accordance with the rules of construction of the state designated in the instrument for this purpose. In the absence of such a designation, the instrument is construed (i) in the case of interests in land, in accordance with the rules applied by the courts of the situs, and (ii) in the case of an interest in movables, in accordance with the rules of construction of the state whose local law governs the administration of the trust as to matters pertaining to administration or of the state which the settlor would probably have desired to be applicable as to matters not pertaining to administration.[171]

5. Conflict-of-Laws Principles Governing Anti Alienation Clauses

a. Real Property Trusts

Whether a beneficiary's interest in a real property trust is assignable and reachable by creditors is determined by the law that would be applied by the courts of the situs as long as the land remains subject to the trust.[172] The situs courts would apply their own local law to determine this question.[173]

b. Personal Property Trusts

Whether a beneficiary's interest in a personal property trust is assignable and reachable by creditors is determined:

(1) in the case of a testamentary trust, by the local law of the testator's domicile at death, unless the testator has manifested an intention that the trust be administered in another state, in which case it is governed by the local law of that state; and

(2) in the case of an inter vivos trust, by the local law of the state, if any, in which the settlor has manifested an intention that the trust be administered, and otherwise by the local law of the state where trust administration is most substantially related.[174]

---

[171] *See id.* §§ 268, 277.
[172] *See id.* § 280.
[173] *See id.* § 280 cmt. a.
[174] *See id.* § 273.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

D. Application of Conflict-of-Laws Principles to Claims That Asset Transfer Was Fraudulent

If an action challenging a transfer of assets into an Alaska, Delaware, Nevada, or Rhode Island trust is brought in another state's court, the forum state must decide whether to apply the law of the asset protection state, the law of the forum state, or the law of another state.[175] Several commentators have concluded that trust conflict-of-laws principles do not apply in determining what law governs a fraudulent transfer claim because this claim is unrelated to trust validity, construction, or administration.[176] Rather, the fraudulent transfer cause of action is described as a tort or quasi-tort claim because the creditor is challenging the transfer of assets into the trust and not the internal affairs of the trust itself.[177] Furthermore, the commentators concluded that settlors of a trust cannot bind third-party creditors to the settlors' choice-of-law.[178]

1. Enforceability of Settlors' Choice-of-Law

Because the choice-of-law clauses authorized or mandated by asset protection states provide generally that the law of the asset protection state governs only the validity, construction, or administration of the spendthrift trust, a forum court likely will not enforce settlors' choice-of-law clauses in cases involving fraudulent transfer claims. Although Delaware's asset protection statute specifically states that fraudulent transfer claims can only be brought against a qualified disposition pursuant to Delaware's fraudulent transfer law, a court in another state may refuse to enforce this provision based on the theory that settlors cannot bind third-party creditors to the settlors' choice-of-law.

2. Resolution of Conflict-of-Laws Issue

Assuming that the forum court will reject the settlors' choice-of-law in a fraudulent transfer claim, commentators have concluded that the court will most likely apply the law of the state that has the most significant

[175] *See* Gebbia-Pinetti, *supra* note 149, at 242-43.

[176] *See* Jeremy M. Veit, *Self-Settled Spendthrift Trusts and the Alaska Trust Act: Has Alaska Moved Offshore?*, 16 ALASKA L. REV. 269, 286 (1999); Gebbia-Pinetti, *supra* note 149, at 246.

[177] *See* Gebbia-Pinetti, *supra* note 149, at 247.

[178] *See* Hogan, *supra* note 148, at 286; Gebbia-Pinetti, *supra* note 149, at 247; Veit, *supra* note 176, at 286.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

relation to the issue of whether the asset transfer to the trust is voidable under fraudulent transfer law.[179]

The Restatement sets out the following factors that are used to determine the jurisdiction with the most significant relationship to the contract: (i) the place of contracting; (ii) the place of contract negotiation; (iii) the place of performance; (iv) the location of the contract's subject matter; and (v) the domicile, residence, nationality, place of incorporation, and place of business of the parties.[180]

The home state of a settlor who does not reside in an asset protection state will likely be the jurisdiction with the most significant relationship to the contract.[181] In any event, the critical issue for settlors of asset protection trusts is that the forum court is not bound to apply the law that the settlor has chosen.[182]

E. Application of Conflict-of-Laws Principles to Claims That Spendthrift Trust Is Invalid

Unlike the fraudulent transfer challenge, a claim that the spendthrift trust is invalid does relate to the internal affairs of the trust.[183] Therefore, conflict-of-laws principles regarding trusts in general and antialienation clauses in particular would likely apply to determine which state's law governs the validity of a spendthrift trust.

1. Real Property Trusts

The Restatement provides that the law of the situs of real property generally governs questions concerning the validity of the trust as well as the ability of a spendthrift clause to prevent creditors from reaching the beneficiary's interest.[184] If the real property that is held by a self-settled spendthrift trust is located in an asset protection state, the laws of that state should determine the validity of the trust.[185] However, if the trust owns property outside the asset protection state, then forum courts may apply the laws of the situs state, and deem the trust invalid.[186]

---

[179] *See* Gebbia-Pinetti, *supra* note 149, at 250; Veit, *supra* note 176, at 285-86.
[180] *See* RESTATEMENT, *supra* note 160, § 188.
[181] *See* Veit, *supra* note 176, at 291.
[182] *See* Gebbia-Pinetti, *supra* note 149, at 251.
[183] *See id.* at 258.
[184] *See* RESTATEMENT, *supra* note 160, §§ 278, 280.
[185] *See* Hogan, *supra* note 148, at 31.
[186] *See id.*

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

2. Personal Property Trusts

Conflict-of-laws issues pertaining to personal property held in trust are more complicated than those concerning real property held in trust. The Restatement provides that in the case of an inter vivos trust, the local law of the state in which the settlor has manifested an intention that the trust be administered determines the issue of whether a beneficiary's interest in a personal property trust can be reached by the beneficiary's creditors. For all other trusts, the local law of the state to which trust administration is most substantially related determines whether a beneficiary's creditors can reach the beneficiary's interest.[187] Because the asset protection states all require some degree of in-state trust administration, this conflicts-of-law principle would support a forum court's application of the law of an asset protection state.[188] However, the conflict-of-laws principles governing the validity of trusts in general is not as favorable to the settlor's choice-of-law. The Restatement provides that an inter vivos personal property trust is valid if valid under the local law of the state designated by the settlor, but only if this state has a substantial relation to the trust and if the application of its law does not violate a strong public policy of the state with which the trust has its most significant relationship.[189]

a. Substantial Relation to the Trust

The commentary to the Restatement provides that a state has a substantial relation to a trust when it is: (i) the state, if any, which the settlor designated as that in which the trust is to be administered; (ii) the state of the place of business or domicile of the trustee at the time of the trust's creation; (iii) the state of the location of the trust assets at creation; (iv) the state of the settlor's domicile at creation; or (v) the state of the beneficiaries' domicile.[190] Many self-settled spendthrift trusts likely will satisfy this requirement because most asset protection statutes either permit or require the settlor to designate that state as the one in which part or all of the trust administration will take place, or require the trustee to be a resident of the respective asset protection state, or both.[191]

---

[187] *See* RESTATEMENT, *supra* note 160 § 273.
[188] *See* Gebbia-Pinetti, *supra* note 149, at 258.
[189] *See* RESTATEMENT, *supra* note 160 § 270.
[190] *See id.* § 270 cmt. b.
[191] *See* Hogan, *supra* note 148 at 30.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

b. Violation of Strong Public Policy

The commentary to the Restatement provides that the local law of the designated state will not be applied if this would violate a strong public policy of the state with the most significant relationship to the trust on the issue involved.[192] This requirement may be the most difficult for asset protection trusts to meet.[193] One commentator has concluded that "courts have virtually never applied the law of the trust's situs or the law expressly chosen by the settlor when the settlor chose situs or the law to evade a strong public policy of the settlor's."[194] Thus, states that are hostile to self-settled spendthrift trusts would be unlikely to enforce the spendthrift provisions in self-settled asset protection trusts based on the theory that such enforcement would violate strong public policies in the forum states against self-settled spendthrift trusts.[195]

IX. PRACTICAL PROBLEMS WITH RESPECT TO DOMESTIC ASSET PROTECTION TRUSTS

A. Enforceability of Foreign Judgments[196]

One often-repeated advantage of foreign asset protection trusts is that in most applicable jurisdictions, local law specifically prohibits the automatic enforcement of foreign judgments. In the Cook Islands, for example, a judgment of a non-Cook Islands court has no legal significance. As a result, the underlying cause of action must be relitigated in the foreign jurisdiction. Circumstances such as the unavailability of witnesses, the "loser pays" fee environment, and the lack of local legal talent impedes relitigation. These impediments do not exist in the case of the onshore domestic protection trusts because of the requirement of the United States Constitution that each state give "full faith and credit" to judgments handed down by courts in all of the states. Accordingly, once the creditor reduces a claim to judgment in any United States court, relitigating the underlying cause of action in the state where assets are held in trust is unnecessary. In effect, the successful creditor will bring an action to enforce the judgment with respect to the assets in the onshore domestic protection trust, either in

---

[192] *See* RESTATEMENT, *supra* note 160 § 270 cmt. b.

[193] *See* Hogan, *supra* note 148, at 30; Veit, *supra* note 176, at 291.

[194] Sterk, *supra* note 149, at 1086.

[195] *See id.* at 1089.

[196] Most of the many recent articles addressing the Alaska and Delaware trust laws consider this issue. For the most detailed analysis, see Leslie C. Giordani & Duncan E. Osborne, *Will the Alaska Trusts Work?*, J. OF ASSET PROTECTION (Sept./Oct. 1997), at 7.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

the state where the creditor and debtor reside (typically the same jurisdiction of the underlying judgment) or in the state where the trust has its situs.

1. Enforcement of Judgment in Original Forum

With respect to an enforcement action brought in the original forum or elsewhere other than where the trust has its situs, Giordani and Osborne suggest that the courts may ignore the law of the trust situs and apply their own self-settled trust rules. In such a case, the judgment taken to Alaska, Delaware, Nevada, or Rhode Island for enforcement is not the underlying judgment on the dispute between the parties, but a judgment requiring that the trust assets be turned over to the creditor. Although a creditor may obtain this result, it runs contrary to the general rule that the law governing the interpretation of a trust is the law of the trust's situs. In *The Law of Trusts*, Professors Scott and Fratcher include a lengthy analysis of these conflicts issues. In pertinent point, they indicate:

> Where the settlor creates a trust to be administered in the state of his domicil, the law of that state is applicable in determining whether the interest of a beneficiary can be reached by his creditors. This is clearly so where a proceeding is brought by a creditor in that state. It would seem that the same principle would apply where a proceeding is brought in some other state to reach the beneficiary's interest. The court, if it has jurisdiction and chooses to exercise it, will apply the law of the state of the situs of the trust.
>
> 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 of his domicil, ordinarily is applicable.[197]

This discussion, pertaining to third-party beneficiaries, is equally applicable to the Alaska, Delaware, Nevada, and Rhode Island situations in which the self-settled trust rule is replaced for certain settlor-beneficiaries. Accordingly, although the original jurisdiction will possibly apply its own self-settled trust rules in support of its own public policy, such a decision would run contrary to long-standing conflict principles and should not be relied on by a creditor seeking to enforce a judgment without additional precedent.

---

[197] 5A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 626(2) (4th ed. 1989).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

2. *Enforcement in Jurisdiction Where the Trust Has Its Situs*

More typically, the creditor will bring an enforcement action in the state where the trust has its situs, and the creditor will then be required to rely on the Alaska, Delaware, Nevada, or Rhode Island statutes for relief. This would include the applicable fraudulent conveyance laws of those states, as well as the exceptions contained in the statutes.

Although Alaska, Delaware, Nevada, and Rhode Island have chosen to adopt laws that run contrary to the centuries-old traditions embodied in the Statute of Elizabeth, the courts in those states quite possibly will construe those laws strictly (and thus, in a creditor-friendly manner) to avoid the appearance that those states have somehow removed themselves from the mainstream of American legal doctrine. Instructive in this regard is the widely-reported decision of the High Court of the Cook Islands in *515 Orange Grove Owners Association v. Orange Grove Partners*.[198] The interlocutory nature of the proceeding, coupled with the apparent settlement of the case prior to a substantive hearing, make deriving meaningful guidance from the case difficult, if not impossible; however, the amount of commentary on the decision reflects the fact that some believe the High Court has taken a stand against the use of Cook Islands "International Trusts" to encourage fraud and deceit, while others believe the High Court was simply wrong in its decision.

The High Court possibly expressed in dicta that it would not sanction abusive practices in creating these trusts, and its decision perhaps was based on this philosophy. The legislature of the Cook Islands rapidly modified its governing law concerning these trusts by way of the International Trusts Amendment Act 1995-96, which became effective on November 21, 1996. That Act changed the provisions of the prior law on which the High Court based its creditor-friendly opinion and made several other changes.

B. Judgment Against Trust and Not Settlor

Many commentators believe that if an enforcement action is brought only against the settlor of a trust in Alaska, Delaware, Nevada, or Rhode

---

[198] *See* Plaint No. 208/94 (High Ct., Rarotonga, Civil Division, No. 6, 1995), cited in and discussed further by Charles Bruce & Wendy Wojewodzki, *Will the Orange Grove Case Have a Long-Term Impact on Cook Islands' Asset Protection Trust Law?*, 2 J. OF ASSET PROTECTION Jan.-Feb. 1997 at 41 and John McFadzien, *Two New Pieces of Cook Islands Legislation Revise Trust Laws and Protect Integrity*, J. OF ASSET PROTECTION March-Apr. 1997, at 19.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Island, courts would protect the trust assets when asked to enforce the judgment of another state.

Another question is whether the Alaska, Delaware, Nevada, or Rhode Island courts would enforce the judgment of another state, not against the settlor, but against the trustee and the trust assets. Supporters of the Alaska, Delaware, Nevada, and Rhode Island Acts point to two cases to counter this.

In *Hanson v. Denckla*,[199] the U.S. Supreme Court upheld the decision of a Delaware trustee to refuse to enforce the order of a Florida court. In *Hanson*, a Pennsylvania resident established a trust, naming a Delaware trustee. The settlor moved to Florida, where he died. The widow attempted to exercise certain powers of appointment over the trust. The children disputed the validity of the exercise of the power, and the Florida court entered an order mollifying the exercise of the power. The family then went to Delaware to have the order enforced. The Delaware trustee declined, arguing that the full faith and credit clause was inapplicable because the Florida court lacked jurisdiction over the Delaware trustee and the trust assets.[200]

In *Baker v. General Motors*,[201] the U.S. Supreme Court held that Missouri courts were not bound to enforce a Michigan judgment prohibiting testimony from a particular witness when the parties to the Missouri action had no connection to the Michigan courts.[202]

X. ATTACK ON SPENDTHRIFT PROTECTION FOR THIRD PARTY BENEFICIARIES

The foregoing discussion focuses on the consequences to the settlor of creating an irrevocable trust, either foreign or domestic. The effects of such a trust on the settlor, both tax and nontax, have been dramatically changed by the developing legislative environment in Alaska, Delaware, Rhode Island, and Nevada. The elimination of the Rule Against Perpetuities in those states has no practical impact on the settlor, except for the leveraging of the generation-skipping tax exemption. The opportunity to create perpetual trusts (whatever perpetual means in a nation less than 250 years old) has a greater impact on beneficiaries. It is often suggested that

---

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

[200] *See* 357 U.S. at 254-55.

[201] *See* 522 U.S. 222 (1998).

[202] *See* 522 U.S. at 241. For more discussion of this, see Kaleen S. Hasegawa, *Re-evaluating the Limits of the Full-Faith and Credit Clause after* Baker v. General Motors Corporation, 21 U. HAW. L. REV. 747 (1999).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

a major reason for tying up assets on a long-term basis for beneficiaries is to achieve a measure of protection of the beneficiary's assets from creditors. While the creditor of a trust beneficiary generally cannot secure more from the trust than the beneficiary can, this rule may be breaking down, at least with respect to tort creditors.

On October 9, 1997, in *Sligh v. First National Bank of Holmes County*,[203] the Supreme Court of Mississippi undermined the protection conferred by a spendthrift trust by ruling that the assets of a spendthrift trust may be reached by a beneficiary's tort creditors.

With the decision in *Sligh*, Mississippi joined Georgia and Louisiana to become the third jurisdiction in the country to carve out an express exception to the spendthrift trust doctrine for tort creditors and became the first to do so by judicial opinion. By statute, Georgia and Louisiana allow tort creditors to reach a beneficiary's interest in a spendthrift trust.[204] However, in March 1998, the Mississippi legislature passed the Family Trust Preservation Act of 1998,[205] which overturns *Sligh*.

All practitioners who routinely rely on spendthrift clauses to shield trust assets from a beneficiary's creditors should take note of *Sligh*. Even though a statute has now overturned the case, the case stands as precedent that other jurisdictions might follow. If followed by other states, the decision could herald a significant erosion of the spendthrift trust doctrine. This is important, among other reasons, because parents are increasingly leaving their property to children and grandchildren, not outright, but in trust (often for the lives of the beneficiaries) in order to obtain spendthrift protection.

Settlors make gifts in trust to protect the intended beneficiary of the gift, and American law has long recognized their right to do so by use of a spendthrift clause. A spendthrift clause prohibits the beneficiary from voluntarily or involuntarily alienating an interest in a trust. In every state except New Hampshire,[206] a spendthrift clause affords at least some measure of protection from the claims of a beneficiary's creditors.[207] The degree of protection provided by a spendthrift clause varies significantly from state to state. Furthermore, the distribution standard adopted in the

---

[203] 704 So. 2d 1020 (Miss. 1997).

[204] *See* GA. CODE ANN. § 53-12-28 (2001); LA. REV. STAT. ANN. § 9:2005 (West 2002).

[205] *See* MISS. CODE ANN. §§ 91-9-501 to 91-9-511 (2001).

[206] *See, e.g.*, Bradley v. State, 123 A.2d 148 (N.H. 1956).

[207] *See* Osborne, *supra* note 19, at § 14:15 (1997).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

trust instrument has a significant impact on the scope of a creditor's ability to reach the assets of a spendthrift trust in various states.

A support trust, which allows distributions only for the support of the beneficiary, typically will offer less creditor protection than a discretionary trust providing that distributions can be made only in the discretion of the trustee. This disparity exists even in states with significant general limitations on the enforcement of spendthrift clauses.

In California, for example, notwithstanding a spendthrift clause, a beneficiary's creditors may reach up to 25% of the payment, income or principal that otherwise would be made to, or for the benefit of, the beneficiary.[208] At the same time, however, a creditor cannot compel a trustee to make a discretionary payment to or for the benefit of the beneficiary.[209]

Likewise, in Oklahoma, "income due or to accrue in the future to the beneficiary" over $25,000 per year is subject to all creditor claims, notwithstanding a spendthrift clause, but a creditor has no rights to a discretionary trust until the trustee exercises discretion in favor of the beneficiary.[210] The distinction between support and discretionary trusts does not apply in Virginia, which limits the amount of property that can be sheltered in a spendthrift trust to $600,000.[211]

Apart from general limitations such as those adopted in California, Oklahoma, and Virginia, many states ignore spendthrift clauses in favor of certain classes of creditors. The most frequently recognized exception to the spendthrift trust doctrine involves claims against a beneficiary for child or spousal support.[212] In addition, the government may assert claims against a beneficiary's interest in a spendthrift trust. If a beneficiary has a property interest in a spendthrift trust, federal law dictates that state law is inoperative to prevent attachment of a federal tax lien.[213] State law also may provide that property in a spendthrift trust is subject to governmental

---

[208] *See* CAL. PROB. CODE § 15306.5(b) (West 1991).

[209] *See id.* § 15306.5(f).

[210] OKLA. STAT. ANN.. tit. 60 § 175.25 (West 1994).

[211] VA. CODE ANN. § 55-19(B) (Michie 1995).

[212] *See, e.g.*, ARIZ. REV. STAT. ANN. § 14-7707 (West 1995); CAL. PROB. CODE § 15306(c) (West 1991); GA. CODE ANN. § 53-12-28 (1997) ; 735 ILL. COMP. STAT. ANN. 5/2-1403 (West 1992); KY. REV. STAT. ANN. § 381.180(6)(c) (Michie 2002); MO. ANN. STAT. § 456.080(2) (West 1992); OKLA. STAT. ANN. tit. 60, § 175.25(B)(1) (West 1994); 20 PA. CONS. STAT. ANN. § 6112 (West 1975); TEX. FAM. CODE ANN. § 154.005 (Vernon 1996); WASH. REV. CODE ANN. § 11.96.150 (West 1998); WIS. STAT. ANN. § 701.06(2) (West 2001).

[213] *See, e.g.*, LaSalle Nat'l Bank v. United States, 636 F. Supp. 874, 877 (N.D. Ill. 1986).

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

claims.[214] Some states also allow creditors to obtain satisfaction of judgments for "necessaries" furnished to a beneficiary.[215]

Prior to the *Sligh* decision, only Louisiana and Georgia made a special exception to the spendthrift trust doctrine for tort claims against a beneficiary. Under Georgia law, a spendthrift provision is not valid as to claims against the beneficiary for tort judgments, taxes, governmental claims, alimony, child support, or judgments for necessaries not voluntarily provided by the claimant.[216] Louisiana's statute allows the court to reach a beneficiary's interest in a spendthrift trust to satisfy claims for alimony, child support, necessaries furnished to the beneficiary, or offenses or quasi-offenses committed by the beneficiary.[217] The model spendthrift statute proposed by Professor Erwin Griswold in his treatise on spendthrift trusts[218], first published in 1936, which proposed an exception for tort creditors, appears to have influenced Louisiana's statute, enacted in 1938.

In *Sligh*, the Mississippi Supreme Court became the first court to create a common-law exception to the spendthrift trust doctrine for tort creditors. William Sligh, the plaintiff, suffered a broken spine and became paralyzed as a result of a 1993 automobile accident with Gene Lorance, an uninsured motorist who was driving while intoxicated. Lorance was convicted of a felony and given a ten-year sentence, with six years suspended. Sligh and his wife won a default judgment against Lorance for gross negligence and were awarded $5,000,000 in compensatory and punitive damages.

Lorance's only asset was his beneficial interest in two trusts established by his mother in 1984 and 1988, prior to her death in 1993. Both trusts named the First National Bank of Holmes County (the "Holmes County Bank") as trustee, and both stated that the trustee "shall have full and complete authority to expend all or any part of the income or corpus of said trust property for the benefit of myself and my said son, Gene Lorance." [219] Both trusts also provided that "[n]o part of this trust, either principal or

[214] *See, e.g.*, ARIZ. REV. STAT. ANN. § 14-7707 (West 1995); GA. CODE ANN. § 53-12-28 (1997); VA. CODE ANN. § 55-19(B) (Michie 1995); Miller v. Dep't of Mental Health, 442 N.W.2d 617, 621 (Mich. 1989).

[215] *See, e.g.*, ARIZ. REV. STAT. ANN. § 14-7707 (West 1995); GA. CODE ANN. § 53-12-28 (1997); KY. REV. STAT. ANN. § 381.180(6)(c) (Michie 2002); OKLA. STAT. ANN. tit. 60, § 175.25(B)(1) (West 1994) ; WASH. REV. CODE ANN. § 11.96.150 (West 1998); Sisters of Mercy Health Care Corp. v. First Bank of Whiting, 624 N.E.2d 520 (Ind. App. 1993).

[216] *See* GA. CODE ANN. § 53-12-28 (1997).

[217] LA. REV. STAT. ANN. § 9:2005 (West 1991).

[218] *See* ERWIN GRISWOLD, SPENDTHRIFT TRUSTS § 565 (2d ed. 1947).

[219] *Sligh*, 704 So. 2d at 1021.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

income, shall be liable for the debts of the said Gene Lorance, nor shall the same be subject to seizure by any creditor of his."[220]

The Holmes County Bank was served with a writ of garnishment, and the proceeding was transferred from Circuit Court to Chancery Court. The Slighs then filed a complaint against the Holmes County Bank, Lorance, and the two remainder beneficiaries, alleging that Lorance's mother had actual knowledge that her son was an alcoholic and also knew that he regularly operated motor vehicles while intoxicated. The Slighs alleged that Lorance's mother created the trusts "as part of her intentional plan and design to enable her son to continue to lead his intemperate, debauched, wanton and depraved lifestyle while at the same time shielding his beneficial interest in the trusts from the claims of his involuntary tort creditors."[221] The Chancery Court, upholding the protection provided by the spendthrift clause, ruled in favor of the Holmes County Bank, and the Slighs appealed.

The Mississippi Supreme Court reversed. As a starting point, the court recognized the longstanding rule in Mississippi allowing the donor of property to protect a gift from the claims of the donee's creditors. It noted that the principal Mississippi case on the issue, *Leigh v. Harrison*,[222] emphatically defends a donor's right to "limit his bounty according to his own will."[223] As the court asked in that opinion, "what law is violated by disposing of property with a limitation which confines its benefit to the person of the donee?"[224]

Leigh v. Harrison in turn relied upon the opinion of the United States Supreme Court in *Nichols v. Eaton*,[225] in which the Supreme Court stated:

> [T]he doctrine, that the owner of property, in the free exercise of his will in disposing of it, cannot so dispose of it, but that the object of his bounty, who parts with nothing in return, must hold it subject to the debts due his creditors, though that may soon deprive him of all of the benefits sought to be conferred by the testator's affection or generosity, is one which we are not prepared to announce as the doctrine of this court.[226]

Relying upon *Nichols*, the Mississippi Supreme Court held that the preservation of spendthrift trusts for "improvident and spendthrift persons,

---

[220] *Id.*
[221] *Id.*
[222] *See* 11 So. 604 (Miss. 1892).
[223] *Sligh*, 704 So. 2d at 1021.
[224] *Leigh*, 11 So. at 606.
[225] 91 U.S. 716 (1875).
[226] *Id.* at 725.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

who are objects of solicitude to their parents and friends," is entirely consistent with equitable principles.[227] Prior to *Sligh*, Mississippi had likewise followed that principle:

> [I]t is permissible for a parent to place property in the hands of a trustee to secure a child from poverty, want, or misfortune, and to provide for the necessities of life for such child. A creditor has no right to look to property in such a trust for the satisfaction of his demands.[228]

After noting the legitimacy of spendthrift trusts under state law, and the policy arguments in favor of such trusts, the Mississippi Supreme Court discussed the applicability of section 157 of the Second Trust Restatement. Under the Second Trust Restatement, a creditor may reach a beneficiary's interest in a spendthrift trust for claims of alimony or child support, for necessary services rendered to the beneficiary, for services and materials which preserve or benefit the beneficiary's interest, or for claims by the United States or a state against the beneficiary.[229] The commentary accompanying section 157 of the Second Trust Restatement further opines that it is "possible that a person who has a claim in tort against the beneficiary of a spendthrift trust may be able to reach his interest under the trust."[230]

The authors of the Second Trust Restatement could not include a tort creditor exception to the spendthrift trust doctrine, because, until *Sligh*, such a restriction had no case authority. Professor Austin Scott, in his treatise on trusts, recognized this fact, but suggested that "courts may well come to hold that the settlor cannot put the interest of the beneficiary beyond the reach of those to whom he has incurred liabilities in tort."[231] Scott's views, and those of the Second Trust Restatement authors expressed in commentary, merely confirm that no precedent for dramatically undermining the status of spendthrift trusts exists. Furthermore, such scholarly speculations hardly amount to a chorus of criticism. Indeed, while the Mississippi Supreme Court claimed in *Sligh* that "[l]egal scholars for years have called for the recognition of a public policy exception to the spendthrift trust doctrine in favor of tort judgment creditors,"[232] the

---

[227] *Leigh*, 11 So. at 606-07.
[228] Calhoun v. Markow, 151 So. 547, 549 (Miss. 1933).
[229] *See* RESTATEMENT (SECOND) OF TRUSTS § 157 (1959).
[230] *Id.* § 157 cmt. a.
[231] AUSTIN SCOTT, THE LAW OF TRUSTS § 157.5, at 222 (4th ed. 1987).
[232] *Sligh*, 704 So. 2d at 1026.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

commentary cited is meager and dated: in the past thirty five years, two student notes and three articles written between 1929 and 1952.[233]

Undeterred by the absence of precedent, the Mississippi Supreme Court concluded the policy reasons favoring the creation of spendthrift trusts should not apply to judgments for gross negligence and intentional torts. With respect to the most important public policy in favor of enforcing spendthrift trusts—the right of donors to dispose of their property as they wish—the court stated as follows:

> Clearly, the right of donors to place restrictions on the disposition of their property is not absolute, for as discussed above, there are several generally recognized exceptions to the spendthrift trust doctrine. Rather, a donor may dispose of his property as he sees fit so long as such disposition does not violate the law or public policy. We find that it is indeed against public policy to dispose of property in such a way that the beneficiary may enjoy the income from such property without fear that his interest may be attached to satisfy the claims of his gross negligence or intentional torts.[234]

The court's formulation of the spendthrift doctrine, under existing law, is incorrect. No general public policy exception to the spendthrift doctrine exists, and the exceptions that have been recognized in various jurisdictions should not be so construed. If such a public policy exception were to be adopted, why should public policy favor tort creditors over contract creditors?

At a time when trust instruments are frequently not a matter of public record, the fiction that contract creditors have notice of the provisions of a spendthrift trust cannot support a distinction between tort and contract creditors. The reasoning of *Sligh* would herald the end of the spendthrift trust doctrine as applied to any creditor, tort or contract. While for more than a century courts have repeatedly emphasized that a donor may gift property without making the property available to the donee's creditors, the

---

[233] The Mississippi Supreme Court cited Laurence M. Brooks, Comment, *A Tort-Creditor Exception to the Spendthrift Trust Doctrine: A Call to the Wisconsin Legislature*, 73 MARQ. L. REV. 109 (1989); Frank A. Gregory, Note, *Trusts: Tort Claims as an Exception to the Spendthrift Trust Doctrine*, 17 OKLA. L. REV. 235 (1964); William M. Antonis, Note, *Spendthrift Trusts: Attachability of a Beneficiary's Interest in Satisfaction of a Tort Claim*, 28 NOTRE DAME LAW. 509 (1952); George P. Costigan, *Those Protective Trusts Which Are Miscalled "Spendthrift Trusts" Reexamined*, 22 CAL. L. REV. 471 (1934); Erwin N. Griswold, *Reaching the Interest of the Beneficiary of a Spendthrift Trust*, 43 HARV. L. REV. 63 (1929).

[234] *Sligh*, 704 So. 2d at 1028.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

reasoning in *Sligh* would swallow this principle. If vague formulations of public policy are sufficient to override the spendthrift trust doctrine, then any appeal to public policy would potentially be sufficient to give a creditor access to a beneficiary's interest in a spendthrift trust.

The suggestion in *Sligh* that the settlor of a spendthrift trust, by seeking to protect the beneficiary, is somehow culpable for any torts committed by the beneficiary is extremely disturbing. The court stated that "[t]he Slighs have alleged facts to the effect that Lorance's mother intended that her son should be able to commit acts of gross negligence or intentional torts without fear that his beneficial interests would be attached as a result thereof."[235] The court seems to agree that Lorance's mother, merely by establishing a trust for her son, was in effect an accessory to his wrongdoing. The court established a new evidentiary presumption: now the presumption that a settlor's intent to sanction acts of gross negligence or intentional torts follows merely from the fact that a beneficiary is found liable for such an act.

The Mississippi Supreme Court, by suggesting that the establishment of a spendthrift trust is a wrongful act, is spelling the end of the spendthrift trust in that state. The court seemed to base its decision on a difference between contract creditors, tort creditors generally, and tort creditors based upon gross negligence and intentional torts. Distinguishing in a reasoned way a settlor's desire to protect a beneficiary from contract creditors, from tort creditors generally, and from tort creditors based upon gross negligence and intentional torts is difficult, if not impossible. Without even attempting to supply such a distinction, the Mississippi Supreme Court merely declares by judicial fiat that the latter is impermissible, but that the two former are not.

By abandoning the common-law rule protecting spendthrift trusts in favor of insupportable distinctions among various creditors, the Mississippi Supreme Court has opened the door for every creditor to argue that a spendthrift trust is a violation of public policy. The *Sligh* decision is also alarming in another respect. The court failed to acknowledge the important difference between a discretionary trust and other forms of trusts. The *Sligh* court seemed to suggest that even if the trustee has absolute discretion over trust distributions, the entire corpus of the trust can be reached by the tort creditors of a single beneficiary. Such a ruling would overturn the fundamental rule that the trustee of a discretionary trust cannot be compelled to exercise discretion to make a particular distribution.

---

[235] *Id.*

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

Because the trust in *Sligh* was arguably a discretionary trust, this rule may no longer apply to certain tort creditors in Mississippi.

Finally, the Mississippi Supreme Court ignored the interests of the two remaindermen on the grounds that the trustee had authority to expend all of the principal for Lorance. This decision in turn made the remainders subject to complete defeasance. Thus, the court reasoned, Lorance had an interest in all of the trust assets, and those assets could be reached by tort creditors. The court, surprisingly, seems to say that vested remaindermen in a discretionary trust now have no rights. The court relied upon *Deposit Guaranty National Bank v. Walter E. Heller & Co.*[236] However, that case is inapplicable because it concerned the lack of spendthrift protection afforded to the settlor of a trust from creditors, which is the law in all states, except Alaska and Delaware in certain circumstances.

The injuries suffered by William Sligh were undeniably devastating. Unfortunately, the Mississippi Supreme Court's desire to compensate him led the court to an unsound result. In Mississippi and in any state where the flawed reasoning of this case may be adopted, the spendthrift trust is in serious trouble. That, in turn, will have terrible consequences for settlors of trusts who have legitimate expectations of leaving property to beneficiaries in the manner and subject to the restrictions they choose. While the Mississippi legislature has partially closed the lid on this Pandora's box, the *Sligh* court has done damage by creating a dangerous precedent.

A recent Colorado case illustrates that a beneficiary's interest in a trust may not be inviolable, even when a spendthrift provision is not directly attacked. In *In re Balanson*,[237] the Colorado Supreme Court held that "a beneficiary's remainder interest in a trust from which a trustee may, in his discretion, distribute income and principal, constitutes property, for purposes of property division in a dissolution case."[238] The wife's father created the trust during the Balansons' marriage, and the wife was given a discretionary interest in the trust, but only after her father's death, which had not occurred at the time of the divorce. The value of the trust at the time of its creation was a gift to the wife during her marriage, and, under Colorado law, constituted separate property. The court held, however, that any appreciation on the property constituted marital property, which would be taken into account in determining the division of property.[239]

---

[236] *See* 204 So. 2d 856 (Miss. 1967).
[237] 25 P.3d 28 (Colo. 2001) (en banc).
[238] *Id.* at 32-33.
[239] *See id.* at 40-43.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

As one commentator has observed, the inclusion of the wife's interest in the trust as marital property can occur, even though the court could not order the trustee, or a party to the dissolution action, to distribute any property from the trust. Rather the court would probably allocate the marital property interest in the trust to the beneficiary spouse and allocate other marital property to the other spouse.[240] This result vitiates the commonly proffered advice that by passing property in trust, it will be protected from a beneficiary's spouse upon dissolution of a marriage. Although such advice may be literally correct, this ruling has placed in jeopardy the expectation behind such advice: that other property of the spouses would be divided without taking into account the beneficiary's interest in the trust.

If the ruling in *Balanson* becomes generally accepted,[241] the drafter will have to consider placing more restrictions on a beneficiary's interest in trust to achieve true protection from spousal creditors. These might include restrictions on discretionary distributions, the use of an ascertainable standard for discretionary distributions of principal,[242] inclusion of other beneficiaries, and lengthening the term of the trust.[243] Although none of these techniques will guarantee that the economic value of an interest in a trust will not be used in the determination of property division, they may well diminish the value of such an interest to the point that it would have no practical effect on the property division. The trade-off, of course, is that inclusion of these provisions will also diminish the real ability of the

---

[240] *See* Nancy R. Crow, *Balanson: Drafting Trusts to Deflect the Spousal Creditor*, COLO. LAW., October 2001, at 131, 131.

[241] A recent Vermont Supreme Court case may lead to a similar result. *See* Clark v. Clark, 779 A.2d 42 (Vt. 2001) (involving the challenge by the obligor father to an increase in child support). The court upheld the trial court's decision in not imputing income to the mother from (1) stock in the mother's trust that was not producing income because the court will not evaluate investment portfolios and decisions; (2) taxes and fiduciary and investment fees paid out of income because the trust instrument gave the trustee discretion to allocate such items to income or principal; or (3) increase in value of the trust because the father failed to raise the issue in an earlier appeal. However, the overall tenor of the court's opinion is that in the proper circumstances a beneficiary's interest in a trust would be taken into account in child support and by extension, property division orders, regardless of the existence of a spendthrift clause in the trust instrument. In support of such a result, the court indicated that the Vermont statute governing such matters includes "trust income" in its definition of "gross income." *See id.* at 46-48 (citing VT. STAT. ANN. tit. 15, § 653(5)(A)(i) (Supp. 2001)).

[242] The trustee of the trust at issue in *Balanson* was apparently not subject to an ascertainable standard.

[243] *See* Crow, *supra* note 240, at 132-34.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

intended beneficiary to enjoy the benefits of the trust, perhaps to a degree that is unacceptable to the settlor.

XI. CONCLUSION

Undoubtedly, many United States persons have transferred significant assets to foreign jurisdictions for management and investment purposes and the domestic trust industry has thereby lost the opportunity to handle this business. This trend undoubtedly will continue as wealthy individuals become aware of high-profile litigation results and the opportunity to protect assets by using offshore protection trusts. Importantly, very few individuals creating offshore protection trusts wish to treat the creation of the trusts as a completed gift; it is the authors' understanding that virtually all such trusts are designed to be included in the settlors' estates for federal estate tax purposes. A logical and almost inevitable result of this environment is that those legislators interested in the domestic trust industry would search for ways to accomplish similar goals in the United States.

On the other hand, those same legislators do not wish to have their states viewed as jurisdictions which give no respect to the rights of creditors; after all, a fundamental concept of American constitutional law is that states are to give full faith and credit to the judicial actions of courts sitting in other states. As a result, the new statutes take a different route from that taken by the offshore trusts. The starting point is the assumption that individuals wish to make completed gifts for gift and estate tax purposes but cannot do so if creditors can reach the transfers. The solution is to eliminate the creditors' rights, with the exceptions noted above.

At least four states have laws encouraging the creation of trusts that may benefit the settlor, while still being completed gifts and generally exempt from claims of the settlor's creditors. How will courts in other states react to the fact that their citizens have avoided the application of long-standing local law by adopting the laws of a jurisdiction which has a fundamentally different public policy? Will other states attempt similar statutory change? The authors understand that South Dakota, a trust-friendly jurisdiction, has decided not to pursue similar legislation for now because of its present belief that, despite legislation, assets cannot be fully protected against creditors. How will the "creditor community" feel about the elimination of the Statute of Elizabeth? Are fraudulent transfer rules enough? Will Congress react by expanding the reach of Code sections 2036 and 2038? After all, the essence of those sections is to treat assets transferred with strings attached as includible in the gross estate.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms

These and other unanswered questions will undoubtedly be the subject of much comment and law in the next several years.

This content downloaded from 67.115.155.19 on Thu, 25 Jan 2018 10:36:13 UTC
All use subject to http://about.jstor.org/terms