

# DEFEATING THE SELF-SETTLED SPENDTHRIFT TRUST IN BANKRUPTCY

MICHAEL SJUGGERUD\*

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## I. INTRODUCTION

Low- and middle-income Americans benefit little from recent developments in trust laws enabling the wealthy to shelter assets from creditors. Many foreign nations allow Americans to establish asset protection trusts abroad, purportedly making it impossible for American creditors to collect from American debtors. While bankruptcy courts rarely face cases involving these foreign trusts, the few cases on point have been decided unanimously against the debtors on public policy grounds. Not to be outdone, several American states have now modified their trust laws to compete with foreign nations. These recent amendments facilitate continued social stratification by discouraging wealthy debtors from repaying their

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\* J.D., Florida State University, 2001; M.B.A., Clemson University, 1994; B.S., University of Florida, 1993. Special thanks to Professor Adam Hirsch for his insight and encouragement.

debts even when they have the ability to do so. The unresolved question is how bankruptcy courts will treat those trusts.

Federal courts have exclusive and original jurisdiction over property of a bankruptcy estate.<sup>1</sup> The Bankruptcy Code defines property of the estate as “*all* legal or equitable interests of the debtor in property as of the commencement of the case.”<sup>2</sup> The Supreme Court affirmed the breadth of this definition in *United States v. Whiting Pools, Inc.*<sup>3</sup> Ordinarily, even nontransferable property is included in the estate.<sup>4</sup> However, there is an exception to that broad definition where “a restriction on the transfer of a beneficial interest of the debtor in a trust [ ] is enforceable under applicable nonbankruptcy law.”<sup>5</sup> Under those circumstances, the nontransferable interest is not included in the estate.<sup>6</sup> The unanswered question explored in this Comment is the extent to which recently enacted state laws validating self-settled spendthrift trusts prevent inclusion of trust assets in the bankruptcy estate.

Part II briefly describes self-settled spendthrift trusts, and Part III illustrates the issues they create in bankruptcy using previously decided cases involving offshore trusts. Part IV then offers an overview of the recently enacted state laws making these trusts enforceable, describing the statutes and the motives underlying their passage. Parts V and VI outline a number of ways bankruptcy courts and trustees might safeguard the purposes and spirit of the bankruptcy laws by bringing the assets of these trusts into the bankruptcy estate, or how they might otherwise deny self-settlers the “head start” they are trying to gain by exploiting the bankruptcy laws. Part VII then describes how this loophole came to be in the law, noting in particular that it was unintended and is in need of repair.

Finally, Part VIII concludes that allowing bankruptcy debtors to keep their assets out of the bankruptcy estate in this manner is offensive to the bankruptcy code’s purpose of providing a fresh start to debtors and creates a serious inequity that should not be tolerated. While there are mechanisms that allow the judiciary to mitigate the situation, only Congress can provide a fully satisfactory solution. Congress should assume responsibility for closing this unforeseen loophole rather than leaving such an important issue to the vagaries of judicial interpretation.

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1. See 28 U.S.C. § 1334 (1994).
  2. 11 U.S.C. § 541(a)(1) (1994) (emphasis added).
  3. 462 U.S. 198, 209 (1983).
  4. See § 541(c)(1).
  5. *Id.* § 541(c)(2).
  6. See *id.*

## II. SELF-SETTLED SPENDTHRIFT TRUSTS DEFINED

Suppose a parent makes a gift of money to a child. If the gift is a lump sum, the child can spend it as she chooses. If the gift is a stream of payments (an annuity), the child can sell the income stream for its present value and spend the proceeds as she chooses. In either case, the child's access to funds means that the child's creditors can levy against the gift.<sup>7</sup> Using a spendthrift trust, however, a parent can gift to a child while ensuring that the child cannot alienate her interest in the trust and, consequently, that creditors cannot reach her interest.<sup>8</sup>

When a settlor creates a trust for his own benefit, it is said to be "self-settled."<sup>9</sup> The common law rule, followed by the vast majority of American jurisdictions, is that a self-settled trust is ineffective against the claims of creditors.<sup>10</sup> Nevertheless, exceptions do exist. For example, creditors cannot reach a debtor's interest in an ERISA-qualified pension plan in bankruptcy, because federal law makes such an interest inalienable.<sup>11</sup> There may be an exception for the spendthrift clauses of overseas military personnel where they do not take effect unless the settlor is captured by hostile forces.<sup>12</sup> Similarly, spendthrift clauses created by corporate executives and taking effect only if the executives are kidnapped by individuals seeking ransom may be enforceable as well.<sup>13</sup> Finally, it is unclear whether indirectly self-settled spendthrift trusts are permissible.<sup>14</sup>

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7. See ROGER W. ANDERSEN, UNDERSTANDING TRUSTS AND ESTATES 113 (2d ed. 1999) ("[C]reditors' rights typically follow alienability: the creditor usually can get what the beneficiary can transfer.")

8. See JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS AND ESTATES 631 (5th ed. 1995). Dukeminier and Johanson offer the following example of a spendthrift clause:

[The beneficiary is] restrained from alienating, anticipating, encumbering, or in any manner assigning his or her interest or estate, either in principal or income, and is without power so to do, nor shall such interest or estate be subject to his or her liabilities or obligations nor to judgment or other legal process, bankruptcy proceedings or claims of creditors or others.

*Id.* at 633 (quoting *Shelley v. Shelley*, 354 P.2d 282 (Or. 1960)).

9. See, e.g., *Sattin v. Brooks* (*In re Brooks*), 217 B.R. 98, *passim* (Bankr. D. Conn. 1998) (using the term repeatedly).

10. See RESTATEMENT (THIRD) OF TRUSTS § 58(2) (Tentative Draft No. 2, 1999) (citing RESTATEMENT (SECOND) OF TRUSTS § 156(1) (1959)).

11. See *Patterson v. Shumate*, 504 U.S. 753, 760 (1992) (holding that "applicable nonbankruptcy law" includes both federal and state law).

12. See ASSET PROTECTION: LEGAL PLANNING & STRATEGIES ¶ 6.08[3] (1999) [hereinafter ASSET PROTECTION].

13. See *id.*

14. See Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives*, 73 WASH. U. L.Q. 1, 5 (1995) (stating that the case law fails to resolve conclusively whether a structured settlement of a tort claim wherein the tortfeasor creates a spendthrift trust for the victim falls into this category). *But see* ASSET PROTECTION, *supra* note 12, at ¶ 6.08[1] (asserting that funding an irrevocable spendthrift trust with the proceeds of a personal injury recovery subjects trust to creditor attachment).

### III. OFFSHORE SELF-SETTLED SPENDTHRIFT TRUSTS IN BANKRUPTCY

Americans use offshore trusts to prevent creditors from forcing the repatriation of assets to the United States. Many foreign jurisdictions such as Bermuda, the Bahamas, the Cook Islands, Jersey, and Nevis allow foreigners to shield their assets from creditors through self-settled spendthrift trusts.<sup>15</sup> The ability of Americans to ensure complete asset protection, however, depends on the laws of the applicable jurisdiction. Thus, some understanding of the procedure one would follow to transform vulnerable assets into protected assets is necessary to understand the issues that arise in bankruptcy cases involving offshore self-settled trusts.

#### A. *Creating the Offshore Self-Settled Spendthrift Trust*

*FTC v. Affordable Media, LLC*,<sup>16</sup> a nonbankruptcy case from the Ninth Circuit, illustrates an American couple's failed attempt to insulate themselves from liability by safeguarding assets through an offshore asset protection trust. An American husband and wife self-settled an asset-protection trust in the Cook Islands.<sup>17</sup> They then transferred their assets to their offshore trust.<sup>18</sup> They named themselves "protectors," giving themselves the power to oversee the foreign trustees and veto the trustees' actions as necessary.<sup>19</sup> The trust included a provision requiring the foreign trustees to refuse to repatriate the trust assets when the settlors experienced an event of "duress."<sup>20</sup> Under the duress provision, the foreign trustees would acquire exclusive control of the trust if a court in the United States were to issue an order against the settlors.<sup>21</sup>

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15. See John E. Sullivan III, *Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes with Offshore Trusts*, 23 DEL. J. CORP. LAW 423, 439 (1998); see also Sattin v. Brooks (*In re Brooks*), 217 B.R. 98, 101 (Bankr. D. Conn. 1998) (citing Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 32-33 (1996)).

16. 179 F.3d 1228 (9th Cir. 1999).

17. See *id.* at 1231.

18. See *id.*

19. See *id.* at 1243.

20. *Id.* at 1240 n.9 (quoting the trust agreement). The trust defines "duress" to include the following:

"the issuance of any order, decree or judgment of any court or tribunal in any part of the world which in the opinion of the protector will or may directly or indirectly, expropriate, sequester, levy, lien or in any way control, restrict or prevent the free disposal by a trustee of any monies, investments or property which may from time to time be included in or form part of this trust and any distributions therefrom."

*Id.* (quoting the trust agreement).

21. See *id.* The trust provided:

Notwithstanding any other provision contained in this deed any trustee hereof shall automatically cease to be a trustee upon the happening of an event of duress within the territory where such trustee is . . . resident (in the case of an individual) and upon ceasing to be a trustee pursuant to this clause such

Since the foreign trustees were beyond the jurisdiction of a United States court, the only entities within the court's jurisdiction were the settlors.<sup>22</sup> The district court circumvented this problem by ordering the settlors to repatriate the assets; the court then found them in civil contempt for failing to comply with its order.<sup>23</sup> The settlors protested, arguing that they could not comply and that impossibility of performance is a defense to civil contempt.<sup>24</sup> But the Ninth Circuit affirmed, stating that "[i]n the asset protection trust context . . . the burden on the party asserting an impossibility defense will be particularly high because of the likelihood that any attempted compliance with the court's orders will be merely a charade rather than a good faith effort to comply."<sup>25</sup>

### B. Choice of Law and Public Policy

In *In re Brooks*,<sup>26</sup> a bankruptcy court sitting in Connecticut faced the question whether funds held in offshore trusts were property of the estate under section 541(a) or were excluded from the estate under section 541(c)(2).<sup>27</sup> The bankruptcy trustee argued that because the offshore trusts were self-settled and therefore unenforceable, they were property of the estate.<sup>28</sup> The debtor countered that the trusts were not in fact self-settled, and so could be excepted from the estate under 541(c)(2) as enforceable spendthrift trusts.<sup>29</sup> Before addressing whether the trusts were self-settled, the *Brooks* court commenced a choice-of-law analysis to determine which jurisdiction's law constituted the "applicable nonbankruptcy law" for purposes of determining whether self-settled trusts would be enforceable.<sup>30</sup>

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trustee shall be divested of title to the property of this trust which shall automatically vest in the remaining or continuing trustee (if any) *located in a territory not having an event of duress and the form for administration of this trust shall notwithstanding any other provision in this deed be deemed to be the place of residence or incorporation (if a corporation) of such continuing trustee.*

*Id.* (quoting the trust agreement).

22. See *FTC v. Affordable Media, LLC*, 179 F.3d 1228, 1240 (9th Cir. 1999).

23. See *id.* at 1232-33.

24. See *id.* at 1240 (citing *United States v. Rylander*, 460 U.S. 752, 757 (1983)).

25. *Id.* at 1241. Even if the settlors had resigned from their position as protectors, the court might still have found them in control of the trust. The court did not decide the issue because the settlors conceded they were protectors of the trust. See *id.* at 1243.

26. 217 B.R. 98 (Bankr. D. Conn. 1998).

27. *Id.* at 100.

28. See *id.*

29. See *id.* at 100, 102. The debtor transferred stock certificates to his wife, who then traveled to Bermuda and Jersey to establish the trusts. She was the one to actually transfer the assets to the trusts. See *id.* at 101.

30. *Id.* at 101. The trusts contained choice-of-law provisions providing that the law of the respective foreign countries would apply for purposes of interpreting the trust, but the debtor (as well as his wife) was domiciled in Connecticut. See *id.*

The parties agreed that the choice-of-law rules of Connecticut were applicable, in accordance with the general rule to apply the rule of the forum.<sup>31</sup> The court noted that the general rule under Connecticut's choice-of-law rules is to respect the expressed intent of the settlor as to which jurisdiction's law will govern the trust.<sup>32</sup> Nonetheless, as the court noted, there are two exceptions to this general rule. First, the validity of a trust in personal property is determined by the law of the settlor's domicile.<sup>33</sup> Second, Connecticut courts will not enforce the law of another jurisdiction that violates the public policy of Connecticut.<sup>34</sup> In the case at hand, the settlors were domiciled in Connecticut and the trusts consisted of personal property (stock certificates).<sup>35</sup> Consequently, the bankruptcy court applied Connecticut trust law rather than the foreign law designated in the trust documents.<sup>36</sup>

In discussing Connecticut's substantive law, the court stressed why the Connecticut Supreme Court had held self-settled trusts unenforceable. Enforcing these kinds of trusts, Connecticut's high court had explained, would violate public policy by "open[ing] too wide an opportunity for a man to evade his just debts to be permissible unless sanctioned by statutory enactment."<sup>37</sup> Ultimately, having earlier found the trusts to be self-settled, the court determined the trusts were not enforceable under Connecticut law.<sup>38</sup>

### C. *The "Common Sense" Rationale and Inalienability*

One bankruptcy court was recently persuaded by the "common sense" rationale of *Affordable Media*.<sup>39</sup> *In re Lawrence*,<sup>40</sup> a 1999 opinion from the Southern District of Florida, underscores the point

31. See *id.* at 101 (citing *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496-97 (1941), which extended *Erie* to the field of conflict-of-law analysis). But see *infra* Part V.A (pointing out that bankruptcy courts may use federal common law choice-of-law rules instead of the forum's).

32. See *In re Brooks*, 217 B.R. at 101; accord *Marine Midland Bank v. Portnoy (In re Portnoy)*, 201 B.R. 685, 697 (Bankr. S.D.N.Y. 1996) (citing RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 267 (1971)).

33. See *In re Brooks*, 217 B.R. at 101.

34. See *id.*; accord *In re Portnoy*, 201 B.R. at 697 (applying New York and federal common law choice-of-law rules); accord *Dzikowski v. Edmonds (In re Cameron)*, 223 B.R. 20 (Bankr. S.D. Fla. 1998) (applying New York law).

35. See *In re Brooks* 217 B.R. 98.

36. See *id.*

37. *In re Brooks*, 217 B.R. at 104 (quoting *Greenwich Trust Co. v. Tyson*, 37 A.2d 166, 171 (Conn. 1942)); accord *In re Portnoy*, 201 B.R. at 685, 698. The *Portnoy* court went even further, stating, "It is not at all clear what the policy behind the Jersey amendment is except, perhaps, to augment business." *Id.* at 700.

38. See *In re Brooks*, 217 B.R. at 104.

39. *FTC v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999); see also *supra* Part III.A.

40. *Goldberg v. Lawrence (In re Lawrence)*, 238 B.R. 498 (Bankr. S.D. Fla. 1999).

that a settlor who retains the power to change the trustee of an overseas trust also retains the power to have a trustee repatriate the trust corpus to the United States.<sup>41</sup> In that case, the settlor was a Chapter 7 debtor under attack by a bankruptcy trustee.<sup>42</sup> According to the *Lawrence* court:

[I]t defies reason—it tortures reason—to accept and believe that this Debtor transferred over \$7,000,000 in 1991, an amount then constituting over ninety percent of his liquid net worth, to a trust in a far away place administered by a stranger—pursuant to an Alleged Trust which purports to allow the trustee of the Alleged Trust total discretion over the administration and distribution of the trust *res*. The Court declines to abandon common sense and to torture reason in the manner urged by the debtor.<sup>43</sup>

In other words, pure common sense dictates that no rational person would irrevocably transfer all or nearly all of his assets and not retain *some* mechanism to reacquire them. The bankruptcy court found the settlor in civil contempt for failing to repatriate the trust corpus, giving the settlor thirteen days to repatriate the trust corpus and fining him \$10,000 each day until repatriation occurred.<sup>44</sup> If the settlor failed to repatriate the corpus within thirteen days, he would be incarcerated until he purged his contempt.<sup>45</sup>

#### D. Summary

The common sense approach to offshore trusts in bankruptcy can achieve desirable results where, as in *Lawrence*, courts find that debtors have the ability to repatriate assets. Choice-of-law analysis may also allow the court to defeat the unjustified expectations of a self-settlor of an offshore trust who files for bankruptcy. But whether the courts engage in choice of law analysis or use common sense, debtors find themselves in contempt of court when they fail to comply with court orders mandating repatriation. As evidenced by *Lawrence*, civil contempt may lead to substantial monetary fines or incarceration. Few (if any) debtors choose to serve as martyrs to their offshore trusts: instead, the limited case law suggests that debtors eventually comply with court orders—“they hold the keys to their own cells.”<sup>46</sup> In essence, bankruptcy courts have implicitly held that

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41. See *id.* at 500 (citing *Affordable Media*, 179 F.3d at 1228, 1240); see also *In re Lawrence*, 227 B.R. 907, *aff'd*, 251 B.R. 630 (holding that self-settled trusts violate public policy).

42. See *In re Lawrence*, 238 B.R. 498.

43. *In re Lawrence*, 238 B.R. at 500 (footnote omitted).

44. See *id.*

45. See *id.*

46. LoPucki, *supra* note 15, at 38.

offshore self-settled trusts are *not* “enforceable under applicable nonbankruptcy law.”

#### IV. THE ADVENT OF THE ONSHORE SELF-SETTLED SPENDTHRIFT TRUST

Bankruptcy courts coerce settlors into retrieving assets from offshore self-settled trusts with relative ease. The bankruptcy courts are presumably insulated from the politics and pressures of offshore jurisdictions. Recently, however, the legislatures of a number of American states have enacted various laws recognizing the effectiveness of self-settled spendthrift trusts. This creates a more difficult question for the bankruptcy courts: whether *onsshore* asset protection trusts are “enforceable under applicable nonbankruptcy law.” Before addressing this issue, however, it is helpful first to examine this recent legislation.

##### A. State Legislation

###### 1. Alaska

The Alaska Trust Act became effective in 1997.<sup>47</sup> The statute recognizes the effectiveness of self-settled spendthrift trusts with four important exceptions.<sup>48</sup> First, creditors may generally pursue fraudulent transfers into these trusts that are made within four years of the creation of the trust.<sup>49</sup> Second, the trust will not defeat the claims of a creditor if the settlor may “revoke” or “terminate” all or part of the trust against the wishes of a beneficiary.<sup>50</sup> Third, the transfer will not defeat a creditor’s claim if the trust requires that all or part of the trust’s income and/or principal *must* be distributed to

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47. SLA 1997, Ch. 6 (H.B. 101); *see also* Alan S. Gassman & James F. Gulecas, *Alaska Spawns a New Trust: Alaskan and Other Asset Protection Trusts*, 13 THE PRACTICAL TAX LAW. 25, 28 (1998).

48. ALASKA STAT. § 34.40.110(b) (Michie 1997). The statute provides, “If a trust contains a transfer restriction allowed under [section] (a) of this section, the transfer restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor, or another person from satisfying a claim out of the beneficiary’s interest in the trust . . . .” *Id.*

49. *See id.*; *see also* § 34.40.110(d). Section 34.40.100(d) states:

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

(1) is a creditor when the trust is created, 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.*

50. *See id.* § 34.40.110(b)(2).

the settlor.<sup>51</sup> Hence, this third exception permits only *discretionary* self-settled trusts; creditors can reach mandatory distributions to a settlor who doubles as beneficiary. Finally, the transfer will not be upheld in Alaska if, at the time of the transfer, the settlor is thirty or more days late in making a child support payment.<sup>52</sup>

The second exception is a particularly significant one: the words “revoke” and “terminate” do “not include a power to veto a distribution from the trust.”<sup>53</sup> Yet the power to veto a distribution represents significant power over the trust assets. The exercise of such power is clearly unfair to creditors—a debtor retaining the power to veto a distribution from his own self-settled spendthrift trust should be required to repay his creditors.

## 2. Delaware and Rhode Island

Delaware also enacted legislation in 1997, the Qualified Dispositions in Trust Act,<sup>54</sup> making enforceable self-settled spendthrift trusts.<sup>55</sup> Rhode Island enacted legislation almost identical to Delaware’s in 1999.<sup>56</sup> Two features make Delaware and Rhode Island trusts “clearly inferior to the Alaska trust” (from the settlor’s perspective).<sup>57</sup> First, in both Delaware and Rhode Island, persons entitled to spousal or child support can pierce a self-settled trust to the extent of the debt owed.<sup>58</sup> Second, in both Delaware and Rhode Island, persons who suffer wrongful death, personal injury, or property damage on or before the date of the transfer can pierce the trust.<sup>59</sup> Delaware law also provides that a trust instrument otherwise conforming to the Qualified Dispositions in Trust Act “shall be deemed to be a restriction on the transfer of the transferor’s beneficial interest in the trust that is enforceable under applicable nonbankruptcy law within the meaning of § 541(c)(2) of the Bankruptcy Code . . . or any successor provision thereto.”<sup>60</sup> Clearly, the Delaware legislature was well aware of the potential impact of

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51. See § 34.40.110(b)(3).

52. See § 34.40.110(b)(4).

53. *Id.* § 34.40.110(b)(2).

54. DEL. CODE ANN. tit. 12, § 3574(a) (1997).

55. See Gassman & Gulecas, *supra* note 47, at 34. *But cf.* Sullivan, *supra* note 15, at 446. Mr. Sullivan argues that debtors hope it is cost-prohibitive for creditors to sue because the statute provides that a general creditor can avoid a transfer into trust “only to the extent necessary to satisfy the transferor’s debt to the creditor at whose instance the disposition had been avoided.” *Id.* (quoting DEL. CODE ANN. tit. 12, § 3574(a) (1997)).

56. See R.I. GEN. LAWS §§ 18-9.2-2, 18-9.2-4, 18-9.2-5, 18-4-27 (1999) (amended 2000).

57. Gassman & Gulecas, *supra* note 47, at 35.

58. See DEL. CODE ANN. tit. 12, § 3573(1) (1999).

59. See § 3573(2). This includes vicarious liability claims. The unfortunate corollary to this provision is that post-transfer involuntary tort victims cannot defeat debtor’s self-settled spendthrift trust.

60. *Id.* § 3570(9)(c).

the Qualified Dispositions in Trust Act in bankruptcy, where state trust law is incorporated by reference into the Bankruptcy Code.

### 3. Nevada

Nevada's legislature enacted the Spendthrift Trust Act in 1999.<sup>61</sup> Like the recent changes to the trusts laws of Alaska, Delaware, and Rhode Island, the essence of the legislation is to generally enforce self-settled spendthrift trusts except in the case of fraudulent transfers.<sup>62</sup> Nevada's legislation is especially unsympathetic to federalism concerns: it expressly requires trustees of spendthrift trusts to ignore bankruptcy court orders seeking the turnover of trust assets.<sup>63</sup> The key difference between Nevada's legislation and that of Alaska and Delaware is that Nevada abandoned the interests of child- and spousal-support creditors, as well as involuntary tort creditors.<sup>64</sup> Consequently, Nevada should attract the trust business of those individuals seeking maximum asset protection.

#### B. Why States Enact Anticreditor Legislation

The very provisions of some of this legislation reveal what fueled their passage. For example, Alaska's law provides a number of telling conditions that must be satisfied before a choice-of-law provision in the trust instrument will be respected. First, at least one trustee must be an Alaskan resident, bank, or trust company with its principal place of business in Alaska.<sup>65</sup> Clearly, Alaskan attorneys, banks, and trust companies have much to gain when individuals begin to establish Alaskan trusts.<sup>66</sup> Second, the Alaskan trustee is responsible for maintaining trust records or preparing the trust income tax return.<sup>67</sup> Obviously, Alaskan accountants are also hoping for a boost in business. Third, assets must be deposited in Alaska and administered by the Alaskan trustee.<sup>68</sup> Again, Alaska's financial institutions stand to gain. Finally, part of the trust administration must take place in Alaska.<sup>69</sup>

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61. NEV. REV. STAT. ANN. § 166.010 (1999).

62. *See id.* § 166.040(1)(b).

63. *See id.* § 166.120(2).

64. *See id.* § 166.090(1) ("Provision for the beneficiary will be for the support, education, maintenance and benefit of the beneficiary alone, and without reference to or limitation by his needs, station in life, or mode of life, *or the needs of any other person, whether dependent upon him or not.*"(emphasis added)).

65. *See* ALASKA STAT. §§ 13.36.035(c), 13.36.390 (Michie 1997).

66. *See* Gideon Rothschild et al., *Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?*, 32 VAND. J. TRANSNAT'L L. 763, 777 (1999) (conceding that "some consideration" must be given to the goal of keeping trust capital and business in the United States).

67. *See* § 13.36.035(c).

68. *See id.*

69. *See id.*

Indeed, the bill's sponsor described the Alaska Trust Act as a result of his desire to stimulate economic development in Alaska and to make it more of a financial center for the world.<sup>70</sup> Hence, the Alaskan legislature created jobs for Alaskans (and a greater tax base for itself!). Unfortunately, such jobs were created at the expense of creditors.<sup>71</sup> It will be no great surprise to see more states pass similar legislation to fend off capital flight and job losses.

#### V. BRINGING ONSHORE SELF-SETTLED SPENDTHRIFT TRUSTS INTO THE BANKRUPTCY ESTATE

Thus far, no bankruptcy court has decided whether a domestic self-settled spendthrift trust constitutes property of the bankruptcy estate. The impenetrable protection onshore self-settled trusts purportedly provide makes it inevitable that such cases will arise in the near future. These cases implicate complex issues of federalism and conflict of laws. As noted above, section 541(c)(2) of the Code provides that “[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.”<sup>72</sup>

On the one hand, bankruptcy judges could simply construe the meaning of “applicable nonbankruptcy law” to mean state trust law, find the transfer restrictions of self-settled spendthrifts enforceable, and thereby protect these assets from creditor attack. But there are several alternatives to this unattractive prospect. First, because at least some of the creditors are likely to be from a state other than the one where the trust was created—as the settlor will also often be—the judge may determine that the “applicable” law is that of a state that does not enforce these types of trusts. Second, even where all the parties and the trust reside in a state enforcing these trusts, the judge may find that transfer is not truly restricted, because the settlor has retained control and dominion over the property—in a sense ruling that federal bankruptcy policy is the “applicable law” here. Finally, the bankruptcy trustee could assume the interest, rights, and powers of the debtor—causing the trustee to turn over the assets.

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70. See *Trusts & Property Transfers in Trusts: Hearing on H.B. 101 Before the House Labor and Commerce Comm.*, 20th Legis., 1st Sess. (Alaska 1997) (statement of Al Vezey, Representative), Alaska State Legislature Textual Infobases, <http://www.legis.state.ak.us/Folhome.htm> (Search of 20th Legislature Committee Minutes).

71. The Delaware Qualified Dispositions in Trust Act is essentially job-creation legislation as well. See DEL. CODE ANN. tit. 12, § 3570(c)(8) (1999).

72. 11 U.S.C. § 541(c)(2) (1994) (emphasis added).

A. *Conflict of Law Issues: Finding the “Applicable Nonbankruptcy Law”*

The first question a bankruptcy court faces is this: What nonbankruptcy law is applicable to determine whether the trust is enforceable?<sup>73</sup> Consider a case where the debtor, a continuous resident of State *X* for many years, self-settled an Alaskan trust years ago. In addition, suppose the creditors are all from State *X*. State *X* does not enforce self-settled spendthrift trusts. The question for the bankruptcy court will ultimately be whether the intent of the settlor (retention of assets) outweighs the public policy of State *X* (prohibition against self-settled spendthrift trusts).

Because bankruptcy cases are not diversity cases, the bankruptcy court is not required to apply local choice-of-law rules.<sup>74</sup> Nonetheless, “a number of courts have suggested that, when the issue before a bankruptcy court is the scope of a state-created right, the bankruptcy court should look to the choice-of-law rules of the state in which the court sits.”<sup>75</sup> Even this approach, however, permits the bankruptcy court to displace local choice-of-law rules when “important concerns implicating national bankruptcy policy are implicated”<sup>76</sup> or “where there is a compelling federal interest.”<sup>77</sup> Deciding whether to enforce self-settled spendthrift trusts in bankruptcy easily triggers and fulfills the requirements of these tests, allowing the court to apply federal common law choice-of-law rules.

Under federal common law choice-of-law rules, the substantive law to be applied is that “of the jurisdiction having the greatest interest in the litigation.”<sup>78</sup> Significantly, a choice-of-law provision contained in the trust is not solely determinative of whose law will dictate whether the trust is valid.<sup>79</sup> While the intent of the settlor is an important factor, it cannot override important public policy concerns of an interested state.<sup>80</sup> This includes the creditors’ states; it

73. *Cf. Sattin v. Brooks (In re Brooks)*, 217 B.R. 98 (Bankr. D. Conn. 1998).

74. *See Marine Midland Bank v. Portnoy (In re Portnoy)*, 201 B.R. 685, 697 (Bankr. S.D.N.Y. 1996); *see also* Stewart E. Sterk, *Asset Protection Trusts: Trust Law’s Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1117 n.359 (2000).

75. Sterk, *supra* note 74, at 1117 n.359; *see also In re Portnoy*, 201 B.R. at 697

76. Sterk, *supra* note 74, at 1117 n. 359 (quoting *Koreag, Controle et Revision S.A. v. Refco F/X Assocs. (In re Koreag, Controle et Revision S.A.)*, 961 F.2d 341, 350-51 (2d Cir. 1992)).

77. Sterk, *supra* note 74, at 1117 n.359 (quoting *Compliance Marine, Inc. v. Campbell (In re Merritt Dredging Co. v. Campbell)*, 839 F.2d 203, 206 (4th Cir. 1998)).

78. *In re Portnoy*, 201 B.R. at 685, 697.

79. *See id.* at 697-98.

80. *See id.* The Restatement describes the rule this way:

The chief purpose in making decisions as to the applicable law is to carry out the intention of the creator of the trust in the disposal of the trust property. It is important that his intention, to the extent to which it can be ascertained, should not be defeated, unless this is required by the policy of a state which has

also includes the United States.<sup>81</sup> That is, the judge may choose not to apply the law of the state that enforces these trusts because it would offend federal bankruptcy policy to do so. Instead, the law of the creditors' state (or the settlor's domicile) would apply, rendering the trust unenforceable.

One of the primary purposes of bankruptcy is to "relieve the honest debtor from the weight of oppressive indebtedness, and permit him *to start afresh* free from the obligations and responsibilities consequent upon business misfortunes."<sup>82</sup> This purpose has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders his property for distribution a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt. The Supreme Court has long stressed the importance of achieving the fresh start and once went so far as to insist that "[l]ocal rules *subversive of that result cannot be accepted as controlling the action of a federal court.*"<sup>83</sup>

It is not difficult to see how self-settled spendthrifts undermine federal bankruptcy policy. As one federal judge has explained:

[I]t probably goes without saying that it would offend our policies to permit a debtor to shield from creditors all of his assets because ownership is technically held in a self-settled trust, where the settlor/beneficiary nonetheless retains control over the assets and may effectively direct disposition of those assets.<sup>84</sup>

Respecting these trusts would give debtors not only a *fresh* start, the goal of the bankruptcy law, but a head start. Bankruptcy is designed for people who need it, not for people who find clever ways to make millions of dollars appear inaccessible to themselves. This kind of affront to public policy should allow a bankruptcy court to find in its choice-of-law analysis that the right substantive law is the one that would bring the trust into the bankruptcy estate.

Yet, choice-of-law rules are very broad and pliable—almost unfairly whimsical. For example, the Restatement (Second) of Conflict of Laws offers the following general factors for determining the applicable substantive law:

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such an interest in defeating his intention, as to the particular issue involved, that its local law should be applied.

RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1971).

81. See *In re Portnoy*, 201 B.R. at 698 ("[A]pplication of Jersey's substantive law would offend strong New York *and federal bankruptcy policies* . . ." (emphasis added)).

82. *Williams v. U.S. Fidelity & Guar. Co.*, 236 U.S. 549, 554-55 (1915) (emphasis added).

83. *Local Loan Co. v. Hunt*, 292 U.S. 234, 245 (1934) (emphasis added) (rejecting Illinois law as being "destructive of the purpose and spirit of the Bankruptcy Act").

84. *In re Portnoy*, 201 B.R. at 685, 700.

- the needs of the interstate and international systems
- the relevant policies of the forum
- the relevant policies of other interested states and the relative interest of those states in the determination of the particular issue
- the protection of justified expectations
- the basic policies underlying the particular field of law
- certainty, predictability, and uniformity of result, and
- ease in determination and application of the law to be applied.<sup>85</sup>

Bankruptcy judges could differ on this question when faced with nearly identical facts. For example, one bankruptcy judge might reason that the policies underlying trust law forbid a resident of State *X* from protecting himself against creditors of State *X* by using a self-settled trust established in state *Y*.<sup>86</sup> But another bankruptcy judge might find that a trust established pursuant to the laws of a sister state is enforceable under applicable nonbankruptcy law. Under the following approach, perhaps bankruptcy courts never need to address the complex conflict-of-law issues that self-settled spendthrift trusts create.

*B. Using Common Sense: Defining “Restriction on the Transfer”*

As a starting point, consider a bankruptcy case brought in Alaska involving an Alaskan debtor with a self-settled Alaskan trust and Alaskan creditors. On the one hand, the bankruptcy judge could look to the Alaskan trust laws, find the trust enforceable under nonbankruptcy law (Alaska state law), and preclude the creditors from piercing the trust. Under this logic, Alaskan voters presumably considered development of the Alaskan financial services industry more important than the interests of Alaskan creditors when they attended the voting polls.<sup>87</sup> The bankruptcy judge could reason that any changes to Alaskan trust law must originate from the Alaskan legislature and not the federal bench.

On the other hand, a bankruptcy judge might also look to the purpose and spirit of the bankruptcy laws. As outlined above, the bankruptcy laws are designed to offer a fresh start—not a head start. Permitting a debtor to obtain discharge of their debts while retaining enjoyment of trust funds—as these few state laws would do—would undeniably frustrate that purpose. This not only explains why these

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85. RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1971).

86. See ASSET PROTECTION, *supra* note 12, at ¶ 6.08[5] (opining that self-settled onshore trusts are vulnerable when the settlor/beneficiary is not a resident of one of the states with trust laws permitting self-settled trusts).

87. Presumably, if the citizens of Alaska disapproved of self-settled trusts, they could seek recourse through the Alaskan legislature.

trust assets should not be excluded from the bankruptcy estate, it also provides the key to including them.

By the very terms of section 541(c)(2), if the transfer of an interest is not restricted, the statute simply does not apply. Further, as one court has stated, "In determining whether [a trust qualifies for exclusion from the bankruptcy estate], the overriding policies of the Bankruptcy Code must be kept in mind . . . . Accordingly, § 541(c)(2) must be narrowly construed to avoid impinging upon the policies sought to be furthered by the Code."<sup>88</sup> Applying the Ninth Circuit's "common sense" rationale tells us that access to these funds will rarely be truly restricted.<sup>89</sup> For example, Alaska's law allows the settlor to keep the power to veto a distribution from the trust,<sup>90</sup> and settlors frequently retain the power to change the trustee.<sup>91</sup> Part V.C.2 below describes other significant powers retained by self-settlors. When settlors retain this kind of control over the trust assets, the common sense approach offers a promising way to include these assets in the estate without wading into the complexities of choice-of-law analysis.

### C. *Exercising the Powers of the Bankruptcy Trustee*

#### 1. *Avoiding the Fraudulent Transfer*

The bankruptcy trustee has the power to avoid certain fraudulent transfers.<sup>92</sup> Under some circumstances, the trustee may be able to characterize creation of the trust as a fraudulent transfer. In that event, the trust would effectively never have been created, and the assets would enter the estate. However, fraudulent transfer laws of many states probably cannot reach the assets of trusts established more than four years before the filing of the bankruptcy petition.<sup>93</sup> Moreover, proving a transfer fraudulent may be more difficult in some states than in others.<sup>94</sup> Nonetheless, fraudulent transfer law is often an appropriate starting point.

#### 2. *Succeeding to the Settlor's Powers*

The trustee has a powerful alternative to fraudulent transfer law as a means of bringing the trust corpus into the bankruptcy estate—

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88. *In re Baldwin*, 142 B.R. 210, 214 (Bankr. S.D. Ohio 1992).

89. *See supra* Part III.

90. *See* ALASKA STAT. § 34.40.110(b)(2) (Michie 1997).

91. *See, e.g.,* *Goldberg v. Lawrence* (*In re Lawrence*), 238 B.R. 498, 500 (Bankr. S.D. Fla. 1999).

92. *See* 11 U.S.C. §§ 548, 544(b) (1994).

93. *See* Sterk, *supra* note 74, at 1044-47, for a discussion on fraudulent transfer law.

94. *See id.* at 1055. Proving actual fraud may be more difficult than constructive fraud.

the power to direct the legal and equitable interests of the debtor. Using this approach, a self-settled spendthrift trust would remain enforceable in *form* under state law. However, the bankruptcy trustee could effectively eviscerate the trust corpus in substance by, for example, simply changing the trustee of the trust.

*a. Rhode Island and Delaware.*—Rhode Island allows the settlor of a self-settled spendthrift trust to possess the “power to revoke, amend, alter, or modify the trust in whole or part.”<sup>95</sup> Should the bankruptcy trustee encounter a trust with such provision, he may concede the trust is enforceable. Nonetheless, he may also succeed to these interests retained by the debtor and revoke, amend, alter, or modify the trust to bring its assets into the bankruptcy estate.<sup>96</sup> Rhode Island also allows the settlor to “withdraw from . . . the trust all or any part of the principal or income.”<sup>97</sup> Thus, the bankruptcy trustee can bring the entire principal into the estate. Finally, Rhode Island allows the settlor to “remove the trustee or trustees and appoint a successor trustee or trustees.”<sup>98</sup> The Delaware trust laws contain similar provisions.<sup>99</sup> Hence, the bankruptcy trustee can appoint himself or another as trustee of the self-settled spendthrift trust who will turn over the funds to the bankruptcy estate. Self-settled spendthrift trusts containing language providing settlors such patently obvious control over their assets are subject to immediate attack by bankruptcy trustees.

*b. Nevada and Alaska.*—In contrast, self-settled spendthrift trusts attempting to bury the settlor’s control in hypertechnical jargon require the bankruptcy trustee to be a little more creative. For example, Nevada requires the self-settled spendthrift trust to be irrevocable. Nevada and Alaska state that a trust is irrevocable “even if the settlor may prevent a distribution from the trust or holds a testamentary power of appointment or *similar power*.”<sup>100</sup> The power to prevent a distribution from the trust is the power to allow a distribution from the trust. In either case, the settlor is directing the flow of funds. Hence, it may be a “similar power.”

#### VI. OTHER WAYS TO DENY THE SELF-SETTLOR A “HEAD START”

If the trust assets cannot be brought into the estate, the self-settlor might nonetheless be denied his “head start.” For example, a bankruptcy court could deny a discharge to a debtor who has filed for

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95. R.I. GEN. LAWS § 18-4-27(a)(1) (1999).

96. See Eisen v. Frangos (*In re Frangos*), 132 B.R. 723 (Bankr. N.D. Ohio 1992).

97. § 18-4-27(a)(3).

98. *Id.* § 18-4-27(a)(4).

99. See DEL. CODE ANN. tit. 12, § 3570(c) (1999).

100. NEV. REV. STAT. ANN. § 166.040(2)(a) (Michie 1999) (emphasis added); ALASKA STAT. § 34.40.110(b)(2) (Michie 1997) (emphasis added).

bankruptcy yet has failed to include in her personal property schedules her interests, rights, or powers in a self-settled spendthrift trust. Alternatively, a bankruptcy court could dismiss a debtor's case for filing bankruptcy in bad faith even when that debtor lists such information in her schedules.

#### A. Denial of Discharge

Debtors who file for bankruptcy protection are required to provide the bankruptcy court with a complete picture of their financial position.<sup>101</sup> Such financial information enables the bankruptcy trustee to identify and distribute assets of the bankruptcy estate. By making a false oath in connection with or in relation to any bankruptcy case, debtors who misrepresent their financial affairs to the bankruptcy court may be denied a discharge and may be subject to criminal prosecution (possibly resulting in fines and/or imprisonment).<sup>102</sup>

One of the bankruptcy schedules (Schedule B—Personal Property) requires debtors to identify all assets and interests including “[e]quitable or future interests, . . . and rights or powers exercisable for the benefit of the debtor.”<sup>103</sup> Should the debtor who has created a self-settled spendthrift trust fail to include her interests, rights, or powers of such a trust in her personal property schedules, that debtor has made a false oath. Her argument that she has no exercisable rights or powers under the trust for her benefit must fail.<sup>104</sup> The court's reasoning in cases involving self-settled spendthrift trusts established overseas applies with equal force to such a trust established in any one of the American states permitting self-settled spendthrift trusts.<sup>105</sup>

The control that a debtor retains when she creates a self-settled spendthrift trust is where the falsity of the oath may be found. Whether she appoints herself as trustee or whether she reserves the right to veto the decisions of a trustee she appoints, she retains some degree of control.<sup>106</sup> In *In re Gugliada*,<sup>107</sup> the court denied a discharge to a debtor who had *inter alia* knowingly and fraudulently made a false oath or account by concealing his equitable interests in his wife's bank account and in a business he did not own, but over which

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101. See 11 U.S.C. § 541 (1994).

102. See 11 U.S.C. § 727(a)(4)(A) (1994); see also 18 U.S.C. § 152(2) (1994).

103. Official Bankruptcy Form 18 (Schedule B—Personal Property (continuation Sheet)).

104. See *supra* Part III.C for further support of the argument that the debtor retains exercisable rights or powers for her benefit.

105. See *id.*; *supra* Part V.B.

106. See Henry J. Lisher, Jr., *Domestic Asset Protection Trusts: Pallbearers to liability?*, 35 REAL PROP., PROB. & TR. J. 479, 525, 559 (2000) (arguing such transfers may not be “complete”).

107. 20 B.R. 524, 534 (Bankr. S.D.N.Y. 1982).

he had “unfettered control.”<sup>108</sup> The court found the debtor to have an equitable interest in his wife’s bank account because the debtor shielded his salary checks from creditors by depositing them in his wife’s bank account and requesting funds from her as needed.<sup>109</sup> *Gugliada* is analogous to the debtor who files for bankruptcy protection, having previously established a self-settled spendthrift trust; such a debtor has an equitable interest in the assets she has transferred to a trustee from whom she is later able to receive (or decline to veto) distributions.

The *Gugliada* court also found that the debtor held an equitable interest in a company not listed in his schedules.<sup>110</sup> Although the debtor did not own the business, he signed checks, hired employees, and had a free hand in making decisions and overseeing the company’s daily affairs.<sup>111</sup> The company was “a vehicle for the operation of the defendant’s business.”<sup>112</sup> Here again, *Gugliada* is analogous to the debtor who files for bankruptcy, having previously established a self-settled spendthrift trust. Such a debtor does not “own” the trust res, but she vetoes distributions from it and appoints its trustees. Thus, she inherently has a free hand in the decisionmaking. In short, her trust is a vehicle for her assets.

Debtors who knowingly and fraudulently misrepresent their financial positions to the bankruptcy court face severe consequences. Penalties include denial of discharge, criminal fines, and imprisonment.<sup>113</sup> Such harsh consequences should deter debtors from deliberately omitting their self-settled spendthrift trusts from their bankruptcy schedules. But when debtors do neglect to include their trust interest, the court has a powerful tool for denying them a “head start.”

### B. Dismissal of the Debtor’s Case

The harsh consequences of making a false oath suggest that a debtor will include his interest in a self-settled spendthrift trust somewhere in his property schedules. The bankruptcy court facing such a debtor cannot deny him a discharge for making a false oath. Nevertheless, the bankruptcy court could dismiss the case for filing a bankruptcy petition in bad faith.

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108. *Id.* at 534.

109. *See id.* at 531.

110. *See id.* at 533.

111. *See id.*

112. *Id.*

113. *See* 11 U.S.C. § 727(a)(4)(A) (1994); *see also* 18 U.S.C § 152(2) (1994).

Under section 707(a) of the Bankruptcy Code, the bankruptcy court may dismiss a case *inter alia* “for cause.”<sup>114</sup> Courts disagree over the extent to which lack of good faith is a valid basis to dismiss a case “for cause.”<sup>115</sup> Some courts read the statute broadly and consider that the list of factors found in the statute is not exclusive of other factors.<sup>116</sup> In *In re Zick*, the debtor was an employee of a company who signed a nonsolicitation agreement with the company.<sup>117</sup> The following year, the employee left the company.<sup>118</sup> Shortly after, the former employee solicited the company’s former clients.<sup>119</sup> A court-induced mediation resulted in a \$600,000 award to the company for deliberate breach of contract.<sup>120</sup> A few days later, the former employee filed for Chapter 7 bankruptcy protection.<sup>121</sup> The court applied the following test:

Dismissal based on lack of good faith must be undertaken on an ad hoc basis. It should be confined carefully and is generally utilized only in those egregious cases that entail concealed or misrepresented assets and/or sources of income, and excessive and continued expenditures, lavish lifestyle, and intention to avoid a large single debt based on conduct akin to fraud, misconduct, or gross negligence.<sup>122</sup>

Accordingly, the court dismissed the debtor’s case for lack of good faith.

The *Zick* test seems applicable to the facts which are likely to surround a self-settled spendthrift trust. The debtor would have cleverly transferred the title to his assets and may have designated someone else as trustee. Spendthrift trust provisions coupled with the debtor’s power to veto distributions from the trust are akin to the concealment of assets from creditors. In contrast, it is unlikely that the debtor would continue to live a lavish lifestyle. Rather, he would use his powers (for the first time?) to block distributions from the trust to preserve his assets. By establishing a self-settled spendthrift trust and later filing for bankruptcy protection, the debtor’s conduct may well fall into one of the categories of fraud, misconduct, or gross negligence. Therefore, the debtor who has established a self-settled spendthrift trust and who seeks bankruptcy protection could find his

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114. 11 U.S.C. § 707(a) (1994) (“The court may dismiss a case under this chapter only after notice and a hearing and only for cause . . .”).

115. *Industrial Ins. Servs., Inc. v. Zick (In re Zick)*, 931 F.2d 1124, 1126-27 (6th Cir. 1991).

116. *See id.*

117. *See id.* at 1125.

118. *See id.*

119. *See id.*

120. *See id.* at 1125-26.

121. *See id.* at 1126.

122. *Id.* at 1129 (citation omitted).

case dismissed under the *Zick* court's test for a bad faith bankruptcy filing.

In contrast to the *Zick* court, other bankruptcy courts concede that the bankruptcy court may inquire into a debtor's motivation for filing bankruptcy, but they find that the debtor's lack of good faith should not turn on financial considerations.<sup>123</sup> Instead, such courts argue that it is not the domain of the bankruptcy court to make "judgmental pronouncements that the debtor really should be paying his or her debts rather than seeking refuge in bankruptcy liquidation."<sup>124</sup> In *In re Khan*, the court sharply criticized the *Zick* court and stated that inquiries into a debtor's good faith (or lack thereof) should be predicated upon the "debtor's manifested attitude toward the integrity of the bankruptcy process."<sup>125</sup> The *Khan* court's test was decidedly more restrictive:

[B]ad faith in the filing of a Chapter 7 petition would be evidenced by a pervasive and orchestrated effort on the part of the debtor to obtain the benefits of a bankruptcy filing while at the same time intentionally and fraudulently taking action to avoid any of the detriments. Such an effort might involve an intention to file solely to interpose the automatic stay . . . against pending litigation or foreclosure, without a concomitant acceptance of the statutory duties of financial disclosure, cooperation with the trustee, and surrender of non-exempt assets. It might also be prompted by a vindictive motivation to use bankruptcy solely as a "scorched-earth" tactic against a pressing creditor or opponent in litigation . . . . *Of necessity, a "bad faith filing" would involve manifested dishonesty toward a legal tribunal.*<sup>126</sup>

*Zick* and *Khan* illustrate the split of authority concerning whether lack of good faith is a valid basis for dismissal of a debtor's bankruptcy case. In any event, lack of good faith has been a winning argument to "remove" a case to a state court in some circumstances.

## VII. THE NEED FOR A LEGISLATIVE SOLUTION

Neither denial of a discharge nor dismissal of the case brings the trust corpus into the hands of creditors. Should the bankruptcy trustee be unable to reach the assets of self-settled spendthrift trust or to characterize the settlor's access to funds as unrestricted, the focus returns to the debate over the enforceability of the trusts under

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123. See *In re Khan*, 172 B.R. 613, 622-24 (Bankr. D. Minn. 1994). Later, however, the court stated, "the Bankruptcy Court should abdicate its jurisdiction over the debtor and the estate only if, in fact, there is no form of relief available to creditors through bankruptcy. This would only occur if the estate contained no nonexempt *assets* or rights of recovery that had any significant *value* . . ." *Id.* at 626 (emphasis added).

124. *Id.* at 624.

125. *Id.* at 625.

126. *Id.* (emphasis added)

applicable nonbankruptcy law. The judiciary should not be placed in the position of having to reform a statute of Congress, section 541(c)(2) of the Bankruptcy Code, because it is ambiguous as to whether it allows a court to achieve the desirable goal of penetrating the self-settled spendthrift trust. Hence, the solution should be legislative rather than judicial.

Some might disagree. Professor Warren has argued:

The treatment of spendthrift trusts can make a nice legal point and it rightly concerns many people who hear of the debtor's ability to retain this kind of property, but it strains credibility to believe that a change in the law will affect more than a handful of people each year. It is unlikely that a substantial number of debtors in bankruptcy are beneficiaries of trusts.<sup>127</sup>

Nonetheless, Congress should exercise its power to repair the statute and eliminate the loophole that provides wealthy debtors with a post discharge "head start." As the Supreme Court has stated, "a central purpose of the Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."<sup>128</sup> But this fresh start was intended to be limited to the "honest but unfortunate debtor."<sup>129</sup>

Nor was section 541(c)(2) ever intended to protect the assets of a self-settled trust; it was designed to honor the wishes of a donor who wanted to limit the scope of his or her gift. The spendthrift trusts the drafters debated were the "traditional" sort—those where the settlor is distinct from the beneficiaries. The Senate's original proposal was to include as property of the estate any income from the trust beyond what was "reasonably necessary to the support of the debtor and his dependents,"<sup>130</sup> prompting the Commercial Law League of America to

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127. Elizabeth Warren, *Reducing Bankruptcy Protection for Consumers: A Response*, 72 GEO. L.J. 1333, 1335 (1984).

128. *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)).

129. *Id.* at 287.

130. S. REP. NO. 95-989, at 83 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787. Consider the "reasonably necessary" test some bankruptcy courts use to determine whether a debtor is entitled to claim exemption in IRAs. Funds in IRAs may be (fully or partially) exempt if the court determines they are "reasonably necessary" for support of debtor or debtor's dependents. Those courts use the following (litigation conducive) factors to make such a determination:

- (1) Debtor's present and anticipated living expenses;
- (2) Debtor's present and anticipated income from all sources;
- (3) Age of the debtor and dependents;
- (4) Health of the debtor and dependents;
- (5) Debtor's ability to work and earn a living;
- (6) Debtor's job skills, training, and education;
- (7) Debtor's other assets, including exempt assets;

complain that the language “reasonably necessary” would spawn expensive litigation.<sup>131</sup> The House of Representatives rejected the Senate’s proposal, emphasizing the distinction between the beneficiary and the settlor: “The bankruptcy of the beneficiary should not be permitted to defeat the legitimate expectations of the *settlor* of the trust.”<sup>132</sup> The House’s distinction reveals that self-settled spendthrift trusts were not even under consideration;<sup>133</sup> otherwise, this settlor-beneficiary dichotomy would not make sense. The final result was the statute on the books today, one that renders “traditional” spendthrift trusts untouchable by creditors in bankruptcy; unfortunately, it has also created the possibility of self-settled trusts being protected, despite the legislature’s intentions.

A congressional hearing concerning the interplay between ERISA law and bankruptcy provides a strong argument for refusing protection to self-settled trusts.<sup>134</sup> In the hearing, the committee emphasized the fundamental difference between a head start and a fresh start and the unfairness of a head start:

While . . . tension [between ERISA and the Bankruptcy Code] exists when the debtor is a beneficiary of a spendthrift trust, the lack of control the debtor has over the trust, as well as the fact that spendthrift trusts may not be established for the benefit of the settlor of the trust, eliminates injury to the creditors. Nothing is being taken from the creditors. *If the debtor establishes a trust in his own benefit, however, current assets are being used to protect the debtor’s future income. In that sense, creditors suffer an immediate harm if they are not able to reach those assets.* Furthermore, if the debtor has no control over the assets of a

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(8) Liquidity of other assets;

(9) Debtor’s ability to save for retirement;

(10) Special needs of the debtor and dependents;

(11) Debtor’s financial obligations, e.g., alimony or support payments.

*In re Link*, 172 B.R. 707, 710-11 (Bankr. D. Mass. 1994) (citing *In re Flygstad*, 56 B.R. 884, 889-90 (Bankr. N.D. Iowa 1986)).

131. See *Bankruptcy Reform Act of 1978: Hearings on S. 2266 & H.R. 8200 Before the Subcomm On Improvements in Judicial Machinery of the Senate Comm. On the Judiciary*, 95th Cong. 618 (1977) (Supplemental Statement of Commercial League).

132. H.R. REP. NO. 95-595, at 176 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, (emphasis added). Professor Vukowich argued that “in addition to the settlor’s intent, however, the interests of the debtor-beneficiary’s creditors certainly are relevant. The congressional position causes an unjustified and irrational diversion of assets from creditors to a debtor who has separate and generally ample exemption law protections, plus a discharge of debts.” William T. Vukowich, *Debtors’ Exemption Rights Under the Bankruptcy Reform Act*, 58 N.C. L. REV. 769, 777-78 (1980).

133. Cf. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 209 (1983). There the Court noted, “[n]othing in the Bankruptcy Code or its legislative history indicates that Congress intended a special exception for the tax collector in the form of an exclusion from the estate of property seized to satisfy a tax lien.” *Id.*

134. See *Consumer Issues in Bankruptcy: Hearing Before the Subcommittee on Economic and Commercial Law of the House Comm. on the Judiciary*, 102d Cong. 147 (1992).

spendthrift trust, he or she is unable to turn the “fresh start” into a “head start” by obtaining a discharge and then gaining access to the entire fund.<sup>135</sup>

This committee recognized the evils of the self-settled trust well before a small minority of states began enacting legislation permitting self-settled trusts. It applies with equal force today.

#### VIII. CONCLUSION

State legislatures have recently enacted trust laws that strive to frustrate a central purpose of the Bankruptcy Code—providing a fresh start to the honest but unfortunate debtor.<sup>136</sup> These laws purportedly permit a debtor to obtain a discharge *and* retain his interest in an onshore self-settled spendthrift trust. Such laws operate to the detriment of creditors and provide a windfall to the debtor.<sup>137</sup>

States desiring greater tax revenues enact such laws to increase jobs in their states. Yet only short-term gains in jobs and tax revenues can be realized. In the long run, other state legislatures can enact identical laws. The net result would not be an increase in jobs or taxes, but rather a decrease in creditors' rights.

The judiciary could prevent such laws from protecting debtors in bankruptcy.<sup>138</sup> A variety of mechanisms allow bankruptcy courts to soundly reason that such laws are not “enforceable under applicable nonbankruptcy law.”<sup>139</sup> Their reasoning could run the gamut from the policy of the Bankruptcy Code to the policy of trust law in general. In contrast, bankruptcy courts could also find it unpalatable to preempt state legislation when section 541(c)(2) of the Bankruptcy Code can be read to exclude self-settled spendthrift trusts from property of the estate. The judiciary should not be forced to choose between the lesser of two evils, but if it must, bankruptcy concerns should outweigh outdated language preventing the trusts from being considered property of the estate. The responsibility for change and the power to change both exist within the halls of Congress. Without delay, Congress should prevent debtors from obtaining discharges while retaining interests in self-settled spendthrift trusts. Such legislation would eliminate a significant loophole unavailable to the less affluent.

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135. *Id.* (emphasis added).

136. *See supra* Part V.A-B.

137. *See supra* Part IV. Nonetheless, fraudulent conveyance law may be available to some creditors.

138. One commentator raises the interesting issue whether an attorney may be subject to personal liability for establishing an asset-protection trust. *See Eric Henzy, Offshore and “Other” Shore Asset Protection Trusts*, 32 VAND. J. TRANSAT'L L. 739, 760 (1999).

139. 11 U.S.C. 541(c)(2) (1994).

