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DEVELOPING THE ASSET PROTECTION DYNAMIC: A LEGACY OF FEDERAL CONCERN

*John K. Eason**

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"How far the law will allow a man to enjoy rights in property which he cannot transfer, and which his creditors cannot take for their debts, is a question becoming more and more frequent in this country."

—John Chipman Gray, 1883.[1]

I. INTRODUCTION

To Gray and other commentators of the day, in the late 1800s the matter of trust asset protection was cutting-edge and charged with issues ranging from personal responsibility to discrepancies across socio-economic strata. The policy debate was grounded in the proposition that an individual of means might bestow upon another the right to enjoy property in a form that was immune from attachment by that person's creditors. Specifically, the idea was that an individual (the settlor) could place assets in a trust, designate a person (the beneficiary) as being entitled to enjoy the benefits of the trust assets, and preclude that beneficiary's creditors from forcing a transfer of the trust interest or assets in satisfaction of their claims.[2] Both then and now, such protection

1. JOHN CHIPMAN GRAY, RESTRAINTS ON THE ALIENATION OF PROPERTY iii (1st ed. 1883). The second edition of this work was published in 1895 and includes the quoted language in a reprint of the original preface. JOHN CHIPMAN GRAY, RESTRAINTS ON THE ALIENATION OF PROPERTY iii (2d ed. 1895) [hereinafter GRAY, RESTRAINTS].

2. These concepts of trust settlor, beneficiary, and the possible exclusion of creditors from such enjoyment are discussed more fully beginning in Part II, *infra*.

is most simply obtained through state law recognition of trust provisions that prohibit any such transfer. These provisions are commonly referred to as spendthrift, or anti-alienation, provisions.[3] A trust that is subject to this type of provision is typically denominated a spendthrift trust.[4]

While the policy debate concerning such arrangements is both historic and rich, a more pragmatic point of view reveals three important observations. These observations, in turn, suggest a less obvious but more focused inquiry into this matter of protected private endowment. First, at its core, the question recognized by Gray in 1883 concerns the contrived enjoyment of assets (or interests therein) that are structurally shielded from creditor claims. That question is, therefore, essentially one of asset protection. Second, the particularly troublesome spendthrift trust variant of asset protection had by the close of the nineteenth century become an established fixture in the United States legal framework, notwithstanding the early policy debate.[5] Finally, despite its articulation over 120 years ago, the asset protection question quoted from Gray at the outset of this Article is today both unresolved and undeniably apropos. For example, longstanding notions regarding the scope of protections and parties that might be currently affected by what began simply as the state-sanctioned spendthrift trust are today challenged by the emergence of offshore and domestic asset protection trust devices,

3. The anti-alienation characterization reflects the fact that such provisions present a classic restraint on the ability to alienate an interest in property, which restraints are in most instances void. *See generally* Gregory S. Alexander, *The Dead Hand and the Law of Trusts in the Nineteenth Century*, 37 STAN. L. REV. 1189 (1985) (discussing restraints on alienation); Richard E. Manning, *The Development of Restraints on Alienation Since Gray*, 48 HARV. L. REV. 373 (1935) (providing an examination of post-1900 developments in restraints on alienation jurisprudence).

4. A "spendthrift trust" is defined basically as a trust that is subject to a provision that states simply, for example, that the interest of the beneficiary is inalienable and that creditors cannot reach the interest in satisfaction of their claims. *See* 1 RESTATEMENT (SECOND) OF TRUSTS § 152, cmt. b-c (1959). This type of provision might be included in the trust instrument as an expression of the trust settlor's intent that the beneficiary's interest be so restricted and thus protected, or the provision might apply, for example, by operation of some statute that deems the particular type of trust at issue to be subject to such a restriction. To be truly effective, the provision must operate to preclude both voluntary alienation at the behest of the beneficiary, as well as involuntary alienation at the behest of the beneficiary's creditors.

5. With regard to the definition of a "spendthrift trust," see *id.* With regard to the early acceptability of spendthrift trusts, see, for example, Lawrence M. Friedman, *The Dynastic Trust*, 73 YALE L.J. 547, 582 (1964) ("The decisive cases validating the [spendthrift] clause fall into a relatively narrow time-span, beginning about 1880, following in rapid succession for about 25 years, then tapering off, since most jurisdictions had by then settled the major issue."). *See also* Karen E. Boxx, *Gray's Ghost—A Conversation About the Onshore Trust*, 85 IOWA L. REV. 1195, 1197 (2000) ("As spendthrift trusts gained recognition at the turn of the nineteenth century, their primary foe, John Chipman Gray, acknowledged defeat without surrendering his objections.") (footnotes omitted).

fluidity in the codification and posturing of traditional spendthrift trust protections, and an increasing emphasis on asset protection for a vast array of trust-like retirement arrangements. These observations suggest that the operative legal landscape, historically prompting such fervent debate about the enjoyment of property and the obligation to pay one's debts, is today in the midst of a significant evolution that warrants further inquiry.

Despite over a century's worth of debate and the contemporary importance of such issues, however, something is missing from the analysis. Specifically, what has been neither clearly nor adequately addressed is the role and influence of *federal* policies and pronouncements in the development of the legal paradigms through which the desired and debated asset protection is today pursued. So posited, there is a need for a broader perspective from which consideration might be given to the evolution of today's burgeoning creditor-protected trust environment and its likely future direction. It is just such a perspective that informs and guides this Article, which at its core seeks insight through an examination of the subtle, yet important, shaping of the larger asset protection environment occasioned by a legacy of federal influence upon protective trust devices that have long been regarded as the province of state law. This divergent perspective reveals that *federal* policy choices are fundamentally important to the origins and evolution of the existing asset protection dynamic, and only by reference to this understanding can more sound policy choices affecting asset protection be achieved.

Fundamental to appreciating this federal undercurrent is a recognition of what are loosely characterized here as two distinct paradigms of the creditor-protected trust. Those paradigms are most succinctly enunciated by reference to the basic rules that define each paradigm and the identity of the beneficiary whose interest is protected, as follows:

•*The Traditional Paradigm*, pursuant to which a settlor is permitted under applicable state law to create a creditor-protected trust *to be enjoyed by a third-party beneficiary*, as discussed more fully in Part II of this Article; and

•*The Self-Settled Paradigm*, pursuant to which an individual settlor is permitted under applicable state or offshore jurisdictional law to establish and fund a creditor-protected trust *to be enjoyed by that funding individual settlor*, as discussed more fully in Part III of this Article.

The analysis undertaken here, however, probes more deeply than bare doctrinal rules. Specifically, this Article presents a critique of the asset protection environment as grounded in both a modern conception of the proffered paradigms and in recognition that each paradigm has been uniquely influenced by federal pronouncements, policies, and pursuits. Particular emphasis is placed upon the varying degrees of federal influence exerted upon these paradigms through the arenas of federal bankruptcy and tax policies. This view reveals also the questionable roles of federalism and tax revenue concerns in shaping the broader asset protection landscape. Consideration ultimately turns to the potential interaction between an ideally purposive rubric of trust asset protection, versus the less boundaried Traditional and Self-Settled Paradigms currently supported under federalism-inspired bankruptcy principles. Such analysis raises questions as to why, *from a federal perspective*, considerations of purpose and equity—long dominant in the evaluative asset protection trust commentary—are cast aside for little apparent reason in the context of the *federal* policy choices affecting the Traditional and Self-Settled Paradigms. Those policy choices are both numerous and significant, and absent further exploration of this inquiry, efforts to condemn, applaud, or otherwise critique the growing asset protection phenomenon cannot possibly capture the true dimensions of the issues presented. In short, any meaningful appreciation of the currents affecting the modern asset protection dynamic requires a more comprehensive understanding of the federal influences underlying the development of the paradigms at issue in this Article.

A. *A Framework for Elucidation*

The noted paradigms interact and are in many respects branches of the same tree. However, stepping away from variations on a single, homogenous spendthrift trust categorization to instead conceptualize the paradigms as distinct vehicles within the modern environment of asset protection provides a framework from which to elucidate the important federal influences that are the subject of this Article. In addition to providing the underlying framework for exploration of such pursuits, when the paradigms are separated and considered in this manner, it becomes apparent that the paradigms are not a simple basket of "dead law" to be gleaned from old commentaries and even older case law. The Traditional Paradigm discussed in Part II of this Article, for example, has recently been embodied within a completed Uniform Law Commission project, with similarly fresh consideration occurring under the auspices of a Restatement project now in its final stages.[6] In the course of these important new projects addressing trust issues in a broader context, it was the asset protection dynamic that generated the most input from the practicing bar as well as the most vigorous debate among the drafters.[7] As explained further in Part II, these troublesome contemporary state law issues have firm roots in federal jurisprudence dating back well over a century.

Further, the Self-Settled Paradigm has recently seen the abrogation of what had been a longstanding and widely accepted prohibition against protection for self-settled arrangements.[8] The "self-settled" moniker denotes an arrangement under which the same individual is not only the settlor funding the trust, but also a trust beneficiary eligible to receive distributions from the trust.[9] In this regard, at least four United States jurisdictions have since 1997 joined the ranks of numerous entrepreneurial offshore jurisdictions in permitting an individual to shelter assets from creditors in a trust arrangement that includes: (1) the funding settlor as a trust beneficiary, and (2) a spendthrift provision designed to thwart efforts by the settlor's creditors to reach the trust property or the settlor's trust interest.[10] Where the spendthrift nature of the self-settled arrangement is enforced, such a trust so fundamentally departs from the limitations historically recognized under the Traditional Paradigm that it is classified here as a paradigm unto itself.[11] This

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6. *See* RESTATEMENT (THIRD) OF TRUSTS §§ 56-60 (Tentative Draft No. 2, 1999) [hereinafter DRAFT RESTATEMENT]. *See generally* Edward C. Halbach, Jr., *Uniform Acts, Restatements, and Trends in American Trust Law at Century's End*, 88 CAL. L. REV. 1877 (2000). With respect to developments in the area of creditor protection under the Draft Restatement, see in particular *infra* notes 39 and 94 and the accompanying text.

7. The exceptions to such protection proved to be a particularly difficult issue upon which to achieve consensus. *See* Raymond H. Young, *New Uniform Trust Code Modernizes and Clarifies Rules Governing Trusts*, 27 EST. PLAN. 108, 109 (Mar./Apr. 2000) (noting that exceptions to efficacy of spendthrift trust provisions generated the most input from the ACTEC and ABA advisors to the Uniform Trust Code); David M. English, *Is There a Uniform Trust Act in Your Future?*, 14 PROB. & PROP., Jan.-Feb. 2000, at 24, 30 ("Crafting the provisions . . . on spendthrift protection and the rights of a beneficiary's creditors to reach the trust proved to be the most difficult task in drafting the Act. The area is controversial, and conflicting policy directions . . . [led to compromised] results.").

8. *See* Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1043 (2000) (discussing the foundation for the historical prohibition against self-settled trusts).

9. *See* BLACK'S LAW DICTIONARY 1518 (7th ed. 1999).

10. *See infra* notes 112-17 and accompanying text.

11. With respect to this fundamental departure, see, for example, Sterk, *supra* note 8, at 1043 ("[E]ven more entrenched than spendthrift trust doctrine itself is the rule that a spendthrift provision for the settlor's own benefit is unenforceable.") (footnote omitted). In fact, the origins of this prohibition against self-settled spendthrift trusts can be traced to at least 1487. *See* 2A AUSTIN

phenomenon is examined more thoroughly in Part III of this Article and is shown to have roots in the burgeoning offshore trust industry and the narrow congressional response thereto.[12] One effect of that response has been a shift in the perception of the offshore industry from one of tax advantage to one of asset protection.[13] While the parameters of this Self-Settled Paradigm are briefly explored in Part III, more attentive consideration is given to the legitimization of this asset protection reality through analysis of certain federal bankruptcy and tax policy choices and the activities thereby countenanced.

As discussed in Part IV, the exposition of the paradigms in association with the activities through which federal policies are pursued suggests that a more focused, comprehensive federal view be taken of trust asset protection.[14] In shaping that view, due regard should be given to bankruptcy, tax, and more generally conceived social policy considerations. In other words, and to borrow from a tried-and-true metaphor, the creditor-protected trust landscape can be viewed as populated by two distinct paradigmatic trees, spawned perhaps from related seeds but in many respects nurtured in different ways by federal influences. The perspective here is one from which those trees can be surveyed, thus revealing a larger forest by reference to which more coordinated federal policy decisions impacting trust asset protection might be cultivated. As explored in Part IV, such decisions implicate not only the future evolutionary direction of the paradigms, but also the very survival of the paradigms as viable asset protective legal structures.

B. *Of Currents, Not Causes*

The argument is not, however, that something monstrously federal "caused" a particular paradigm to be exactly as it is today or that some federal action should perforce stamp-out asset protection trust planning altogether. Instead, the object here is to examine the extent to which a federal undercurrent has at times moved one or more of the paradigms, and if such movement is found, to consider both its rationales and implications going forward. Those federal influences vary in both degree and character, and they are explored here in large part from a selective period perspective that guides this endeavor. In particular, the noted

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WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 156 (4th ed. 1987) (tracing the origin of this rule to the 1487 Statute of King Henry VII, Stat. 3 Hen. VII, c.4, which voided conveyances in trust for the use of the transferor).

12. *See infra* notes 206-24 and accompanying text.

13. *See* Sterk, *supra* note 8, at 1048.

14. *See infra* notes 276-89 and accompanying text.

conceptualization of paradigms and the federal currents affecting those paradigms are presented in the context of two historical periods which saw significant developments in or away from the Traditional Paradigm. The period focused upon with the most attention in this Article began in the mid-1970s and continues through the present day. It has been during this period that a variety of federal actions, pronouncements, and omissions have unequivocally affected the Self-Settled Paradigm. Some consideration of the Traditional Paradigm is also undertaken within the context of this period, although the "Traditional" label suggests a need to probe further into the historical origins of what at one time was considered a uniquely American opportunity to shelter assets.[15] In this vein, consideration begins in Part II of this Article a century earlier with the Supreme Court's 1875 decision in *Nichols v. Eaton*,[16] which serves also to whet the appetite for something more contemporary and federally directed. As to the historical, there is a rich and thorough debate concerning the merits and shortcomings of spendthrift and other variations of the creditor-protected trust, and while at times referenced, that ongoing debate is not repeated here.[17] Instead, the creditor-protected trust bent here is one of perspective, geared towards particular insights to be gleaned from the larger federal view. To say more at this point, however, is to merely delay the promised foray into the federal influences upon the evolution of the creditor-protected trust paradigms.

II. THE TRADITIONAL PARADIGM

The origins and parameters of the Traditional Paradigm present a logical starting point for an exploration of the nature of trust asset protection and the extent of the federal influence upon and interest in the evolution of that dynamic. First discussed in this Part II, then, are the

15. *See* Friedman, *supra* note 5, at 572 (describing "a peculiarity of American trust law, the spendthrift trust doctrine"); George P. Costigan, Jr., *Those Protective Trusts Which Are Miscalled "Spendthrift Trusts" Reexamined*, 22 CAL. L. REV. 471, 474 (1934) ("[T]he doctrine [of spendthrift trust law] is modern American . . . .").

16. 91 U.S. 716 (1875).

17. It is not the purpose of this Article either to repeat or directly revisit the arguments of Gray and others regarding the merits and demerits of spendthrift trust asset protection. Such arguments, pro and con, are addressed in scores of scholarly articles and are summarized nicely in GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 223 (rev. 2d ed. 1992); DRAFT RESTATEMENT, *supra* note 6, § 58, reporter's note to cmt. a; and SCOTT & FRATCHER, *supra* note 11, § 152. The authors of the Draft Restatement note that "[t]he philosophical and policy debate about spendthrift trusts . . . has continued for generations, still without consistent or enduring resolution." DRAFT RESTATEMENT, *supra* note 6, ch. 12 Introductory Note. The focus here is more guided, though perhaps at times more general, and is pursued through the perspective of federal policy.

doctrinal considerations that define such parameters. Having laid that foundation, consideration then moves more directly into the federal influence at the roots of a Traditional Paradigm that is most often evaluated by reference to state law doctrines and concerns. The particular federally-inspired focus of that consideration is upon the 1875 Supreme Court decision in *Nichols v. Eaton.*[18]

A. *The Doctrinal Foundation*

Doctrinally, the creditor-protected trust paradigms conceptualized here have in common the idea of beneficial enjoyment coupled with some limitation or restraint upon the alienability of the trust interest.[19] Simply stated, beneficial enjoyment entails the grant to a beneficiary of an equitable interest in trust property from which distributions might be made to that beneficiary.[20] Superficially and by definition, the beneficiary lacks any legal authority to transfer the *underlying trust property*.[21] Such authority instead resides with the person or entity (the trustee) charged with managing the property with the best interests of the beneficiary in mind.[22] Absent a spendthrift or some other limitation, however, the beneficiary would have full power to transfer *her rights and interests in the trust*—including the right to receive distributions.[23] Thus, those rights could be taken away from the beneficiary, either at the beneficiary's doing or through involuntary transfer such as that occasioned by creditor requisition.[24] The concept of asset protection is

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18. 91 U.S. 716 (1875).

19. *See generally* JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 553-94, 631-32 (6th ed. 2000).

20. *See generally id.*

21. *See generally id.*

22. For a basic exposition of these inherent trust characteristics, see, for example, *id.* at 557-62.

23. Thus, for example, the beneficiary could transfer her right to receive distributions of income from the trust, but could not transfer any legal interest in the underlying trust property by virtue of which income is earned in support of such distributions.

24. As to the manner in which a creditor might actually liquidate or realize upon the value of a beneficiary's unprotected interest in a trust:

> Except in the rare case in which a debtor is the sole beneficiary of a trust and can presently demand conveyance of the trust property, a creditor cannot reach the trust property itself. It is the beneficial interest of the debtor that is subjected to the claim. The basic remedy of the creditor is to have the beneficial interest sold and the proceeds of the sale applied to satisfy the claim. The buyer acquires the rights that the debtor owned as beneficiary, whether it be the right to receive periodic income payments or the right to share in the principal on termination. The element of sacrifice involved in a forced sale of such rights is likely to work a hardship on the beneficiary [because the circumstances of the sale are likely to yield a depressed value for the interest]. Consequently, courts

interjected when the settlor, who establishes and funds the trust, crafts it such that both the beneficiary and the beneficiary's assignees or creditors are denied the ability to effect a transfer of the beneficiary's trust interest.[25] Most often, the settlor will attempt to provide such protection through one or more of the following:

> •*A forfeiture provision*, pursuant to which the ability to alienate the beneficiary's interest is indirectly restrained through a trust provision stating that the beneficiary's interest will terminate upon the beneficiary's bankruptcy or any attempt by the beneficiary or her creditors to alienate the beneficiary's equitable trust interest;[26]
>
> •*An anti-alienation or "spendthrift" provision*, or some similar expression of intent that the alienability of the beneficiary's interest be directly restrained;[27] or
>
> •*A particular type of beneficial interest*, the inherent limitations of which preclude either transfer by the beneficiary or meaningful attachment by the beneficiary's creditors.[28]

It is not uncommon for trusts crafted with both maximum flexibility and asset protection in mind to include a spendthrift provision and some other compatible feature to better guarantee that the desired protection will in fact be achieved.[29] That added feature is often provided through the crafting of a particular type of beneficial interest, as contemplated in

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> [will] . . . instead direct[] that the trustee pay the creditor the distributions to which the beneficiary is entitled . . . . If this milder remedy is inadequate . . . the court will normally direct a sale of the interest.

EUGENE F. SCOLES, ET AL., PROBLEMS AND MATERIALS ON DECEDENTS' ESTATES AND TRUSTS 627 (6th ed. 2000).

25. It should be noted that sometimes this characteristic arises by operation of state law as opposed to any specifically expressed intent of the settlor.

26. *See, e.g.*, 1 RESTATEMENT (SECOND) OF TRUSTS § 150 (1959) (describing and recognizing such a forfeiture provision as valid); SCOTT & FRATCHER, *supra* note 11, § 150 (discussing forfeiture provisions).

27. For more on the definition of a "spendthrift trust" specifically, see *supra* note 4. With respect to the distinction between direct and indirect restraints on alienation, see SCOTT & FRATCHER, *supra* note 11, § 150.

28. *See* 1 RESTATEMENT (SECOND) OF TRUSTS §§ 154 cmt. b, 155 cmt. b (1959) (describing that in "support trusts" and "discretionary trusts" it is the inherent "nature of the beneficiary's interest rather than a provision forbidding alienation which prevents the transfer of the beneficiary's interest").

29. *See* SCOTT & FRATCHER, *supra* note 11, § 151.1 (discussing the coordinate benefits of trusts that include a restraint on the alienability of a discretionary or support interest).

the third protective feature noted above.[30] In that regard, reference is made specifically to two trust types commonly referred to individually as "discretionary trusts" and "support trusts."[31] A "support trust" is defined simply as one in which the trustee's decision-making authority to effect distributions is constrained by a standard that most often relates to the beneficiary's health, education, maintenance, or support needs.[32] This affords a degree of protection, because any distribution (to either the beneficiary or a creditor) that is outside the scope of the specified standard would exceed the trustee's authority, and would therefore be prohibited.[33] Also suggested, however, is a degree of protective limitation, because the beneficiary's creditors may be able to force a distribution in satisfaction of claims relating to the provision of goods or services contemplated by the specified standard.[34]

More liberal is the "discretionary trust," by virtue of which "a beneficiary is entitled only to so much of the income or principal as the trustee in [the trustee's] uncontrolled discretion shall see fit to give [the beneficiary, who] cannot compel the trustee . . . to pay any part of the trust property, nor can creditors of the beneficiary reach any part of the trust property."[35] The discretionary trust has historically been recognized at common law as providing a degree of protection from the beneficiary's creditors, albeit by virtue of the nature of the beneficiary's interest and not because of any particular anti-alienation provision

30. *See id.*

31. *See id.* §§ 154-55.

32. Such standards are often referred to as "ascertainable" in the estate tax context, and the indicated proviso is often referred to as a "HEMS" standard among estate planning practitioners. *See* 5 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 126.6.4 (2d ed. 1993) (discussing in the context of Internal Revenue Code § 2036(a)(1), the transferor's right to income under a standard which may be asserted to compel a distribution to the transferor, and those which might not be so enforced). Title 26 of the United States Code is often referred to as the Internal Revenue Code, and is sometimes hereinafter referred to as the I.R.C.

33. *See* 1 RESTATEMENT (SECOND) OF TRUSTS, § 154 cmt. b (1959); SCOTT & FRATCHER, *supra* note 11, § 154; Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It Too*, 47 RUTGERS L. REV. 11, 24 (1994).

34. SCOTT & FRATCHER, *supra* note 11, § 157.

35. *Id.* § 155 (footnotes omitted). For a standard definitional treatment of discretionary and spendthrift trusts relying upon Restatement propositions, see *Estate of Paxton v. Commissioner*, 86 T.C. 785, 804 n.12 (1986) (noting that a "discretionary trust" is a trust under the terms of which "'it is provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit'") (quoting 1 RESTATEMENT (SECOND) OF TRUSTS § 155(1) (1959)). The court further notes that "[a] spendthrift provision provides that the interest of the beneficiary is inalienable and that creditors cannot reach the interest in satisfaction of their claims." *Id.* at 817 n.31.

included in the trust instrument.[36] In this sense, then, it might be said that a de facto restraint on the alienability of the beneficiary's interest is achieved through particularized crafting of the discretionary or support interest itself and notwithstanding the absence of any specific disabling provision expressly stating the restraint.[37] However, although a discretionary or support trust need not rely upon the inclusion of a spendthrift provision to achieve some measure of asset protection, the inclusion of such a provision is clearly desirable from an asset protection standpoint.[38] In this regard, the discretionary and spendthrift forms are

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36. *See* Twopeny v. Peyton, 10 Sim. 487, 59 Eng. Rep. 704 (1840), and other cases cited in SCOTT & FRATCHER, *supra* note 11, § 155, at 152 n.2; 1 RESTATEMENT (SECOND) OF TRUSTS § 155 cmt. b (1959); Marty-Nelson, *supra* note 33, at 24-25. More specifically, since the beneficiary is often regarded under the law as having no "right" to receive a distribution except upon the trustee's discretionary decision to make such a distribution, it is often said that absent the trustee's exercise of such discretion, there is no enforceable interest available for the beneficiary to transfer or for a creditor to attach. Further to this idea and in conclusory terms which have confounded both law students and Restatement drafters alike, it is sometimes said that the beneficiary of a purely discretionary trust has only a "mere expectancy" of receiving distributions and that such interest falls short of the "property" right required for alienation (whether voluntary or at the behest of creditors) to be possible. *See generally* SCOTT & FRATCHER, *supra* note 11, § 155 (discussing protection afforded by virtue of the nature of the interest as discretionary); BOGERT & BOGERT, *supra* note 17, § 228, at 721 (same).

37. *See, e.g.*, ERWIN N. GRISWOLD, SPENDTHRIFT TRUSTS § 18 (2d ed. 1947) ("[T]rusts for support have many elements in common with spendthrift trusts, and it is sometimes held that the fact that the settlor expresses his intent that the interest of the beneficiary shall be for his support is enough to show his intent to restrain the alienation of the interest . . . .").

38. For example, where the trustee has exercised discretion to make a distribution or where the trustee's discretion is limited to the particular timing or manner of an otherwise required distribution, the beneficiary's interest is vulnerable in the absence of a spendthrift provision, as the prospect of payment to the beneficiary is no longer subject to the trustee's absolute discretion to withhold payment. "Moreover, if the trustee of a discretionary trust without a spendthrift or forfeiture clause is served with process by a creditor of the beneficiary, he will be liable to the creditor if he thereafter exercises his discretion and elects to pay the beneficiary." Marty-Nelson, *supra* note 33, at 28. If a discretionary or support trust includes a spendthrift restraint (as should be the case where creditor-protection is a planning objective), the issue is more easily resolved in that the restraint will preclude most creditor claims from attaching to the trust interest in the first instance. *See, e.g.*, UNIF. TRUST CODE § 504 cmt. (2000) (dealing with discretionary trust interests, and noting: "This section will have limited application . . . . Only if the trust is not protected by a spendthrift provision, or if the creditor falls within one of the exceptions to spendthrift enforcement . . . does this section become relevant"); DRAFT RESTATEMENT, *supra* note 6, § 60 cmt. a (dealing with discretionary trust interests, and noting: "The rule does not apply if the beneficiary's interest is subject to a valid spendthrift restraint . . . ."). Both the UTC and Draft Restatement authors attempt to further clarify the creditor-protected status of discretionary and support trusts where a spendthrift restraint on alienation is lacking. The attempted UTC and Draft Restatement clarification comes primarily in the form of directly confronting and then rejecting the often elusive distinctions upon which protection for such non-spendthrifted trust interests often turn. *See generally* Halbach, *supra* note 6, at 1895 (discussing problems with prior law treatment of discretionary and support trust interests). Both models treat support trusts as simply a variant of the discretionary trust, having a support standard to guide the exercise of discretion. Thus implicated is

complimentary, frequently used in tandem, and often equated in terms of operational effect upon rights of alienation.[39]

Rather than delve further into the finer points of such distinctions and the myriad of combinations and variations attendant their use and operative effect, it is more appropriate to simply recognize the foregoing as a necessary precursor to appreciating the broader framework that shall guide the direction of this Article. Indeed, the specific trust forms just noted are all easily characterized as species within the larger genus of what is conceptualized above as the Traditional Paradigm of the creditor-protected trust.[40] Going forward, it is the spendthrift restraint upon the alienability of the beneficiary's trust interest that provides both a central paradigmatic theme and a most direct means to the settlor's

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a more unified set of rules governing the vulnerability of a beneficiary's interest to creditor claims where either a support of "purely" discretionary trust is involved. *See* UNIF. TRUST CODE § 504(b)(1) & cmt. (2000); DRAFT RESTATEMENT, *supra* note 6, § 60, reporter's note to cmt. a ("[T]he supposed distinction . . . [is] arbitrary and artificial . . . ."). *Cf.* 1 RESTATEMENT (SECOND) OF TRUSTS §§ 154, 155 (1959) (providing separate treatment for discretionary and support trusts). Both models then proceed to similarly reject the idea that the beneficiary of a discretionary trust lacks the power to compel a distribution, thus rejecting also the idea that there is no interest for creditors to attach. The UTC clarifies the idea that such a beneficiary actually does possess the right to compel a distribution, but then simplifies the analysis by limiting that conclusion to only the situation where the trustee has abused its discretion or failed to comply with a standard guiding that discretion. *See* UNIF. TRUST CODE § 504 & cmt. (2000). The UTC drafters further simplify the matter by stating that such right belongs to the beneficiary alone, and thus creditors may not compel a distribution from a discretionary trust to satisfy their claims. The lone creditor exception is for dependent spouses and children, who are limited to the same rights to compel as held by the beneficiary. *See id.* In contrast, the Draft Restatement provides that any creditor may compel a distribution to the extent the beneficiary might do so, noting specifically that the rights of such creditors are to be protected from trustee abuse of discretion. *See* DRAFT RESTATEMENT, *supra* note 6, § 60 cmt. e.

39. *See, e.g., In re* Bass, 171 F.3d 1016, 1028 (5th Cir. 1999) ("Discretionary Trusts are similar in effect to a spendthrift trust in that . . . the beneficiary cannot alienate the funds nor can creditors reach the fund until the trustee's discretion has been exercised.") (footnote omitted); *In re* Blackwell, 142 B.R. 301, 303 (Bankr. E.D. Ark. 1992) ("The committee overseeing the administration of the [pension plan which was in the nature of a trust] has complete discretion over when to disburse the funds. Thus, until that decision is made, the pension trust is tantamount to a spendthrift trust such that the property would be excluded from the bankruptcy estate."); *see also* 2A SCOTT & FRATCHER, *supra* note 11, § 152 ("[C]ourts do not always clearly appreciate the distinction between spendthrift trusts and trusts for support and discretionary trusts . . . ."); *id.* § 155.1 ("The fact that discretion is conferred on the trustee to withhold income from the beneficiary may indicate an attempt to prevent alienation, voluntary or involuntary, of the beneficiary's interest.") (footnote omitted); BOGERT & BOGERT, *supra* note 17, § 228 ("The discretionary trust effects an indirect restraint on alienation . . . ."); Anne S. Emanuel, *Spendthrift Trusts: It's Time to Codify the Compromise*, 72 NEB. L. REV. 179, 185 (1993) (noting how the discretionary nature of a trust interest can compliment the protection afforded solely by virtue of a spendthrift restraint). With regard to the relevance of a spendthrift provision in a discretionary or support trust, as dealt with under the UTC and the Draft Restatement, see *supra* note 38.

40. *See supra* Part II.

desired ends.[41] With the foregoing ideas in mind, then, consideration now shifts more directly to federal influences upon the evolution of asset protection within the Traditional Paradigm.

B. Protection in Context

The concept of spendthrift asset protection received a pivotal Supreme Court endorsement as the turn of the twentieth century approached.[42] To appreciate the unique relevance of that endorsement, some context must be given to the legal environment in which the Supreme Court acted. Further to this idea, as of 1875 a retrospective view of the first century of the United States' existence saw economic cycles and political disagreements that left a constitutionally-conferred federal power to regulate the relationship between financially troubled debtors and their creditors largely unexercised.[43] By default, such regulation fell to the states.[44] When Congress did act, the result was short-lived federal legislation that revealed the uncertain balance between federal and state roles in regulating the various aspects of

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41. The various avenues to asset protection that shape the Traditional Paradigm are without question closely related. This interrelationship can be seen in the progression of protection and enjoyment evidenced when moving from the forfeiture trust to the bare spendthrift trust to the discretionary trust, as well as in the more pragmatic recognition that the bare spendthrift clause is utilized most effectively in conjunction with such other measures in order to enhance the degree of asset protection each such measure could provide in isolation. With regard to the relative advantages of a spendthrift restraint, see *supra* note 38. With regard to this overlap in protective features, see also *supra* note 39, and accompanying text. Thus, the Traditional Paradigm as conceptualized here encompasses a combination of the asset protection features examined above, but always with the spendthrift provision at its core. Most often, the added feature will appear in the form of a discretionary trust interest. This combination of spendthrift and discretionary features appears prominently, for example, in the self-settled spendthrift trust legislation first appearing on the scene domestically in 1997, as discussed more fully in Part III.

42. The reference is to *Nichols v. Eaton*, 91 U.S. 716 (1875), certain aspects of which are discussed in more detail *infra*.

43. U.S. CONST. art. I, § 8, cl. 4, confers upon Congress the power to promulgate "uniform laws on the subject of bankruptcies." The history of federal legislation in the bankruptcy arena prior to the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, is detailed in Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. L. REV. 5, 13-14 (1995); Vern Countryman, *A History of American Bankruptcy Law*, 81 COM. L.J. 226, 228-30 (1976); *see also* NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT 118 (1997) [hereinafter 1997 FINAL REPORT] (noting that prior to 1898 Bankruptcy Act, various federal bankruptcy laws impacting exemptions were in effect for a cumulative total of less than twenty years); David A. Skeel, Jr., *Rethinking the Line between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 477-78 (1994) ("Rather than a single, enduring bankruptcy statute, Congress passed a series of laws . . . in response to financial crises; each of these laws was repealed almost as soon as the particular crises had passed." (footnotes omitted)).

44. *See* Tabb, *supra* note 43, at 13.

bankruptcy, particularly with respect to delineating the property that would be available to, or protected from, the claims of a bankrupt's creditors.[45] From the slightly broader perspective of what today might be dubbed the "asset protection rubric" of the period, it seems that prior to 1875 the concept of "spendthrifting" a person's interest in property—effectively immunizing such property from the claims of creditors through the simple expedient of subjecting that interest to an anti-alienation provision—was a concept rejected under the English common law and not otherwise embraced in this country.[46]

Now that is not to say that the shielding of trust assets and interests from creditors was not in any way recognized at this time. Trusts including *indirect* restraints such as forfeiture provisions were permitted, notwithstanding the continued rejection in England of the more direct

45. Although coverage was limited to particular categories of debtors, the Bankruptcy Act of 1800, ch. 19, 2 Stat. 19, *repealed by* Act of Dec. 19, 1803, and the Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614, each provided for a completely federal scheme of property which was to be exempted from creditors' claims, while the more broadly applicable Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99, provided for a minimum level of property to be exempt, although permitting states to grant more generous property exemptions. *See* Tabb, *supra* note 43, at 14-20 (discussing these first three bankruptcy acts); *see also* Countryman, *supra* note 43, at 229-30 (same); Raymond C. Marier, Note, *Bankruptcy Exemptions: A Full Circle Back to the Act of 1800?*, 53 CORNELL L. REV. 663, 666 (1968).

46. *See* Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives*, 73 WASH. U. L.Q. 1, 6 n.17 (1995) ("Prior to *Nichols*, English and American cases had held almost uniformly that disabling restraints [on alienation] were ineffective . . . ."); *See* Alexander, *supra* note 3, at 1198 ("[N]ineteenth century English trust doctrines reinforced the established common law doctrines restricting the power of settlors to impose restraints on the alienability of their transferees' interests."). Regarding anti-alienation provisions and spendthrift trusts more generally, see *supra* notes 3-4 and accompanying text. On the topic of acceptance of spendthrift trusts in England and in the pre-1875 United States, see also *Brandon v. Robinson*, 18 Ves. 429, 34 Eng. Rep. 379 (Ch. 1811) (rejecting spendthrift trust doctrine); Willard M. Bushman, *The (In)validity of Spendthrift Trusts*, 47 OR. L. REV. 304, 306-09 (1968) (discussing historical origins of the spendthrift trust). It would be incorrect to ignore the fact that the spendthrift trust had been "recognized" in at least two states prior to 1875, although it would be perhaps even more remiss to overlook the indirect and perhaps unintended manner in which such recognition came about. Indeed, Bushman summarizes this "minority position" as consisting of "a decision in one state, dictum in another, and statutes in four states which permitted restraints to a limited extent" in dealing with broader legal issues. *Id.* at 306. Further insight on this aspect of the history of spendthrift trust doctrine in this country can be found in GRAY, RESTRAINTS, *supra* note 1, § 214 (noting absence of courts of equity in Pennsylvania as affecting spendthrift doctrine); Hirsch, *supra*, at 6 n.17 (summarizing this issue by reference to Gray, Griswold and other sources, with particular emphasis upon New York law); Alexander, *supra* note 3, at 1198-1200 (discussing early English and American law, with particular emphasis upon laws of New York and Pennsylvania).

The relationship between assets held in a trust that includes a spendthrift provision and exempt property in a bankruptcy proceeding is discussed in more detail in Part III.B.

spendthrift restraint.[47] On a policy level, the forfeiture trust is distinguished by the specific denial to the beneficiary of any enjoyment of the trust property once bankruptcy occurs or creditors attempt to reach the interest; i.e., the beneficiary's trust interest is simply forfeited upon the happening of such event.[48] In contrast, the beneficiary protected by virtue of a direct restraint on alienation retains the prospect of further enjoyment of her trust interest notwithstanding the thwarted creditors' efforts to reach that interest or the trust property supporting it.[49] From the settlor's perspective, although a forfeiture provision may protect the underlying trust property from the claims of a beneficiary's creditors, such a provision is unsatisfactory where a coextensive goal is to provide ongoing benefits to the object of the settlor's bounty via the trust interest.[50] It is this latter desire that is most effectively served through the operation of some limitation—like a spendthrift provision—that allows for continuation of the beneficiary's trust interest while precluding its voluntary or involuntary transfer.[51] Grounded in this distinction then, is this prospect of continued enjoyment of spendthrifted property that is immune from creditor claims, and therein lies one of the more significant bases for the ongoing policy debate surrounding spendthrift trusts.[52] Reflecting on this very point, one noted commentator concluded that "[i]t seems that it is not so much that the common law wants creditors paid . . . but that it is opposed to having debtors refuse to pay creditors and still retain the property."[53] A more opinionated statement of the underlying fear was succinctly captured by Gray in his oft-quoted 1895 treatise conclusion that: "[t]he general introduction of spendthrift trusts would be to form a privileged class, who could indulge in every speculation . . . and yet . . . roll in wealth."[54]

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47. With respect to forfeiture provisions, see *supra* text accompanying note 26. Regarding prior English precedent, see *supra* note 46.

48. *See* Marty-Nelson, *supra* note 33, at 23.

49. This is particularly so if the beneficiary emerges from a federal bankruptcy proceeding with a discharge of all prior debts, while the trust interest remains intact. *See infra* note 122. The status of protected trusts in bankruptcy is developed more fully beginning in Part III.B.

50. *See, e.g.*, SCOTT & FRATCHER, *supra* note 11, § 150.

51. *See* Emanuel, *supra* note 39, at 185 (discussing this distinction).

52. *See, e.g.*, Scott v. Bank One Trust Co., N.A., 577 N.E.2d 1077, 1083 (Ohio 1991) ("The most important argument against spendthrift trusts is that they are unfair to the beneficiary's creditors because they allow the beneficiary to enjoy the trust property without paying his debts."). The court goes on to deny this objection "both logically and as a matter of policy." *Id.*; *see also* SCOTT & FRATCHER, *supra* note 11, § 150 (distinguishing forfeiture provisions from spendthrift provisions by reference to the ability to continue to enjoy the trust property in the case of a spendthrift trust).

53. Costigan, *supra* note 15, at 480.

54. GRAY, RESTRAINTS, *supra* note 1, § 262.

The 1875 *Nichols v. Eaton*[55] Supreme Court decision inspired a change in the operative legal landscape. Consideration of that decision here however, presents less a penultimate resolution of the matter at hand than it does an opportunity to develop a particular point of view, thus building momentum towards more concrete applications of that view. Likewise, and as discussed more thoroughly below, the significance of *Nichols* lies in its dictum and the views thereby advanced, more so than in the particular holding of the case. The point of the *Nichols* dictum was to endorse protections, like those garnered from a spendthrift restraint, as legitimate and defensible asset protection devices.[56] The point here, again, is to illuminate a legacy of federal impact upon what is commonly regarded as the province of state trust law.[57]

The settlor of the trust at issue in *Nichols* attempted to provide a degree of protection coupled with continued enjoyment that was akin to that underlying the noted criticisms of spendthrift restraints.[58] This prompted the creditor's assignee to argue that enforcing the trust protections would amount to accepting a fraud upon creditors.[59] Specifically, the trust at issue in *Nichols* initially provided for mandatory distributions of income to the settlor's son during the son's lifetime.[60] Then and now, a settlor's grant of such a bare mandatory trust interest generally provides no asset protection whatsoever.[61] This is because, without a forfeiture or spendthrift restraint, creditors of the beneficiary can attach the beneficiary's trust interest and receive those mandated trust distributions in the beneficiary's stead.[62] Had the son's interest

55. 91 U.S. 716 (1875).

56. *See id.* at 727.

57. As noted in this Article's introduction, *supra* Part I, the view here is one that pursues a federal perspective on what has typically been regarded as the province of state trust law. While revealing the federal role that is central to that view, the period perspective adopted here is at times painted with a broad brush in order to maintain focus upon the array of federal actions, pronouncements, and seeming omissions that have influenced the paradigms, with tailored consideration of the Traditional and Self-Settled Paradigms undertaken in that regard.

58. *See Nichols*, 91 U.S. at 727; DRAFT RESTATEMENT, *supra* note 6, § 57 cmt. c.

59. *See Nichols*, 91 U.S. at 717-18.

60. *See id.* at 717. Such a trust is hereinafter referred to as a "mandatory trust."

61. *See* SCOLES, ET AL., *supra* note 24, at 437.

62. *See* 1 RESTATEMENT (SECOND) OF TRUSTS § 155 cmt. c (1959) ("If by the terms of the trust the trustee must pay to or apply for the beneficiary the whole or any part of the income or principal, the interest of the beneficiary can be reached by his transferee or creditor, unless the trust is a spendthrift trust . . . ."). The creditor, of course, may prefer to sell the interest once attached, so as to receive presently the value represented by the future distributions. *See* SCOLES, ET AL., *supra* note 24. From an asset protection standpoint, another key weakness of a spendthrift trust in which the nature of the beneficiary's interest is mandatory is that as a general proposition, once distributed

simply been forfeited upon assignment or creditor pressure or devolved such that the son was left with only a discretionary or support interest as one of a group of several beneficiaries, the proffered protection would have been easily honored by the Court.[63] In this case, however, the settlor had provided that upon such financial distress, the son's mandatory income interest converted to a purely discretionary one, for the son alone and pursuant to which the trustee could at any time or manner and for any reason thereafter distribute the subject property to the son.[64] The Court held that the required forfeiture of the son's mandatory right to distributions and the substitution in lieu thereof of rights purely discretionary in nature placed the son's interest on the proper side of the line dividing those cases where creditors were denied access to a trust interest versus those where creditors succeeded.[65] But to the Court, so holding was not a sufficient point at which to conclude consideration of the matters implicated.

Instead, the Supreme Court engaged in a digression that even the Court noted was directed less at resolving the matter at hand than at open rejection of the view espoused under prior English precedent.[66] That precedent invalidated settlor imposed direct restraints on the alienation of an equitable trust interest.[67] Specifically, the Court directly challenged the prevailing asset protection trust dynamic by forcefully

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and placed in the hands of the beneficiary, the former trust property is no longer protected by the spendthrift nature of the trust. *See* 1 RESTATEMENT (SECOND) OF TRUSTS § 152 cmt. j (1959); DRAFT RESTATEMENT, *supra* note 6, § 58 cmt. d. Thus, to provide any real measure of asset protection, trusts created within the framework of the Traditional Paradigm will include (if effectively crafted) both a spendthrift clause and some other compatible mechanism to better guarantee that the desired protection will in fact be achieved.

63. *See Nichols*, 91 U.S. at 722. This variation of the forfeiture trust is most commonly known as a "protective trust" and is—like its forfeiture trust counterpart but unlike the pure spendthrift trust—clearly accepted under modern English law. *See* SCOTT & FRATCHER, *supra* note 11, § 150 (acknowledging validity of the protective trust and citing both English and U.S. precedent). Unlike a forfeiture trust where the beneficiary is effectively separated from her trust interest entirely upon the happening of a specified event, under the protective trust rubric the triggering event *converts* the beneficiary's status from that of a *mandatory* income beneficiary into merely one of several *discretionary* beneficiaries. In other words, the protective trust by its terms automatically converts from a mandatory trust to a discretionary trust upon threat of creditor attachment. *See generally id.* §§ 150, 155 (discussing protective trusts and their utility and validity under English law, where spendthrift trusts are not permitted to this day); DRAFT RESTATEMENT, *supra* note 6, § 57 cmt. c (discussing protective trusts in a manner virtually identical to that at issue in *Nichols*, 91 U.S. at 718).

64. *See Nichols*, 91 U.S. at 722-23. *See generally* Emanuel, *supra* note 39, at 186-88 (discussing the posture of the *Nichols* case).

65. *See Nichols*, 91 U.S. at 724-25.

66. *See id.* at 725.

67. See *supra* note 46 regarding prior precedent.

opining "that [trust] property may . . . be enjoyed by . . . an individual without liability for his debts being attached as a necessary incident to his enjoyment."[68] As to the nature of this gratuitous federal digression, it has been critically stated that "in addition to being an unwarranted dictum, [the endorsement] was also an 'unconstitutional' interference by a Federal Court on a matter of state law."[69] Nevertheless, with the *Nichols* pronouncement and the arguments proffered in support thereof, the propriety of trust interests protected without forfeiture, and in particular the spendthrift trust and the unguided asset protection incidents it afforded, were indelibly etched upon the tapestry of American legal discourse.[70] Although completely lacking in precedential effect upon trust laws historically crafted at the state level in the federalism landscape of American jurisprudence, the Supreme Court's foray into this state-dominated area has been recognized as both a "startling novelty"[71] as well as "the greatest single factor in the establishment of spendthrift trusts in the United States,"[72] providing what in another commentator's opinion is "the foundation upon which the American spendthrift-trust doctrine is built."[73] Indeed, the leading critic

68. *Nichols*, 91 U.S. at 725.

69. GRISWOLD, *supra* note 37, § 29, at 27-28 (citing Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938)). Griswold notes also that "[t]he decision was clearly contrary to the local law in the state where the case arose." *See also* GRAY, RESTRAINTS, *supra* note 1, § 254, at 238 (noting decision was grounded in "ill-considered dictum"); Friedman, *supra* note 5, at 573 ("The trust in question [in *Nichols*] was not strictly speaking a spendthrift trust . . . ."). For a more recent and less impassioned consideration of the matter, see Emanuel, *supra* note 39, at 186-88.

70. *See* Friedman, *supra* note 5, at 572-74; Emanuel, *supra* note 39, at 186-88.

71. GRAY, RESTRAINTS, *supra* note 1, § 254, at 238.

72. GRISWOLD, *supra* note 37, § 26; *see also* DRAFT RESTATEMENT, *supra* note 6, § 58, at 434 reporter's note to cmt. a (quoting Griswold on this point). Griswold goes on to note that shortly after the *Nichols* decision, influential text writers of the day had revised their works to embrace the *Nichols* dictum as law. *See* GRISWOLD, *supra* note 37, § 30(4), at 28.

73. Bushman, *supra* note 46, at 307; *see also* GRAY, RESTRAINTS, *supra* note 1, at v ("It is impossible to read the later cases without seeing the great power with which the argument of the late Mr. Justice Miller, in the case of *Nichols v. Eaton*, has been in the spread of spendthrift trusts."); Sterk, *supra* note 8, at 1042 n.46 ("Judicial enforcement of spendthrift trusts can be traced to two leading decisions," citing *Nichols*, 91 U.S. 716 (1975)); *Broadway Nat'l Bank v. Adams*, 133 Mass. 170 (1882)); Emanuel, *supra* note 39, at 179 n.1 ("I date the [spendthrift trust] controversy from the dictum of Justice Miller in Nichols v. Eaton . . . ."); *Id.* at 186-88 (discussing historical importance of *Nichols* decision in the development of this country's spendthrift trust doctrine, but criticizing Justice Miller's rationales). Again, however, it is not the purpose here to argue that the Supreme Court's dictum in *Nichols* was the sole force guiding the acceptance of spendthrift trusts in this country. Although it is clear that the case was at the forefront of shaping judicial thought on this topic, the subsequent state court decision in *Broadway National Bank* and other dynamics of the legal, financial and social fabric of the day should also be noted. *See generally* Alexander, *supra* note 3, at 1201-08 (discussing the *Nichols* decision in the broader context of restraints on alienation as evolved during the period 1875-1900); Friedman, *supra* note 5, at 582-83 (discussing the broader economic and social climate of the day in relation to the development of spendthrift trust doctrine).

of the day went so far as to conclude that the tide would likely have turned *against* the acceptability of such protected trusts had Miller's arguments been levied with equal force in the negative.[74] These and similar authorities support the notion that this pronouncement from the highest federal bench was profoundly influential in the formative stages of the domestic asset protection movement.[75] Yet, the legacy of *Nichols* endures in more subtle ways, as discussed next.

C. The Nichols *Arguments and Influence Examined More Closely*

To better appreciate the continuing significance of the Supreme Court's 1875 decision, it is appropriate to examine more closely Justice Miller's rationales posited in favor of permitting settlor-imposed restraints on the alienability on trust interests.[76] It is in the articulation of those rationales that the most enduring influence of the *Nichols* decision resides.

1. Freedom of Disposition

In support of the efficacy of such protected trusts, Justice Miller relied foremost in *Nichols* upon the argument that a donor should be permitted to dispose of her property for the benefit of a specified individual, without the courts usurping that freedom by including the favored individual's creditors in the class of persons entitled to benefit from the trust property.[77] Succinctly stated, Justice Miller argued that "the rule of public policy which subjects a debtor's property to the payment of his debts, does not subject the property of the donor to the debts of his beneficiary . . . ."[78] Justice Miller clearly framed the argument in terms of deference to the donor's freedom of disposition, with the only limitation thereon being that derived from public policy considerations.[79] The result elevated the donor's goals, and consequently

74. *See* GRAY, RESTRAINTS, *supra* note 1, at v.

75. As to the significance of this dictum emanating from the U.S. Supreme Court in particular, Griswold observed that "[t]he prominence of the Court gave the opinion wide circulation, and it was not many years before the dictum . . . had been cited and followed to make law in many jurisdictions." GRISWOLD, *supra* note 37, § 29(3), at 26.

76. In this vein and in light of the discussions of the Self-Settled Paradigm which follow, it is important to recall that with regard to the Traditional Paradigm, the trust asset protection spoken of is limited to that pursued by a trust settlor on behalf of another person as trust beneficiary.

77. *See Nichols*, 91 U.S. at 724.

78. *Broadway Nat'l Bank*, 133 Mass. at 174. This Massachusetts case is the leading state court decision embracing the spendthrift trust. *See supra* note 73.

79. The public policies specifically referenced were those pertaining to the Rule Against Perpetuities, the rule against excessive trust accumulations, and that proscribing the perpetuation of frauds against creditors. *See Nichols*, 91 U.S. at 725. With regard to the impact of public policy

the trust beneficiary's status as the object of the donor's largess, over the creditor status of other third parties.[80] The momentum occasioned by this analytical shift helped to produce a steady progression in the law away from the more purposive asset protection trust, respected by reason of the legally or mentally impaired status of its beneficiaries and their consequent need for protection, to a doctrine focused upon the trust settlor's rights and desires.[81] As one author commenting on the heels of this evolution put it:

> the need of protection for the [beneficiary] was not stressed in the spendthrift trust cases, but the supposed freedom of the donor to protect his own acquired property from the creditors of his donee was emphasized, with the result that . . . [spendthrift trust settlors] . . . were permitted to provide for the beneficiaries of such trusts . . . incomes of any amount—no matter how large—free from the claims of the beneficiaries' creditors . . . [and regardless of] the need of the beneficiaries for protection . . . .[82]

Lest there be any doubt as to the influence this aspect of Justice Miller's opinion has exerted in affecting the course of the Traditional Paradigm—and in particular regarding the acceptability and rationales underlying the spendthrift component thereof—one need simply note that the arguments delivered from the highest federal bench in *Nichols* continue over a century later to influence important state decisions as to the efficacy of the spendthrift trust.[83]

2. Exemption Laws and Creditor Reliance

In addition to directly challenging the then-prevailing view of donor-imposed spendthrift restraints, Justice Miller articulated another

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considerations in the context of enforcing spendthrift restraints under the Self-Settled Paradigm, see *infra* notes 142-45 and accompanying text.

80. *See, e.g.*, Alexander, *supra* note 3, at 1249 ("Approval of the restraints represented an unacknowledged but practically evident choice in favor of beneficiaries rather than creditors and others with whom beneficiaries deal."); Friedman, *supra* note 5, at 580-81 (noting the various decisions reflected more of a conclusion than any sound policy distinction, and discussing the various parties having an interest in the trust relationship and their status relative to that conclusion).

81. *See* Bushman, *supra* note 46, at 307-08.

82. Costigan, *supra* note 15, at 483.

83. *See* Scott v. Bank One Trust Co., N.A., 577 N.E.2d 1077, 1082 (Ohio 1991) (citing *Nichols* and Justice Miller's freedom of disposition argument as proffered in *Nichols* as "most persuasive" in reasoning that prior Ohio precedent rejecting spendthrift trusts should be reversed); *see also* Sligh v. First Nat'l Bank, 704 So. 2d 1020, 1025-27 (Miss. 1997) (citing *Nichols* and echoing the arguments posited by Justice Miller as among the strongest favoring the enforcement of spendthrift protections, but ultimately rejecting enforcement on the particular facts). With regard to the *Sligh* decision, see *infra* note 94.

line of reasoning that demonstrates the important collateral influences that more specific debtor-creditor laws and policies exert in the asset protection trust arena. That influence still pertains today and will be shown to derive in part from the modern association of various asset protection planning opportunities countenanced under federal law. For the moment, the core association is revealed by the appeal in *Nichols* to the operative effect of state exemption laws as supporting what Justice Miller argued to be a similar exemption of spendthrift trust interests.[84]

Specifically, at the time of the *Nichols* decision the various debtor-creditor laws then in effect at the state level (and deferred to under federal law)[85] generally provided that certain property of a debtor would not be made available for creditor attachment and liquidation in satisfaction of creditor claims.[86] Simply stated, the affected property was rendered "exempt" from such claims.[87] Seizing upon the reality that "[t]o property so exempted the creditor has no right to look . . . as a means of payment," Justice Miller argued that the same result should hold true with respect to the assets and interests implicated in the case of a spendthrift trust.[88]

Not satisfied with the bare analogy from exemption to trust law, however, Justice Miller utilized the similarity between the creditor rights consequences of exemption laws and donor-imposed restraints in order to refute another early argument levied against the recognition of such protected trusts.[89] This anti-protected trust argument stated that such trusts serve to defraud creditors by allowing the trust beneficiary to exude—through enjoyment of the protected trust interest—the appearance of a person having the means to repay her debts, thus unfairly and deceptively influencing creditors' decisions to extend credit.[90] In response, Justice Miller argued that creditors have no more right or expectation of looking to spendthrift trust property for the

84. *See Nichols*, 91 U.S. at 726. Exploration of this aspect of *Nichols* presages a more detailed discussion of modern federal bankruptcy exemptions and exclusions which follows in Part III. The specific treatment of spendthrift trust interests under current federal bankruptcy laws is discussed in the text accompanying *infra* notes 131-42.

85. See *supra* notes 42-46 regarding the state-federal legal landscape concerning bankruptcy matters, as of the time of the *Nichols* decision.

86. With respect to the concept of exempt property generally, see William T. Vukowich, *Debtors' Exemption Rights Under the Bankruptcy Reform Act*, 58 N.C. L. REV. 769 (1980). For federal bankruptcy legislation in effect prior to and at the time of the *Nichols* decision, see *supra* note 45.

87. *See Nichols*, 91 U.S. at 726.

88. *Id.*

89. *See id.*

90. *See id.* at 721-22.

repayment of debts than to property immune from such claims under exemption laws.[91] In other words, if this "creditor reliance" argument fails with respect to exempt property, it likewise fails with respect to spendthrift trust property.[92] The argument essentially is that the creditor is on notice that by legal strictures a person may have at her disposal certain property that is not available to satisfy such person's debts.[93] Therefore, the creditor who fails to investigate the security of its credit extension more deeply than the mere outward appearance of wealth does so at its peril.[94] While Justice Miller's refutation of this creditor reliance argument remains influential in its own right today,[95] it is Justice Miller's general association of legally sanctioned creditor-protected

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91. *See id.* at 726.

92. *See id.*

93. *See id.*

94. As has been oft-noted since Justice Miller's digression in *Nichols*, the argument favoring protection of trust interests on the grounds that creditors have only themselves to blame upon finding a debtor's assets beyond reach is valid only with respect to voluntary contract creditors. The argument fails outright where the creditor is an involuntary tort plaintiff seeking to realize upon a judgment against the protected trust beneficiary. *See, e.g.*, GRISWOLD, *supra* note 37, § 555 (recognizing this distinction between the two classes of creditors relative to the spendthrift trust rationale). Although a limitation upon the protective aspects of a trust falling within the Traditional Paradigm has long been suggested with respect to such tort creditors, it has generally failed to make headway into spendthrift trust law in actual operation. For example, Griswold proposed a model act that, among other interesting features, permitted tort creditors to access the income from a trust the interests in which were otherwise restricted as to alienability. *See id.* § 565 (proposed act § 2(c)). This exception "was adopted in a couple of early statutes (Oklahoma and Louisiana) but thereafter has not generally had much influence on legislation or judicial decisions . . . ." DRAFT RESTATEMENT, *supra* note 6, § 59 & reporter's note to cmt. a. The UTC and Draft Restatement authors similarly opted to omit any such exception from their pronouncements, UNIF. TRUST CODE § 503 & cmt. (2000); DRAFT RESTATEMENT, *supra* note 6, § 59 & reporter's note to cmt. a., despite the possible impetus that might have been derived from the widely noted 1997 Mississippi case of *Sligh v. First National Bank*, 704 So. 2d 1020 (Miss. 1997). In *Sligh*, the state court opined that a trust beneficiary's gross negligence bordering on intentional conduct was a sufficient justification to override the discretionary-spendthrift nature of the trust at issue so as to permit the tort victim to satisfy his judgment against the trust beneficiary out of trust property. *See id.* at 1028. Ultimately, the *Sligh* decision failed to carry the day, even in the jurisdiction in which rendered. *See* MISS. CODE. ANN. § 91-9-503 (1999) (codifying protection of certain trust interests, without exception for tort claimants); *see also* Scheffel v. Krueger, 782 A.2d 410 (N.H. 2001) (tort judgment debtor's interest in spendthrift trust held protected under statute, and public policy arguments based on criminal nature of beneficiary's sexual assault upon minor plaintiff deemed beyond court's purview to consider. *See generally* Steven J. Oshins & Christopher M. Riser, Scheffel v. Krueger*: The Effectiveness of Statutory Spendthrift Trust Protection*, TR. & EST., Oct. 2001, at 12, 14 (discussing the *Scheffel* decision); Charles D. Fox, IV & Rosalie Murphy, *Are Spendthrift Trusts Vulnerable to a Beneficiary's Tort Creditors?*, TR. & EST., June 1998, at 6 (criticizing the result in *Sligh* and noting dearth of authority to support the court's holding). Regarding the exception of other creditors from the protections otherwise afforded a spendthrift trust interest, see also *infra* notes 145-47 and accompanying text.

95. This idea is developed more fully *infra* Part III.

trusts with the exempt property scheme that is most significant in the modern era of self-settled asset protection.

It must be noted, however, that from a policy standpoint, the appeal to exemption laws in *Nichols* was somewhat misplaced. Specifically, although "spendthrift trust laws have some of the attributes of exemption laws[,]" the two doctrines are grounded in distinct policies.[96] On the one hand, both state and federal exemption policies are premised upon the longstanding tenant that such exemptions exist for the primary purpose of fostering the greater social good through granting to debtors a "fresh start."[97] This fresh start objective dictates that in the case of bankruptcy or insolvency, certain property should be shielded from creditor claims so as to provide the debtor with a base of resources sufficient to allow the debtor to pursue a productive lifestyle geared to a more successful financial future, in lieu of that debtor becoming a public charge by virtue of "losing everything" to creditors.[98] That such exemptions persist today speaks to the efficacy of this fresh start objective and its concern for the debtor's long-term financial recovery and well-being.[99]

In contrast, the spendthrift trust "exemption" so equated in *Nichols* is at its core grounded in deference to a donor's freedom of disposition, completely disassociated from any concept of a fresh start policy basis for allowing assets to be protected.[100] Indeed, two major policy criticisms of recognizing spendthrift trust restrictions cut directly against an

96. William T. Vukowich, *Debtors' Exemption Rights*, 62 GEO. L.J. 779, 790 (1974). Vukowich cites 1 RESTATEMENT (SECOND) OF TRUSTS § 149 cmt. a (1959), for describing a beneficiary's interest in a spendthrift trust as "exempt." With regard to other justifications asserted in favor of recognizing spendthrift trust protections, see generally the sources cited *supra* note 17. To the extent the posited justification lies in some concept of beneficiary infirmity, see *supra* notes 80-83 and accompanying text.

97. The underlying fresh start policy is the same, regardless of whether the exemption is derived at the state or federal level. The federalism dispute arises, however, over that derivation—i.e., whether it should be state or federal law that identifies the specific property that is to be exempted in furtherance of this fresh start objective. For a modern example of this federalism dispute, see *infra* note 204.

98. *See* H.R. REP. NO. 95-595, at 126 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6087; G. Marcus Cole, *The Federalist Cost of Bankruptcy Exemption Reform*, 74 AM. BANKR. L.J. 227, 228 (2000) (noting that the fresh start objective is a "central justification for a consumer bankruptcy system. Productive but unfortunate individuals might decline to contribute to society if the benefits of their past productive energies were completely captured by creditors.") (citations omitted); *see also* Vukowich, *supra* note 86, at 769; Judge William Houston Brown, *Political and Ethical Considerations of Exemption Limitations: The "Opt Out" as Child of the First and Parent of the Second*, 71 AM. BANKR. L.J. 149, 163-70 (1997).

99. The focus here is upon the bankrupt debtor and, ultimately, the interplay between federal bankruptcy doctrine and state exemption laws. For consideration of the role of state exemption laws in a state nonbankruptcy setting, see Brown, *supra* note 98, at 181.

100. *See* Vukowich, *supra* note 96, at 791.

association with exemption policies. Those spendthrift criticisms are that such protections (1) may actually discourage a productive lifestyle going forward, and (2) are not generally limited in degree by any fresh start or other needs-based criteria.[101] Evaluated in this more thoughtful light, the appeal to exemption laws in *Nichols* may be logically sound as a response to creditor reliance arguments, but from a broader policy perspective, perhaps less indicative of sound reasoning than might otherwise appear.

Notwithstanding this policy disconnect between exemption laws and spendthrift trust doctrine, however, the underlying premise of the appeal in *Nichols* to state exemption laws appears to have retained its vitality as a defense of trust asset protection.[102] The underlying premise—that protected assets visit no fraud upon the diligent creditor—is frequently cited today in connection with creditor-protected trust interests. For example, one federal circuit court recently noted, in denying creditor access to a trust, that: "[w]hen it extended the credit that it [now] seeks to collect from [the debtor's] (remaining) interest in [the spendthrift trust], the [creditor] . . . should have recognized that this wealth could not be reached in a bankruptcy action."[103] A key reason this

101. For what is perhaps the most impassioned refutation of the association in *Nichols* between exemption laws and spendthrift trust doctrine, see Bushman, *supra* note 46, at 312. *See also* Vukowich, *supra* note 96, at 791 ("[S]pendthrift trusts do not reflect a state policy of debtor protection."); GRAY, RESTRAINTS, *supra* note 1, § 262 (criticizing spendthrift trust protections as fostering a "privileged class," as discussed in the text accompanying *supra* note 54). As to weaknesses in the creditor reliance response, see *supra* note 94. For more on spendthrift trust policy arguments, see *supra* note 17.

102. *See* SCOTT & FRATCHER, *supra* note 11, § 155.

103. *In re* Baker, 114 F.3d 636, 640 (7th Cir. 1997). The Seventh Circuit in *Baker* was dealing with a pension trust that included a spendthrift provision, as required under federal pension laws. *See id.* at 638-39. The federal spendthrift provision is mandated under ERISA § 206(d)(1), 29 U.S.C. § 1056(d)(1) (1995), and is also set forth as a requirement for certain favorable tax consequences at 26 U.S.C. § 401(a)(13) (1994). *See* Employee Retirement Income Security Act of 1974 ("ERISA") Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at various sections of Title 29 (labor provisions) and Title 26 (tax provisions) of the United States Code). The federal spendthrift provisions embrace language that "looks strikingly like language describing a traditional spendthrift trust." Lawrence B. Wohl, *Pension and Bankruptcy Laws: A Clash of Social Policies*, 64 N.C. L. REV. 3, 16 (1985). Thus, ERISA arguably gives rise to what could, in the context of this Article, be loosely characterized as a third paradigm of the creditor-protected trust. Relative to the paradigms conceptualized *supra* Part I.A., a third paradigm so conceived would be described as follows:

•*The Federal Retirement Paradigm*, pursuant to which an individual, acting directly or through an employer, may be permitted—indeed encouraged *by virtue of federal law*—to establish and fund a tax-favored, creditor-protected trust or related arrangement *to be enjoyed by that individual, typically under the ambit of furthering such individual's income security during retirement years.*

spendthrift/exemption association persists is that, both spendthrift trust doctrine and exemption laws implicate the ability to enjoy property that is in some manner maintained beyond the reach of creditor claims.[104] The noted policy disconnect is often overlooked in the face of this pragmatic observation.

That the underlying spendthrift/exemption policies differ, yet produce what appear to be equivalent asset protection results, is perhaps most important in the realm of perceptions as to the acceptable boundaries of planning for the possibility of financial peril.[105] Justice Miller's observations certainly advanced the perception of equivalent acceptability in this regard. This conclusion is supported by the observations of one early commentator who, recognizing the spendthrift trust analogy to exemption law as "makeweight" relative to the freedom of disposition justification for spendthrift trusts, nevertheless proceeded to equate the fundamental restraint on alienation aspect of creditor-protected spendthrift trust doctrine with bankruptcy exemptions in the important context of societal attitudes concerning debtor-creditor relations:

> The community's attitude toward the debtor-creditor relationship will be especially important [to the viability of spendthrift and similar restraints on alienation], since most restraints serve to protect debtors' assets from the claims of creditors. Although society generally is in favor of upholding and enforcing private obligations, the intensity of

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Although this conceptualization presents many interesting possibilities and ties quite firmly into the prospect of an overriding federal interest in the spendthrift trust landscape, developing this idea of a Federal Retirement Paradigm would consume and transform the balance of this Article, and will thus not be pursued further here. For example, appreciating the Federal Retirement Paradigm requires, at a minimum, an understanding of: (1) the complex tax structure through which federal retirement policy is pursued; (2) the overriding policy objective, which is retirement income security; and (3) the primary mechanisms of social security, private pension plans and personal savings, through which that policy objective is pursued. Moreover, although the trust form dominates arrangements in the employer-sponsored retirement plan context, any consideration of a Federal Retirement Paradigm would by necessity have to address retirement-associated vehicles like the Individual Retirement Arrangement ("IRA"), which may or may not take the form of a trust and which may or may not be employer-sponsored. Thus, such ideas are alluded to here, but their development is left for another day.

104. Indeed, it is this characteristic of the creditor-protected trust that is most often cited as objectionable. *See, e.g.*, Scott v. Bank One Trust Co., N.A., 577 N.E.2d 1077, 1083 (Ohio 1991) ("The most important argument against spendthrift trusts is that they are unfair to the beneficiary's creditors because they allow the beneficiary to enjoy the trust property without paying his debts.").

105. *See, e.g.*, *In re* Baker, 114 F.3d at 640.

this feeling is not uniform, as is demonstrated by the differences in homestead exemptions . . . .[106]

It is to such societal attitudes and the pragmatic appeal and influence of this protected trust/exemption association to which this Article now turns, in pursuit of a more contemporary analysis of federal influence upon the concept of asset protection across the trust paradigms.

III. THE SELF-SETTLED PARADIGM AND THE BANKRUPTCY/TAX DYNAMIC: A SHIFT IN PERSPECTIVE

Discussion has thus far focused upon the last quarter of the nineteenth century, and in particular the momentum occasioned by the express endorsement and defense of donor-imposed spendthrift trust protections in the Supreme Court's 1875 *Nichols v. Eaton* decision.[107] Historical episodes of federal venturing into the bankruptcy arena both prior to and during this era have been alluded to, with the objective of providing some degree of context to the larger legal landscape attending that judicial decision. Among other insights, this exposition revealed the articulation of an association between exemption laws and trust asset protection. That association and its sometimes subtle shaping of perceptions remain important today, and the relevance of that association is enhanced by a more expansive modern federal foray into the realm of debtor-creditor relations—and paradoxically by limitations imposed by Congress upon that federal venture.

More specifically, modern federal bankruptcy laws (and certain deferrals thereunder to state exemption laws) are fundamentally important to understanding both the current status of and federal influences upon the creditor-protected trust paradigms at issue here. With this in mind, the focus of this Article and its period perspective now shift a century forward, to the era beginning circa 1975 and continuing through the present day, with only an occasional glance backwards as context so demands. It is within this time-frame that federal, state, and offshore influences have provided considerable direction and momentum in the progress from the third-party beneficiary focus of protection under the Traditional Paradigm towards the more settlor-oriented protection at issue under the Self-Settled Paradigm.[108] As

106. Manning, *supra* note 3, at 373-74. Homestead exemptions are discussed in more detail *infra* Part III.B.

107. *See* 91 U.S. 716, 725 (1875).

108. *See supra* Part III.A-B.

discussed in more detail below,[109] for example, the mid-1970s saw the enactment of a new bankruptcy code and new foreign trust tax provisions, both of which must be considered in relation to their impact upon the evolution of the trust paradigms at issue here.

In developing these ideas, consideration is first given to the recent emergence domestically of the Self-Settled Paradigm. The purpose of such initial consideration is to lay the foundation for understanding the paradigm, such that issues more pertinent to the theme and thesis of this Article can then be explored with understanding.[110] Thus, discussion in this Part III soon turns to select developments in the bankruptcy arena from the mid-1970s through the present day, with particular emphasis upon the thoroughly considered federal choice to maintain a bankruptcy framework that rewards the forum shopping efforts of savvy debtors.[111] Relevant aspects of that framework are considered in Part III.B., as is the important influence of the perceptions engendered through the asset protective endeavors countenanced under that framework. Finally, analysis of the federal impetus behind the Self-Settled Paradigm concludes in Part III.C. with consideration of the direct federal response to the offshore trust movement, examined by reference to the overriding tax concerns which motivated that response in derogation of concerns for the more general asset protection dynamic then developing.

A. *Basic Parameters of the Self-Settled Paradigm*

In a clear break from the historically discernable parameters of the Traditional Paradigm, many jurisdictions now by statute permit a trust settlor to create, fund, and enjoy the benefits of a trust that is immune from the claims of the settlor-beneficiary's creditors, at least with respect to an action controlled by the laws of the relevant state.[112] From a purely domestic perspective, the Self-Settled Paradigm blossomed in 1997 when the State of Alaska enacted domestically unprecedented legislation aimed at encouraging the creation of self-settled asset protection trusts ("APT") in that state.[113] The Alaska legislature pursued

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109. *See supra* Part III.B.

110. This is consistent with the earlier introduction of the Traditional Paradigm. See *supra* Part II.A.

111. *See infra* notes 199-205 and accompanying text.

112. With respect to conflicts of law issues in the context of self-settled asset protection trusts, see, for example, Sterk, *supra* note 9, at 1081-89; John K. Eason, *Home From the Islands: Domestic Asset Protection Trust Alternatives Impact Traditional Estate and Gift Tax Planning Considerations*, 52 FLA. L. REV. 41, 69-72 (2000). *See also infra* note 142 and accompanying text.

113. ALASKA STAT. § 34.40.110 (Michie 2000). Pertinent legislation in Missouri should be examined for its self-settled asset protective features, although such legislation is of debatable legal

this objective through statutory language that expressly permits a person to transfer property to an Alaska-sitused trust and to provide in the trust agreement that the beneficiaries' trust interests—including specifically the interest of the settlor as beneficiary—may not be voluntarily or involuntarily alienated.[114] By statute, such a 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 . . . ."[115] The statute makes clear that protection from creditors will not be lost simply because the settlor retains "the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor . . . ."[116] Not to be outdone, Delaware, Nevada, and then Rhode Island quickly followed suit in adopting their own domestic APT legislation, bearing substantial similarities to the Alaska model in both form and substance.[117] This competition among states for trust business has been equated with the similar competition among states for corporate charters, being thusly described as posing a "race to the bottom" scenario like that

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and practical impact in the context of the Self-Settled Paradigm, particularly in light of the domestic asset protection trust movement so clearly initiated by Alaska's 1997 adoption of comprehensive asset protection trust legislation. *See* MO. REV. STAT. § 456.080 (1992) (providing what appears to be limited asset protection for self-settled spendthrift trusts, dating back to 1983). For an equally equivocal assessment of the Missouri statute, see BOXX, *supra* note 5, at 1203 n.30 ("Missouri may also recognize self-settled trusts as enforceable to some degree.").

114. The term "situs" generally refers to the place at which a thing—in this case, a trust—is deemed to be located for legal purposes. *See* BLACK'S LAW DICTIONARY 1392 (7th ed. 1999). However, the choice of law issues can become quite complex where self-settled spendthrift trust protections are at issue and multiple jurisdictions have contact with the parties, the trust, or the transactions giving rise to the dispute. *See infra* note 142.

115. ALASKA STAT. § 34.40.110(b). However, such asset protection will not be available if the settlor retains the power to revoke or terminate all or a portion of the trust without the consent of a person possessing "a substantial beneficial interest in the trust [which] . . . would be adversely affected by the exercise of [such] power." *Id.* § 34.40.110(b)(2).

116. *Id.* § 34.40.110(b)(2). The statute is less than artfully drafted in allowing the settlor to be a creditor-protected beneficiary, doing so by implication in defining a power to revoke or terminate as *not* including "a power to veto a distribution from the trust, a testamentary special power of appointment or similar power, or the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor." *Id.*

117. *See* DEL. CODE ANN. tit. 12, §§ 3570-73 (2001); NEV. REV. STAT. ANN. §§ 166.040-.060 (Michie 1993); R.I. GEN. LAWS §§ 18-9.2-1 to 18-9.2-7 (2000). A mirror image of the Alaska legislation was proposed but not acted upon in the 1999 session of the Texas House. H.B. 1553, 1999 Leg., 76th Sess. (Tex. 1999) (introduced Feb. 17, 1999). It is sometimes said that Missouri and Colorado might be self-settled asset protection trust jurisdictions, but this claim is questionable. See in this regard *supra* note 113 (discussing Missouri statute); 1 A. JAMES CASNER & JEFFREY N. PENNELL, ESTATE PLANNING § 4.1.4 n.23 (6th ed. 2000 Supp.) (discussing COLO. REV. STAT. § 38-10-111 (1997)).

described in the corporate context by William Cary in his well-known 1974 *Yale Law Journal* article.[118]

Although a detailed examination of the mechanics by which these statutes purport to offer asset protection and their potential weaknesses is beyond the scope of this Article and unnecessary to its thesis, this domestic movement's origins in the laws of certain non-U.S. or "offshore" jurisdictions must be stated. Directly revealing are the legislative histories of the Alaska and Delaware legislation, which expressly cite the offshore APT environment as inspiring these domestic counterparts.[119] The legislative history behind Delaware's trust legislation, for example, explicitly notes that "[t]hese new [statutory] features should make Delaware a more attractive jurisdiction for establishing trusts that are protected, under certain defined conditions, from claims of a settlor's creditors" and that certain of those statutory features were specifically "intended to facilitate the repatriation of existing offshore trusts to Delaware."[120] Accordingly, there can be little doubt that this domestic current to embrace the Self-Settled Paradigm found inspiration in the offshore trust arena. But have federal policies and actions played a role in this evolution, either domestically or with regard to the underlying offshore movement? The answer is most definitely yes. That influence and the mechanisms by which it has been exerted are less than obvious, however. It is towards this modern federal influence upon the course of trust asset protection that the focus of this Article now turns.

B. Asset Protection: The Bankruptcy Foundation and its Attendant Perceptions

Understanding the movements in trust asset protection requires an appreciation of principles of taxation, bankruptcy, economics, and the

118. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974), as discussed in the context of a potential "race to the bottom" in the trust law setting in Sterk, *supra* note 8, at 1038.

119. *See* H.B. 747, 139th Gen. Assem., 2d Sess. (Del. 1997), *reprinted in* 71 DEL. LAWS 343 (1998); H.B. 101, 20th Leg., Reg. Sess. (Alaska 1997).

120. H.B. No. 747, 139th Gen. Assem., 2d Sess. (Del. 1997), *reprinted in* 71 DEL. LAWS 343 (1998). The history of the Alaska statutory changes reveals similar motivations. *See* H.B. 101, 20th Leg. Reg. Sess. (Alaska 1997) (statement of Rep. Al Veezy) (stating that Alaska has the opportunity to establish itself as a major financial market for the U.S. and even the world.); *see also Opposing Parties Join Forces to Attract Family Trust Industry to Alaska*, ALASKA J. COM., Apr. 14, 1997, at 6 (describing the new trust legislation as being "aimed at luring a multi-billion dollar industry to Alaska . . . [and] intended to make the state a national and international center for administering trusts."); ALASKA STAT. § 13.36.043 (Michie 2000) (permitting change of situs of trust to Alaska).

role of perceptions in shaping both the development of and responses to that movement. A starting point is to consider certain specifics of the federal bankruptcy framework, and in particular the formalities by which a trust designed with asset protection in mind might retain such protected status notwithstanding the trust beneficiary's inability to pay her debts.[121] This rubric and all of its attendant subtleties have immense significance in the continued asset protective viability of the Traditional and Self-Settled paradigms.

Of critical importance to this bankruptcy framework is the scheme by which certain property of a bankrupt debtor might be removed from the pool of assets from which creditor claims are satisfied.[122] Beginning

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121. *See, e.g.*, *In re* Moses, 167 F.3d 470, 473 (9th Cir. 1999).

122. A debtor-creditor action may be thrust into the federal bankruptcy forum at the request of the debtor or, if certain conditions are satisfied, at the request of the debtor's creditors. However, a Chapter 13 proceeding (discussed below) can only be initiated by the debtor. *See* 11 U.S.C. § 303 (2001) (initiation of involuntary proceedings upon filing petition under 1978 Code Chapter 7); *Id.* § 301 (initiation of voluntary proceeding upon filing petition under any Chapter). More generally, where a trust beneficiary is unable to pay debts, the beneficiary's creditors might force that debtor into a federal bankruptcy proceeding in an effort to marshal as much property of the debtor as possible for an orderly payment of debts, or alternatively, an insolvent debtor might herself choose voluntarily to proceed under federal bankruptcy legislation in order to avail herself of some of the protections afforded thereunder. Two particular debtor advantages of proceeding under the federal bankruptcy rubric are: (1) the automatic stay, which generally halts all collection efforts and proceedings outside the bankruptcy forum; and (2) the discharge, which generally serves as a release of the debtor (and the debtor's exempt or excluded assets) from liability on all but a handful of specified debts which arose prior to the filing of the bankruptcy petition. *See id.* § 362 (automatic stay); *Id.* § 727 (discharge in Chapter 7 proceeding); *Id.* § 1328 (discharge in Chapter 13 proceeding). The advantages to creditors center upon the broad powers of the bankruptcy court to effect a marshalling of the debtor's assets for payment of claims, coupled with a process for orderly administration and satisfaction of those claims. *See, e.g.*, *id.* § 507 (establishing priorities for payment of claims); *Id.* § 541(a) (providing for broad inclusion of a debtor's assets in the bankruptcy estate). If neither the debtor nor any creditors initiate a federal bankruptcy proceeding, the resolution of matters pertaining to satisfaction of the debtor's obligations may be handled as a matter of state law. Given the relevance and preemptive effect of federal bankruptcy laws in this setting, this Article focuses on the federal bankruptcy proceeding as the forum of primary relevance for pursuit of the types of creditor claims which implicate the paradigms discussed here. Indeed, a similar posture was taken by the commentators in a recent roundtable discussion addressing the current asset protection trust environment. *See* Symposium, *Roundtable Discussion*, 32 VAND. J. TRANSNAT'L L. 779, 785 (1999) [hereinafter *Roundtable Discussion*] (discussing asset protection trusts and noting that "bankruptcy courts are really going to be the battle ground on these things").

A proceeding under Chapter 7 of the 1978 Code typically involves a debtor lacking the means to repay creditors. A Chapter 7 proceeding is often referred to as a liquidation proceeding, because all of the debtor's nonexempt or nonexcluded property is essentially liquidated and applied to payment of creditor claims. *See* 11 U.S.C. § 109(b) (providing rules of eligibility for Chapter 7 filing); *Id.* § 726 (providing for distribution of property of bankruptcy estate in payment of creditor claims). Thus, under a Chapter 7 plan, the debtor's assets are collected by the bankruptcy trustee and liquidated or distributed, with the proceeds distributed to creditors under the oversight of the bankruptcy court. Generally speaking, the debtor thereafter emerges from the proceeding freed from liability for debts which arose prior to the filing of the bankruptcy petition. *See id.* § 727 (addressing more generally, competitive with the fresh start goal of the federal bankruptcy system is a second goal—to marshal debtor assets for use in satisfying creditor claims.[123] Consequently, when resolution of a debtor's obligations are subjected to a federal bankruptcy proceeding upon the filing of a bankruptcy petition, a broadly-conceived pool of debtor assets—denominated the "bankruptcy estate"—is identified and then administered under the supervision of the bankruptcy court in furtherance of the payment of creditor claims.[124] However, property excepted or removed from this bankruptcy estate is generally preserved for the debtor's benefit, notwithstanding the debtor's obligations to creditors.[125] The Bankruptcy Code of 1978 ("1978 Code")[126] provides for two basic mechanisms by virtue of which such preservation might be achieved. The first is that of *excluding* property from the bankruptcy estate from the outset.[127] The second more broadly applicable mechanism is that of *exempting* certain property, otherwise included in the bankruptcy estate, from the claims of creditors.[128] Because the exemption issue only arises if property is determined in the first instance to be part

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discharge from debts). For individual debtors, the second most likely scenario would have the matter resolved under Chapter 13 of the 1978 Code, whereby a plan is formulated pursuant to which the debtor might pay off creditors over time. A proceeding under Chapter 13 is available only to debtors having a regular income and owing debts below specified dollar amounts. *See id.* § 109(e) (providing rules of eligibility for Chapter 13 filing). A Chapter 13 proceeding entails a plan of repayment, after completion of which the discharge may be granted. *See id.* § 1322 (calling for plan of repayment not to span more than three years absent cause and court approval). *See generally* H.R. REP. NO. 95-595, at 118-26 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6079-6087 (discussing operation of Chapters 13 and 7).

123. The fresh start objective is discussed in the text accompanying *supra* notes 96-99. Regarding the juxtaposition of these goals, see H.R. REP. NO. 95-595, at 126 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6087.

124. *See* 11 U.S.C. § 541(a); *see, e.g., In re* Moses, 167 F.3d at 473 ("The act of filing a petition under the Bankruptcy Code commences bankruptcy proceedings and creates an estate comprised of [all of the debtor's property].").

125. *See* 11 U.S.C. § 541(c).

126. The 1978 Code is codified in Title 11 of the United States Code. The first comprehensive and long-lived bankruptcy legislation in this country was the Bankruptcy Act of 1898. *See supra* notes 43-45. Although subject to important amendments along the way, that Act defined the bankruptcy landscape until it was replaced by the Bankruptcy Code of 1978, which remains in effect today.

127. Excluded property remains beyond the purview of the bankruptcy court and its power to marshal assets in furtherance of creditor satisfaction. *See* Wohl, *supra* note 103, at 6 n.18; Brown, *supra* note 98, at 178 (discussing bankruptcy estate inclusion as bringing the debtor's property within the jurisdiction of the bankruptcy courts, while exemptions thereafter essentially subject property within that jurisdiction to the substantive laws of the various states).

128. The exemption provisions are set forth in 11 U.S.C. § 522, and are discussed in depth in Part III.B.2. The focus shifted from that of exclusions under the 1898 Act to an emphasis upon exemptions under the 1978 Code, although much of the same reasoning applied in both instances. *See* Wohl, *supra* note 103, at 6 n.18, 11 n.48.

of the bankruptcy estate,[129] the exclusion issue is considered first, followed by consideration of the exemption issue.[130] While statutory rules frame this examination, true insight is found in the more subtle implications of the policy choices that underlie the federal bankruptcy scheme.

1. Exclusion of Certain Trust Interests

Section 541(a) of the 1978 Code provides that property of the bankruptcy estate consists of "all legal or equitable interest of the debtor in property as of commencement of the [bankruptcy proceeding]."[131] Although federalism principles often implicate reference to state law in deciding if a debtor has a legal or equitable interest in a given item, the determination of whether or not such interest then becomes property of the bankruptcy estate is a matter of federal law.[132] Accordingly, restrictions that purport to limit the transferability of a property interest are specifically nullified under 1978 Code section 541(c)(1) such that the allegedly restricted interest nevertheless comes into the bankruptcy estate.[133] In isolation, therefore, this seemingly all-encompassing pool of assets from which creditor claims might be satisfied appears to include an equitable trust interest such as that enjoyed by a spendthrift trust beneficiary.[134]

However, the 1978 Code respects such transfer restrictions in one instance by providing for a single *exclusion* of such restricted property from the bankruptcy estate. That exclusion is found in 1978 Code section 541(c)(2), which 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 [the 1978 Code]."[135] In other words, if a bankrupt debtor is the beneficiary of a

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129. *See In re* Moses, 167 F.3d at 474.

130. *See, e.g., id.* ("[E]xemption issues only arise if the court concludes that the [property at issue] is part of the bankruptcy estate. In other words, ... an 'exemption' statute ... does not [a]ffect [property that] ... is not part of the bankruptcy estate" by virtue of the operation of 11 U.S.C. § 541(c)(2)).

131. 11 U.S.C. § 541(a).

132. *See* H.R. REP. NO. 95-595, at 367-68 (1977); S. REP. NO. 95-989, at 82-83 (1978), as discussed in 5 COLLIER ON BANKRUPTCY ¶ 541.LH(3)(a) (Alan N. Resnick et al., eds., 15th ed. 2002) [hereinafter COLLIER]. For a more current example of the federalism issue in operation, see *infra* note 204.

133. *See* 11 U.S.C. § 541(c)(1).

134. *See id.*

135. *Id.* § 541(c)(2). This provision of the 1978 Code is hereinafter referred to as "§ 541(c)(2)." In contrast to the deference accorded spendthrift restrictions, restrictions on the transfer of interests the debtor may have in other nontrust property are not recognized, and such

trust, the terms of which include an enforceable restriction on transfer such as that typically associated with a spendthrift restraint, both the trust property and the debtor's equitable interest in the trust property are excluded from the debtor's bankruptcy estate.[136] The trust property and the debtor's trust interest therefore remain beyond the reach of creditors.[137] This result with respect to trusts is consistent with the treatment of such interests under the Bankruptcy Act of 1898 ("1898 Act"),[138] and is attributable more to federal deference to state law than to either constitutional mandate or any overriding fairness concern implicating such treatment.[139]

Three points should be noted with respect to the section 541(c)(2) exclusion of property from the pool of assets from which creditor claims might be satisfied. First, virtually every state recognizes to some degree the traditional third-party beneficiary spendthrift trust that lies at the

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other property will be immunized from creditor claims only if that particular type of property is described in an applicable exemption provision. *See id.* § 541(c)(1).

136. *See, e.g., In re* Wilcox, 233 F.3d 899, 904 (6th Cir. 2000), *cert. denied sub nom.* Taunt v. General Retirement Sys. 533 U.S. 929 (2001) ("An inquiry under § 541(c)(2) normally has 3 parts: First, does the debtor have a beneficial interest in a trust? Second, is there a restriction on the transfer of that interest? Third, is the restriction enforceable under nonbankruptcy law?"). Similar though perhaps not universal reasoning has been applied with respect to discretionary trust interests. *Compare In re* Blackwell, 142 B.R. 301, 303 (Bankr. E.D. Ark. 1992) ("Thus, until that [discretionary distribution] decision is made, the pension trust is tantamount to a spendthrift trust such that the property would be excluded from the bankruptcy estate."), *with* DRAFT RESTATEMENT, *supra* note 6, § 60, reporter's note to cmts. b, c (concluding that discretionary trust interest would be property of bankruptcy estate, but then floundering somewhat as to the practical significance of this conclusion, which is acknowledged to "raise other troublesome issues").

137. This protection is ultimately attributable to the interaction of 1978 Code § 541(c)(2) and the bankruptcy discharge discussed *supra* note 122.

138. Bankruptcy Act of 1898, § 70(a)(5) (1899) (formerly codified at 11 U.S.C. § 110); *see also supra* note 43. Under that provision, the excludability of a property interest turned upon its transferability or leviability under state law, considered in light of the dual fresh start versus marshalling of assets objectives of the bankruptcy laws. This approach generally resulted in the exclusion of both spendthrift and other types of protected trusts from the bankruptcy estate, whereas the current act truly "excludes" only the spendthrift trust. *See In re* Goff, 706 F.2d 574, 578-80 & n.19 (5th Cir. 1983), *overruled by* Patterson v. Shumate, 504 U.S. 753 (1992) (discussing spendthrift trust treatment under current § 541(c)(2) and its predecessor under the Bankruptcy Act of 1898); William J. Woodward, Jr., *Exemptions, Opting Out, and Bankruptcy Reform*, 43 OHIO ST. L.J. 335, 347 (1982) (discussing "property of the estate" under the 1898 Act).

139. *See supra* note 138; *see also* DRAFT RESTATEMENT, *supra* note 6, § 58, reporter's note to cmt. a (noting that 11 U.S.C. § 541(c)(2) "continues a long tradition of giving effect to this particular restriction"). However, the spendthrift trust exception to rejecting such restrictions stands out relative to the broad marshalling of assets concept embodied in the expansive 11 U.S.C. § 541(a). In fact, it has been noted that the general rejection of paying heed to such restrictions "emphasizes the increased independence of the [1978] Code from nonbankruptcy law concerning [what debtor interests constitute] property of the estate." 5 COLLIER, *supra* note 132, ¶ 541.24.

heart of the Traditional Paradigm.[140] Consequently, where such a trust is at issue, section 541(c)(2) will generally operate to preserve the trust assets for utilization in satisfaction of the debtor-beneficiary's protected trust interest going forward, notwithstanding creditor claims.[141] Similarly, a self-settled spendthrift trust created under one of the new domestic statutes or comparable offshore laws will likely be excluded from the bankruptcy estate under section 541(c)(2), so long as the bankruptcy court applies the laws of the APT jurisdiction by reference to which such provision might be deemed enforceable.[142]

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140. With regard to variations in state law recognition of spendthrift trust restraints, see *infra* note 143.

141. In this regard, it may be generally observed that other forms of the creditor-protected trust which might comprise a trust fitting within the Traditional Paradigm would arguably be likewise excluded, at least in practical result, so long as the protective aspect would be recognized under applicable state law. See *supra* note 136 and accompanying text regarding the similarity in treatment often accorded such other trust forms. With respect to the application of jurisdictional law by virtue of which protection is offered, see *infra* note 142 and accompanying text.

142. The court's doing so is by no means a foregone conclusion, particularly when the parties or transactions at issue seem more closely related to a non-asset protection trust ("APT") jurisdiction that deems self-settled protection from creditors violative of its public policy. More specifically, a trust settlor is typically regarded as having the power to designate in the trust instrument the state law which is to govern the trust. *See* BOGERT & BOGERT, *supra* note 17, §§ 301, 330. If the law of an APT jurisdiction is designated by the settlor and thereafter respected and applied by a court hearing a creditor dispute, the spendthrift and other trust protections should generally be effective in preserving the trust assets from claims of the settlor's creditors. However, it is also generally accepted that a choice of law provision may be ignored where the laws of the expressly chosen jurisdiction offend the public policy of the forum state in which a legal action concerning the trust is brought. *See* 17 JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE § 124.32(4) (3d ed. 1999) (noting that choice of law provisions will not be given effect where "[a]pplication of the law of the chosen state would be contrary to a fundamental policy of a state . . . that has a materially greater interest than the chosen state in the determination of the particular issue"). Thus, if an action is brought against a settlor-beneficiary in a non-APT forum which has jurisdiction over the settlor, that non-APT forum may find the self-settled APT a violation of its public policy, and, therefore, the forum court may apply the laws of the state in which it sits and refuse to recognize the trust as a valid protection against the claims of the settlor's creditors. *See generally* BOGERT & BOGERT, *supra* note 17, §§ 291, 301; 5A SCOTT & FRATCHER, *supra* note 11, § 573. *See* RESTATEMENT (SECOND) CONFLICT OF LAWS § 270 (1971) (addressing the validity of a trust generally, where the applicability of the laws of multiple jurisdictions is at issue); *id.* § 273 (addressing the more specific question of whether a spendthrift provision restraining a beneficiary's ability to alienate an interest in the trust property will be given effect). Determining the law that governed the effectiveness of self-settled APT was a pivotal issue in *In re* Portnoy, 201 B.R. 685 (Bankr. S.D.N.Y. 1996), and *In re* Brooks, 217 B.R. 98 (Bankr. D. Conn. 1998), although the bankruptcy courts there opted not to apply the laws of the APT jurisdiction where the trusts were sitused, thus rendering the spendthrift provisions unenforceable and outside the protection afforded under 11 U.S.C. § 541(c)(2) (2000). In addition to these uncertainties where the Self-Settled Paradigm is at issue, the exact role played by 11 U.S.C. § 541(c)(2) under the Federal Retirement Paradigm has been a matter of some contention over the last few decades, as discussed *supra* note 103.

Second, there are exceptions to this exclusion outcome, most notably where the nonbankruptcy trust laws upon which the bankruptcy court bases its inclusion/exclusion determination provide that a spendthrift clause will to some extent not be enforced. For example, while asset protection under the Traditional Paradigm is available in some form in almost every state, several states permit that creditor barrier to be breached at some dollar or percentage level of trust assets, at some percentage of trust distributions, or where the creditor is of a particular class.[143] Typical are the new Uniform Trust Code ("UTC") and Draft Restatement (Third) of Trusts, both of which reaffirm the prior law vulnerability of a spendthrift trust interest where the claimant is a dependent spouse or child, a creditor who has provided services that helped to protect the beneficiary's trust interest, or a government claimant where federal or other law expressly so allows.[144] Such exceptions are grounded in the longstanding notion that in some circumstances public policy considerations should override the settlor's freedom to dispose of property to the exclusion of creditors.[145] As a

143. In some instances the referenced limitations are imposed by the state legislature, and in other instances by judicial decision. *See, e.g.*, SCOTT & FRATCHER, *supra* note 11, § 152.1 (listing jurisdictions which impose limitations upon the recognition of spendthrift trust protection); *see id.* § 157 (listing jurisdictions recognizing exceptions to spendthrift trust protections based on class of claimant); Boxx, *supra* note 5, at 1202 & n.28 (discussing various state limitations); *see also* Oshins & Riser, *supra* note 94, at 14 (noting distinction between a court's power to limit spendthrift protection where protection is founded upon judicial precedent versus statutory recognition). A state-by-state survey of spendthrift trust law is beyond the scope of this Article and is generally unnecessary in light of the survey provided in the foregoing treatises, with annual supplementation. For examples of statutory limitations on spendthrift trust protections, see VA. CODE ANN. § 55-19 (Michie 1995) (protecting trust principal up to $500,000 per beneficiary); CAL. PROB. CODE §§ 15300, 15306.5, 15307 (West 2000) (providing that trust distributions are reachable to extent in excess of the amount reasonably necessary for beneficiary's support and education, up to twenty-five percent of the total distributions).

144. *See* UNIF. TRUST CODE § 503 (2000); DRAFT RESTATEMENT, *supra* note 6, § 59. For prior law, see 1 RESTATEMENT (SECOND) OF TRUSTS § 157 (1959). Creditors entitled to reach the interest notwithstanding spendthrift protection have typically been limited to these groups. *See generally id.* (listing exceptions from enforceability of spendthrift protections). Comment "a" to that section alludes to the "possibility" that tort creditors might be similarly excepted, although to date this idea has not been widely embraced and was excluded from the specified exceptions in the body of section 157 of the Restatement (Second) of Trusts due to the absence of any judicial precedent to such effect. *See also supra* note 94.

145. *See* DRAFT RESTATEMENT, *supra* note 6, § 59, reporter's note to cmt. b (discussing similar exemptions with regard to pension plans under 29 U.S.C. § 1056(d)(3) (1995), ERISA § 206(d)(3) (1994), and the exception from bankruptcy discharge of such debts as provided in 11 U.S.C. § 523(a)(5)). Referenced support for such exceptions was found in federal laws that similarly elevate spouses and children over asset protections otherwise afforded under federal law. *See, e.g.*, *id.* § 59, reporter's note to cmt. a. Interestingly, however, the drafters of the UTC departed from the position adopted in both the Second and Draft Restatements of Trust by excluding providers of necessaries from the class of excepted creditors. *Compare id.* § 59, *with* UNIF. TRUST CODE § 503

result, there are clearly some limited circumstances where a spendthrift provision is not fully "enforceable under applicable nonbankruptcy law" within the section 541(c)(2) exclusionary language, and therefore the provision will not serve to fully protect the trust interest from creditor claims.[146] Notwithstanding that caveat, however, the scope of policy-based limitations upon spendthrift protections has generally been restricted in actual practice at the state level.[147] As a consequence, the ongoing interaction between section 541(c)(2) and state trust law continues to provide an expansive path to asset protection.

The final point to note with respect to the operation of section 541(c)(2) entails what is best characterized as an opportune federal occasion to significantly reshape the parameters of trust asset protection through federal bankruptcy laws. Had such reshaping occurred, the trust paradigms would have been fundamentally altered in operative effect and relative to objections that might be levied against the protection so afforded. More specifically, Congress created a special Commission in 1970 to assist with the impending bankruptcy reform that would ultimately culminate in the enactment of the 1978 Code.[148] As part of its 1973 report, that Commission recommended to Congress that the spendthrift trust bankruptcy exclusion (now embodied in section 541(c)(2)) be limited so as to protect *only* that amount of trust property or interest necessary to provide for the *reasonable support needs* of the beneficiary and her dependents.[149] Any excess above the

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(2000). The apparent belief was that the exception most often inured to the benefit of government claimants seeking reimbursement for medical expenses paid on behalf of the trust beneficiary through Medicaid, and that any such exception to the protected nature of the beneficiary's trust interest in this regard was a more proper subject for specific legislation targeted to address that concern. *See* UNIF. TRUST CODE § 503 cmt. Apparently, as a matter of pure creditor-protected trust doctrine, the settlor's desire to enhance the quality of her trust beneficiary's life trumps the public interest in alleviating the burden to society at large for such expenses as paid under the taxpayer-funded Medicaid program, absent legislated judgment otherwise. *See* Young, *supra* note 7, at 109 ("There may be a policy argument in favor of this [exception to asset protection] in terms of relieving other taxpayers of the Medicaid burden, but it is probably far from the wishes of most third-party settlors.").

146. *See* 11 U.S.C. § 541(c)(2) (2000).

147. See, for example, the discussion *supra* note 94 of excepting tort creditors from the class of persons precluded from realizing on a judgment out of the tortfeasor's interest in a spendthrift trust.

148. The 1973 commission was established under Pub. L. No. 91-354, 84 Stat. 468 (effective July 24, 1970). The Commission's 1973 final report, H.R. Doc. No. 93-137, 93d Cong., 1st Sess., pt. I (1973), is *reprinted in* COLLIER, *supra* note 132, vol. B app., Part 4-C [hereinafter 1973 Commission Report]. The 1973 Commission's Report is discussed extensively in *In re Goff*, 706 F.2d 574, 581 n.19 (5th Cir. 1983), *overruled by* Patterson v. Shumate, 504 U.S. 753 (1992).

149. This recommendation is embodied in Section 4-601(b) of the Commission's proposed statute included in the 1973 Commission Report, *supra* note 148, which was a focal point of debate concerning the impending new bankruptcy legislation. With respect to the exclusion of spendthrift

amount necessary to satisfy this objective would be subject to possession or disposition by the bankruptcy trustee in satisfaction of creditor claims.[150] In so recommending, the Commission expressly opined that:

> There is no sound justification for permitting a debtor to take advantage of [federal bankruptcy laws] and, at the same time, to shield from his creditors assets because local law does not allow creditors to reach his interest. The Commission generally recommends that these [spendthrift] restraints not be enforceable. However, in recognition of the possibility that the spendthrift trust may be used to protect one incapable of providing for his own welfare, the debtor should be allowed to retain sufficient income to support himself and his dependents. But to the extent the beneficial interest is of a value in excess of the reasonable support needs of the debtor and his dependents, the interest should be available to the debtor's creditors.[151]

The Commission's opinion was embraced by the Senate and the limitation was included in the Senate-passed version of the new bankruptcy legislation.[152] This momentum was not novel, as similar views had been expressed in the commentary relating to the Traditional Paradigm and were also then reflected in the laws of a handful of states.[153] Note that the point is not that the Senate was embracing a heretofore rejected theory, as was more the case with the Supreme Court decision in *Nichols v. Eaton.*[154] Rather, the point is that Congress was directly confronted with and specifically considered imposing a

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trust property under the prior 1898 Act, see *supra* note 138 and *infra* notes 172-87 and accompanying text.

150. The notes to the Commission's proposed Section 4-601 as set forth in the 1973 Commission Report, *supra* note 148, state that

> "[i]f the income exceeds such amount [as may be necessary to support the debtor and the debtor's dependents], the [bankruptcy] trustee can sell the right to the excess income, hold open the case so as to collect the income, or reach the principal to the extent in excess of the principal needed to generate the support income . . . subject, of course, to the rights of any third persons in the principal."

With regard to collecting against a trust beneficiary's equitable trust interest, see *supra* note 62.

151. 1973 Commission Report, *supra* note 148, at 197-98.

152. *See* S. REP. NO. 95-989, at 83 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5869.

153. For commentary on this point, see GRISWOLD, *supra* note 37, § 565 (imposing a limitation in the model statute by means of a dollar cap on the amount of income interest that would be protected); Wohl, *supra* note 103, at 17 n.79; SCOTT & FRATCHER, *supra* note 11, § 152. With regard to variations in state laws, see *supra* note 143.

154. For the discussion of the federal impact the *Nichols* decision had upon the Traditional Paradigm, see *supra* Part II.

nationally-uniform limitation of substantial asset protection consequence upon trust interests otherwise sheltered under state law.[155]

Interestingly, this "reasonable support needs" standard before Congress in the mid-1970s mirrored the limiting inquiry deemed by some commentators to have been foreclosed by the pervasive influence of the freedom of disposition argument emphasized in *Nichols* almost a century earlier.[156] On point is one commentator's succinct evaluation of *Nichols* and its progeny: "[h]ad the need of the beneficiaries for protection been emphasized [in early spendthrift trust analysis], it would easily have been made to appear that often only a reasonable amount of income should be freed from the claims of the creditors."[157] Similarly, had Congress chosen to embrace the Senate limitation in the 1978 Code, the trust paradigms and the analysis of the proper bounds of asset protection thereby afforded would have almost certainly inspired a fundamentally different asset protection trust landscape going forward through the present day. In lieu of the unlimited amounts that may now be sheltered from creditors by reference to most state spendthrift trust laws, a section 541(c)(2) so limited would have given creditors direct access to spendthrift trust funds in excess of those reasonably necessary to provide for the debtor-beneficiary's support.[158] Since bankruptcy is the forum in which the truly decisive battles over such trust interests and assets are waged,[159] for all practical purposes trust settlors could only spendthrift for their beneficiaries an amount of property corresponding to the support needs of those beneficiaries.[160] Gray's "privileged class"[161] would have been transformed into a genus of some privilege, to be sure, but one perhaps a bit more attuned to the mantra "attention K-Mart shoppers."

155. Unlike the Commission's recommendation to limit the § 541(c)(2) exclusion and the Senate's embracement of that recommendation, it has never been seriously considered that the Bankruptcy Code would not include some provision recognizing the traditional spendthrift trust, and therefore the mere existence of section 541(c)(2) as a federal influence upon the paradigm does not warrant further discussion.

156. *See supra* note 82 and accompanying text.

157. Costigan, *supra* note 15, at 483.

158. *See* 11 U.S.C. § 541(c)(1) (2001).

159. This is because of the expansive nature of the bankruptcy estate as affected by the federal bankruptcy courts' broad powers to marshal debtor assets. *See Roundtable Discussion*, *supra* note 122, at 785 (discussing asset protection trusts and noting that "bankruptcy courts are really going to be the battle ground on these things"). With regard to how a debtor-creditor action might come to be governed by federal bankruptcy laws, see *supra* note 122.

160. *See Roundtable Discussion*, *supra* note 122, at 828.

161. *See supra* note 54 and accompanying text.

Alas, although adopted wholesale by the Senate, the Commission's recommendation was not reflected in the House version of the new bankruptcy legislation that ultimately became law.[162] The legislative history of the completed 1978 Code contains no meaningful discussion of the issue,[163] so it is left to speculation as to whether this omission was ultimately the result of considered rejection of the Commission's opinion or simple compromise attributable to political expediency which cast in an unfavorable light the task of reconciling the difficult federalism and other policy choices implicated in the competing House and Senate versions of the pending legislation. What is clear, however, is that (1) the paradigms were threatened by the prospect of fundamental limitation, (2) the issue was ripe for federal consideration upon having been placed squarely before Congress as part of major new bankruptcy legislation, (3) the opportunity was ultimately passed over without explanation, and thus, (4) the asset protection afforded by virtue of spendthrifted trust interests was ultimately permitted to continue its evolution within the wide-open bounds permitted under section 541(c)(2).[164] The federal influence wrought by rejecting an invitation to considerably narrow the parameters of the asset protection offered under the paradigms is important. It is, at the very least, an event of federal shaping of the paradigms through considered omission. That omission lies in Congress contemplating, but ultimately abstaining from, imposing any purposive limitations upon the federal avenues pursuant to which spendthrift trust asset protection maintains its viability.[165] This congressional passivity becomes a bit more aggressive, however, when attention is paid to the attitudes clearly fostered under the chosen bankruptcy exemption scheme, as explored next.

2. Fostering Perceptions Through the Exemption Opt-Out

Turning now to the second avenue by which property might be sheltered from creditor claims in a federal bankruptcy proceeding, a brief examination of the approach to exemptions under federal bankruptcy law reveals a history of considerable deference to federalism concerns. That deference is manifest in consistent rejection of calls for

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162. *See* H.R. REP. NO. 95-595, at 367-69 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6323-6325; *see also* 124 CONG. REC. H11,096 at 32395 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

163. *See generally* 124 CONG. REC. H11,096 (daily ed. Sept. 28, 1978); 124 CONG. REC S17,413 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini).

164. *See* 11 U.S.C. § 541(c)(2) (2000). *See generally* H.R. REP. NO. 95-595; 124 CONG. REC. H11,096 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,413 (daily ed. Oct. 6, 1978).

165. *See supra* note 163.

the uniform delineation of property that may be exempted in a federal bankruptcy proceeding.[166] Analysis consistently suggests that uniformity would eliminate instances of manipulative conduct that are so critical in cultivating perceptions that unfairness and lax boundaries abound in the pursuit of liability avoidance.[167] These perceptions have inspired the Self-Settled Paradigm. Unlike the general appeal to the bare existence of exemption laws in *Nichols*, however, the reference here is more pointed in its contemplation of the particular "opt-out" exemption scheme embraced by Congress.[168]

Specifically, once property is included in the bankruptcy estate, it may nevertheless escape the reach of creditors by virtue of certain exemptions provided for under section 522(b) of the 1978 Code.[169] Section 522(b)(1) provides that a debtor may exempt the property described on a list of federal exemptions set forth in section 522(d) of the 1978 Code, "unless the State law that is applicable to the debtor . . . specifically does not so authorize . . . ."[170] The laws of approximately thirty-five states specifically do not so authorize—in other words, those states have "opted out" of the federal exemption list in accordance with the foregoing federal statutory language.[171] A debtor residing in one of those "opt-out states" is limited under section 522(b)(2) to the exemptions provided for under that state's laws, plus a handful of exemptions called for under federal laws other than the 1978 Code.[172]

166. Although the United States Constitution article I, § 8, clause 4, confers upon Congress the power to promulgate "uniform laws concerning bankruptcy," the Supreme Court has concluded that the Constitution permits (but does not require) deference to state laws, despite the result that a debtor in one state might receive different treatment in bankruptcy than a debtor residing in a different state. *See* Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 187-88 (1902). Instead, all that is required is "geographical uniformity," which will be deemed to exist where: "(i) the substantive law applied in a bankruptcy case conforms to that applied outside of bankruptcy under state law; (ii) the same law is applied to all debtors within a state and to their creditors; and (iii) Congress uniformly delegates to the states the power to fix those laws." Tabb, *supra* note 43, at 47; *see also* 1997 FINAL REPORT, *supra* note 43, at 118-19 (discussing *Hanover* and noting that "geographical uniformity did not change the fact that creditors of financially identical debtors would receive very different distributions in bankruptcy depending on where those debtors happened to live").

167. *See, e.g., infra* text accompanying note 191.

168. *See id.*

169. 11 U.S.C. § 522(b) (2000); *see* S. REP. NO. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868. Section 522(b) of the 1978 Code is hereinafter referred to as "§ 522(b)."

170. 11 U.S.C. § 522(b)(1).

171. *See* 5 COLLIER, *supra* note 132, ¶ 522.01.

172. 11 U.S.C. § 522(b)(2). In the limited number of states that have not opted-out, debtors may choose *either* the federal exemptions referenced under § 522(b)(1) and set forth in § 522(d), or the state and nonbankruptcy federal law exemptions described in § 522(b)(2). This further dilutes the impact of the federal exemption scheme under the 1978 Code. *See generally* 5 COLLIER, *supra* note 132, ¶ 522.02(1). For a list of the "opt-out" states, see *id.* ¶ 522.01 n.2. *See also* NAT'L BANKR.

3. Exemption Planning

This scheme fosters a longstanding and prevalent asset protection technique in the bankruptcy arena that is often referred to as "exemption planning."[173] The general objective of exemption planning is to convert property that would otherwise be subject to creditor claims by virtue of its inclusion in the bankruptcy estate and the inapplicability of any exemption, into property that qualifies for an exemption under the relevant bankruptcy rules.[174] Under the opt-out scheme, such planning often entails the debtor's relocating to a state that offers more generous exemption laws, thereby expanding the nature and extent of property that may be shielded from creditor claims.[175] There is a clear cross-influence between the availability of this type of planning in the bankruptcy context with similar planning in the trust field.[176] For example, consider one recent commentator's juxtaposition of this idea in noting that "[i]t is not at all clear why [bankruptcy] exemption planning should be regarded differently than other legitimate forms of estate

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REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT 299-301 (1997) (setting forth state-by-state designation of homestead exemption and opt-out status in table form). Federal nonbankruptcy laws provide exemptions for social security benefits, 42 U.S.C. § 407, and other federal benefits such as those paid in retirement to civil servants, 5 U.S.C. § 8346 (2000). *See* 5 COLLIER, *supra* note 132, ¶ 522.02(3); *In re* Goff, 706 F.2d 574 (5th Cir. 1983). For a discussion of the operation of these federal exemptions under the Bankruptcy Act of 1898, see generally Vern Countryman, *For a New Exemption Policy in Bankruptcy*, 14 RUTGERS L. REV. 678, 738-40 (1960).

173. *See* Lawrence Ponoroff, *Exemption Limitations: A Tale of Two Solutions*, 71 AM. BANKR. L.J. 221, 227-33 (1997).

174. *See generally id.* ("'Exemption planning' . . . entails the deliberate effort on the part of a financially beleaguered debtor to liquidate assets that are not exempt from the claims of general creditors and then use the proceeds . . . to purchase, make improvements upon, or pay down existing encumbrances on assets that are exempt . . . ."). Exemption planning is also sometimes denominated "bankruptcy estate planning." *See, e.g.*, Cole, *supra* note 98, at 248-49 ("Bankruptcy estate planning consists of the sheltering of assets through the conversion of nonexempt property in the state of origin to exempt property in the destination state."). The term "prebankruptcy planning" is also sometimes used to refer more generally to the exercise of seeking to retain for the debtor property that might otherwise be available for satisfaction of creditor claims in the absence of such planning. *See* Brown, *supra* note 98, at 163-70, 187 (defining "exemption planning" as a more specific category of "prebankruptcy planning"). Exemption planning is also sometimes referred to as "asset conversion," denoting the converting of property into a form which falls within the applicable list of exempt property.

175. *See* Cole, *supra* note 98, at 230-31.

> What makes jurisdiction jumping both possible and attractive . . . is the conjunction of two facts: states vary dramatically as to the types and extent of property they deem exempt . . . and federal bankruptcy law operates as a procedural device for the orderly resolution of disputes and claims on a debtor's property, while generally leaving undisturbed the rights created by state property law . . . . [This] has created an environment in which debtors are capable of choosing the regime that provides for the most advantageous disposition of their property.

176. *See* Ponoroff, *supra* note 173, at 234.

planning and wealth preservation."[177] Of course, estate planning and wealth preservation are the traditional realm of the spendthrift trust.[178]

The homestead exemption in particular evinces the rewards of forum shopping in the context of exemption planning. Homestead property generally consists of a debtor's equity in her primary residence and perhaps some surrounding acreage, although specific definitions vary widely between states relative to one another and relative to the federal homestead exemption available where no opt-out occurs.[179] A matter of particular variation across jurisdictions is the value of homestead property that may be exempted.[180] The dollar values subject to exemption range from zero to infinity.[181] Herein lies the prospect of forum shopping resulting in significant asset protection advantages. Specifically, a solvent but troubled debtor residing in a state permitting a nominal homestead exemption might relocate to a state that provides for an unlimited homestead exemption. As part of this process, nonexempt assets might be liquidated or otherwise utilized to purchase equity in the now protected homestead property.[182] If bankruptcy does ultimately ensue, it is quite likely that the debtor can emerge from this process

177. *Id.* at 235.

178. Preserving assets from creditor claims and beneficiary improvidence has long been a tenant of trust and estate planning for the transfer and ongoing management of wealth. *See, e.g.*, Jonathan Blattmachr et al., *Trusts and Estates: Alaska's Revision of Its Trust Act, Which Sets Out to Permit Trusts to Preserve Assets and Reduce Taxes, May Have Implications for Trust Planning Nationwide*, NAT'L L.J., June 6, 1997, at B5 ("Two common goals in estate planning are estate tax reduction and protection of assets from claims of creditors."); Joseph A. Field, *Asset Protection Planning—A Look at Some of the Drawbacks—The Case Against*, *in* WALTER H. DIAMOND & DOROTHY B. DIAMOND, 1 INTERNATIONAL TRUST LAWS AND ANALYSIS ¶ 2001, at INT 201-07 (1999) ("[T]his type of [asset protection] planning is really nothing more or less than fine tuning of 'plain vanilla' trust structuring, which practitioners have undertaken for centuries in one form or another.").

179. Under the federal exemption list, a debtor may exempt "up to $15,000 in value, in real or personal property that the debtor or dependent of the debtor uses as a residence." 11 U.S.C. § 522(d)(1). Recall that the federal homestead exemption is inapplicable to debtors in thirty-four states and to those debtor's who elect their state law exemptions over the federal exemptions.

180. Five states and the District of Columbia currently place no limit on the amount of homestead property that may be exempted, while twenty-two states limit the exemption to $15,000 or less. *See* Letter from Barry Adler, Professor, New York School of Law, et al., to Patrick Leahy, U.S. Senator, and F. James Sensenbrenner, U.S. Congressman, *available at* http://www.abiworld.org/research/homeletter52202.html (last visited Oct. 1, 2002) [hereinafter Professors' Letter]. The states having unlimited homestead exemption are Florida, Iowa, Kansas, Texas, and South Dakota, whereas Maryland law, for example, has no provision for a homestead exemption. California, like many states, falls somewhere in between by providing for a homestead exemption capped at $75,000 in value. For a listing of state homestead exemption amounts and related treatments, see 1997 FINAL REPORT, *supra* note 43, Annex D, at 299-301.

181. *See id.*

182. *See* Professors' Letter, *supra* note 180, at 2.

discharged of her pre-bankruptcy obligations, yet still possessed of the homestead property and the value thereby represented.[183]

4. Attention Without Action

There can be little doubt that the prospect of such manipulation has been the subject of much congressional attention, but again, limited congressional action. For example, there have been two serious reconsiderations of the exemption issue by Congressional Commissions in the last thirty years. The first reconsideration informed the current 1978 Code exemption framework, and the second has informed legislative activity of more recent origin.[184] Regarding the first, the Commission on Bankruptcy Laws recommended in 1973 that a set of uniform federal exemptions be adopted in lieu of the state exemption opt-out scheme.[185] The 1973 Commission Report specifically pointed out that "[a]s a result of the . . . deference to . . . state law as to exemptions, . . . the exemptions available are not the result of reasoned policy but the happenstance of history and location."[186] Yet Congress chose in the 1978 Code to continue deferring to state exemption laws through the opt-out mechanism, notwithstanding such concerns.[187]

183. *See generally* Ponoroff, *supra* note 173, at 288-91 (discussing case law typifying "the relocation controversy" common to this type of homestead exemption planning). *See* Cole, *supra* note 98, at 230-36 (discussing the problem of "deadbeat jurisdiction jumping" accompanying this "forum shopping phenomenon").

184. With regard to the establishment of the first Congressional Commission, see the 1973 Commission Report, *supra* note 148. Concerning the establishment of the later Congressional Commission, see the 1997 FINAL REPORT, *supra* note 43.

185. *See* 1973 Commission Report, *supra* note 148, at 11.

186. 1973 Commission Report, *supra* note 148; COLLIER, *supra* note 132, app. 4-421. This can be attributed to the historical deference to state law exemptions and, as to location, because the exemptions available to a debtor are those granted by the state of the debtor's domicile at or near the time the bankruptcy proceeding is commenced. With respect to the historical aspect of exemptions, see generally Woodward, *supra* note 138, at 336-45 (discussing the history of exemptions in bankruptcy). As to domicile determining the state to which reference is made for exemption availability, see 11 U.S.C. § 522(b)(2)(A) (2000) and *infra* notes 197-99.

187. The reasons are most likely political and historical, as Congress has twice exercised its constitutional authority to specify exclusively the property that would be exempt in a federal bankruptcy proceeding. However, the resulting 1800s legislation was short-lived, and in 1898 the matter of exemptions was expressly deferred to the states excepting only a small number of exemptions preserved for all debtors under federal law. The constitutional grant of authority with respect to bankruptcy is found in the United States Constitution article I, § 8, clause 4, discussed *supra* note 43. The first two federal bankruptcy acts are discussed *supra* note 45. *See* Bankruptcy Act of 1800, ch. 19, 2 Stat. 19, *repealed by* Act of Dec. 19, 1803; Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614; *see also* 1997 FINAL REPORT, *supra* note 43, at 118 (discussing this history). It would be inaccurate to say that the matter of exemptions was *wholly* deferred to the states under the 1898 Act, as (with current practice) a few exemptions were preserved in federal laws that were not part of the 1898 Act. The merits of Congress' choice of

Returning more pointedly to ideas of fairness and the perceptions that have helped shape the development of the Self-Settled Paradigm most specifically at issue in this Part III, the second Congressional Commission of recent decades to take a comprehensive look at the federal bankruptcy system issued a telling Final Report in 1997.[188] That document presents a current analysis of the ramifications of the 1978 Code's opt-out exemption scheme.[189] The analysis is particularly insightful when evaluated by reference to the parallel concerns voiced in objection to the recent rise of the Self-Settled Paradigm and the exemption/spendthrift trust analogy posited in *Nichols*.[190] Specifically, the 1997 Commission concluded that under the opt-out bankruptcy exemption scheme:

> Debtors with roughly equivalent economic profiles and similar property are receiving vastly dissimilar treatment through the federal bankruptcy system, and correspondingly their creditors do as well. A debtor who cannot save a car, a home, and household furniture under one state's exemption laws may look across the state line to see a similar debtor saving all of those items and more . . . .
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> In deferring to state law exemptions, the current system also multiplies the opportunities for forum shopping and prebankruptcy asset conversion.[191]

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methods here and the federalism issues thereby raised continue to be the subject of considerable academic commentary the likes of which are not the object of this Article. Instead, confronting certain consciously accepted and clearly recognized ramifications of that federal choice is the focus here, as an aspect of the federal influence upon the development of the Self-Settled Paradigm. For academic commentary spanning five decades on this exemption issue, for example, Marier, *supra* note 45, at 666; Vukowich, *supra* note 96, at 790; Woodward, *supra* note 138, at 335; Brown, *supra* note 98, at 163-70; Cole, *supra* note 98, at 227.

188. *See generally* 1997 FINAL REPORT, *supra* note 43.

189. *See id.* at 121-25.

190. Concerning that analogy, see *supra* Part II.C.2. For criticism of the growing affinity for self-settled trust protection, see, for example, Sterk, *supra* note 8, at 1041, and Henry J. Lischer, *Domestic Asset Protection Trusts: Pallbearers to Liability?*, 35 REAL PROP., PROB. & TR. J. 479, 534-36 (Fall 2000). *See also* Randall J. Gingiss, *Putting a Stop to "Asset Protection" Trusts*, 51 BAYLOR L. REV. 987 (1999).

191. 1997 FINAL REPORT, *supra* note 43, at 122-23. With regard to similar concerns voiced in connection with regard to self-settled asset protection trusts, see Lischer, *supra* note 190, at ("If the APT were to be respected . . . it would permit the wealthy to avoid their debts . . . in a way that those of less wealth could not . . . [and would thus] degrade the public perception of the duty to pay one's debts."); Sterk, *supra* note 8, at 1086-87 (discussing forum shopping in the context of offshore asset protection trusts); GRAY, RESTRAINTS, *supra* note 1, § 262 (condemning spendthrift trusts generally as promoting "a privileged class" and "the most contemptible aristocracy").

Yet only recently have such objections moved Congress with respect to bankruptcy exemption laws.[192] For example, the homestead exemption planning opportunity appears to have finally garnered a limited congressional response, although many potential abuses remain.[193] Specifically, under federal bankruptcy legislation recently passed by both houses of Congress, ("Bankruptcy Amendments")[194] forum shopping by means of relocating to a state with more generous exemption laws must be undertaken well in advance of filing the bankruptcy petition if the laws of the new domiciliary state are to govern exemption issues.[195] The Senate's call for a more generally applicable and nationally uniform dollar cap on the homestead exemption was not

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192. *See, e.g.*, *infra* notes 194-95 and accompanying text.

193. The planning opportunity is significant, as shown by the substantial variation in values permitted to be sheltered in different states, as discussed *supra* note 180. For a critical examination of asset conversion opportunities, including this homestead exemption planning opportunity, see generally Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. REV. 235 (1995).

194. Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 333, 107th Cong. (Mar. 1, 2001) (The House of Representatives passed this Act by a vote of 306 to 108). A modified version of the House Bill passed the Senate by a vote of 82 to 16, and was denominated simply the "Bankruptcy Reform Act of 2001." H.R. 333, 107th Cong. (July 17, 2001) (as amended by S. Amend. 974 and S. Amend. 977). The events of September 11, 2001, resulted in a postponement of a formal meeting of a joint House-Senate conference, originally scheduled for that day to reconcile the status of the bills. Reni Gertner, *Bankruptcy, HMO Reforms are Stalled After Terrorists Attacks*, LAW. WKLY USA, Oct. 15, 2001, at 1. The conference meeting did ultimately occur in the Spring of 2002. Despite compromise on all other significant outstanding issues, including those aspects specifically at issue in this Article, the bill now appears to be stalled by a single ideological battle over the protection to be afforded certain abortion protestors. *See* Letter from Dick Armey, U.S. Congressman, to Thomas Daschle, U.S. Senator (May 12, 2002), *available at* http://www.freedom.gov/library/economics/bankletter.asp (last visited Oct. 1, 2002); *Conference Committee Reaches Agreement on Bankruptcy Reform*, LAW. WKLY USA, May 13, 2002, at 12. Virtually identical legislation was twice vetoed by President Clinton, but now enjoys the support of President Bush, who has indicated he will sign the legislation if presented to him. Sheila Creaton, *Pro-Creditor Bankruptcy Reform Moves Quickly Through Congress*, LAW. WKLY USA, Feb. 19, 2001, at 1.

195. Under current law (i.e., without regard to the Bankruptcy Amendments), a debtor relocating to a state with a more generous homestead exemption would get the benefit of that state's law if the debtor resided in that state for ninety-one of the 180 days prior to filing—in other words, forum shopping could result in significant advantages if the debtor relocated ninety-one days in advance of filing. 11 U.S.C. § 522(b)(2)(A) (2000). Under the Bankruptcy Amendments as passed by both the House and Senate, a change in domicile would need to occur a full two years prior to filing if the exemption laws of the new domicile are to govern. *See* H.R. 333 § 307 (House version); H.R. 333 § 307 (Senate version). Through the reconciliation process this period has been extended to forty months with respect to homestead property in excess of $125,000 in value. *See Congress Reaches Homestead Compromise*, 11 CONSUMER BANKR. NEWS No. 17, May 16, 2002, LEXIS, News Library, News Group File, [hereinafter *Homestead Compromise*]; *Conference Committee Reaches Agreement on Bankruptcy Reform*, *supra* note 194.

embraced, however.[196] Accordingly, while the new provisions appear to limit the utility of some of the more egregious "eve-of-bankruptcy" asset conversions by checking the temporal aspects thereof, the opportunity remains for a debtor not in immediate bankruptcy peril to avail herself of an unlimited homestead exemption by changing domiciles sufficiently in advance of filing.[197] It thus appears that little will change in the realm of perceptions engendered by a federal bankruptcy system that continues to reward the forum shopping efforts of well-advised debtors.[198]

5. Equating the Planning Opportunities

Notwithstanding the noted but limited statutory modifications of homestead exemption planning through change of domicile, the multi-forum exemption framework has prevailed for over one hundred years despite intense scrutiny and revisitation over the last three decades.[199] A strong argument can be made that the perceptions attendant the prospect of such forum shopping, as permitted to continue under the 1978 Code's exemption framework, have exerted a discernable measure of influence upon the growing prevalence of asset protection over the last few

196. The Senate had proposed a firm $125,000 cap on the amount of homestead property to be exempted for any debtor, regardless of the length of the debtor's residency in a particular state. *See* H.R. 333 (Senate version). The House version of the legislation contemplated a $100,000 exemption cap with respect to homestead property acquired within two years of the filing of the bankruptcy petition, with a seven year "look back" provision where fraud or abuse was deemed to have occurred. *See* H.R. 333 § 308 (House version) (instituting "look back" provision); H.R. 333 § 322 (House version) (instituting $100,000 cap); *see also Enron's Texas Home Puts New Fuel in Case to Limit Homestead Exemption*, 14 BANKR. L REP. (BNA) No. 10, at S6 (March 7, 2002) (discussing House-Senate disagreement on this issue and the competing proposals); *House GOP Courts Senate Democrats with Bankruptcy Legislation Compromise*, 13 BANKR. L. REP. (BNA) No. 9, at 225-26 (Feb. 28, 2002) (same). Through compromise agreement, the 1978 Code would provide that the homestead exemption remains unlimited where state law permits, except in the case of a debtor convicted of a felony or certain types of fraud, in which event the $125,000 cap will apply notwithstanding state law. *See Homestead Compromise*, *supra* note 195. That cap will also apply during the first forty months that a debtor resides in a state that permits homestead property to be exempted in an amount in excess of $125,000. *See id.; see also Conference Committee Reaches Agreement on Bankruptcy Reform*, *supra* note 194. Subject only to narrow exceptions, then, the Bankruptcy Amendments and the resulting House-Senate compromise fail to include a generally applicable federal cap on the amount of homestead value that can be exempted when the residence requirement has been met, thus leaving intact the unlimited homestead exemptions available to debtors residing (for a sufficient time in advance of filing) in Florida, Iowa, Kansas, Texas, South Dakota or the District of Columbia.

197. Actually, the Bankruptcy Amendments pose new forum shopping problems (or opportunities) for the well-advised, as outlined in the Professors' Letter, *supra* note 180.

198. *See, e.g.*, Professors' Letter, *supra* note 180 ("[T]he compromise compounds the unfairness of the homestead exemption . . . . [T]he wealthy and the well-counseled continue to find complete shelter from their creditors in a few states . . . . [I]t almost certainly will lead to new headlines and new scandal . . . .").

199. *See, e.g.*, *id.*

decades.[200] The only practical difference between homestead exemption and trust asset protection planning is that forum shopping in the exemption context requires a change of domicile, whereas forum shopping in the asset protection trust context requires, in the first instance, only that a trust's situs be carefully selected.[201] Indeed, the limited nature of the congressional response to homestead exemption planning—in light of the significant commentary long accompanying consideration of that issue[202]—provides a potent frame of reference for those who argue that there is absolutely nothing objectionable about a solvent individual setting aside a "nest egg" in a self-settled asset-protection trust where no creditors are looming on the horizon.[203] A belief that individuals concerned about liability exposure would equate the two planning opportunities is anything but tenuous.

Metaphorically, one could say that the bankruptcy exemption planning "fertilization" of the asset protection trust landscape is rooted in the association between the two areas and the apparent congressional unwillingness to supplant federalism deference by embracing a uniform exemption scheme that would ameliorate the benefits of debtor forum shopping.[204] Indeed, the proper boundaries of acceptable asset protection

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200. With respect to the perceptions engendered by the 1978 Code's exemption framework, see Brown, *supra* note 98, at 194 ("From a policy view ... a system that allows such disparate treatment of exemption planning that both debtors and creditors may have an expectation that bankruptcy laws permit abuse is destructive."); Ponoroff, *supra* note 173, at 235 & n.70 ("[T]he more high-profile and notorious cases [of exemption planning] ... even if not outright abusive ... do present problems in that they create the impression in the public mind that the whole system is tilted and unfair."); Adam J. Hirsch, *Inheritance and Bankruptcy: The Meaning of the "Fresh Start,"* 45 HAST. L.J. 175, 245 n.236 (1994) ("There does in fact appear to be a popular perception that bankruptcy is frequently abused by the well-to-do.").

201. With regard to trust situs, see *supra* note 114. Actually, a change of settlor domicile could still prove beneficial in the trust context. Specifically, the most certain asset protection obtainable domestically through a self-settled spendthrift trust would be that available to a settlor establishing her domicile in one of the states that expressly recognizes self-settled spendthrift trusts as effective against the claims of the settlor's creditors. In such a case, the conflict of laws issues would be minimized, thus similarly minimizing the policy bases for setting aside the trust in a bankruptcy proceeding. Regarding conflict of law and policy issues, see *supra* note 142.

202. *See supra* notes 173-93 and accompanying text.

203. *See, e.g.*, *Roundtable Discussion*, *supra* note 122, at 807-08 (reflecting views of noted asset protection attorney concerning the nest-egging concept, and the standard advice that "something has to be left on the table").

204. On the federalism issue, compare the positions of Senators Hatch and Kohl in debating the Bankruptcy Amendments. 147 CONG. REC. S2329 (daily ed. Mar. 15, 2001) (statement of Sen. Hatch) ("States have the right to set the homestead cap rather than the Federal Governement."); 147 CONG. REC. S2329-30 (daily ed. Mar. 15, 2001) (statement of Sen. Kohl) ("[B]ankruptcy is a Federal proceeding that occurs in Federal courts .... The argument that every State should be allowed to set an unlimited exemption if they so wish is not logical because it is not a States' rights issue."). For a more analytical, less ideologically biased perspective on the Bankruptcy

planning in both the trust and bankruptcy contexts are generally defined only as a matter of degree, with the obligation to repay one's debts versus maximizing wealth preservation opportunities available under the prevailing legal framework yielding moral judgments that are ambiguous, at best, with respect to less egregious conduct.[205] Ergo, to the extent the bankruptcy framework results in disparate treatment for similarly situated debtors, the perception is created that there is considerable asset protection advantage to be had by those willing to pursue it—and that doing so is not only acceptable, but wise. The fostering of such perceptions is not confined to the federal bankruptcy framework, however. These perceptions have also been enhanced by federal activities in the tax policy arena, as considered next.

C. A Taxing Perspective

Both logic and the period perspective adopted here suggest that a tax policy view of the offshore asset protection trust movement be considered in the context of the 1970s-forward period emphasized above with respect to federal bankruptcy policies. As to logic, it was in the mid-1970s that the movement of funds "offshore"—used here to mean out of the U.S. financial system, at least directly, and into the financial system of a foreign jurisdiction—motivated congressional action directed at the offshore trust financial vehicle, with subsequent actions culminating in a substantial revisitation of the issue in the late 1990s.[206] An examination of certain federal endeavors undertaken during this period illuminates the environment which helped foster the recent domestic self-settled APT movement that has so significantly abrogated whatever inhibitions may have previously constrained the development of the Self-Settled Paradigm within the United States legal system.[207] In particular, Congress' almost exclusive attention to offshore trust *tax* ramifications and motivations—both in 1976 and when those issues again rose to the forefront almost twenty years later—played a subtle but nonetheless important role in the development of the APT arena and the Self-Settled Paradigm in particular.[208] Explored next are the ramifications

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Amendment's approach to the homestead exemption issue that clearly supports the uniform federal exemption position, see generally the Professors' Letter, *supra* note 180.

205. *See* Hirsch, *supra* note 200, at 227 ("[M]oral analysis of debtor behavior is today steeped in ambiguity.").

206. *See, e.g.*, 147 CONG. REC. S2329-30, *supra* note 204.

207. *See* discussion *supra* Part III.A.

208. This is not to say that the federal government is inattentive to the more pervasive aspects of the global financial economy generally, but rather the suggestion is that with respect to the

of that focus upon tax considerations to the exclusion of the developing asset protection momentum.

1. Blunting the Offshore Tax Motive

Growing attentiveness to the offshore trust phenomenon culminated in 1976 amendments to the Internal Revenue Code ("I.R.C.") provisions that address the taxation of offshore trusts, or more technically, "foreign trusts" settled by "United States persons."[209] Prior to these amendments, it was generally possible for a U.S. person to utilize an offshore trust vehicle to manage assets and to accumulate income tax-free.[210] Specifically, a U.S. person could create and fund an offshore trust having U.S.-person beneficiaries (which often included the settlor), and if the trust were properly structured and administered, income generated by the trust property and accumulated within the trust would not be subject to taxation by the United States government.[211] An important

offshore trust vehicle specifically, the approach has been one focused upon tax avoidance and revenue maintenance. As to the global financial environment and looking outside the more limited context of offshore asset protection trusts, no less than three Congressional Committees, the Federal Reserve, the GAO, the Comptroller of the Currency, the Treasury Department, and the U.S. Attorney's Office have recently investigated issues relating to currency movement, money laundering and the "regulatory nightmare" that has become private banking on a global scale. *See* S.C. Gwynne, *Just Hide Me the Money*, TIME, Dec. 14, 1998, at 46.

209. In tax parlance, the type of offshore trusts discussed in this Article—namely, those created by a U.S. citizen or resident but sitused in a non-U.S. jurisdiction and not directly subject to primary supervision by any court in the United States—fall under the tax category of "foreign trust," a technical term now defined by joint operation of I.R.C. § 7701(a)(30)(E) and (a)(31) to include any trust which is not a "United States person." A trust is a U.S. person—and therefore not a foreign trust—only if: "(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more United States persons have the authority to control all substantial decisions of the trust." I.R.C. § 7701(a)(30)(E) (1999). Prior to the 1996 statutory amendment, the classification of a trust as foreign or domestic was less clear and generally turned upon the balancing of certain factors. *See* Carlyn S. McCaffrey, *Fencing in TaxTravelers—The New Foreign Trust Rules*, 31 U. MIAMI SCH. OF L. PHILIP E. HECKERLING INST. ON EST. PLAN. ¶ 1701.2 (Tina Hestrom Portundo ed., 1997) (discussing foreign trust status prior to 1996 legislative changes). With respect to individual natural persons, "[t]he term 'United States person' means . . . a citizen or resident of the United States." I.R.C. § 7701(a)(30)(A). "United States person" became a statutorily defined term effective in self-settled asset protection trusts in the Revenue Act of 1962, Pub. L. No. 87-834, § 7, 76 Stat. 960, 988 (1962), and the trust aspect of that definition was amended in the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755, 1904-08 (1996). The term "U.S. person" as used in this Article is intended to reference a person falling within the I.R.C. definition of a "United States person" and generally refers to natural person trust settlors or beneficiaries.

210. *See* Susan D. Harrington, *Planning for U.S. Beneficiaries of Foreign Trusts Under Recent Regs.*, EST. PLAN., June 2001, at 258.

211. *See id.* at 258-59 (explaining some of the particulars of how this outcome was achieved). Generally, however, distribution of trust income to a U.S. person beneficiary in the year in which

corollary to this offshore advantage was that the offshore jurisdictions most often utilized as the situs of such trusts were "tax-haven" jurisdictions that imposed little or no taxes of their own, elevating the offshore trust to what was effectively a tax-free vehicle for holding and accumulating wealth.[212]

Congress was thus concerned at the time of the 1976 foreign trust legislation that U.S. persons were establishing such trusts in order to accumulate income without tax liability, and that the ability to do so created an undesirable tax-motivated impetus for the creation of offshore trusts.[213] Confronted with such happenings, Congress in 1976 changed the income tax rules concerning foreign trusts settled by U.S. persons to provide that if such a trust had a U.S.-person beneficiary, the property transferred to the trust would be treated as if it were still owned by the U.S. settlor.[214] Therefore, in lieu of the tax-preferred offshore trust result occasioned under prior law, the effect of the 1976 legislation was to render such trusts subject to U.S. taxation under what are commonly referred to as the "grantor trust" rules.[215] The specific consequence was that income earned and accumulated within the trust was made taxable

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such income was earned by the trust would typically result in that income being taxed to the beneficiary. *See also* I.R.C. §§ 652, 662 (2001).

212. U.S. DEP'T OF TREASURY, DEPARTMENT OF TREASURY'S GENERAL EXPLANATION OF ADMINISTRATIONS REVENUE PROPOSALS, Mar. 20, 1996, LEXIS, FEDTAX Library, TNT File, Doc. 96-8483, [hereinafter *1996 Treasury Explanation*]. Moreover, this favorable tax regime was often coupled with strict bank-secrecy laws which made it difficult for creditors, including the Internal Revenue Service, to trace assets. *See id.; see also* Sterk, *supra* note 8, at 1048 ("Offshore trusts . . . remain popular with some American settlors, because financial institutions [there] . . . retain the . . . tradition of bank secrecy.") (footnote omitted). *But see* Maurice Offit, *The Truth About Offshore Asset Protection Trusts*, J. FIN. SERV. PROFS. 66, 66 (2000) (complaining by offshore trust proponent that "the word 'offshore' has a negative connotation, and a significant portion of the planning community mistakenly believes that offshore asset protection trusts are devices to illegally hide assets in tax-haven jurisdictions").

213. *See* Elena Marty-Nelson, *Taxing Offshore Asset Protection Trusts: Icing on the Cake?*, 15 VA. TAX REV. 399, 411 (1996).

214. *See* I.R.C. § 679(a) (2001) originally enacted as Pub. L. No. 94-455, § 1013(a), 90 Stat. 1520, 1614 (effective for taxable years ending in 1976 or later with respect to foreign trusts created or funded after May 21, 1974). For a discussion of this I.R.C. provision and its operation, see *1996 Treasury Explanation*, *supra* note 212, and Marty-Nelson, *supra* note 213, at 410-15. The discussion of foreign trusts presented in this Article is limited to so-called "outbound trusts," which are grantor trusts for U.S. tax purposes, meaning those foreign trusts created by U.S. persons, having at least one U.S. person beneficiary, and which are treated as owned by a U.S. person under the grantor trust rules discussed *infra* note 216. The tax consequences and legislative proposals pertaining to trusts created by non-U.S. persons is less germane and generally beyond the scope of this Article.

215. *See* Harrington, *supra* note 211, at 258.

to the U.S. settlor and not the tax-haven sitused trust entity.[216] In essence, for income tax purposes the offshore trust was ignored and the settlor was taxed as if the settlor and the trust were one and the same taxpayer, thus (allegedly) thwarting the opportunity for tax-free wealth accumulation via the offshore trust vehicle.[217]

Notwithstanding the operational effect of the 1976 legislation, the new tax rules generally did little to dissuade the establishment of foreign trusts, and in particular the "offshore asset protection trust" or "OAPT" as to which the settlor retained an interest as a beneficiary.[218] While this failure is addressed below,[219] it is sufficient to note here that from an *income* tax perspective, the new rules at best "leveled the field" between domestic and foreign trusts, but did not create any particular disadvantage to going offshore.[220] This is because the grantor trust rules were and remain broad in scope so as to similarly capture many domestic trusts in this settlor-taxed-as-owner scheme, thus placing such domestic trusts on equivalent (but not preferred) income tax footing with their foreign trust counterparts.[221] Moreover, crafting a foreign or

216. The provisions of I.R.C. §§ 671-79, which result in the taxation of trust income to the person funding the trust, are commonly known as the "grantor trust" rules, because a person treated as owner of trust property and so taxed is referred to under the I.R.C. for income tax purposes as a "grantor." I.R.C. § 671 (2001). In this Article, the funding individual is referred to as the trust "settlor." A trust as to which income is taxed to the grantor/settlor is typically referred to as a "defective" grantor trust, implying that such tax consequence is undesirable. This is because, prior to the advent of the grantor trust rules now set forth in I.R.C. §§ 671-679, a trust could be used to shift income from property to the beneficiaries of a trust and away from the grantor—thus, if a trust were established and the income still taxed to the grantor, this assignment of income objective was defeated and the trust was "defective." However, with the compression of the marginal tax rates for trusts such that the highest marginal tax rate applies to all trust income over $7,500, this result actually became desirable in many instances, leading to the advent of the "intentionally defective grantor trust." *Compare* I.R.C. § 1(e)(2) (providing that for the 2001 tax year, 39.6% tax rate applies to nondefective grantor trust's taxable income over $7,500), *with* I.R.C. § 1(c) (providing that for the 2001 tax year, an unmarried individual's taxable income—which would include income earned by a defective grantor trust as to which such individual was the deemed owner under §§ 671-79—is taxed at between 15% and 36% up to $250,000, and only income in excess of $250,000 is subjected to the higher 39.6% marginal tax rate). The apparent irony and tax planning advantages of the "intentionally defective" grantor trust are common knowledge among tax practitioners. Additional discussion of this concept in the context of the asset protection trust can be found in Marty-Nelson, *supra* note 213, at 406-07.

217. *See* I.R.C. § 697(a) (2001).

218. *See infra* notes 229-49 and accompanying text.

219. *See id.*

220. *See* Marty-Nelson, *supra* note 213, at 414-15 ("[T]he equally harsh tax treatment home and abroad for grantors of asset protection trusts renders moot any offshore deterrence effect of section 679 of the Code, legislative intent notwithstanding.").

221. *Compare* I.R.C. §§ 671-77 (delineating powers over or interests in a trust that will result in grantor trust status for any trust, including a domestic trust), *with* I.R.C. 679(a) ("A United States person who directly or indirectly transfers property to a foreign trust . . . shall be treated as the

domestic APT that fits within the Self-Settled Paradigm essentially guarantees grantor trust income tax treatment by virtue of the settlor's beneficial interest in the trust.[222] Therefore, while Congress may have at least equated the tax consequences of going offshore versus establishing a domestic trust, the federal initiative left intact other *nontax* advantages that favored going offshore.[223] Most notable among those advantages was the availability offshore of self-settled trust asset protection that was virtually unknown in U.S. jurisdictions prior to the 1997 Alaska legislation.[224] Ironically, those asset protection features of offshore jurisdictional trust laws provided settlors a unique *transfer* tax advantage under U.S. law, as discussed next.

2. The Income-Transfer Tax Dichotomy

Perceived weaknesses in the tax effectiveness of the 1976 legislation led to a subsequent federal response to the foreign trust movement that was once again tax-centric.[225] Similar to that prior legislative effort, the 1996 response focused upon altering the income tax rubric governing such trusts.[226] The perceived weaknesses in the earlier legislation that spurred this response are articulated succinctly in a 1996 Treasury Department explanation:

> U.S. tax rules applicable to foreign trusts have not been revised for nearly two decades. New rules are needed to accommodate changes in the use and incidence of foreign trusts and to limit the avoidance and evasion of U.S. taxes . . . .
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owner . . . of . . . such property . . . [for any tax year during which] there is a United States beneficiary of any portion of such trust."). *See* NORMAN H. LANE & HOWARD M. ZARITSKY, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS § 13.01 (3d ed. 2001); Marty-Nelson, *supra* note 213, at 406-12.

222. *See* I.R.C. § 673 (effecting grantor trust status with respect to certain retained rights in trust principal); *Id.* § 677 (same with respect to rights to trust income). Inclusion of the grantor's spouse as a beneficiary, perhaps in lieu of the grantor in order to circumvent these rules, was thwarted as a means to avoid application of the grantor trust rules by the expansion in 1986 of the grantor trust rules to include an interest held by the grantor's spouse. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1013(a), 90 Stat. 1520, 1615. *See generally* LANE & ZARITSKY, *supra* note 221, § 7.02 & n.8 (detailing development of the grantor trust rules beginning with the 1934 case of *Helvering v. Clifford*, 309 U.S. 331 (1940)).

223. *See* discussion *supra* Part III.A-B.

224. The domestic APT legislation is discussed in *supra* Part III.A.

225. *See 1996 Treasury Explanation*, *supra* note 212.

226. *See id.*

> U.S. grantors of foreign trusts often do not report the income earned by foreign trusts and often do not comply with required information reporting. These foreign trusts are frequently established in tax haven jurisdictions with stringent secrecy rules. Attempts by the IRS to verify income earned by foreign trusts are often met with silence or a representation that foreign secrecy laws prevent the U.S. taxpayer from obtaining required information. Existing penalties have not proven adequate to encourage some U.S. taxpayers to comply with existing rules.[227]

The referenced changes in the "use and incidence of foreign trusts" were known to span beyond the income tax issues contemplated under the grantor trust income tax rules and to encompass the more general asset protection being pursued through the use of these offshore trusts.[228] In fact, a few years before the foregoing Treasury Department explanation, the asset protection attributes of the laws of one offshore jurisdiction were, without critical analysis, confirmed in an IRS ruling as making available to a trust settlor certain desirable U.S. *transfer* tax consequences.[229] This OAPT transfer tax planning opportunity is perhaps

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227. *Id.* (emphasis added).

228. *See also infra* note 247 and accompanying text.

229. *See* Priv. Ltr. Rul. 9332006 (Aug. 20, 1992). The IRS is a division of the Treasury Department. *See also* Rev. Rul. 76-103, 1976-1 C.B. 293 (dealing with a self-settled discretionary trust that was deemed ineffective under applicable state law to protect trust assets from the claims of the settlor's creditors). As to the prior case law, see, for example, *Estate of Paxton v. Comm'r*, 86 T.C. 785, 808 (1986) (acknowledging and applying these principles); *Estate of German v. United States*, 7 Cl. Ct. 641, 642 (1985) (same); *Estate of Green v. Comm'r*, 64 T.C. 1049, 1061-63 (1975) (same); *In re Estate of Uhl*, 241 F.2d 867, 870 (7th Cir. 1957) (finding that state law did not clearly establish the rights of creditors to reach trust property, and, thus, that inclusion of trust property in the settlor's federal estate tax gross estate, by virtue of such creditors' alleged access to trust property, was improper); *Herzog v. Comm'r*, 116 F.2d 591 (2d Cir. 1941) (finding completed gift where creditors' rights under applicable state law were "in doubt" due to a lack of applicable precedent in the precise context of a self-settled trust). The accuracy and extent of the various courts' and the IRS inquiries into the asset protection aspects of state trust law is another issue entirely, and is explored in Eason, *supra* note 112, at 83-94 ("There is little indication in the IRS rulings that any detailed consideration would be given to potential arguments that a hypothetical creditor might assert in attempting to defeat the creditor protection purportedly offered under the laws of the jurisdiction selected by the settlor or trustee to govern the trust."). For example, in *Herzog*, the court noted the widely accepted Restatement principles in favor of creditor access to the trust property, but went out of its way to find the Restatement rule unpersuasive as to the *hypothetical* creditor's rights in the tax case at hand (where no actual creditor was claiming against the trust and seeking to thwart the trust protections), citing the more real presence of remainder beneficiaries under the trust as significant. 116 F.2d at 594. The court believed the Restatement rule to be based in large part on decisions where the settlor beneficiary was the sole beneficiary, in contrast to the circumstance before the court in which there were other beneficiaries of the trust. *See id. But see* Estate of Uhl v. Comm'r, 25 T.C. 22, 25 (1955) (distinguishing *Herzog* based upon lack of other trust beneficiaries in the case at hand), *rev'd*, 241 F.2d 867 (7th Cir. 1957). For the applicable Restatement rule, see 1 RESTATEMENT (SECOND) OF TRUSTS § 156 (1959).

best understood through consideration of the tax consequences of a self-settled trust that is *not* effective in sheltering trust assets from the settlor's creditors.[230] Specifically, it has long been a tenet of federal transfer taxation that property contributed to a trust will be deemed the subject of an incomplete gift and taxed as part of the settlor's gross estate at the settlor's death, if the settlor retained certain interests in, or controls over, the transferred property.[231] With respect to a trust falling within the Self-Settled Paradigm, the penalized retained interest or control is deemed to exist where the settlor's creditors have access to the trust property—in other words, negative transfer tax consequences pertain if the self-settled trust is *not* recognized as an effective asset protection device.[232] The theoretical justification for taxing such trust property to the settlor-beneficiary at her death is as follows: if the settlor's creditors can reach the trust property during the settlor's lifetime in order to satisfy the settlor's obligations, the settlor's original gifts to the trust are incomplete and the trust property is regarded as effectively "owned" by the settlor until death, because the settlor retained the ability (1) to enjoy the trust property and (2) to revoke the interests of other beneficiaries.[233] The settlor is deemed able to do this by incurring but failing to pay debts, thereby relegating creditors to the vulnerable trust property for satisfaction of their claims.[234] Prior to the 1997 Alaska legislation, such vulnerability and the attendant negative transfer tax consequences were inherent characteristics of a *domestic*

230. *See generally* Marty-Nelson, *supra* note 213.

231. I.R.C. § 2036(a)(1) (2001) brings into the settlor's gross estate transferred property if the settlor retains "the possession or enjoyment of, or right to the income from, the property." The purpose behind I.R.C. § 2036(a)(1) is to bring into a decedent's gross estate property transferred during life but in a manner akin to a testamentary transfer by virtue of the interests which the decedent retained in the property until the time of death. *See* Estate of Whitt v. Comm'r, 751 F.2d 1548, 1558 (11th Cir. 1985), *cert. denied*, 474 U.S. 1005 (1985). Also, under I.R.C. § 2038, property will be included in the settlor's gross estate where the settlor has retained a power "to alter, amend, revoke or terminate" any other person's beneficial enjoyment of the property. With respect to gifts, Treas. Reg. § 25.2511-2(b) (2002) provides: "As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon the transfer of property . . . the donor reserves any power over its disposition, the gift may be wholly . . . or . . . partially incomplete . . . ." For a detailed treatment of the estate tax issues pertaining to domestic and offshore asset protection trusts, see Eason, *supra* note 112, at 73-100.

232. For a more thorough discussion of the unified estate and gift tax statutory structure and the (un)desirability of incompleted gift status, see *Estate of Paxton*, 86 T.C. at 801-02 & n.8 (expressing concern over potential estate and gift tax "whipsaw" arguments that taxpayers sometimes assert).

233. *See, e.g.*, *Estate of German*, 7 Cl. Ct. at 642.

234. *See, e.g.*, Rev. Rul. 76-103, 1976-1 C.B. 293 (acknowledging and applying these principles); *Estate of German*, 7 Cl. Ct. at 642 (same); *Estate of Green*, 64 T.C. at 1061-63 (same).

self-settled trust, because neither spendthrift nor discretionary distribution provisions would be enforced against creditors of a settlor-beneficiary.[235] In contrast, if a settlor were to create a self-settled trust as to which protection from creditors were granted under the applicable *foreign* jurisdiction's laws (notwithstanding the settlor's status as a beneficiary of such trust), the gift would be deemed complete and the trust property would not be included in the settlor's gross estate at death.[236] Consequently, the transfer tax advantage of going offshore was clear.

The general unavailability of self-settled trust asset protection domestically, effectively meant that offshore asset protection laws presented a unique domestic transfer tax planning opportunity.[237] Moreover, the favorable IRS ruling on this very point was significant in the spread of OAPTs and their marketing, as evidenced by the fact that confirmation of similar transfer tax advantages for an Alaska APT was among the first orders of business for proponents of that domestic APT legislation.[238] In light of the other foreign trust *income* tax efforts undertaken by Congress in 1976[239] and again in 1996,[240] it is quite ironic that an OAPT could (until 1997) provide domestic *transfer* tax planning advantages by virtue of its unique self-settled but creditor-protected nature.[241] That the Alaska self-settled spendthrift trust legislation ultimately became the true "equalizer" between offshore and domestic trusts is telling with respect to federally inspired movements reflected in

235. See, in this regard, *supra* note 11.

236. *See supra* notes 229-35 and accompanying text.

237. *See* Marty Nelson, *supra* note 213, at 415.

> First, OAPTs [Offshore Asset Protection Trusts] allow for greater flexibility in qualifying for treatment as an intentional grantor trust, an instrument that maximizes the economic value of the transfer of assets to the trust. Second, the flexibility in casting a transfer of assets to an OAPT as a "gift," quite apart from qualifying for intentional grantor trust status, has tax-planning advantages in its own right.

Id.

238. The confirmation of such advantages with respect to the Alaska legislation came in Priv. Ltr. Rul. 9837007 (June 10, 1998). Counsel for the party requesting the ruling was Jonathan G. Blattmachr, one of the drafters of the Alaska legislation. *See* Daniel G. Shaftel, *Newest Developments in Alaska Law Encourage Use of Alaska Trusts*, 26 EST. PLAN. 51, 57 n.46 (1999). One commentator has stated that these transfer tax advantages were a significant factor in the Alaska decision to adopt asset protection trust legislation, although in truth the transfer tax advantages are simply one front upon which the domestic jurisdictions need to present themselves as viable alternatives to the offshore trust vehicle if they are to be competitive. *See Roundtable Discussion*, *supra* note 122, at 815.

239. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1013(a), 90 Stat. 1520, 1615 (1976).

240. Small Business Job Protection Act of 1996, Pub. L. No. 104-88, § 1901, 110 Stat. 1755 (1996).

241. *See* Marty-Nelson, *supra* note 213, at 401.

state-level asset protection decisions.[242] This seeming lack of federal concern with such potential ironies and outcomes is considered next.

3. One Dimensional Concern

There can be little question that the federal government had fixated on the offshore trust movement as of the decision in 1996 to substantially revise the foreign trust income tax rules.[243] In light of the confirmation of the foregoing transfer tax advantages tied to the asset protective features of OAPTs,[244] there can also be little question that the federal government had contemplated specifically the asset protection facet of that movement.[245] Nevertheless, the federal reaction seemed to focus on asset protection only to the extent it entailed protecting assets *from the reach of the IRS*.[246] The larger impact upon other areas of federal policy or interests received only casual mention outside the income tax-evasion context:

> According to the administration, the U.S. market for asset protection trusts is "exploding," but is believed to be fueled less by a desire to evade taxes than to protect assets from creditors. Once the assets are overseas, however, taxpayers soon realize that income generated in the overseas accounts—and protected by strict bank secrecy laws—can accumulate without the IRS's knowledge and, therefore, is not reported.[247]

As the foregoing synopsis foreshadows, the Clinton Administration's proposals and the resulting legislative and regulatory changes to address foreign trust issues were entirely income tax driven, with no discernable attempt to otherwise even contemplate the more general asset protection ramifications of the offshore trust movement.

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242. *See generally* Eason, *supra* note 112 (detailing the domestic responses to proliferation of OAPTs).

243. *See id.* at 51-52.

244. *See supra* notes 230-41 and accompanying text.

245. *See* Eason, *supra* note 112, at 51-52.

246. *See id.*

247. *See Administration Proposes AntiAbuse Rules for Foreign Trusts, Expatriation*, 66 TAX NOTES 915 (Feb. 13, 1995); *see also 1996 Treasury Explanation*, *supra* note 212; *Treasury Explanation of Clinton's Proposals to "Curb Foreign Tax Avoidance"*, TNT, Feb. 7, 1995, LEXIS, FEDTAX Library, TNT File, Doc. 95 TNT 25-42. In context, the "US market" refers to U.S. persons establishing trusts under the laws of offshore jurisdictions. *See also* Ryan Donmoyer, *Tax Principles Must Be Applied to Wired Economy, Richardson Says*, 72 TAX NOTES 1588 (Sept. 23, 1996) (noting IRS Commisioner's finding objectionable the idea that "asset protection" via a foreign trust might include protection from an IRS enforcement action). For a more detailed discussion of the federal government's activities in this area, and in particular the perspective of the Internal Revenue Service, see Eason, *supra* note 112, at 51-53.

Instead, the end result was legislative authorization for new income tax regulations that ultimately focused upon information reporting for the benefit of the IRS, the imposition of rather harsh penalties for noncompliance,[248] and revision of certain grantor trust rules to address perceived shortcomings of the then-existing income tax framework.[249]

Viewing the offshore trust movement from the vista of income tax revenue and tax-neutrality was not itself misplaced, but the federal government's singular perspective with respect to actions taken served to shift and then to solidify the lure of the "legitimate" offshore trust environment from one of tax advantage to one of asset protection. Indeed, the chairman of a Bahamian financial services corporation recently summarized the matter thusly: "we consider that, as a tax-advantaged vehicle, the offshore trust is now virtually useless and we no longer advocate that it should be used for any tax purpose."[250] Yet interest in the offshore trust has remained so strong that growth in the

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248. *See* I.R.C. § 679(d) (2001) ("The [Treasury Department] shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."). For an analysis of the regulations so promulgated, see Carlyn S. McCaffrey, *Taking the "Foreign" Out of Foreign Trusts*, 34 U. MIAMI SCH. OF L. PHILIP E. HECKERLING INST. ON EST. PLAN. ¶ 700 (Tina Hestrom Portundo ed., 2000); McCaffrey, *supra* note 210, ¶ 1700; Robert F. Hudson, Jr., *Loch Ness Monster or Komodo Dragons—Actual and Unexpected Results of the Foreign Trust Legislation of 1996/1997*, 32 U. MIAMI SCH. OF L. PHILIP E. HECKERLING INST. ON EST. PLAN. ¶ 1900 (Tina Hestrom Portundo ed., 1998).

249. *See* I.R.C. § 679(a)(5) (closing a loophole with respect to trusts originally treated as domestic but which convert to foreign trust status during the settlor-grantor's lifetime). Additional changes followed in 1997. *See* I.R.C. § 684, Pub. L. No. 105-34, § 1131(b), 111 Stat. 788, 978 (1995). I.R.C. § 684 was added as part of the Taxpayer Relief Act of 1997 and requires immediate gain recognition on the transfer of property transferred to a foreign trust as to which the owner is not a U.S. person under the grantor rules prescribed at I.R.C. §§ 671-679. However, this provision has no impact on the typical offshore asset protection trust, as the settlor-beneficiary of any such trust will be treated as the owner for purposes of the grantor trust rules. *See, e.g.*, I.R.C. §§ 674(a), 677(a).

250. David L. Lupi-Sher, *The IRS's Fight Against Abusive Offshore Trusts*, 88 TAX NOTES 162, 165 (July 10, 2000); *see also* Sterk, *supra* note 8, at 1048 ("Starting in the mid-1980s ... several offshore jurisdictions identified a new source of trust business: clients seeking to avoid not taxing authorities, but creditors."). The "legitimate" offshore trust environment should be contrasted with the "abusive" offshore trust environment, pursuant to which unscrupulous promoters and settlors alike tout offshore trusts as a means to evade (as distinguished from legitimately minimize) U.S. tax liabilities. "Abusive trust arrangements typically are promoted by the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets." I.R.S. Notice 97-24, 1997-1 C.B. 409 (warning also that "[t]axpayers should be aware that abusive trust arrangements will not produce the tax benefits advertised ... and that the Internal Revenue Service is actively examining these types of trust arrangements"); *see also* Senate Finance Committee Hearing on Tax Scams, relevant links available at LEXIS, Tax Analysts Library, Tax Publications File, Doc. 2001-9901.

Bahamian financial services industry continues to outpace that for tourism.[251]

A focus upon the income tax-motivated federal treatment of offshore trusts is revealing in its own right with respect to federal influence upon the burgeoning APT market. The federal nonresponse to the asset protection dynamic of which it was keenly aware is even more telling when considered in light of concurrent movements in the forum of federal bankruptcy legislation, as discussed above.[252] An important factor in this shift towards asset protection is that while the income tax advantages presented by the offshore trust were in large measure checked by congressional and Treasury Department initiatives, the asset protection promise of going offshore and its attendant transfer tax advantages were essentially left untouched. Those advantages included the potential transfer tax benefits noted above.[253] Such benefits were derived most assuredly by virtue of the asset protection features of carefully selected offshore trust law, as to which even a cursory examination of domestic trust law would have revealed no counterpart prior to 1997.[254] With the federal government providing competitive equalization through its pursuit of income tax neutrality on the tax front, in retrospect it seems almost inevitable that domestic state jurisdictions would exact their own measure of competitive equalization via the emerging dynamic of self-settled trust asset protection.[255] Of course, such hindsight is more easily grasped when formulated from the vista of federal influence upon the paradigms, and the development of that perspective has been a central theme of this Article. Having so progressed in that regard, attention now turns more pointedly to the insights and ramifications that flow from such a perspective.

IV. IMPLICATIONS OF THE FEDERAL VIEW ACROSS THE PARADIGMS

Although John Chipman Gray and others of his ilk present a historic and ongoing assault upon creditor-protected trust interests, pragmatically the status of such interests under current law appears to be

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251. *See The Bahamas Boasts Banking Bonanza*, LAW., Nov. 3, 1998, at 21 (noting growth in Bahamian financial services sector and citing new 1990's Bahamian trust legislation as important among the underlying causes).

252. *See generally supra* Part III.B.

253. *See supra* notes 229-35 and accompanying text.

254. *See* Friedman, *supra* note 5, at 572.

255. *See, e.g.*, ALASKA STAT. § 34.40.110 (Michie 2000).

the product of additional influences.[256] Among those influences is a palpable, sometimes considerable federal undercurrent that has over time and in varying degrees moved the dialogue and operative rules affecting both the Traditional and Self-Settled Paradigms.[257] The present status quo, for example, reveals a Traditional Paradigm long blessed at the federal level with the promise of deference under federal bankruptcy laws to state decisions concerning the parameters and acceptability of imposing restraints on the alienation of property conveyed in trust for the benefit of a third-party.[258] Likewise, the fiscal concerns underlying the federal treatment of the offshore trust industry, as well as the gamesmanship available under federalism's opt-out bankruptcy exemption scheme, have done little if not helped to inspire a burgeoning asset protection environment.[259] Consequently, it is not particularly surprising that domestic jurisdictions would attempt to capitalize upon this flow by fitting new self-settled asset protection trust wares within the section 541(c)(2) exclusion rule—a rule originally conceived against the backdrop of the Traditional Paradigm but hardly crafted so as to foreclose more expansive application.[260]

256. Regarding the statements of John Chipman Gray and others, see *supra* notes 1, 17, and 46-54, and the accompanying text.

257. *See generally* Part I.C. For a specific discussion of federal undercurrents in the reals of the Traditional and Self-Settled Paradigms, see Parts II and III, respectively.

258. *See* Tabb, *supra* note 43, at 13-14.

259. Those fiscal concerns and the opt-out exemption scheme are the primary focus of Part III. The consequently burgeoning asset protection environment is evidenced, for example, by Alaska's codification of self-settled asset protection provisions and the effect Alaska legislation has had on other states.

260. See *supra* note 142 and accompanying text regarding the applicability of the 1978 Code § 541(c)(2) to self-settled spendthrift trusts. Moreover, the applicability of the § 541(c)(2) exclusion to tax-qualified retirement plan interests—which are most often governed by a spendthrift restraint mandated under federal law—seems to have been little considered by Congress. Based upon that lack of consideration, it is not surprising that a split arose among the Federal Circuit Courts of Appeal when it came to applying that exclusion to spendthrifted ERISA pension trust interests. *See, e.g.*, Velis v. Kardanis, 949 F.2d 78, 79 (3d Cir. 1991) ("[T]he reported decisions are in disarray, as to whether 'applicable nonbankruptcy law' in this context was intended by Congress to be limited to state spendthrift trust law, or whether it embraces federal law as well."). That circuit split was ultimately resolved by the Supreme Court's holding in *Patterson v. Shumate*, 504 U.S. 753 (1992). The specific question raised in that case concerned ERISA's spendthrift mandate as constituting "applicable nonbankruptcy law," such that a retirement plan interest subject to the mandate would be immune from creditor attachment under the 1978 Code § 541(c)(2). With regard to this statutory language, see *supra* note 135 and accompanying text. The Court held that the § 541(c)(2) exclusion embraced such arrangements as spendthrifted under federal law. *See Patterson*, 504 U.S. at 765. See the discussion of ERISA and its attendant "Federal Retirement Paradigm" in note 103, *supra*.

A. Dynastic Privilege

Leaving such matters to the states has resulted in a framework with few limits on the amount of wealth that can be sheltered under the rubric of the Traditional Paradigm.[261] Although the prospect of curbing such deference to state laws by limiting the spendthrift trust bankruptcy exclusion to a needs-based standard was placed squarely on the congressional agenda under the Senate's proposed version of 1978 Code section 541(c)(2), by that time the entrenched nature of the Traditional Paradigm and the federalism concerns thereby implicated, trumped both the competing marshalling of assets/fresh start bankruptcy policies and the philosophical underpinnings of federal wealth transfer taxation espoused by some.[262] Indeed, *Nichols v. Eaton*[263] helped spur the acceptance of the traditional spendthrift trust as grounded not in respect for any beneficiary-specific policy consideration deemed sufficient to warrant a corresponding and measured degree of asset protection, but rather in respect for a donor's freedom to dispose of her property absolutely to a trustee, to be held for the benefit of whomever the donor chose to confer such largess upon and with due regard to the donor's decision to specifically withhold her generosity from such beneficiary's creditors.[264]

As to the philosophical arguments concerning federal wealth transfer taxation, some have posited that the relatively small revenue generated by such taxes implicates other underlying motivations for the levy over the course of its existence.[265] Cited in particular is the general concept of a democratic and capitalistic aversion to both privileged wealth and the perpetuation of accumulated capital through generations.[266] Yet, as recognized and condemned early-on by John Chipman Gray, it is by virtue of the Traditional Paradigm that privileged wealth coupled with asset protection is quite easily enjoyed (at least by

261. *See supra* Part II.B.

262. Regarding the Senate proposal, see Part III.B.1. As to wealth transfer taxation, see *infra* note 271 and accompanying text.

263. 91 U.S. 716 (1875).

264. *See id.* at 725, 727.

265. *See* Barbara A. Hauser, *Death Duties and Immortality: Why Civilization Needs Inheritances*, 34 REAL PROP. PROB., & TR. J. 363, 376-77, 384-87 (1999); Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69, 86-99 (1990). However, it should also be noted that this fiscal reality has been recently relied upon by some in calling for the repeal of the federal wealth transfer taxes, on grounds that the revenue generated does not justify the alleged havoc reeked upon the owners of family businesses and other industrious sorts.

266. *See* Hauser, *supra* note 265, at 376-77, 385-87.

generations subsequent to the primary benefactor).[267] And it is this very opportunity that is preserved in the face of creditor claims by virtue of the unbounded section 541(c)(2) federal bankruptcy exclusion mechanism.[268] Such deference to state law decisions concerning the efficacy of restraints on alienation is supported only upon federalism principles, and fails to account for any overriding purpose or consideration of the protection's possible impact upon other areas of federal policy.[269]

It must also be recognized that the opportunity to shield assets in trust is one not easily overlooked by those contemplating the fate of their fortunes and offspring. In contrast to planning with a traditional spendthrift trust, however, prudent planning and even the most outspoken advocates of the Self-Settled Paradigm suggest that a domestic or offshore APT is best suited for setting aside a "nest egg" amount.[270] The perceived limitation here emanates from reasonably tailored hesitancy among the federal bench to recognize the validity of some of the more aggressive protective trust strategies designed to benefit the settlor during life.[271] Interestingly, though, it is the self-settled possibility that has from the outset been most vigorously decried, despite this practical limitation and despite the oft-noted counter argument that, at least with respect to the settlor's protected interest, the Self-Settled Paradigm pertains to earned rather than gratuitously conferred wealth.[272] Nevertheless, the dynastic trust opportunity available through both paradigms squarely presents the potential for multi-generational transfers of substantial creditor-protected wealth. The ramifications of

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267. *See supra* note 54 and accompanying text.

268. *See* Hirsch, *supra* note 200, at 241-42.

269. For example, one specific area of federal policy concern that is implicated by the asset protection trust debate is that pertaining to tax-qualified retirement plans. Such plans are often equated with self-settled spendthrift trust arrangements, and for many such plans the inclusion of a spendthrift restraint is mandated by federal law. *See supra* notes 103 and 260. With regard to the relationship between more traditional spendthrift trust considerations and tax-qualified retirement plans, see generally Patricia E. Dilley, *Hidden in Plain View: The Pension Shield Against Creditors*, 74 IND. L.J. 355, 385 (1999); Daniel Spitzer, *Contra Goff: Of Retirement Trusts and Bankruptcy Code § 541(c)(2)*, 32 U.C.L.A. L. REV. 1266, 1294-1310 (1985).

270. *See supra* note 203 and accompanying text.

271. *See* Estate of Paxton v. Comm'r, 86 T.C. 785 (1986) (refusing to recognize self-settled trust for transfer tax purposes where settlor had transferred virtually all assets to the trust); *In re* Brooks, 217 B.R. 98 (Bankr. D. Conn. 1998) (refusing to recognize OAPT as excludable from bankruptcy estate); *In re* Portnoy, 201 B.R. 685 (Bankr. S.D.N.Y. 1996) (same); F.T.C. v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999) (holding settlors of OAPT in civil contempt for failing to repatriate trust assets).

272. *See* GRISWOLD, *supra* note 37, § 557 (noting this point). This would be so with respect to the settlor's interest, but not subsequent beneficiaries, if any.

this are exacerbated by movements at the state level to repeal the Rule Against Perpetuities as applied to trusts—an idea that seems coordinate with asset protection in those domestic (and many offshore) jurisdictions that have adopted the Self-Settled Paradigm via statutory enactment.[273] Couple this with the scheduled congressional repeal of federal wealth transfer taxes,[274] and it would seem that the privilege of accumulating wealth to be enjoyed currently and then passed-on to subsequent generations without depletion by the claims of outsiders has never been more vibrant than today, and that federal policy either encourages or passively favors such a state of affairs.[275]

B. A More Considered Federal Perspective

This broader view of trust asset protection and its underlying federal influence suggests that a more considered federal approach to the issue is warranted. At the very least, such analysis calls into question the seeming federal disregard of purpose and wealth-based equity considerations that are deemed so relevant in the crafting of many tax and bankruptcy policies, yet cast aside for little apparent reason (apart from federalism concerns) in the context of wealth preservation through trust asset protection.[276] In this regard, an appreciation of the significant role federal policies and pronouncements have played in the evolution of the Traditional and Self-Settled Paradigms ought to foreclose a unilateral grant of unbounded asset protection fostered through federal mechanisms like section 541(c)(2), absent the advancement of some meritorious purpose that goes beyond blind deference to historical federalism principles and the questionable property rights rationale thereby supported.[277] So long as this state of affairs endures through a lack of federal attention to such matters, asset protection as an end unto itself will continue to dominate progressions across the paradigms, such

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273. *See* Shaftel, *supra* note 238, at 52 (noting Alaska has joined Arizona, Delaware, Idaho, Illinois, Maryland, South Dakota, and Wisconsin as states which have abolished the Rule Against Perpetuities); *See, e.g.*, ALASKA STAT. § 34.27.050 (Michie 2000) (abolishing the Rule Against Perpetuities).

274. *See* Economic Growth and Tax Relief Reconciliation Act of 2001, § 611(d)(1)(B), 26 U.S.C. § 402(g)(B); I.R.C. §§ 511(a)-(c), 521(a) (2001).

275. *See* Sterk, *supra* note 8, at 1114; Gingiss, *supra* note 190, at 1005.

276. *See* Gingiss, *supra* note 190, at 1005.

277. See the discussion of the freedom of disposition argument as supporting recognition of spendthrift restraints, as posited by Justice Miller in *Nichols v. Eaton* and discussed *supra* Part II.C.1.

as the evolution—or some might say devolution—that has brought home the domestic self-settled APT.[278]

More directly concerning this Self-Settled Paradigm, many have criticized both the domestic and offshore APT opportunities as fundamentally undermining federal bankruptcy policy by permitting a prospective debtor to essentially "endow" herself without regard to any fresh-start or other socially conscious concerns.[279] This is achieved by stashing assets in a trust of which the debtor is a beneficiary, and which will allegedly thereafter be immune from creditor claims by virtue of jurisdictional APT legislation and the bankruptcy exclusion under section 541(c)(2).[280] Although creditors have plausible arguments to assert in contravention of the alleged effectiveness of these APTs,[281] the likelihood that such arrangements will be successful at least as to some debtors has independently led many to conclude that congressional action is necessary to thwart this end-run around the debtor-creditor framework of federal bankruptcy laws.[282] These calls for federal action in the context of the Self-Settled Paradigm further implicate a reconsideration of the basic federal mechanisms that have affected the movements in trust asset protection more generally.[283]

Further, a call to curtail the forces underlying congressional deference to state law on matters like the 1978 Code section 541(c)(2) spendthrift trust exclusion and the section 522(b) exemption opt-out is far from heresy. Indeed, the call actually finds growing support of late as the perspectives engendered by some of the more egregious asset protection scenarios garner an increasing amount of negative attention.[284]

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278. *See supra* Part I.B.

279. *See, e.g.*, Sterk, *supra* note 8, at 1043; Lischer, *supra* note 190, at 534-36.

280. *See supra* Part III.

281. For an analysis of arguments that potentially undermine the effectiveness of a domestic APT, see, for example, Boxx, *supra* note 5, at 1208-40; Sterk, *supra* note 8, at 1074-1104; Eason, *supra* note 112, at 63-72.

282. As to calls for congressional action and even criminal sanctions in the arena of self-settled asset protection trusts, see Sterk, *supra* note 8, at 1114-17 (concluding that criminal sanctions may be the only viable deterrent) and Gingiss, *supra* note 190, at 1005-08 (proposing legislative solutions to address the rise of OAPTs).

283. *See* Gingiss, *supra* note 190, at 1005-08; *see also supra* Part IV.B.

284. *See, e.g.*, Ponoroff, *supra* note 173, at 239 (noting in context of arguing for replacement of the opt-out bankruptcy exemption scheme with a system of uniform federal exemptions that "there is little to say about the states' rights argument . . . other than to note that it is an increasingly unimportant one in the current environment"); 1997 FINAL REPORT, *supra* note 43, at 124 (noting that discrepancies in treatment of debtors across state lines threatens to undermine integrity of federal bankruptcy system); Professors' Letter, *supra* note 180 (noting the potential for negative press resulting from continued and new asset protection forum shopping opportunities under the Bankruptcy Amendments). But see *supra* note 204 regarding the continued assertion of ideological

In fact, Congress appears to have at least acknowledged the deleterious effect of unbridled deference to state law in the Bankruptcy Amendments' limited curtailment of homestead asset protection planning. Such action and its supporting rationale—as presented in the 1973 and 1997 Bankruptcy Commission Reports[285]—lend credence to the argument that federalism in and of itself is little justification for a regime that clearly permits circumvention of larger federal objectives. To those arguing that the Traditional or Self-Settled Paradigms do in fact serve such a purpose by sheltering assets for those (potentially) in need and thus keeping debtors off the public tab to the detriment of the public fisc, the protections otherwise afforded under bankruptcy fresh start principles serve as a partial rejoinder.[286] More importantly, however, such arguments are undermined from the outset by the general disassociation of any beneficiary-specific infirmity or need in what is likely the bulk of settlor decisions to establish a trust falling within either the Traditional or Self-Settled Paradigms.[287] It was exactly this disassociation that was decried in the aftermath of the Supreme Court's 1875 pronouncements in *Nichols v. Eaton*,[288] and that general disassociation continues today.[289]

C. *The Means to Federally-Conceived Ends*

Short of abolition of the current trust protections, a course more consistent with a purposive asset protection trust framework would be to impose a dollar cap upon the protection afforded under the Traditional and Self-Settled Paradigms by means of federal bankruptcy principles. For example, rather than leaving the door open to asset protection forum

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notions of state's rights in this context. Moreover, two early iterations of federal bankruptcy legislation included a uniform federal exemption scheme that trumped state law exemptions entirely. *See supra* note 45.

285. See *supra* notes 148-51 and 191 and accompanying text for an analysis of the 1973 and 1997 Bankruptcy Commission Reports.

286. Indeed, those fresh start protections as furthered in the bankruptcy context are in no way inherently tied to state law, and could easily (and perhaps more effectively) be addressed through a uniform set of debtor exemptions in bankruptcy. Moreover, the § 541(c)(2) spendthrift trust exclusion has never been theoretically supportable as grounded in any conception of the fresh start rationale underlying exemption policy, although as a practical matter the association between the effect of exemptions and spendthrift trusts upon creditors has been drawn. For a discussion of that association and the disconnect in policies underlying the recognition of exemptions versus spendthrift trusts, see *supra* Part II.C.2.

287. See Part II.C.1 regarding the divergence of spendthrift trust justification grounded in special beneficiary needs versus the donor's freedom of disposition.

288. 91 U.S. 716 (1875); *see also* Emanuel, *supra* note 39, at 179 n.1.

289. *See supra* text accompanying note 82.

shopping through deference to state laws on such matters, a dollar cap could be placed directly within the confines of the section 541(c)(2) spendthrift trust exclusion.[290] Protection for traditional and self-settled spendthrift trust arrangements could perhaps be even further limited to the more purposive situations where a particular beneficiary infirmity is shown.[291] To the extent federalism concerns continue to push in the other direction, respect for a donor's freedom to craft protective trust interests can always be retained for those interests that are grounded in a trust forfeiture provision, thus eviscerating the more troublesome idea of retained beneficiary enjoyment garnered through traditional spendthrift protection.[292] Limitations upon creditor-protected dynastic trust accumulations could also be imposed by restricting the section 541(c)(2) federal bankruptcy exclusion to interests derived under trust instruments in effect not more than some stated period of time, such as ninety years,[293] after which period the nonforfeited trust interest or underlying assets could be subjected to the exigencies of modern life—i.e., creditor claims.[294] In short, freedom to accumulate and to dispose fall short of compelling justifications for bestowing federally sanctioned but unlimited asset protection upon the particular traditional or self-settled spendthrift trust vehicle through which such activities are pursued, and

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290. This would be consistent, for example, with the treatment accorded IRA accounts under the Bankruptcy Amendments. Under that legislation, IRAs are subject to an inflation-adjusted $1,000,000 cap on the aggregate account balance to be shielded from creditors. Bankruptcy Amendments § 224(e), amended 1978 Code § 522(n). The cited provision specifies that the $1,000,000 amount "may be increased if the interests of justice so require."

291. *See supra* notes 79-83, 148-64 and accompanying text; *see also* Costigan, *supra* note 15, at 492 (suggesting spendthrift protection should be limited based upon consideration of an actual need for such protection). For practical reasons, this author prefers the dollar cap limitation set by reference to some general conception of needs-based parameters, in lieu of a case-by-case, debtor-specific reasonable needs inquiry. From a practical standpoint, exemptions tied to specific debtor needs inquiries were criticized in the congressionally commissioned 1997 Final Report as being too dependent "upon subjective judicial determinations of what would be 'reasonably necessary' for that debtor." The Commission further noted that "[t]his fact-based test can lead to excessive litigation or intrusive and time-consuming inquiries." 1997 FINAL REPORT, *supra* note 43, at 139-40; *see also* Ponoroff, *supra* note 173, at 224-25 (criticizing case-by-case approach to the proper bounds of exemption planning as leading to inconsistency, ambiguity and frustration among both courts and debtors).

292. As to forfeiture provisions compared to direct restraints on alienation, see *supra* Part II.A, as well as the text accompanying notes 48-54.

293. This ninety-year period represents one of the benchmarks adopted under the Uniform Statutory Rule Against Perpetuities. *See generally* Lawrence W. Waggoner, *The Uniform Statutory Rule Against Perpetuities: The Rationale of the 90-Year Waiting Period*, 73 CORNELL L. REV. 157 (1988).

294. *See* Ronald C. Link & Kimberly A. Licata, *Perpetuities Reform in North Carolina: The Uniform Statutory Rule Against Perpetuities, Nondonative Transfers, and Honorary Trusts*, 74 N.C. L. REV. 1783, 1790-92 (1996).

the absence of such limitations is by no means a necessary characteristic of the existing framework.[295]

V. CONCLUSION

The purpose of this Article has been to explore the degree and origins of federal influence across the creditor-protected trust landscape, with an eye towards applying the perspective thereby gained. Rejecting any effort to espouse "proof" that might rise to some level of federal "causation" of the Traditional or Self-Settled Paradigms, pronouncements from the highest federal bench were revealed as having been foundationally inspirational to acceptance of the directly restrained trust interest that pervades the creditor-protected paradigms conceptualized here. Further, the opt-out exemption framework applicable in a federal bankruptcy proceeding was shown to both encourage and endorse forum shopping to preserve assets, and when viewed coordinately with the parallel focus upon only the income tax ramifications of the offshore trust movement, the resulting structures can be seen to have contributed to the legal and social environment that helped inspire the Self-Settled Paradigm domestically. The continuation of that environment as fostered through federal mechanisms, actions, and perhaps passive acceptance, was then challenged as being neither inevitable nor clearly defensible. The perspective thereby gained through examining trust asset protection from the viewpoint of federal influence dictates a need for more considered federal attention to the asset protection currently offered under the Traditional and Self-Settled Paradigms.

295. *See* GRISWOLD, *supra* note 37, § 552, at 631 ("[T]he ... major premise [underlying this spendthrift trust justification]—that the owner of property may dispose of it as he desires—is patently fallacious.").

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