DOMESTIC ASSET PROTECTION TRUSTS

Domestic Asset Protection Trusts and the Bankruptcy Challenge

This second part of a two-part article analyzes a creditor attack in bankruptcy court of a domestic asset protection trust created by a settlor who is a nonresident of the DAPT state. A key issue is choice of spendthrift trust law.

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The first part of this two-part article[1] examined the eight states' domestic asset protection trust ("DAPT") statutes, the purposes of such trusts, how they can be attacked by creditors or a tax agency, and how proper planning can avoid most of such attacks. This second part of the article analyzes the most sensitive scenario: a creditor attack in bankruptcy court of a DAPT created by a settlor who is a nonresident of a DAPT state. The focus here is on the special issues that arise under federal bankruptcy law and how a bankruptcy court will approach the crucial choice of spendthrift trust law issue.

Introduction to bankruptcy courts

Jurisdiction. Absent a bankruptcy filing, if the DAPT trustee avoids doing any business or holding any trust assets in another state, a judgment against the settlor in that state may be hard to enforce against the DAPT trustee. Under *Hanson v. Denkla*,[2] where the Supreme Court held that Florida lacked jurisdiction over a Delaware trustee, and *World-Wide Volkswagen Corp. v. Woodson*,[3] there must be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum state. If a state or federal court cannot obtain jurisdiction over a nonresident DAPT trustee, such a court cannot order the trustee to turn over assets to the judgment creditor.[4]

However, if the DAPT settlor becomes a debtor in a bankruptcy case, voluntary or involuntary, the jurisdictional problems are simplified. The constitutional bankruptcy power of the United States is vested in the U.S. District Courts[5] but is generally exercised by the bankruptcy courts which are

[1] See Shaftel and Bundy, "Domestic Asset Protection Trusts Created by Nonresident Settlors," 32 ETPL 17 (Apr. 2005).

[2] 357 U.S. 235 (S.Ct., 1958).

[3] 444 U.S. 286 (S.Ct., 1980).

[4] See the discussion of "Jurisdiction" in Part 1 of this article, *supra* note 1.

[5] 28 U.S.C. §1334.

Article I courts created as "units" of the district courts.[6] Each of the district courts has entered a general order of reference providing that bankruptcy cases are referred to the bankruptcy judges for the district.

The bankruptcy jurisdiction of the district courts and bankruptcy courts is nationwide so that a summons issued in, or in connection with, a bankruptcy case may be served anywhere in the United States.[7] Therefore, if a bankruptcy trustee files an action in the debtor's "home" bankruptcy court against the DAPT trustee located in another state, the court will have jurisdiction to determine whether the trust's asset protection features should be enforced and, if not, to order the turnover of trust assets.[8]

Voluntary or involuntary bankruptcy. A DAPT settlor sufficiently pressed by future creditors may voluntarily seek bankruptcy relief by filing a petition under Bankruptcy Code (Title 11 U.S.C.) section 301. Individuals may file a voluntary bankruptcy case under Chapters 7, 11, or 13 of the Bankruptcy Code. Chapter 7 contemplates liquidation of the debtor's non-exempt assets. Under Chapter 11, the debtor may retain assets, and must propose a reorganization plan to pay creditors.[9] Chapter 13 is intended for wage earners or other individuals with regular income who are able to make periodic payments to creditors for three to five years.[10]

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[6] 28 U.S.C. §151.

[7] 28 U.S.C. §1334 (e); Rule 7004 (d) Federal Rules of Bankruptcy Procedure.

[8] The bankruptcy trustee will file an "adversary proceeding" under Part VII, Federal Rules of Bankruptcy Procedure. (An adversary proceeding is a civil action governed by rules closely parallel to the Federal Rules of Civil Procedure.) Fed. R. Bank. Pro. 7004(d) provides that a summons and complaint in an adversary proceeding may be served anywhere in the U.S.

[9] Also, a debtor against whom an involuntary Chapter 7 petition is filed may convert the case to a case under Chapter 11.

[10] Chapter 13 is currently limited to debtors who owe less than $922,975 in secured debt and $307,675 in unsecured debt. A bankruptcy case involving a DAPT settlor will probably involve a larger amount of debt.

As we went to press, new bankruptcy legislation (the Bankruptcy Abuse Prevention and Consumer Protection Act, Senate Bill 256) has been passed by the Senate. Under this legislation, debtors with income above their state's median income would be required to enter into a five-year repayment plan under which they would repay part of their debts. The new legislation will make it more difficult for debtors to extinguish their debts under Chapter 7.

Most bankruptcy petitions--voluntary and involuntary--are filed under Chapter 7. In every Chapter 7 case, a trustee is appointed, whose task is to collect and reduce to money the property of the bankruptcy estate.[11] The funds so gathered are used first to pay the costs of bankruptcy administration and then distributed to creditors according to the priorities specified in Bankruptcy Code section 726. Even if a debtor concerned over the treatment of a DAPT in bankruptcy avoids filing a voluntary petition, creditors may file an involuntary petition, initiating the bankruptcy process against the debtor's wishes.[12] Once bankruptcy relief is ordered, the trustee may pursue assets belonging to the bankruptcy estate just as if the debtor had filed voluntarily.

If, instead of filing for liquidation under Chapter 7, a debtor files for reorganization under Chapter 11, a trustee is not appointed, and the debtor (referred to in bankruptcy terminology as "debtor-in-possession") is authorized and directed to fulfill the trustee's duties. If a creditor believes that the debtor is not carrying out these duties effectively (if, for example, the creditor believes the debtor is not willing to challenge the validity of a DAPT of which the debtor is a possible beneficiary), the creditors may request the bankruptcy court to order the appointment of a trustee in the Chapter 11

[11] 11 U.S.C. §704.

[12] 11 U.S.C. §303. If there are fewer than 12 creditors, only one petitioning creditor is needed; otherwise three are required. The creditors must be owed at least an aggregate of $12,300 in unsecured debt, and the claims must be not contingent or subject to bona fide dispute. If the creditors establish that the debtor is "generally not paying such debtor's debts as such debts become due," then the court will enter an order for relief, initiating the bankruptcy administration.

case[13] or alternatively, to convert to a Chapter 7 case[14] and then a trustee will be appointed automatically.[15]

One way or another, if a well-planned DAPT[16] is challenged, it is likely that the challenge will be brought in a bankruptcy court.

The concept of property of the bankruptcy estate. The trustee must administer the bankruptcy estate, and therefore "property of the estate" is a key concept, as defined in Bankruptcy Code section 541(a):

. . . all of the following property, wherever located and by whomever held:

(1) except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.[17]

The debtor is required to file, under oath, schedules of assets and liabilities. The debtor must also provide copies of income tax returns and details about income from all sources for the year of the bankruptcy filing and the two prior years. The asset disclosure schedule[18] requires a listing of all property in which the debtor has an interest, including "equitable or future interests" and "other personal property of any kind not already listed." Through the tax returns or other disclosures, the bankruptcy trustee will almost certainly become aware of the existence and terms of a DAPT in

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[13] 11 U.S.C. §1104.

[14] 11 U.S.C. §1112.

[15] A trustee with limited powers is appointed in a Chapter 13 case. If the trustee believes that the bankruptcy estate could include the assets of a DAPT, the trustee will probably ask the court to convert the case to Chapter 7 so that a Chapter 7 trustee with greater powers can pursue the DAPT assets.

[16] For a discussion of the planning techniques that should be followed, see Part 1 of this article, *supra* note 1.

[17] The exclusions in subparagraph (b) are not germane to this discussion; the exclusion in subparagraph (c)(2) is central, and is discussed below.

[18] Official Form No. 6.

which the debtor is a beneficiary.[19] At that point, the bankruptcy trustee will try to determine if, and probably will do his best to establish that, the DAPT assets are property of the bankruptcy estate.

Theories of recovery by the bankruptcy trustee. The bankruptcy trustee may pursue the DAPT assets based on any of several theories, the success of which depends in part on the facts of the case. As to any transfer made within one year of filing the bankruptcy petition, the trustee may claim that the transfer is avoidable under the fraudulent transfer provisions of the Bankruptcy Code, 11 U.S.C. section 548. Section 548 is substantially similar to the Uniform Fraudulent Transfer Act, and allows avoidance of transfers that are either actually[20] or constructively[21] fraudulent.

Further, the new Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (S. 256), which has been passed by the Senate and is pending before the House at the date of publication of this article, amends Bankruptcy Code section 548 to add a new fraudulent transfer provision for DAPTs.[22] This new provision allows the bankruptcy court to look back over the ten-year period prior to the filing of the petition to determine if the DAPT settlor "made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on

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[19] It is assumed that the debtor will provide the trustee with accurate and complete information. Withholding material information from the trustee is cause for denial or revocation of the debtor's discharge (11 U.S.C. § 727(a)(4)). An even greater sanction is contained in 18 U.S.C. §152, under which a false oath in connection with a bankruptcy case is a felony, punishable by fines or imprisonment for up to five years, or both.

[20] "Made . . . with actual intent to hinder, delay or defraud any creditor of the debtor."

[21] "Made . . . without receiving reasonably equivalent value . . . and the debtor was engaged in a business . . . for which the remaining assets of the debtor were unreasonably small . . .; or intended to incur . . . debts beyond his or her ability to pay."

22 Senate Amendment 121 adds a new subsection to Bankruptcy Code section 548, which provides in part as follows: "(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition by the debtor, if—(A) such transfer was made to a self-settled trust or similar device; (B) such transfer was by the debtor; (C) the debtor is a beneficiary of such trust or similar device; and (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted."

or after the date that such transfer was made, indebted." This new provision will be fully discussed in the authors' follow-up article in a future issue of ESTATE PLANNING as soon as the legislation is enacted.

Alternatively, for transfers that were made more than a year pre-petition, the bankruptcy trustee can also resort to applicable state law, under Bankruptcy Code section 544(b), and invoke a remedy a creditor might otherwise use if there were no bankruptcy case pending. (See the section entitled "Fraudulent transfers" in Part 1 of this article, *supra* note 1.)

A trustee might also bring a challenge on the theory that the DAPT has not been properly administered.[23]

Venue for the bankruptcy filing and for challenges to the DAPT. Under 28 U.S.C. section 1408, the venue of a bankruptcy case for an individual debtor may be in the federal judicial district "in which the domicile, residence, principal place of business in the United States, or principal assets in the United States," are located. The bankruptcy case will probably be filed in the state of the debtor's residence, the courts of which, it is assumed, have held, or are likely to follow the general rule that a creditor of the DAPT settlor can reach the DAPT assets to the maximum extent that the DAPT trustee has the power to distribute the principal or income to the settlor.

If the settlor, hoping to find a forum friendly to the DAPT, changes residence to the DAPT state, and then files the bankruptcy case, creditors might seek to transfer venue of the case to the debtor's previous home state.[24] As "parties in interest," creditors may invoke 28 U.S.C. section 1412: "A district court may transfer a case . . . in the interests of justice or for the convenience of the parties."

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[23] See the section entitled "Improper implementation, alter-ego, or sham" in Part 1 of this article, *supra* note 1.

[24] 28 U.S.C. §1408 provides that venue based on residence is proper if the debtor has resided in the district for 180 days prior to filing, or for a longer portion of the 180-day period than anywhere else. Thus, if the DAPT settlor wants to attempt to obtain venue in the DAPT state, he or she can move there, wait 91 days, and file for bankruptcy.

The creditors will prefer that the case be adjudicated in a jurisdiction where they are concentrated, which may also be where the majority of the debts were incurred and often where the debtor's remaining assets can still be found, especially if that jurisdiction is not a DAPT state. The debtor, thinking that the DAPT state may be a friendlier environment in which to test the strength of the DAPT, may file the bankruptcy case in the DAPT state even without changing residence; or the creditors commencing an involuntary case may file in the DAPT state's bankruptcy court.[25]

If the venue of the bankruptcy case is in a non-DAPT state, the bankruptcy trustee can file suit in the "home" bankruptcy court against the debtor and the DAPT trustee to force a "turnover" of the DAPT assets to the bankruptcy estate. Alternatively, the bankruptcy trustee could bring suit against the DAPT trustee in either state court or bankruptcy court in the DAPT state. A suit in bankruptcy court would be filed as an adversary proceeding under Part VII of the Federal Rules of Bankruptcy Procedure, which are analogous to the Federal Rules of Civil Procedure.

Appeal. A bankruptcy court's final judgment in an adversary proceeding may be appealed. Each of the federal circuits has established a bankruptcy appellate panel (referred to as a "BAP"), consisting of active bankruptcy judges from that circuit. An appeal from a bankruptcy court is referred to the BAP for the relevant circuit. However, because BAP judges do not have constitutional Article III status, any party to the appeal may elect to have the appeal transferred to the district court for the district in which the appeal originated. A further appeal may be taken from a BAP or a district court's final judgment to the court of appeals in the same manner as an appeal in any other civil proceeding.[26]

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[25] It is hard to visualize a good argument for a non-DAPT state resident debtor to maintain venue in the DAPT state for a bankruptcy filing. If the DAPT state is not the debtor's domicile, residence or principal place of business, the only remaining basis for venue is the location of the debtor's assets, and it would be self-defeating for the debtor to claim that the DAPT assets were the debtor's assets for venue purposes. On the other hand, creditors could try to use the DAPT as a basis for venue, although they might be better off in a non-DAPT state for the reasons discussed below.

[26] 11 U.S.C. §158.

The DAPT as an excluded spendthrift trust

If the DAPT settlor becomes a debtor in a bankruptcy case in a non-DAPT state, will the bankruptcy court agree that the trust assets are excluded from the bankruptcy estate? The bankruptcy trustee will seek a ruling that the assets are "property of the estate" as defined in Bankruptcy Code section 541(a). This definition brings into the bankruptcy estate all property "wherever located and by whomever held" in which the debtor has a legal or equitable interest on the date the bankruptcy petition is filed. The scope of this section is intended to be quite broad,[27] but it is not unlimited. There is a significant exception, found in section 541(c)(2), as follows:

A restriction on the transfer of a beneficial interest of the debtor that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

It is well-established that Bankruptcy Code section 541(c)(2) protects a traditional spendthrift trust, such as might be set up by a parent for a child whose financial acumen was in doubt.[28] Funds actually received by the beneficiary from the trust prior to bankruptcy would be part of the bankruptcy estate, if the funds were still available.[29]

A bankruptcy filing would first stay[30] and then discharge[31] most creditors' claims, so those claims could be satisfied only from the assets available to the bankruptcy trustee. A nondischargeable claim[32] against a trust beneficiary will be enforceable after bankruptcy, but still could not be

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[27] Whiting Pools, Inc., 462 U.S. 198, 52 AFTR2d 83-5121 (S.Ct., 1983) (funds seized by the IRS pursuant to a tax lien but not yet applied to the debtor's tax liabilities were property of the bankruptcy estate that the debtor, under appropriate circumstances, could use).

[28] In re Spencer, 2004 Bankr. LEXIS 206 (Bk. C.D. Cal., 2004). In re Remington, 14 B.R. 496 (Bk. D. N.J., 1981).

[29] Bass v. Denney, 1998 U.S. Dist LEXIS 1611 (Bk. Tex., 1998).

[30] 11 U.S.C. §362.

[31] 11 U.S.C. §727.

[32] See 11 U.S.C. §523(a).

satisfied from either principal or income of a valid spendthrift trust after a beneficiary's bankruptcy filing, except for any portion of principal or income that has actually been distributed to the trust beneficiary and is therefore not protected by the spendthrift trust.

There is an argument that section 541(c)(2) was not intended to shield a self-settled DAPT in the same manner as a traditional spendthrift trust. This argument is not based on the language of the exclusion, because a self-settled spendthrift trust contains the same restriction on the transfer of the beneficiary's interest as would appear in any other spendthrift trust. The bankruptcy trustee may well argue that the exclusion should be narrowly construed but, without precedent to rely on, it is unlikely that this argument would succeed. The phrase "applicable nonbankruptcy law" in section 541(c)(2) is generally understood to mean state law, where relevant. If the relevant state law enforces the transfer restriction, the bankruptcy court should defer and a self-settled spendthrift trust should be excluded from the bankruptcy estate. To deny self-settled spendthrift trusts the protection of section 541(c)(2), if the DAPT law applies, will require a specific amendment to the section.

A logical inference from section 1402 of Senate Bill 256, the pending Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which sets out limited circumstances under which a bankruptcy trustee can avoid a transfer to a DAPT, is that a DAPT is not property of the settlor's bankruptcy estate. If Congress thought that DAPT assets were property of the bankruptcy estate, then it would not have enacted this new provision.

A bankruptcy debtor wants to shield future income, received post-petition, from the bankruptcy trustee. The fact that such income is only contingent as of the bankruptcy filing is not sufficient to protect it, though. *Segal v. Rochelle*[33] included in the bankruptcy estate a future contingent payment (in this case, a loss carryback tax refund) because it was "sufficiently rooted in the pre-bankruptcy past."

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33 382 U.S. 375, 17 AFTR2d 163 (S.Ct., 1966).

Since then, courts have struggled to differentiate between future income deemed to be sufficiently,[34] or insufficiently,[35] so rooted. While the distinctions are sometimes quite fine, the fact that on the date of bankruptcy the right to future income may not have vested, and may be contingent on future events, is not dispositive. Consider this issue with respect to an irrevocable trust of which the bankruptcy debtor is a beneficiary. Unless the trust itself is excluded from the bankruptcy estate under section 541(c)(2), a bankruptcy debtor's future income from the trust--though contingent on the trustee's discretion to make distributions--may well be included in the bankruptcy estate. If the trust is excluded, however, so also will be post-petition distributions.[36]

The bankruptcy court's issue: Choice of law

Even though a DAPT is protected by Bankruptcy Code section 541(c)(2), the bankruptcy court must still determine the "applicable nonbankruptcy law" that should be applied to the DAPT. A bankruptcy court as a unit of the U.S. District Court generally follows the law of the state in which it sits, including that state's choice of law rules. If the spendthrift clause in the trust is interpreted according to the DAPT state law, the trust would be excluded from the bankruptcy estate. But if the bankruptcy court applies the law of the settlor's non-DAPT state of residence, and if that law does not recognize the spendthrift restraint for the settlor's interest in the self-settled trust, the DAPT would not be excluded.

Restatement rules. Traditionally, self-settled trusts have been brought into a beneficiary's bankruptcy estate where the trustee has the power, although not the duty, to pay trust income or

[34] In re Edmonds*,* 263 B.R. 828 (E.D. Mich., 2001).

[35] In re Schmitz, 270 F.3d 1254 (CA-9, 2001).

[36] In re Newman, 903 F.2d 1150 (CA-7, 1990).

principal to or for the benefit of the debtor-beneficiary.[37] To reach trust assets, courts have followed the Restatement (Second) of Trusts section 156:

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.

Because in non-DAPT states, the beneficiary's creditors can reach the property of a self-settled spendthrift trust, so also can the bankruptcy trustee--acting in their interests--even if the creditors were not aware of the trust, did not rely on it for payment, and became creditors long after the trust was established.

Whether a bankruptcy court sitting outside the DAPT state will honor a settlor's selection of DAPT state law will probably depend on the court's resolution of the principles stated in section 270 of the Restatement (Second) of Conflict of Laws, which provides:

An inter vivos trust of movables is valid if valid

(a) under the local law of the state designated by the settlor to govern the validity of the trust, provided that this state has a substantial relation to the trust and the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in §6, or

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 under the principles stated in §6.

A bankruptcy trustee is likely to argue that a DAPT established by a non-DAPT state resident, for the benefit of non-DAPT state residents, and funded with assets located outside the DAPT state, does not have its most significant relationship with the DAPT state. Therefore, a determination will

[37] In re Hall, 22 B.R. 942 (Bk. M.D. Fla., 1982).

have to be made whether the DAPT violates a strong public policy of the settlor's state of residence.[38]

Choice of law and spendthrift trust--Domestic cases. The DAPT will survive the settlor's bankruptcy filing only if the bankruptcy court respects the trust's choice of the DAPT state law. If the DAPT settlor files a bankruptcy case, or an involuntary case is commenced against the settlor in a non-DAPT state, then the bankruptcy court must decide whether to recognize the trust's choice of the DAPT state law and exclude the trust assets from the bankruptcy estate, or whether to bring the assets into the bankruptcy estate by applying the domestic law of the forum state. The bankruptcy court will have to determine the forum state's applicable choice of law rule.

In the following bankruptcy cases, a trust settlor's choice of law was considered. In *Spindle v. Shreve*,[39] a decision dealing with a trust beneficiary's assignment for the benefit of his creditors, the Supreme Court held that the validity of a trust is generally determined by the law that is designated to govern it.

From this holding, one can conclude that a bankruptcy court in a state that does not recognize a self-settled DAPT should nevertheless enforce the trust according to its terms, if the trust specifies that it is governed by the DAPT state law. But a bankruptcy court may distinguish *Spindle v. Shreve* if it applies the principles of Restatement (Second) of Conflict of Laws section 270. If the bankruptcy court understands that its home state's choice of law principles will prevent the recognition of another state's law where a strong public policy of the forum is threatened, and the exclusion of a

[38] It does not appear that any cases involving domestic trusts have expressly applied the "strong public policy" test to invalidate a settlor's choice of law. Comment e to section 270 speculates that if a settlor domiciled in one state were to create a trust in another state to be administered there, and it appeared that the purpose of the trust was to avoid the spouse's forced share required by the settlor's state of residence, the trust might not be valid. Clark v. Clark, 236 N.E. 2d 152 (N.Y., 1968), applied Virginia law to determine a widow's share of the estate of a Virginia domiciliary, even though the estate consisted largely of securities deposited in New York.

[39] 111 U.S. 542 (S.Ct., 1884).

self-settled trust from the bankruptcy estate would violate that policy, then the trust's choice of law provision will be disregarded and the trust assets will be included in the bankruptcy estate.[40]

Bankruptcy courts dealing with spendthrift trusts created for beneficiaries other than the settlor have generally been willing to accept the trust's choice of law provision. In the cases discussed below, a beneficiary (who was not the settlor) declared bankruptcy, and the bankruptcy trustee attempted to reach the trust assets.

In re Hecht[41] dealt with a spendthrift trust which provided that it was to be governed by the law of Maryland, where it was created. The bankruptcy trustee argued for the application of New York (the debtor's residence) law in order to obtain a greater portion of the trust's income, but the court applied Restatement (Second) Conflict of Laws section 269(b), which provides:

The validity of a trust of interests . . . created by will is determined as to matters that affect only the validity of trust provisions . . . by the local law of the state designated by the testator to govern the validity of the trust . . . providing that this state has a substantial relation to the trust.

The trust in *Hecht* was created in Maryland by Maryland residents, with a Maryland trustee, and the trust was administered in Maryland. The court found that this was sufficient to apply Maryland law, even though the debtor-beneficiary and her creditors were in New York.

In *In re Newman*[42] and *In re Kragness*,[43] the courts excluded from the debtors' bankruptcy estates the corpus of spendthrift trusts created in other states[44] for the benefit of the debtors. The courts

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[40] See also the discussion in Part 1 of this article entitled "Which state's spendthrift trust law applies?," *supra* note 1.

[41] 54 B.R. 379 (Bk. S.D.N.Y., 1985).

[42] 903 F.2d 1150 (CA-7, 1990).

[43] 58 B.R. 939 (Bk. Or., 1986).

[44] In *Newman*, the trusts were created in Missouri, and the bankruptcy was filed in Illinois. In *Kragness*, the affected states were Hawaii and Oregon.

ruled that the trusts were valid where created, and the law designated by the trusts should be applied.[45] In *In re Hunter*,[46] the Florida bankruptcy court held that the validity of a testamentary spendthrift trust should be determined under the law of Missouri, where the trust was established and administered. The court applied Missouri law to exclude the trust corpus from the bankruptcy estate. *In re Schwen*,[47] decided in Minnesota, applied Florida law to interpret a spendthrift trust established in Florida for the debtor's benefit. The court concluded that because the trust was established and administered in Florida, that state's law would determine whether the spendthrift provision was valid. The *Schwen* court noted, "Florida courts have indicated that a spendthrift trust is defined to be a trust that is created with a view of providing a fund for the maintenance of another, and at the same time securing it against his own improvidence or incapacity for self-protection."[48]

*In re Remington*49 involved two spendthrift trusts created in Pennsylvania by the debtor's great-grandfather. The New Jersey Bankruptcy Court enforced the spendthrift provision of one of the trusts under Pennsylvania law and did not allow the bankruptcy trustee to reach the debtor's interest in that income.

[45] In neither case did the court state that the result would have been different under the law of the forum state.

[46] 261 B.R. 789 (Bk. M.D. Fla., 2001).

[47] 240 B.R. 754 (Bk. Minn., 1999).

[48] Similarly, in *In re Gower*, 184 B.R. 163 (Bk. M.D. Fla., 1995), the Florida court recognized and enforced a spendthrift trust created by the debtor's father in Colorado, the state selected in the trust agreement as the governing law. The validity of the spendthrift trust was not challenged; the trustee was seeking to recover only income that had been paid to the debtor. In *In re Hersloff*, 147 B.R. 262 (Bk. Fla., 1992), the court applied Maryland law to enforce a spendthrift clause in a trust created in Maryland by the will of the debtor=s father. There is no indication that Florida law would have produced a different outcome. In *In re Portner*, 109 B.R. 977 (Bk. Colo., 1989), the debtor was a contingent vested remainderman under his grandfather's testamentary trust, which contained a spendthrift provision. Creditors sought to include this interest in his bankruptcy estate, but the court applied Bankruptcy Code section 541(c)(2), held that Colorado law recognized spendthrift trusts, and held that the debtor's interest was excluded. There were no conflict of law issues in this case.

49 14 B.R. 496 (Bk. N.J., 1981).

In a Florida decision, *In re Hunger*,[50] it was stipulated that the validity of a testamentary spendthrift trust should be judged by the law of New York, where the trust was created. The trust was excluded from the bankruptcy estate under Bankruptcy Code section 541(c)(2).

The Vermont Bankruptcy Court applied New York law in *In re Graham*.51 The debtor there was a beneficiary of his grandmother's testamentary trust executed in New York. The court applied New York's statute limiting creditor access to the income of a spendthrift trust. In the same case, with respect to a trust with no spendthrift provision, the court again applied New York law to rule that the bankruptcy trustee was entitled to the debtor's interest.

Bankruptcy courts will follow state law in bringing the assets of a self-settled trust into the bankruptcy estate. *In re Cameron*,[52] a Florida bankruptcy case, dealt with a self-settled trust created by a New York resident. The bankruptcy court applied New York law:

> It is axiomatic that under New York law, self-settled trusts are void against both present and future creditors and a debtor may not avoid his creditors, or future creditors, by placing his property in trust for his own benefit. . . . This principle applies without regard to whether there has been any fraud or other wrongdoing by the debtor, as settlor of the trust.

The court held that the trust was property of the bankruptcy estate.

In re Sanders[53] was a Georgia decision that applied California law. The case concerned a retirement plan of which the debtors were beneficiaries. The court held that under California law, the plans in question were subject to the debtors' control, and thus were self-settled and not protected from creditors, and therefore should be included in the debtors' bankruptcy estates.

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50 272 B.R. 792 (Bk. M.D. Fla., 2002).
51 1989 Bankr. LEXIS 1283 (Bk. Vt., 1989).
52 223 B.R. 20 (Bk. S.D. Fla., 1998).

Challenges to foreign APTs. Some of the cases dealing with asset protection trusts ("APTs") established outside the U.S. have disregarded the settlor's choice of foreign law on the ground that it violated the public policy of the settlor's state of residence.

One such case was *Marine Midland Bank v. Portnoy*.[54] There, the debtor Portnoy established a trust in the English Channel Island of Jersey, naming a Jersey institution as trustee and naming himself and family members as beneficiaries. He transferred substantially all his assets to this trust. The trust document provided that Jersey law governed the trust and that the Jersey courts had exclusive jurisdiction to interpret the trust. The trustee had no U.S. presence. The trustee had discretion to pay trust assets to the beneficiaries.

Portnoy filed his bankruptcy petition about six years after establishing the trust. However, the trust had been established and funded with substantially all his assets shortly after he learned that his wholly-owned corporation, whose bank loan he had guaranteed, was on the verge of defaulting on its loan payments. After disposing of other issues, the court noted:

> Congress has generally left the determination of property rights in the assets of a debtor's estate to state law. *Butner v. United States*, 440 U.S. 48, 54, 59 L. Ed. 2d 136, 99 S. Ct. 914 (1979). Whereas property interests are created and defined by state law, it is federal bankruptcy law which determines the outer boundary of what may constitute property of the estate pursuant to Section 541 of the Bankruptcy Code. [Citations omitted]. Having recognized that local law determines whether Portnoy retained an interest in the offshore trust, I must still determine which local law will supply the substantive rule. [Citations omitted]. There are two possibilities here for the choice of substantive law, that of New York and that of Jersey. Portnoy contends that it is this latter jurisdiction's law which must be applied, given the

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53 89 B.R. 266 (Bk. S.D. Ga., 1988).

language in the offshore trust that it is to be interpreted under Jersey law. Both jurisdictions have an interest in this litigation.

The court concluded that New York, where Portnoy and his creditors lived, had a stronger relationship to the trust than did Jersey, where the trust was administered and the trustee was located. According to the court, applying Jersey law would offend a strong public policy of New York state. The court referred to the established New York law on the ineffectiveness of self-settled trusts to defeat the interests of creditors, and declared that "in the United States state laws uniformly outlaw self-settled spendthrift trusts." The court decided that New York law should prevail and the debtor's interest in the Jersey trust was included in the bankruptcy estate.[55]

The timing of the transfer to the trust in this case is certainly suspicious. If the bank had challenged the trust earlier, a fraudulent transfer claim might well have succeeded, given Portnoy's inability to pay his creditors with his remaining assets. This would have been a more straightforward means of recovering the trust assets, and the strong inference of fraudulent conveyance may have influenced the court.

If a transfer to an APT is clouded by suggestions of fraud or other wrongdoing, as in the best-known foreign APT cases, the chances are few that the court will respect the trust's choice of law. In those situations, a bankruptcy court will analyze a debtor's APT in the context of the debtor's having sought refuge from creditors; any protest that the debtor lacks the ability to recover the assets from the trust is likely to be met with considerable doubt.

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54 201 B.R. 685 (Bk. S.D.N.Y., 1996).

[55] *In re Brooks*, 217 B.R. 98 (Bk. D. Conn., 1998), was similar. There, the debtor had transferred assets to his wife who then transferred them to asset protection trusts in Jersey and Bermuda. The court ignored the trusts' choice of law and instead applied Connecticut (the debtor's residence) law, which held that the spendthrift provisions should be ignored as against Connecticut public policy. The decision does not say that the trusts were funded when the debtor was insolvent, but the filing of the bankruptcy petition a year and half later suggests that this may in fact have been the case.

Federal Trade Commission v. Affordable Media, LLC[56] involved accused Ponzi scheme operators (the Andersons) who created a trust in the Cook Islands. The trust agreement contained a "duress" clause which purported to deprive the settlors of any control over the trust if the settlors were ordered to repatriate the trust assets for the benefit of their creditors. The court ordered the assets to be returned, the foreign trustee refused to comply, and the debtors protested their inability to obtain the assets from the trust. The district court rejected this argument and ordered the debtors to be incarcerated until they purged themselves of contempt by turning over the trust property. The appellate court affirmed, refusing to believe that the debtors would send "millions of dollars overseas and retain absolutely no control over the assets."

In *In re Lawrence*,[57] the result was similar. Lawrence created a trust under the law of Mauritius to which he transferred $7 million shortly before suffering a large arbitration judgment. The trust was amended to exclude the settlor from any control over the assets. Lawrence filed bankruptcy several years later. When he did not obey the bankruptcy court's order to turn over the trust assets, he was incarcerated. This order was affirmed; the appellate court held that there was insufficient evidence that Lawrence in fact lacked the ability to obtain the trust assets and that "where the person charged with contempt is responsible for the inability to comply, impossibility is not a defense to the contempt proceedings."[58]

These APTs were tainted by indications that they were formed to defraud creditors. If those indications can be avoided, the trust proponent should be able to refute any argument from a bankruptcy trustee who relies solely on the foreign APT cases.

Analysis

56 179 F.3d 1228 (CA-9, 1999).
57 279 F.3d 1294 (CA-11, 2002).
58 Pesaplastic, C.A. v. Cincinnati Milacron Co., 799 F.2d 1510 (CA-11, 1986).

Most of the published bankruptcy decisions enforcing a trust's designated choice of law do not deal with self-settled spendthrift trusts. The few that do deal with self-settled trusts invalidate or limit them in accordance with the law of the state where the trust was created. While it is encouraging for the proponents of self-settled spendthrift trusts that the bankruptcy courts are generally willing to apply the law of the state where the trust was created, these decisions must still be relied on with caution because in none of the cases (except for the *Hecht* decision) is it clear that the choice of law was a seriously contested issue.[59] The choice of law may not have been contested because it was not determinative of the outcome.

Most of the published bankruptcy court decisions deal with testamentary spendthrift trusts created by testators for the benefit of their children or other family members. Because testators are generally free to disinherit relatives entirely, transferring property subject to restrictions--rather than absolutely--does not present any difficulties from a public policy viewpoint. There is a policy in favor of allowing testators and trust settlors broad freedom in passing their property to others, subject to almost any restrictions they think appropriate.

As a result, there is no reason why a bankruptcy court sitting in any state should be reluctant to find that the "applicable nonbankruptcy law" to be applied to the usual spendthrift trust under Bankruptcy Code section 541(c)(2) is the state law specified in the trust instrument. That law is almost certainly the same, for all practical purposes, as the law of the state where the bankruptcy court sits. In none of the reported cases where a bankruptcy court has declared that it would enforce a spendthrift trust in accordance with the law called for by the trust agreement was there any significant conflict between that law and the law of the forum state.[60]

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[59] In some of the cases, the choice of law was stipulated. In others, the applicable law was declared by the court with no indication that any of the parties had disputed the question. The courts seem to have followed the general rule that the validity of a trust is judged under state law chosen in the trust instrument.

[60] The one reported decision in which the choice of law did affect the outcome, *In re Hecht*,

So far, no bankruptcy court has decided whether to accept another state's self-settled DAPT. The strength of the policy or general rule that the validity of a trust should be determined by the law of the state where it was created and by which it purports to be governed has not been tested in the DAPT context. Moreover, there are no decisions testing a DAPT against another state's strong public policy that would disallow a self-settled spendthrift trust.

In the bankruptcy cases where a trust's choice of law was followed, there was an apparent strong connection between the settlor and the state law specified by the trust agreement. The trust may have been created by a settlor, or by the will of a testator, resident in that state. The trust may have been created by an employer based in the state whose law was designated to apply, for the benefit of employees in that state and elsewhere, with the trust assets being administered in that state. In all the cited cases, the relationship between the settlor and the state whose law was selected by the trust agreement was clear and derived from facts largely external to, and independent of, the trust itself.

If a non-DAPT state resident wants to create a DAPT, the settlor would do well to establish as strong a relationship to the DAPT state as possible. In fact, there is nothing in any DAPT state law that requires that the trust be physically be created in the DAPT state, nor that either the settlor or any of the beneficiaries be DAPT state residents. A trust can theoretically qualify for exclusive DAPT state law treatment even if most of its assets and their management are located elsewhere.

Nevertheless, a self-settled trust with minimal connections to the DAPT state, and which could--at least in hindsight--be perceived as having been created to shelter assets from creditors, may not inspire deferential feelings in a bankruptcy court sitting in a state where the local law would not permit the same degree of protection from creditors. A court in a non-DAPT state may not feel

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54 B.R. 379 (Bk. S.D.N.Y., 1985), did not involve a self-settled trust. In that case, the bankruptcy trustee was not seeking to invalidate the trust; the dispute was over the amount of trust income to which the bankruptcy estate was entitled.

compelled to respect the choice of DAPT state law when the settlor and beneficiaries are not DAPT state residents, and the bulk of the trust assets, as well as the majority of trust administration, are not located in the DAPT state. The court may view the DAPT state as a "flag of convenience" applied to the trust in order to obtain protection from creditors which is not available under the law of the settlor's residence.

The court may not believe that the choice of law designated in a trust created by a non-DAPT state resident for the special purpose of protecting assets from present or future creditors deserves the same degree of respect as the law specified in the trust of a resident of the state whose law is designated. While it is impossible to guarantee how a court will judge the facts, the DAPT settlor can improve the chances of the trust surviving a subsequent bankruptcy if the settlor takes steps to strengthen ties between the DAPT and the state whose law is chosen to govern it.

A bankruptcy filing and a DAPT with `clean' facts

A nonresident DAPT settlor can maximize the chances of preserving the DAPT by taking a number of steps and avoiding some problem areas. The settlor should execute the trust agreement in the DAPT state and make periodic visits there. The sole trustee should be a DAPT state resident or institution. The trust assets should be transferred in the DAPT state and held there, and the trust records should also be maintained there. These additional steps are not required to establish an enforceable DAPT under the laws of a DAPT jurisdiction, but they will improve the odds of a court in a non-DAPT state enforcing the provision that the trust be interpreted and enforced according to DAPT state law. Of course, the DAPT should not be vulnerable to a fraudulent transfer challenge, and there should be no facts that suggest an implied agreement between the settlor and the DAPT trustee to the effect that the assets will be made available to the settlor on request.

Inevitably, a bankruptcy court will analyze a debtor's DAPT in the context of the debtor's having sought refuge from creditors. Consequently, there should be as much distance as possible between (1) the funding of the trust and (1) the liabilities that give rise to the bankruptcy case. Ideally, a DAPT settlor will create the trust when no claims are pending or threatened, and the future claim which tests the effectiveness of the trust will not be a claim that could have been reasonably foreseeable when the trust was established.

Still, the fact that a subsequent claim exists at all will cast doubt on assertions of the settlor's innocence which will inevitably be judged in hindsight when the possibility of a claim will seem less remote. Even if the actual claim was unknown, the fact that a claim of this sort could arise in the future was always a possibility. The forum bankruptcy court will have to determine how strong that state's policy against self-settled trusts actually is, and will judge that policy against another important policy: the need to respect a trust relationship specifically authorized by the law of a sister state.

If the problem areas are avoided, the settlor should prevail if he can demonstrate that his home state does not have a strong policy against self-settled trusts. Most states exempt from creditor action and bankruptcy estates individual retirement accounts and other tax-qualified retirement accounts, which are frequently self-funded in whole or in part.[61] In addition, IRC Section 529 plans, which are investment accounts for education expenses and are generally self-settled, are exempt from the reach of creditors in some states.[62] Annuities, life insurance, and homestead exemptions are other self-settled approaches which state law may exempt. The DAPT settlor will

[61] Although the Bankruptcy Code is federal law, Bankruptcy Code section 522(b)(2) permits a debtor to exempt from the bankruptcy estate any assets exempted from execution under the law of the debtor's residence.

[62] See www.savingforcollege.com.

want to examine the law of the settlor's residence for other arguments that a DAPT established in another state may not violate a local strong public policy.[63]

Also relevant to this "strong public policy" subject is the fact that now eight states have enacted DAPT statutes (i.e., Alaska, Delaware, Nevada, Missouri, Oklahoma, Rhode Island, South Dakota, and Utah). As more states enact DAPT statutes, a "tipping point" may be reached. That is, assume a non-DAPT state does not have an established "strong public policy" against DAPTs. It would seem reasonable that the more that other states allow the DAPT approach, the less likely a court in the subject non-DAPT state would infer that a DAPT approach is against the "strong public policy" of that state.

Compromise planning: Limit the debtor's property interest

A bankruptcy court will have jurisdiction only over "all legal and equitable interests of the debtor."[64] A settlor may be willing to limit his interest in the trust assets. For example, often a married settlor will be willing to be only a contingent beneficiary. That is, the settlor will become a beneficiary only if the settlor's spouse is incapacitated or deceased, or if the marriage is terminated. As a result, the settlor arguably will not have an interest that can be reached by creditors. Even so, the settlor's bankruptcy estate will probably include the post-bankruptcy distributions received by the settlor if the contingency materializes.

Alternatively, a settlor's interest could be limited to only discretionary distributions of annual income from the trust assets. Then, only this income interest would be vulnerable.

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[63] See Intercontinental Hotels Corp. v. Golden, 254 N.Y.S.2d 527, 203 N.E.2d 210 (N.Y., 1964), for an application of this reasoning involving gambling laws. The prohibition on self-settled trusts is set out in *Scott on Trusts* §156 (1st ed. 1939). However, see Danforth, "Rethinking the Law of Creditors' Rights in Trusts," 53 Hastings L.J. 287 (2002). Professor Danforth concludes that the traditional rule declared by Scott has little basis in prior case law and is theoretically unsound.

[64] 11 U.S.C. §541(a)(1).

Other beneficiaries may be given ascertainable interests which would limit a trustee's power to make distributions to the settlor and consequently may limit or even prevent the trust assets from becoming part of the bankruptcy estate. For instance, during the settlor's lifetime, an ascertainable standard might be provided for distributions to the settlor's descendants for education and emergency health and emergency support needs. After the settlor's death, this standard could end, and the trustee could have absolute discretion over distributions. Such a plan would arguably limit the settlor's property interest and therefore limit a bankruptcy court's ability to reach assets.[65]

Oklahome Preservation Trust

The Oklahoma Family Wealth Preservation Trust Act,[66] enacted in 2004, created a new variety of trust. A settlor, who need not be an Oklahoma resident, is permitted to establish a trust funded with up to $1 million of Oklahoma real estate, an Oklahoma bank account, or securities issued by an Oklahoma business or government. The trustee must be a bank or trust company based in Oklahoma. The beneficiaries must be the settlor's spouse or issue, or an IRC Section 501(c)(3) charitable organization. The trust assets are exempt from execution. Unique in the DAPT world, the trust may be revocable. Section 16 of the statute also provides, as additional protection for the settlor:

No court or other judicial body shall have the authority to compel a person holding a power of revocation over a preservation trust to exercise the revocation.

This new DAPT statute raises several issues. Will the above-quoted provision preclude the revocable trust assets from being included in a settlor's bankruptcy estate? If the settlor reserves the right to revoke the trust, the power to revoke is "a legal or equitable interest in property" as defined in Bankruptcy Code section 541(a). As such, the bankruptcy estate will own that power and the

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[65] However, during the settlor's lifetime, creditors of the settlor's descendants could argue that the standard will allow them to reach trust assets. Therefore, the standard should end at the settlor's death.

66 Okla. Stat. Ann. §§10 through 18.

bankruptcy trustee will be able to exercise it. The intervention of a court will not be needed because the bankruptcy trustee will not need to be compelled to revoke the trust.

Is a bankruptcy court prevented from ordering a debtor to revoke the trust? Can the Oklahoma legislature thus limit the powers of a federal court? Those powers derive from Titles 28 and 11 of the United States Code, which are constitutionally supreme. It may be argued, though, that section 16 of the Oklahoma statute amounts to a restriction on the transfer of a beneficial interest of the debtor, which is protected under Bankruptcy Code section 541(c)(2). The problem with this argument is that the restriction is not couched in traditional spendthrift trust terms.

Finally, section 14 of the Oklahoma statute specifically states that "exemptions provided for under other provisions of the laws of this state shall be mutually exclusive of the exemption provided for under Section 3 of this act." If the Oklahoma statute is characterized as a state law exemption, rather than an exemption for a spendthrift trust under Bankruptcy Code section 541(c)(2), then the Oklahoma statute will protect only settlors who are residents of Oklahoma. Bankruptcy Code section 522(b)(2)(A) limits state law exemptions to those of the debtor's state of domicile.[67]

As of the date of publication of this article, several amendments to The Oklahoma Family Wealth Preservation Trust Act are pending before the Oklahoma Legislature. Some or all of the above deficiencies may be remedied by this pending legislation.

Why don't we have more authority?

Seven years have elapsed since the enactment of the first DAPT statutes, but authority and review remain sparse. With respect to DAPT asset protection issues, the discussions of the jurisdiction, choice of law, and the bankruptcy court scenario demonstrate that most of these issues are both highly fact-specific and depend on unpredictable decisions of the courts located in the settlor's state

[67] Or, unless the state has "opted out," under the exemptions allowed by Bankruptcy Code section 522(d).

of residence, the DAPT state, and bankruptcy courts. When cases are decided in the future, the decisions may be narrow and limited to the specific situation involved. Further, the asset protection cases that are litigated to judgment often involve extreme facts, as demonstrated by the offshore cases.

In regard to personal jurisdiction issues, Professor Boxx states,

Unfortunately, a decision that would expose the trust assets to the judgment in this context would be too fact-specific to have much relevance to future cases, since it would turn on personal jurisdiction of a particular state over a particular trustee. However, depending on the policy analysis done to determine personal jurisdiction, the decision could be a sufficient cautionary tale that would make the trusts less attractive or, at least, affect future litigation strategy.[68]

With respect to DAPT tax issues, only three current private letter rulings exist: Ltr. Rul. 9837007, which concluded that gifts were complete when made to an Alaska DAPT designed for transfer tax reduction; and Ltr. Ruls. 200148028 and 200247013, both of which found that gifts were incomplete when made to a Delaware trust designed only for asset protection and also ruled that the Delaware trust was not a grantor trust for income tax purposes.[69] The IRS has refused to rule further on such trusts.

Despite the formation of numerous DAPTs, practitioners in Alaska and Delaware report that as yet there is no significant IRS audit experience. Anecdotal information indicates that several settlors of

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[68] Boxx, "Gray's Ghost—A Conversation About the Onshore Trust," 85 Iowa L. Rev. 1195, 1221 n. 149 (2000).

[69] Prior to enactment of the DAPT statutes, the Service issued a number of rulings relating to self-settled offshore trusts and self-settled trusts governed by state law which the taxpayers represented prevented creditors from reaching the trust assets. These rulings are consistent with the tax analysis in Part 1 of this article entitled "Transfer tax planning," *supra* note 1. Ltr. Ruls. 7733062, 8037116, 8829030, 9332006, 9535008, and 9536002. See Manley, "Estate Planning and Asset Protection Using Self-Settled Alaska Trusts," 33 *U. Miami Heckerling Inst. on Est. Plan.*, Special Session materials (1999).

DAPTs have died, and the IRS has not challenged the exclusion of such trusts from the settlors' gross estates. Accordingly, there has been no administrative or judicial review of those trusts.

A legislative resolution of the effectiveness of transfer tax planning with DAPTs is also unpredictable. At some point before 2010, Congress will likely "rethink" the transfer tax changes enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001. IRC Section 2036 could be amended to resolve the transfer tax issue. But which way? In the proposed Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress chose to enact only the above-described limited provisions affecting DAPTs.

In view of the above-described limited arguments available to the Service with respect to residents of DAPT states, and the fact-specific character of the issues involving nonresident settlors, there may continue to be a lack of significant judicial authority in this area. In regard to the Section 2036(a)(1) transfer tax issue, Professor Pennell concludes, "[t]his issue will take time to resolve, and there may be fits and starts as various courts analyze the question."[70] Because of this lack of authority, if an asset protection or transfer tax question does arise, the parties often may find a negotiable resolution.

Conclusion

Careful planning and implementation are prerequisites to a successful DAPT formed by a nonresident settlor. A DAPT should not be formed if a settlor has existing liabilities that cannot be satisfied with non-DAPT assets. The choice of trustee(s) should be made so as to minimize the risk that creditors will argue that an implied agreement existed, and to ensure that jurisdiction over the trustee will be only in the DAPT state. Statutory requirements and the formalities of trust ownership should be followed precisely. As a result, the DAPT will not be subject to attack based on the

[70] Pennell, 2 *Estate Planning* §7.3.4.2, pp. 7.345-7.346 (Aspen 2003).

theories of fraudulent transfer, improper implementation, alter-ego, or sham transaction. Solid contacts should be established with the state where the DAPT is formed.

Careful jurisdiction planning will result in any asset protection attack being brought in courts located in the DAPT state or in bankruptcy court. Probably, the only remaining significant issue will be choice of law.

A DAPT settlor would like assurance that the trust will survive in the unlikely event that the settlor is subject to a bankruptcy case several years later. Whether the trust will in fact do so cannot, however, be guaranteed. The settlor will argue that the Restatement principles, academic commentary, and the somewhat analogous case law all support application of the DAPT spendthrift trust law selected in the trust instrument. The bankruptcy trustee will counter by arguing that the DAPT rules violate a strong public policy of the settlor's state of residence, and will rely on the existing foreign asset protection cases. The particular facts of the case will significantly affect the outcome. The settlor's chances of success will be improved by planning that establishes strong ties between the trust and the DAPT state, and by demonstrating that the settlor's home state does not have a strong policy against self-settled discretionary spendthrift trusts.

Nonresident clients and their estate planners should apply an upside/downside analysis. What are the alternative available approaches for asset protection or transfer tax minimization? How do their risks and advantages compare with a DAPT? If the alternative strategies are not superior, then a DAPT should be considered.

In a future issue of ESTATE PLANNING, as soon as the legislation is enacted, the authors will present a follow-up article discussing the provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 which directly affect DAPTs.

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If a non-DAPT state resident wants to create a DAPT, the settlor would do well to establish as strong a relationship to the DAPT state as possible.

Bankruptcy courts will follow state law in bringing the assets of a self-settled trust into the bankruptcy estate.

So far, no bankruptcy court has decided whether to accept another state’s self-settled DAPT.

Despite the formation of numerous DAPTs, practitioners in Alaska and Delaware report that as yet there is no significant IRS audit experience.