THE EFFECT OF SPENDTHRIFT TRUSTS IN BANKRUPTCY

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INTRODUCTION

The expansive language of the Bankruptcy Code attempts to bring as much of the petitioner's assets into the bankruptcy estate as possible, to satisfy the debts owed.[1] Section 541 of Title 11 of the United States Code (Bankruptcy Code or Code) sets forth that "all property, wherever located and by whomever held, to which the debtor has a legal or equitable interest in" is property of the bankruptcy estate.[2] From this starting point Congress made inroads by carving out exceptions and exemptions which the debtor may use to protect certain property from the reach of creditors.[3]

Some of the available exceptions and exemptions are bankruptcy provisions that are explicitly stated in the Bankruptcy Code.[4] Other exceptions and exemptions are pursuant to "applicable nonbankruptcy law,"[5] which includes both federal and

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[1] *U.S. v. Whiting Pools, Inc.*, 1983-2 C.B. 239, 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 10 Bankr. Ct. Dec. (CRR) 705, 8 Collier Bankr. Cas. 2d (MB) 710, Bankr. L. Rep. (CCH) P 69207, 83-1 U.S. Tax Cas. (CCH) P 9394, 52 A.F.T.R.2d 83-5121 (1983).

[2] 11 U.S.C.A. § 541(a)(1)(2010).

[3] See e.g., 11 U.S.C.A. §§ 522, 541(b), (c)(2).

[4] See e.g., 11 U.S.C.A. § 522(2010).

[5] 11 U.S.C.A. § 541(c)(2)(2010).

state law provisions.[6] This article explores one of the exceptions to property of the bankruptcy estate—spendthrift trusts. It begins with a brief introduction of spendthrift trusts, followed by the treatment and impact of spendthrift trusts within a bankruptcy case. Further, the article explores potential issues that arise when state and federal laws conflict regarding self-settled spendthrift trusts and new section 548(e) of the Bankruptcy Code. Finally, spendthrift trusts are created under state law, therefore a breakdown of what constitutes a valid spendthrift trust throughout the various jurisdictions is provided.

1. SPENDTHRIFT TRUSTS

The spendthrift trust began as a fund to provide maintenance to a beneficiary and protect the res of the trust and income generated there from against the improvidence of a spendthrift or the incompetence or incapacity of a beneficiary. Courts throughout the country almost immediately decreased emphasis on the status of the beneficiary as a spendthrift or incompetent, and instead focused on the antialienation provisions and intent of the settlor.[7] This conception of the spendthrift trust provision ensuring that the settlor's intent is carried out and disposition of one's interest in property is not contravened, was elucidated by the Supreme Court of Pennsylvania:

> The law rests its protection of what is known as a spendthrift trust fundamentally on the principle of *cujus est dare, ejus est disponere*. It allows the donor to condition his bounty as suits himself so long as he violates no law in so doing. When a trust of this kind has been created, the law holds that the donor has an individual right of property in the execution of the trust; and to deprive him of it would be a fraud on his generosity. For the law to appropriate a gift to a person not intended would be an invasion of the donor's private dominion. (Internal citation omitted) It is always to be remembered that consideration for the beneficiary does not even in the remotest

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[6] *Patterson v. Shumate*, 504 U.S. 753, 112 S. Ct. 2242, 119 L. Ed. 2d 519, 23 Bankr. Ct. Dec. (CRR) 89, 26 Collier Bankr. Cas. 2d (MB) 1119, 15 Employee Benefits Cas. (BNA) 1481, Bankr. L. Rep. (CCH) P 74621A (1992).

[7] The term "spendthrift trust" arose for historic reasons and is "purely descriptive," such that "to create a spendthrift trust it is no longer necessary that the beneficiary be a spendthrift." *Jones v. Harrison*, 7 F.2d 461 (C.C.A. 8th Cir. 1925) (writ of certiorari denied in 270 U.S. 652, 70 L. ed. 781, 46 S. Ct. 351(1926)); see also, *Wagner v. Wagner*, 244 Ill. 101, 91 N.E. 66 (1910) (holding it was immaterial that beneficiaries were sui juris, compos mentis, and sober and industrious businessmen; the court said that "to create a valid spendthrift trust it is not necessary that the cestui que trust should be denominated a spendthrift in the will," and that "no inquiry can be made whether the person for whose use it was created was, in fact, a spendthrift").

> way enter into the policy of the law. It has regard solely to the rights of the donor. Spendthrift trusts can have no other justification than is to be found in considerations affecting the donor alone.[8]

A valid spendthrift trust is a trust in which the following factors are present: (1) the settlor of the trust is not the trust beneficiary; (2) the beneficiary of the trust has only limited or no control over the trust corpus; and (3) an anti-alienation clause in the trust prohibits both the voluntary and involuntary transfer of the beneficiary's interest in the trust.[9] Spendthrift trusts are intended to insure that the trust property will be used only for the maintenance of the beneficiary and will be secured from the beneficiary's creditors as well as the beneficiary's own improvidence.[10]

2. SPENDTHRIFT TRUSTS IN BANKRUPTCY

The Bankruptcy Code has been drafted as broadly as possible to include as much of the debtor's assets in the bankruptcy estate from which creditors claims may be satisfied. However, there are a number of exceptions which remove certain assets from the reach of creditors in bankruptcy. When a debtor is the beneficiary of a spendthrift trust, the assets comprising the res of the trust and the income generated from those assets are generally excepted from property of the bankruptcy estate.[11]

a. Protecting the Interests of the Debtor-Beneficiary in Bankruptcy

The most common and basic interaction between spendthrift trusts and bankruptcy is when the debtor in a bankruptcy is the beneficiary of a spendthrift trust. Under section 541(c)(2) of the Bankruptcy Code the debtor-beneficiary can except the beneficial interest in the spendthrift trust from property of the bankruptcy estate. Section 541(c)(2) states, "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."[12]

For a spendthrift trust to qualify for this exception, the trust

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[8] *In re Morgan's Estate*, 223 Pa. 228, 230, 72 A. 498 (1909).

[9] *In re Hansen*, 84 B.R. 598 (Bankr. D. Minn. 1987).

[10] See Restatement Third, Trusts § 58; see *Matter of Reagan*, 741 F.2d 95, 11 Collier Bankr. Cas. 2d (MB) 285, 6 Employee Benefits Cas. (BNA) 1142, Bankr. L. Rep. (CCH) P 70039 (5th Cir. 1984).

[11] See note 3, supra.

[12] See note 5, supra.

must be valid under the "applicable nonbankruptcy law," which in the "traditional" sense of trusts, are entities created pursuant to state, not federal law. The results are nonuniform determinations as to what constitutes a valid spendthrift trust and how the spendthrift trust will be treated in bankruptcy. When a bankruptcy practitioner is faced with a case involving a spendthrift trust, it is advisable for the practitioner to focus on all the different entities and property interests involved.

For purposes of this discussion, assume: (1) the debtor is the beneficiary of a valid spendthrift trust, (2) the trustee of the spendthrift trust is an individual, (3) the res is invested in stock certificates paying out dividends, (4) the trustee has discretion whether to distribute this dividend income, when collected, during the debtor-beneficiary's lifetime, and (5) upon the death of the debtor-beneficiary, the corpus of the trust is payable to the debtor-beneficiary's spouse and surviving children, per capita, if they survive, and if not, to a charity named in the trust instrument.

In this example, who owns what property interest can be summarized as follows:

(A) The spendthrift trustee holds legal (but not equitable) title to the stock certificates and the dividend income (plus the legal right to perform the functions of the trustee), and if the spendthrift trustee becomes an individual debtor, the assets in the trust are not property of the estate; and

(B) The beneficiary holds legal title only to a lifetime asset consisting of (1) the right to receive such distributions of income from the trust as the trustee chooses to make, and (2) causes of action (if any) against the trustee.

The beneficiary's other interests are equitable only. The children and the charity are contingent-remainder persons. Since this trust is a valid spendthrift trust, the beneficiary may not validly sell, pledge, donate or otherwise dispose of or transfer all or any part of the right to receive such distributions. Thus, when the beneficiary becomes a debtor in a bankruptcy case, the following assets are not property of the estate:

(1) the corpus of the trust;

(2) the undistributed income earned thereon, whether earned prepetition or postpetition;[13]

(3) the rights of the position of spendthrift trustee and the rights to the income and corpus of the trust after the death of the

[13]However, funds received from a valid testamentary spendthrift trust within 180 days of filing the case are property of the estate under section 541(a)(5)(A). *In re Coumbe*, 304 B.R. 378 (B.A.P. 9th Cir. 2003).

debtor, all of these items being property of the spendthrift trustee, not the debtor; and,

(4) the lifetime right of the beneficiary to receive distributions of income (this right, being inalienable by the debtor, does not become property of the estate, by virtue of Section 541(c)(2)).

The only rights of the debtor that would be property of the estate are the right to the proceeds of causes of action against the trustee and rights to cash distributed to the debtor prepetition that the debtor still holds when the petition is filed.

b. Section 541(c)(2) Exceptions and Federal Antialienation Provisions

The traditional notion of the spendthrift trust has been expanded, at least for the purposes of bankruptcy proceedings, to include ERISA qualified retirement plans.[14] The ERISA statute in which these retirement plans are established contains within in it an antialienation provision,[15] which satisfies the applicable nonbankruptcy antialienation provision of section 541(c)(2).[16] The analysis undertaken in determining whether a retirement plan is excluded from the bankruptcy estate is whether the retirement plan satisfies all of the requirements of ERISA. If the plan satisfies those requirements, then the plan is excluded from the debtor-beneficiary's bankruptcy estate.

c. Invalidating the Spendthrift Provision and Bringing the Asset into the Bankruptcy Estate

There are several issues that can arise in bankruptcy that may invalidate the spendthrift provision and render section 541(c)(2) inapplicable to the assets being held in the trust. First, notwithstanding the fact that the law varies from state to state, in general there are seven possible categories of exceptions to the inalienability of the beneficiary's interest in a spendthrift trust:

(1) self-settled spendthrift trusts;[17]

(2) claims arising from services to the trust interest;

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[14]See note 5, supra.

[15]26 U.S.C.A. § 401(a)(13)(2010).

[16]See note 5, supra at 757–58.

[17]Restatement Third, Trusts § 58(2) ("A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid."); see *In re Spenlinhauer*, 101 F.3d 106 (1st Cir. 1996) (self-settled spendthrift trust invalid under Maine law; unpublished disposition relying on reasoning of courts below); *In re Lawrence*, 251 B.R. 630, 642 (S.D. Fla. 2000), judgment aff'd, 279 F.3d 1294 (11th Cir. 2002) (applying Florida law); see also *In re Robbins*, 826 F.2d 293, 16 Bankr. Ct. Dec. (CRR) 806, Bankr. L. Rep.

(3) federal law (such as a claim of the Internal Revenue Service) reaching the beneficiary's interest that prevails over state anti-alienation law under the Supremacy Clause of the Constitution;[18]

(4) claims arising from the duty of the beneficiary to support children and spouse;

(5) claims for the beneficiary's personal support or medical care;

(6) claims arising from tortious conduct of the beneficiary;[19] and

(7) in California, certain attachments by the beneficiary's general creditors.[20]

(CCH) P 71957 (4th Cir. 1987) (no spendthrift protection in trust containing spendthrift provision where trustee was authorized to apply entire corpus of trust for support and maintenance of settlors); *In re Cutter*, 398 B.R. 6, 21 (B.A.P. 9th Cir. 2008) (California law rendered self-settled spendthrift trust invalid where settlor was the beneficiary.). But see *In re Brown*, 303 F.3d 1261, 1268, 40 Bankr. Ct. Dec. (CRR) 28, 49 Collier Bankr. Cas. 2d (MB) 32, Bankr. L. Rep. (CCH) P 78710 (11th Cir. 2002) (where debtor-settlor retained only the right to income for life under trust, creditors could reach only that interest). Delaware, Alaska and several other states have enacted statutes intended to validate self-settled spendthrift trusts in certain circumstances. See Del. Code Ann. tit. 12, §§ 3570 to 3574 (2010) (amending Del. Code Ann. tit. 12); Alaska Stat. §§ 13.12.205(2), 13.36.035(a), 34.40.010 (2010). Uncertainties persist regarding whether use of these trusts can withstand the various types of challenges made by or on behalf of creditors.

[18]*In re McIver*, 255 B.R. 281, 285, 44 Collier Bankr. Cas. 2d (MB) 1180, 24 Employee Benefits Cas. (BNA) 2908, 86 A.F.T.R.2d 2000-5909 (D. Md. 2000) (IRS possessed secured claim against debtor's retirement fund because tax lien law constituted applicable nonbankruptcy law that trumped restrictions on annuities.); *In re Lyons*, 148 B.R. 88, 94, 28 Collier Bankr. Cas. 2d (MB) 314, 16 Employee Benefits Cas. (BNA) 1082 (Bankr. D. D.C. 1992) (though effective against ordinary creditors, spendthrift trusts are ineffective against federal tax liens); U.S. Const. Art. VI, cl. 2.

[19]See Restatement Third, Trusts § 59(2) general cmt. ("The nature or a pattern of tortious conduct by a beneficiary [ ] may on policy grounds justify a court's refusal to allow spendthrift immunity to protect the trust interest and the lifestyle of that beneficiary, especially one whose willful or fraudulent conduct or persistently reckless behavior causes serious harm to others."); Restatement Third, Trusts § 59(2), comments a-a(2) ("A general exception for tort claimants was recommended by Dean Griswold in his Model Spendthrift Trust Act; the recommendation was adopted in a couple of early statutes . . . [but] has not generally had much influence on legislation or judicial decisions, although an exception for tort creditors was enacted in Georgia Code Ann. § 53-12-28 in 1990.").

[20]For an overview of these exceptions, see Stark, Montana's Spendthrift Trust Doctrine and Recommendations, 57 Mont. L. Rev. 211, 224–29 (1996). As

These exceptions, pose two interesting questions: (1) Do the state-law exceptions make the property alienable to a limited extent and, therefore, property of the estate to such extent; and (2) Does the state-law exception, making part of the beneficiary's interest alienable, operate to deprive the whole interest of the protection of Section 541(c)(2)?[21] With respect to these two questions, not much case law exists.[22]

There are other circumstances that will invalidate a spendthrift provision and bring the assets of the trust into the bankruptcy estate. Most of the invalidating circumstances are factual and require an inquiry into the individual facts of the case. In general, however, there are recurring issues that arise to invalidate spendthrift provisions.

d. Other Invalidation of Spendthrift Provisions

The general policy behind spendthrift trusts is to allow a settlor to donate to a beneficiary property from which maintenance and support of the beneficiary may be derived without fear of the funds being levied by creditors of the beneficiary. The policy does not support "defrauding"[23] creditors by allowing a settlor to encumber trust assets or otherwise prevent creditors from reaching those assets upon default, while the settlor retains full use and enjoyment of the property;[24] nor does the policy support preventing creditors from reaching a beneficiary's interest while allowing the beneficiary to freely transfer that interest to someone else. The anti-alienation provision must restrict both the vol-

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to California, see *In re Neuton*, 922 F.2d 1379, 24 Collier Bankr. Cas. 2d (MB) 555, Bankr. L. Rep. (CCH) P 73788 (9th Cir. 1990) (under provision of California statute, only 75% of debtor's interest in spendthrift trust was excluded from property of the estate).

[21]See *In re Gillespie*, 269 B.R. 383, 388, 47 Collier Bankr. Cas. 2d (MB) 889 (Bankr. E.D. Ark. 2001) ("While it is true that the spendthrift provision in the trust is invalid, it does not necessarily follow that the entire trust is invalid or that the entire res is available to the chapter 7 trustee or creditors.").

[22]With the exceptions to self-settled spendthrift trusts which are discussed further infra.

[23]The Supreme Court has defined "defraud" to include the deprivation of property "by trick, deceit, chicane, or overreaching." See *Hammerschmidt v. U.S.*, 265 U.S. 182, 188, 44 S. Ct. 511, 68 L. Ed. 968 (1924) (defining "defraud"); see also *McNally v. U.S.*, 483 U.S. 350, 358, 107 S. Ct. 2875, 97 L. Ed. 2d 292, R.I.C.O. Bus. Disp. Guide (CCH) P 6663 (1987) (discussing the mail-fraud statute), superseded by statute as stated in *U.S. v. Munna*, 871 F.2d 515 (5th Cir. 1989).

[24]In the majority of jurisdictions this is the case, however, as is discussed there are jurisdictions, which allow for self-settled trusts. See infra § 3(d).

untary and involuntary transfer of the beneficiary's interest in the trust. Trusts that contravene this policy are generally referred to as "sham trusts."

A trust is found to be a "sham" where even though a spendthrift trust has been created for the benefit of another "evidence [exists] regarding dominion and control, disregard for formalities and ultimately, a disregard for the existence of a trust entity separate and apart from the [debtor]."[25] When analyzing a spendthrift trust the court should look to the terms of the trust to see if (1) the trust will terminate upon the debtor's death, (2) the debtor is to serve as trustee, and (3) the debtor is to retain the use, possession, and enjoyment of the property.[26] Should the court find that any of these elements exists, then the court could determine that the trust is a "sham," whereby the assets creating the trust corpus become property of the estate.[27] There are three typical categories of trusts purporting to be valid spendthrift trusts where the spendthrift provision may be invalidated thereby bringing the trust assets into the bankruptcy estate: (1) self-settled trusts; (2) trusts where the debtor-settlor exercises dominion and control over the trust; and (3) trusts where the debtor-beneficiary exercises dominion and control over the trust.

In the majority of jurisdictions if a debtor-beneficiary is able to exercise dominion and control over the assets or income of the trust, then the spendthrift provision is invalid.[28] There appear to be at least three requirements, explicit or implicit, to establish

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[25]*In re Bryan*, 415 B.R. 454, 473 (Bankr. D. Colo. 2009), rev'd and remanded on other grounds, 2010 WL 3894035 (D. Colo. 2010). Accord *In re Nemeroff*, 74 B.R. 30 (E.D. La. 1987).

[26]Supra, note 25, *In re Nemeroff*, 74 B.R. 30 (E.D. La. 1987). See also *In re Lawrence*, 227 B.R. 907, 917–18, 41 Collier Bankr. Cas. 2d (MB) 177 (Bankr. S.D. Fla. 1998); *In re Brooks*, 217 B.R. 98, 32 Bankr. Ct. Dec. (CRR) 23 (Bankr. D. Conn. 1998); *In re Portnoy*, 201 B.R. 685 (Bankr. S.D. N.Y. 1996).

[27]*In re Lawrence*, 227 B.R. 907, 917–18, 41 Collier Bankr. Cas. 2d (MB) 177 (Bankr. S.D. Fla. 1998); *In re Brooks*, 217 B.R. 98, 32 Bankr. Ct. Dec. (CRR) 23 (Bankr. D. Conn. 1998); *In re Portnoy*, 201 B.R. 685 (Bankr. S.D. N.Y. 1996).

[28]See *In re Schwen*, 240 B.R. 754, 43 Collier Bankr. Cas. 2d (MB) 555 (Bankr. D. Minn. 1999); see Restatement Third, Trusts § 58, comment b(1) ("An intended spendthrift restraint is also invalid with respect to a nonsettlor's interests in trust property over which the beneficiary has the equivalent of ownership, entitling the beneficiary to demand immediate distribution of the property. Thus, if an income beneficiary also holds a presently exercisable general power of appointment (that is, a power currently to compel distribution of trust property to the power holder), a spendthrift restraint will not prevent the beneficiary's creditors or transferees from reaching the property that is subject to the power. (A general power exercisable only at death does not give a nonset-

that the debtor-beneficiary exercises dominion and control over the corpus of the trust. First, the debtor-beneficiary must have access to trust assets for the debtor-beneficiary's own use. Whenever beneficiary dominion and control has been found, the debtor-beneficiary has had a right to compel distribution of trust assets to himself.[29] If the ability to compel distribution is limited to the benefit of others, and not the benefit of the debtor-beneficiary, then the debtor-beneficiary does not maintain control over the trust.[30] Second, the debtor-beneficiary must have a present enforceable right to demand the distribution.[31] Third, that right must be unilateral and unqualified; the right to demand distribution must not be concurrent with, or require the consent of any other beneficiary or trustee,[32] nor may a demand of distribution breach any duty owed to any third party.[33] The reasoning is, should a debtor-beneficiary have the ability to exercise dominion

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tlor sole life beneficiary the equivalent of ownership for this purpose. Compare, however, § 56, Comment b.)").

[29]*In re Gillett*, 46 B.R. 642, 644 (Bankr. S.D. Fla. 1985) (debtor-beneficiary's right to have trustee convey trust property to himself at any time caused spendthrift provision to fail); accord, e.g., *Employee Benefits Committee v. Tabor*, 127 B.R. 194, 199–200, 13 Employee Benefits Cas. (BNA) 2357, Bankr. L. Rep. (CCH) P 74115 (S.D. Ind. 1991), judgment vacated on other grounds, appeal dismissed by, 972 F.2d 351 (7th Cir. 1992) (debtor-beneficiary's ability to withdraw funds for his own needs vitiated antialienation term in retirement trust instrument); *In re Williams*, 118 B.R. 812, 815 (Bankr. N.D. Fla. 1990); *In re Boykin*, 118 B.R. 716, 719 (Bankr. W.D. Mo. 1990) (debtor's absolute right to receive retirement trust funds upon terminating employment rendered spendthrift term ineffective).

[30]*Pachter, Gold & Schaffer v. Yantis*, 742 F. Supp. 544, 547, 14 U.C.C. Rep. Serv. 2d 212 (W.D. Ark. 1990); see *Prescott v. Wordell*, 319 Mass. 118, 65 N.E.2d 19, 19–20 (1946); Restatement Second, Property § 13.1, comment a. *Jordan v. Caswell*, 264 Ga. 638, 450 S.E.2d 818, 820 (1994).

[31]See, e.g., *State Cent. Collection Unit v. Brent*, 71 Md. App. 265, 525 A.2d 241, 244 (1987), judgment aff'd, 311 Md. 626, 537 A.2d 227 (1988); *Boston Safe Deposit and Trust Co. v. Paris*, 15 Mass. App. Ct. 686, 447 N.E.2d 1268, 1270 (1983).

[32]*In re Knight*, 164 B.R. 372, 376 n.2, 30 Collier Bankr. Cas. 2d (MB) 1618, Bankr. L. Rep. (CCH) P 75789 (Bankr. S.D. Fla. 1994); *In re Hersloff*, 147 B.R. 262, 265 (Bankr. M.D. Fla. 1992).

[33]*In re Kreiss*, 72 B.R. 933, 938, 941–42, 16 Collier Bankr. Cas. 2d (MB) 983 (Bankr. E.D. N.Y. 1987) (where one beneficiary became sole trustee, beneficiary did not "control" trust and protective provisions were valid; beneficiary-trustee had to account to other beneficiaries for trust administration).

and control over the trust, then the protection of the antialienation provision of the trust is rendered meaningless.[34]

A debtor-beneficiary's ability to exercise dominion and control over the trust does not necessarily make the entire corpus of the trust property of the estate. Courts look to what the debtor-beneficiary has control over, rendering the spendthrift provision to that portion of the trust invalid. The ability of the debtor-beneficiary to invade and control the corpus of the trust can manifest itself in multiple ways. A debtor-beneficiary's ability to control the entire corpus of the trust brings all of the trust assets into the bankruptcy estate,[35] whereas a provision which limiting, for example, the debtor-beneficiary's ability to control a 1/3 interest in the corpus of the trust only invalidates the spendthrift protection to that 1/3 interest, bringing that limited interest into the bankruptcy estate.

Similarly, a validly created spendthrift trust, over which the settlor of the trust uses the property as his own is invalid.[36] For example, *In re Baum*, the Tenth Circuit held that an otherwise validly created spendthrift trust with parents as settlors, a child as the beneficiary, a house and fixtures comprising the res of the trust, and an individual third-party as the trustee, was invalid as to the creditors of the settlors. The settlors, pursuant to the trust, were allowed to reside in the house with full use and enjoyment of its fixtures, while the trust also required the trustee to encumber, expend and alienate the property at the behest of the

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[34]See *In re Moses*, 167 F.3d 470, 473, 33 Bankr. Ct. Dec. (CRR) 1042, 22 Employee Benefits Cas. (BNA) 2364 (9th Cir. 1999); *In re Witwer*, 148 B.R. 930, 937, 28 Collier Bankr. Cas. 2d (MB) 43 (Bankr. C.D. Cal. 1992), opinion aff'd, 163 B.R. 614 (B.A.P. 9th Cir. 1994); *Lunkes v. Gecker*, 427 B.R. 425 (N.D. Ill. 2010); *In re Estate of Bonardi*, 376 N.J. Super. 508, 871 A.2d 103 (App. Div. 2005); *University of Maine Foundation v. Fleet Bank of Maine*, 2003 ME 20, 817 A.2d 871 (Me. 2003).

[35]See *In re Gillett*, 46 B.R. 642, 644 (Bankr. S.D. Fla. 1985) (Holding an ERISA plan that permitted the employer "to terminate the plan at any time or had authority to undertake a partial termination for individual participants" constituted absolute dominion and control by the beneficiaries/employees who were also the sole stockholders, directors and officers of the employer.); *In re Kuraishi*, 237 B.R. 172, 42 Collier Bankr. Cas. 2d (MB) 1082 (Bankr. C.D. Cal. 1999) (debtor was both the employer who adopted the Keogh Plan and a beneficiary; trustee asserted that the spendthrift provision was unenforceable and the Keogh Plan was property of the estate).

[36]*In re Baum*, 22 F.3d 1014, 1018 (10th Cir. 1994); *Peters v. Bryan*, 2010 WL 3894035, *8–9 (D. Colo. 2010).

settlor-parents to acquire a different residence.[37] The court considered the spendthrift trust to be a "sham" and invalid, bringing the corpus of the trust into the bankruptcy estate of the debtor-settlors.[38]

3. SELF-SETTLED SPENDTHRIFT TRUSTS AND BANKRUPTCY

Self-settled spendthrift trusts present a multitude of issues in bankruptcy. In the majority of jurisdictions, self-settled spendthrift trusts are unenforceable under state law.[39] However, in an attempt to seize on some the profits being generated in the offshore asset protection trust industry, some states have enacted legislation allowing self-settled trusts.[40]

In the majority of states, self-settled trusts are not permitted and do not satisfy the "applicable non-bankruptcy law" requirement of Section 541(c)(2), thus the trust assets are reachable by creditors and not excluded from the bankruptcy estate.[41] A debtor may acquire an interest in a self-settled trust through various means:

> (1) the traditional way is by the settling beneficiary actually conveying the property to the trust or executing the trust instrument, or being designated as settlor, (2) by the beneficiary paying the consideration in return for which another transferred property to fund the trust, (3) the life beneficiary paying off encumbrances of property of the trust;[42] (4) if an heir, or devisee under a prior will, contests a will that would leave the testator's property to others, and in order to settle the litigation a spendthrift trust is created in the heir's favor, by agreeing to the settlement of a genuine dispute the heir has given consideration and is settlor of the trust within the rule of this subsection.[43]

However, if others contest a will that would leave the testator's estate in a spendthrift trust, the beneficiaries of that trust do not

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[37]Supra, note 35.

[38]Supra, note 35, *In re Baum*, 22 F.3d 1014 (10th Cir. 1994).

[39]See Restatement Third, Trusts § 58(2) (Tentative Draft No. 2, 1999) (citing Restatement Second, Trusts § 156(1)).

[40]Ford Elsaesser, et al., Concurrent Session: Sophisticated Planning or Playing a Shell Game—Asset Protection Planning Bankruptcy Trustee Tools to Recover Debtor Assets Held in Asset Sheltering Trusts, 040109 ABI-CLE 391 (2009).

[41]Restatement Third, Trusts § 58, comment e.

[42]Restatement Third, Trusts § 58, comment e (spendthrift trust only invalid as to the amount of the contribution). But see, § 3, supra.

[43]Restatement Third, Trusts § 58, comment e.

become settlors by reason of a settlement that gives a portion of the estate to the contestants, and preserves the rest of it in the trust as prescribed by the testator. Similarly, if the beneficiaries of a spendthrift trust under a prior will contest a later will that leaves the testator's estate to others free of trust, and under a bona fide settlement a portion of the estate is placed in trust in accordance with the prior will, the trust beneficiaries are not settlors of the trust.[44] And where a spendthrift trust is created by the will of one spouse in favor of the other, the surviving spouse does not become the settlor of the trust merely because she or he waives a right to insist on a statutory forced share of the deceased spouse's estate.[45] Also, a debtor's funding of a spendthrift trust does not necessarily invalidate it completely, exposing the entire corpus of the trust to creditors.[46] In these circumstances, creditors may reach only the self-funded property of the trust, while the remaining portion remains in tact and excluded from the estate under section 541(c)(2).

There are a number of cases addressing what constitutes a self-settled trust, including those addressing the application of spendthrift trust provisions to Keogh plans.[47] In *In re Moses*,[48] the physician debtor participated in a profit-sharing plan established as a spendthrift trust. Some of the relevant plan attributes were: benefits were payable only upon a participant's termination of employment, retirement, disability or death; more than 2,400 physicians participated in the plan, and; a 12-member committee administered the plan and the debtor was not a member of this committee, although he could vote in elections for one committee member.[49] The Ninth Circuit Court of Appeals held that the debtor's interest in the fund was excluded from the estate as a valid spendthrift trust.[50] In the same year, the bankruptcy court

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[44]Restatement Third, Trusts § 58, comment e.

[45]Restatement Third, Trusts § 58, comment e.

[46]See *In re Tait*, 2008 WL 4183341 (Bankr. S.D. Ala. 2008).

[47]A tax-deferred retirement program developed for the self-employed. Also known as an H.R. 10 plan, Treas. Reg. § 1.401(e)-1, and incorporated into internal revenue code Pub. L. No. 87-792 and subsequent amendatory language. See amendment notes to 26 U.S.C.A. §§ 401 et seq.

[48]*In re Moses*, 167 F.3d 470, 33 Bankr. Ct. Dec. (CRR) 1042, 22 Employee Benefits Cas. (BNA) 2364 (9th Cir. 1999).

[49]*In re Moses*, 167 F.3d 470, 33 Bankr. Ct. Dec. (CRR) 1042, 22 Employee Benefits Cas. (BNA) 2364 (9th Cir. 1999).

[50]Moses, 167 F.3d at 473–74.

for the Central District of California decided In re Kuraishi.[51] *Kuraishi* also involved a Keogh plan, however, in contrast to *Moses* the debtor this time was the sole employer, employee, participant, and administrator, and the plan was established under California law rather than under ERISA.[52]

In *Patterson v. Shumate*,[53] the Supreme Court held that " 'applicable nonbankruptcy law' includes both federal and state law."[54] Specifically, the Court determined that the "important policy underlying ERISA was uniform national treatment of pension benefits. Construing 'applicable nonbankruptcy law' to include federal law ensures that the security of a debtor's pension benefits will be governed by ERISA, not left to the vagaries of state spendthrift trust law."[55] *Patterson v. Shumate*, read in conjunction with *Moses*, indicates that a self-settled spendthrift trust established in accordance with ERISA requirements is excluded from the bankruptcy estate, regardless of the state's laws with regard to self-settled spendthrift trusts.

4. SELF-SETTLED SPENDTHRIFT TRUSTS AND SECTION 548(e) OF THE BANKRUPTCY CODE

In 1997, Alaska[56] and Delaware[57] became the first states to enact legislation recognizing the validity of self-settled spendthrift trusts. These self-settled trusts are referred to as Domestic Asset Protection Trusts.[58] The enactment of this legislation was an attempt to capture some of the $2 trillion offshore asset protection trust market.[59] Soon after, other states began to follow suit.[60] In all, there are currently eleven states recognizing the validity of

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[51] *In re Kuraishi*, 237 B.R. 172, 42 Collier Bankr. Cas. 2d (MB) 1082 (Bankr. C.D. Cal. 1999).

[52] Kuraishi, 237 B.R. at 173–74.

[53] *Patterson v. Shumate*, 504 U.S. 753, 112 S. Ct. 2242, 119 L. Ed. 2d 519, 23 Bankr. Ct. Dec. (CRR) 89, 26 Collier Bankr. Cas. 2d (MB) 1119, 15 Employee Benefits Cas. (BNA) 1481, Bankr. L. Rep. (CCH) P 74621A (1992).

[54] Patterson v. Shumate, 504 U.S. at 759.

[55] Patterson v. Shumate, 504 U.S. at 765 (citing *Fort Halifax Packing Co., Inc. v. Coyne*, 482 U.S. 1, 9, 107 S. Ct. 2211, 2216, 96 L. Ed. 2d 1, 8 Employee Benefits Cas. (BNA) 1729, 2 I.E.R. Cas. (BNA) 134, 125 L.R.R.M. (BNA) 2455, 28 Wage & Hour Cas. (BNA) 89, 106 Lab. Cas. (CCH) P 55729 (1987)).

[56] Alaska Stat. § 34.40.110 (2010).

[57] Del. Code Ann. tit. 12, §§ 3570 to 3576 (2010).

[58] Robert A. Esperti, et al., Irrevocable Trusts: Analysis with Forms, ¶ 14.02 Domestic Asset Protection Trust Legislation (2010).

[59] Supra, note 39.

self-settled spendthrift trusts. While a state's recognition does except the trust from section 541(c)(2)'s exclusion, it does raise other issues. For instance, how does the enactment of section 548(e)[61] of the Code affect the assets held in the trust? While the self-settling provision may not invalidate the trust, it may cause higher scrutiny and a heavier burden to establish that the transfer of property into the trust was not intentionally fraudulent.

Congress identified several motivating factors behind enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), the main focus of which was combating fraud and abuse of the bankruptcy system.[62] BAPCPA was enacted partly in response to the ever-growing offshore and domestic asset-protection trust markets, which allows individuals to hide assets from creditors.[63] As part of BAPCPA, Congress amended section 548 of the Code to include a new provision specifically designed to aid in the recovery of assets shielded through self-settled trusts. Section 548(e) provides as follows:

> (e)
>
> (1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—
>
> (A) such transfer was made to a self-settled trust or similar device;
>
> (B) such transfer was by the debtor;
>
> (C) the debtor is a beneficiary of such trust or similar device; and
>
> (D) the debtor made such transfer with actual intent to

[60]Rhode Island and Nevada enacted legislation in 1999, see R.I. Gen. Laws §§ 18-9.2-1 to 18.9-2-7; Nev. Rev. Stat. § 166.120(2) (2010). Utah enacted legislation in 2003, see Utah Code Ann. §§ 25-6, 75-7. Oklahoma enacted its legislation in 2004, see Okla. Stat. tit. 31, §§ 10-18 et seq. (2010). South Dakota enacted legislation in 2005, see S.D. Codified Laws §§ 55-16-1 to 55-16-16 (2010). Missouri enacted legislation in 2004, see Mo. Rev. Stat. §§ 456.1-101 to 456.11-1106 (2010). Tennessee and Wyoming enacted legislation in 2007, see Tenn. Code Ann. §§ 35-16-101 to 35-16-112 and Wyo. Stat. Ann. §§ 4-10-505 et seq. In 2008 New Hampshire enacted its legislation, see N.H. Rev. Stat. Ann. § 545-A:9 (this legislation is applicable to transfers made after Jan. 1, 2009) (2010).

[61]11 U.S.C.A. § 548(e).

[62]H.R. Rep. No. 109-31(I), **5 (2005).

[63]Supra, note 39 (citing Gretchen Morgenson, Proposed Law on Bankruptcy Has Loophole, NY Times (March 2, 2005)).

> hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.
>
> (2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by—
>
> (A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or
>
> (B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15 (d) of the Securities Exchange Act of 1934 (15 U.S.C. 781 and 78o(d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f).

Although addition of this Code provision was an attempt to prevent debtors from shielding assets, it remains uncertain whether it will have any real effect. The bankruptcy trustee or estate representative must still show that the debtor-beneficiary intended to defraud creditors; and thus the question remains, did this Code amendment really add anything to the existing law?[64]

There are three distinct features in section 548(e) as compared to the already existing fraudulent transfer legislation: (1) a 10-year look-back period; (2) the provision does not look at state law to determine whether the trust is valid, only to aid in a determination of fraudulent intent; and (3) the bankruptcy trustee must show "actual intent to hinder, delay, or defraud" any existing or future creditor.

> In assessing the practical effect of Section 548(e) on Domestic Asset Protection Trusts, one estate planning practitioner found that "the worst-case scenario is that it merely creates a 10-year limitations

[64]See Ahern, III, Homestead and Other Exemptions under the Bankruptcy Abuse Prevention and Consumer Protection Act: Observations on "Asset Protection" After 2005, 13 Am. Bankr. Inst. L. Rev. 585, 609 (2005) ("[T]he new provision in section 548(e) is largely duplicative of existing law. It does not dramatically change the ground rules for asset protection planning, although it does enlarge the window through which a trustee may reach to set aside transfers without being required to find an actual unsecured creditor as to whom a particular transfer was voidable under UFTA and section 544(b) of the Bankruptcy Code.").

> period for avoidance actions based on fraudulent transfers," and that "[t]he best-case scenario is that § 548(e) requires proof that a debtor-transferor had specific creditors in mind when making an alleged fraudulent transfer."[65]

The initial benefit is the 10-year look-back period, which expands the number of transactions a bankruptcy trustee may review. Comparatively, Section 548(a) has a two-year look-back period, and section 9 of the Uniform Fraudulent Transfer Act (UFTA) requires a party to bring an action to avoid a fraudulent transfer of assets "within 4 years after the transfer was made or the obligation was incurred or, if later, within one year after the transfer or obligation was or could reasonably have been discovered by the claimant."[66] The UFTA's statue of limitations period is followed by most of the states that allow Domestic Asset Protection Trusts. Thus, under section 548(e), the bankruptcy trustee has an expanded reach-back period. However, it is unclear whether this additional reach-back period will meaningfully aid the trustee in recovering assets since it becomes increasingly difficult with the passage of time to establish the necessary badges of fraud.[67]

Under the already existing fraudulent transfer laws, one of the key contentions surrounding the validity of self-settled spendthrift trusts is which state law applies to determine whether the trust assets will become property of the bankruptcy estate. Under Section 548(e), the court does not have to determine whether the trust is valid under state law, thereby circumventing the issue of choice of law provisions.[68] The court does, however, look to state law in its analysis inasmuch as intent is determined based on state law,[69] and proving actual intent to hinder, delay, or defraud creditors, is a key element when invalidating the spendthrift pro-

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[65]Supra, note 39 (citing Richard W. Nenno & John E. Sullivan, III, Planning and Defending Domestic Asset-Protection Trusts, SN048 ALI-ABA 795, 885 (2008)).

[66]Uniform Fraudulent Transfer Act § 9 (2010).

[67]Supra, note 39 (citing Richard W. Nenno & John E. Sullivan, III, Planning and Defending Domestic Asset-Protection Trusts, SN048 ALI-ABA 795, 891 (2008) ("[I]t is sometimes hard to defend old transfers due to the loss of critical evidence—memories fade, witnesses may die or move to points unknown, and relevant records can be lost or destroyed in the normal course of business. However, the same factors might also make a stale case hard to prosecute.")).

[68]See generally 11 U.S.C.A. § 548(e) (No reference to "applicable non-bankruptcy law" under this subsection.).

[69]See *In re Potter* and *In re Combes*, infra.

vision in order to bring these trust assets into the bankruptcy estate.

As indicated, under section 548(e), a trustee must prove that the debtor-beneficiary transferred property to the trust "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted."[70] Direct evidence of intent is usually impossible to produce; rather, a showing of actual intent is accomplished by proving the various badges of fraud, as determined by state law. In addition to showing actual intent, it has been suggested, "the trustee would need to show the existence of actual creditors and relate the debtor's intent to those creditors, rather than merely showing that the debtor created or transferred to an asset protection device."[71] "While identifying an actual creditor does present an additional burden, in the bankruptcy context, this is not usually the difficulty. Rather, the problem remains proving actual intent."[72]

Since enactment of BAPCPA, very few courts have addressed the applicability of section 548(e). The most thorough analysis of section 548(e) to date is *In re Potter*.[73] In *Potter*, the bankruptcy court for the District of New Mexico allowed the Chapter 7 trustee to recover assets transferred to a California trust upon finding that the transfers were fraudulent and avoidable under Section 548(e).[74] In *Potter*, the debtor formed the California spendthrift trust approximately two years prior to filing for bankruptcy. The court, looking at statements made by the debtor through various filings, applied California law to find sufficient evidence "establish[ing] the presence of a number of the relevant badges of fraud from which actual intent to defraud may be inferred under the UFTA."[75]

In *Potter*, the trust at issue contained the self-serving statement that it was not meant to defraud creditors. On the contrary, the court found that the debtor created the trust after a large judgment entered against him, he transferred all of his assets

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[70]11 U.S.C.A. § 548(e)(5) (2010).

[71]Richard W. Nenno & John E. Sullivan, III, Planning and Defending Domestic Asset-Protection Trusts, SN048 ALI-ABA at 892 (quoting Brown and Ahern, III, 2005 Bankruptcy Reform Legislation with Analysis at 77 (2005)).

[72]Richard W. Nenno & John E. Sullivan, III, Planning and Defending Domestic Asset-Protection Trusts, SN048 ALI-ABA at 892.

[73]*In re Potter*, 2008 WL 5157877 (Bankr. D. N.M. 2008).

[74]Potter, 2008 WL 5157877 at *8.

[75]Potter, 2008 WL 5157877 at *6.

into the trust rendering him insolvent, and he continued living in the residence transferred to the trust. The court quoted an earlier Ninth Circuit decision, stating "presence of a single badge of fraud may spur mere suspicion; the confluence of several can constitute conclusive evidence of actual intent to defraud, absent 'significantly clear' evidence of a legitimate supervening purpose."[76] The debtor argued that section 548(e) did not apply because he was not the sole beneficiary under the trust and that other entities, which were controlled by the debtor, had transferred assets to the trust. The court held that section 548(e) requires only that the debtor be "a" beneficiary of the trust and not "the sole" beneficiary of the trust. Further, the court found that the assets transferred by other entities were effectuated by the debtor, as the sole member of the entities and thereby satisfied the requirements of section 548(e).[77]

In *In re Combes*,[78] the Bankruptcy Court for the Eastern District of New York considered whether the debtor's purchase of two annuity policies could be avoided and brought into the estate under section 548(e). The *Combes* court's analysis focused entirely on establishing actual intent to hinder, delay or defraud, and the application of state law in that analysis. In reaching its decision, the court determined that an analysis of fraudulent intent under section 548(e) was the same as an analysis under New York law.[79] In reaching its decision, the court considered that "[u]tilizing available exemptions and engaging in pre-petition planning, without more, is not indicative of actual intent to defraud creditors."[80] In looking at the facts of the case, the court concluded, "it is clear that the debtor did not purchase the annuities and file for bankruptcy in a scheme to shield those funds from her creditors."[81] Since the court did not find actual intent to hinder, delay, or defraud by the debtor-beneficiary, the court did not discuss whether the annuities would be considered a "similar device" under section 548(e)(1)(A).

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[76]Potter, 2008 WL 5157877 at *7, (quoting *In re Acequia, Inc.*, 34 F.3d 800, 806, 31 Collier Bankr. Cas. 2d (MB) 1197, Bankr. L. Rep. (CCH) P 76068, 30 Fed. R. Serv. 3d 170 (9th Cir. 1994) (quoting *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1254–55, 24 Collier Bankr. Cas. 2d (MB) 1414, Bankr. L. Rep. (CCH) P 73841 (1st Cir. 1991))).

[77]Potter, 2008 WL 5157877 at *8.

[78]*In re Combes*, 382 B.R. 186 (Bankr. E.D. N.Y. 2008).

[79]In re Combes, 382 B.R. at 193.

[80]In re Combes, 382 B.R. at 190 (quoting *In re Keating*, 2006 WL 2690239, *5 (E.D. N.Y. 2006)).

[81]Combes, 382 B.R. at 192.

Based on case law development of section 548(e) thus far, the crucial factor of any case brought under this provision will be establishing that the debtor-settlor acted with the requisite actual intent to defraud. As of now, the 10-year statute of limitations, rather than the two- or four-year look-back period for other avoidable transfers, appears to be the only real advantage resulting from enactment section 548(e).

5. SPENDTHRIFT TRUSTS, TESTAMENTARY TRANSFERS AND SECTION 541(a)(5)(A)

A further interaction regarding spendthrift trusts and bankruptcy is when a debtor receives assets upon the death of another person. Section 541(a)(5)(A) applies to these situations and reads as follows:

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> (5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date—
>
> (A) by bequest, devise, or inheritance.[82]

A determination as to when the spendthrift trust was created must be undertaken here. If the trust was created inter-vivos and distributions from the trust are made upon the death of another person then section 541(a)(5)(A) does not apply.[83] If the trust was created pursuant to a testamentary will then Section

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[82]Supra, note 3.

[83]See *In re Ciano*, 433 B.R. 431 (Bankr. N.D. Fla. 2010); *In re Roth*, 289 B.R. 161, 49 Collier Bankr. Cas. 2d (MB) 1594 (Bankr. D. Kan. 2003); *In re Schmitt*, 215 B.R. 417, 422 n.2 (B.A.P. 9th Cir. 1997) (holding that inter-vivos trusts are not considered interest obtained by "bequest, devise or inheritance"); *Matter of Newman*, 903 F.2d 1150, 1154, 20 Bankr. Ct. Dec. (CRR) 1026, 23 Collier Bankr. Cas. 2d (MB) 170, Bankr. L. Rep. (CCH) P 73419 (7th Cir. 1990) (holding that payments made to a debtor from inter vivos trusts within 180 days of filing the petition are not interests by way of "bequest, devise, or inheritance" and are not part of the bankruptcy estate); *In re Schauer*, 246 B.R. 384 (Bankr. D. N.D. 2000) (holding that "distributions from an inter-vivos trust do not qualify as bequests, and § 541(a)(5)(A) does not operate to bring such distributions into the bankruptcy estate"); *In re Crandall*, 173 B.R. 836, 32 Collier Bankr. Cas. 2d (MB) 403, Bankr. L. Rep. (CCH) P 76310 (Bankr. D. Conn. 1994) (holding that the court is constrained to give a narrow construction

541(a)(5)(A) does apply and any distribution of income made within the 180-day period is property of the bankruptcy estate.[84]

a. Which "Applicable Nonbankruptcy" Law Is the Proper Law to Be Applied[85]

For practitioners confronted with the issue of having a debtor-beneficiary of spendthrift trust, it is important to know which nonbankruptcy law will be applied. In determining which state law to apply under section 541(c)(2), a court may use several approaches for the choice of law, but most common are the *Klaxon*

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to the words "bequest, devise and inheritance" and to conclude such words do not encompass revocable inter vivos trusts); *In re Shurley*, 171 B.R. 769, 786 (Bankr. W.D. Tex. 1994), subsequently rev'd on other grounds, 115 F.3d 333, Bankr. L. Rep. (CCH) P 77423 (5th Cir. 1997) (holding that "[i]nter-vivos trust distributions are not considered interest obtained 'by bequest, devise, or inheritance.' "). Cf. *Klebanoff v. Mutual Life Ins. Co. of New York*, 362 F.2d 975, 18 A.F.T.R.2d 5025 (2d Cir. 1966) (applying old Bankruptcy Act § 70(a), in holding that insurance proceeds were not included in the statutory language as an asset that could be brought back into the estate within six months of the petition date).

[84]As stated above, "a bankruptcy trustee can assert no claim to the corpus of a spendthrift trust because it is not property of estate." See 11 U.S.C.A. § 541(c)(2). Therefore, it flows logically that a corpus distribution from a spendthrift trust should also be excluded from property of estate. See *Matter of Newman*, 903 F.2d 1150, 1152, 20 Bankr. Ct. Dec. (CRR) 1026, 23 Collier Bankr. Cas. 2d (MB) 170, Bankr. L. Rep. (CCH) P 73419 (7th Cir. 1990) (holding that the debtor's interest in the distribution of the corpus of the spendthrift trusts was not property of estate); see also *In re West*, 81 B.R. 22, 25–26, 16 Bankr. Ct. Dec. (CRR) 1325, Bankr. L. Rep. (CCH) P 72198 (B.A.P. 9th Cir. 1987) ("The debtor's interest in property excluded under section 541(c)(2) is not listed in section 541(a)(5) . . .. [B]y this omission, Congress intended that such property not come into the estate."). "A contrary decision would drain the spendthrift trusts of any meaning and ignore the relevant Bankruptcy Code provision." Newman, 903 F.2d at 1152. *In re Coumbe*, 304 B.R. 378, 384 (B.A.P. 9th Cir. 2003). *Matter of Hecht*, 54 B.R. 379, 383, Bankr. L. Rep. (CCH) P 70821 (Bankr. S.D. N.Y. 1985), decision aff'd, 69 B.R. 290 (S.D. N.Y. 1987) (quoting *Roy v. Edgar*, 11 B.R. 853, 855–56 (Bankr. N.D. Fla. 1981)). Accord Coumbe, 304 B.R. at 384; *In re Kragness*, 58 B.R. 939, 14 Collier Bankr. Cas. 2d (MB) 643 (Bankr. D. Or. 1986); see also *Matter of Moody*, 837 F.2d 719, 723, 18 Collier Bankr. Cas. 2d (MB) 881, Bankr. L. Rep. (CCH) P 72195 (5th Cir. 1988) ("the income payments from a spendthrift trust which the beneficiary is entitled to receive or does receive within the 180 day period after the filing of the bankruptcy petition are brought into the bankruptcy estate"); *In re Schauer*, 246 B.R. 384 (Bankr. D. N.D. 2000) (holding that post-petition income distributions from a testamentary trusts are "bequests" qualified for inclusion in the bankruptcy estate under § 541(a)(5)(A)).

[85]See generally Richard W. Nenno & John E. Sullivan, III, Planning and Defending Domestic Asset-Protection Trusts, SN048 ALI-ABA 795 (2008).

rule and the *Spindle* rule.[86] "The *Spindle* rule provides that the state law of the state where the trust was created must govern the trust.[87] However, the *Spindle* rule comes from the 1884 Supreme Court case of *Spindle v. Shreve*,[88] and since this case predates *Erie Railroad v. Tompkins*,[89] the seminal choice of law case, and may ignore the Rules Decision Act, courts may elect not to follow it."[90]

The majority of jurisdictions follow the *Klaxon* rule. In *Klaxon Co. v. Stentor Elec. Mfg. Co.*, the U.S. Supreme Court held that federal courts must apply forum state choice of law rules when the court has jurisdiction based on diversity jurisdiction.[91] Bankruptcy court jurisdiction is based on 28 U.S.C.A. § 1334, not diversity jurisdiction, as in *Klaxon*, therefore the bankruptcy court should not apply the *Klaxon* rule.[92] "However, federal courts are generally accustomed to applying the *Klaxon* rule, which application may be further supported by the Rules of Decision Act."[93] Thus bankruptcy courts are more likely to apply the choice of law rules of the state where the debtor filed for bankruptcy rather than the state where the trust was formed.

6. OVERVIEW OF STATE AND CIRCUIT SPENDTHRIFT TRUST LAW

As previously mentioned, spendthrift trusts are established pursuant to state law, which necessitates an understanding of the applicable state law. There are three basic groupings within which most jurisdictions fall, those states adopting the Uniform Trust Code, those states that have adopted a statutory framework regarding trusts, and those states that interpret and enforce trusts pursuant to their common law.

a. Uniform Trust Code

The Uniform Trust Code includes the following section concerning spendthrift provisions:

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[86]Supra, note 64, at 885.

[87]Supra, note 64, at 886.

[88]*Spindle v. Shreve*, 111 U.S. 542, 547, 4 S. Ct. 522, 28 L. Ed. 512 (1884).

[89]*Erie R. Co. v. Tompkins*, 304 U.S. 64, 58 S. Ct. 817, 82 L. Ed. 1188, 114 A.L.R. 1487 (1938).

[90]Supra, note 64 at 885.

[91]*Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 U.S. 487, 496–97, 61 S. Ct. 1020, 85 L. Ed. 1477, 49 U.S.P.Q. 515 (1941).

[92]See note 64 at 885, supra.

[93]Note 64 at 885, supra.

§ 502. Spendthrift Provision.

(a) A spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest.

(b) A term of a trust providing that the interest of a beneficiary is held subject to a "spendthrift trust," or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.

(c) A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this [article], a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.

This provision attempts to codify the principles of all jurisdictions, which in general follow the principles included in this article. A number of jurisdictions have recently adopted the Uniform Trust Code, including Alabama,[94] Arizona,[95] Arkansas,[96] D.C.,[97] Florida,[98] Kansas,[99] Maine,[100] Missouri,[101] Nebraska,[102] New Hampshire,[103] New Mexico,[104] North Carolina,[105] North Dakota,[106] Ohio,[107] Oregon,[108] Pennsylvania,[109] South Carolina,[110] Tennessee,[111] Utah,[112] Virginia[113] and Wyoming.[114]

Here is a sample spendthrift provision which would satisfy the

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[94]Ala. Code §§ 19-3B-105(b)(5), 19-3B-502 (2010).

[95]Ariz. Rev. Code §§ 14-10105(b)(5), 14-10502 (2010).

[96]Ark. Code Ann. §§ 28-73-105(b)(5), 28-73-502 (2010).

[97]D.C. Code § 19.1301.05(b)(5) (2010).

[98]Fla. Stat. Ann. § 736.0105(2)(1) (2010).

[99]Kan. Stat. Ann. § 58a-105(b)(5) (2010).

[100]Me. Rev. Stat. Ann. tit. 18-B, § 105(2)(e).

[101]Mo. Rev. Stat. §§ 456.1-105(2)(5), 456.5-502 (2010).

[102]Neb. Rev. Stat. § 30-3805(b)(5); 30-3847 (2010).

[103]N.H. Rev. Stat. Ann. § 564-B:1-105(b)(5) (2010).

[104]N.M. Stat. Ann. § 46A-1-105(B)(5) (2010).

[105]N.C. Gen. Stat. § 36C-1-105(b)(5); 36C-5-502 (2010).

[106]N.D. Cent. Code § 59-09-05(2)(e) (2010).

[107]Ohio Rev. Code Ann. § 5801.04(B)(5) (2010).

[108]Or. Rev. Stat. §§ 130.020(2)(e), 130.305 (2010).

[109]20 Pa. Cons. Stat. Ann. § 7706.

[110]S.C. Code Ann. §§ 62-7-105(b)(5), 67-7502 (2010).

[111]Tenn. Code Ann. §§ 35-15-105(b)(5), 35-15-502 (2010).

requirements in jurisdictions which have adopted the Uniform Trust Code:

> No beneficial interest under this Trust Agreement may be voluntarily or involuntarily anticipated, assigned, encumbered, pledged, sold or otherwise transferred, except pursuant to the exercise of the powers granted in this Trust Agreement to disclaim, appoint, and release. No beneficial interest under this Trust Agreement shall be capable of being taken or reached by any attachment, levy, writ, or other legal or equitable process to satisfy any claim against, or obligation of, the person having that interest. No such interest shall be subject to control or interference by any other person. Any attempt to dispose of, or to take or reach, any interest in violation of this spendthrift provision shall be invalid and given no effect by any Trustee.[115]

b. Statutory Trusts: Spendthrift And Self-Settled Spendthrift Trusts

Other states have enacted their own legislation with regard to trusts in general, which includes their recognition of spendthrift trusts. These states can be separated into two groups, those that recognize self-settled spendthrift trusts and those that do not.

The first group consists of states that recognize self-settled spendthrift trusts, which includes Alaska,[116] Delaware,[117] Nevada,[118] Rhode Island,[119] Utah,[120] Oklahoma,[121] South Dakota,[122] Missouri,[123] Tennessee,[124] Wyoming,[125] and New Hampshire.[126] These states have provisions similar to those found in states that do not

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[112]Utah Code Ann. §§ 75-7-105(2)(e), 75-7502 2010).

[113]Va. Code Ann. §§ 55-541.05(B)(5), 55-545-502 (2010).

[114]Wyo. Stat. Ann. §§ 4-10-105, 4-10-502 (2010).

[115]Spendthrift trust provision—Direct prohibition against alienation—Except exercise of power to disclaim, appoint and release, 16B Am. Jur. Legal Forms 2d § 237:9 (2010).

[116]See note 55, supra.

[117]See note 56, supra.

[118]See note 56, supra.

[119]See note 56, supra.

[120]See note 56, supra.

[121]See note 56, supra.

[122]See note 56, supra.

[123]See note 56, supra.

[124]See note 56, supra.

[125]See note 56, supra.

[126]See note 56, supra.

recognize self-settled spendthrift trusts, however, they include a provision, similar to that in Alaska's statute, which reads:

> (a) A person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust, including a beneficiary who is the settlor of the trust, may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. Payment or delivery of the interest to the beneficiary does not include a beneficiary's use or occupancy of real property or tangible personal property owned by the trust if the use or occupancy is in accordance with the trustee's discretionary authority under the trust instrument. A provision in a trust instrument that provides the restrictions described in this subsection is considered to be a restriction that is a restriction on the transfer of the transferor's beneficial interest in the trust and that is enforceable under applicable nonbankruptcy law within the meaning of 11 U.S.C. 541(c)(2) (Bankruptcy Code), as that paragraph reads on September 15, 2004, or as it may be amended in the future.[127]

This statute has been the model legislation for most of the jurisdictions that have enacted legislation recognizing self-settled spendthrift trusts.

The second group of states consists of those that have enacted spendthrift trust legislation but do not recognize self-settled spendthrift trusts.

- **California**

California recognizes spendthrift trusts, the applicable statutes can be found in sections 15300 to 15309 of the California Probate Code.[128] California does not recognize self-settled trusts and makes available to creditors the amount of the trust res in which the settlor-beneficiary has an interest.[129] California's legislation is different from the Uniform Trust Code by recognizing many exceptions to the anti-alienation provision.[130] The anti-alienation provision in California is not valid against:

- support obligations[131] or liability for public support;[132]

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[127]See note 56, supra.

[128]Cal. Prob. Code §§ 15300 et seq. (2010).

[129]Cal. Prob. Code § 15304.

[130]Cal. Prob. Code §§ 15301(b) et seq. (2010).

[131]Cal. Prob. Code § 15305.

[132]Cal. Prob. Code § 15306.

- may be reachable to judgment creditors seeking restitution;[133]
- any income received by the beneficiary above the amount needed for education or support will be liable for the satisfaction of a judgment creditor upon petition to the court.[134]

The principal of the spendthrift trust is unreachable by creditors, except when an "amount of principal has become due and payable to the beneficiary under the trust instrument," which may be used to satisfy a judgment creditor upon petition to the court.[135]

- **Connecticut**

Connecticut's legislation recognizes spendthrift trusts, however, only to the extent that the trust is for support of the beneficiary or the beneficiary's family.[136] If the trust is created for any other purpose the assets of the trust are available to creditors in equity.[137]

- **Georgia**

Georgia recognizes spendthrift trusts under a similar analysis as was provided in the foregoing[138] however it recognizes certain exceptions. The exceptions to anti-alienation in Georgia are the following:

> A spendthrift provision prohibiting involuntary transfers is not valid as to the following claims against a distribution to a beneficiary, other than a beneficiary who has a medically determined physical or mental disability that substantially impairs the beneficiary's ability to provide for the beneficiary's care or custody and constitutes a substantial handicap . . . to the extent the distribution would be subject to garnishment under the laws of this state if the distribution were disposable earnings:
>
> (1) Tort judgments;
> (2) Taxes;
> (3) Governmental claims;
> (4) Alimony;
> (5) Child support; or
> (6) Judgment for necessaries not voluntarily provided by the claimant.

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[133]Cal. Prob. Code § 15305.

[134]Cal. Prob. Code § 15307.

[135]Cal. Prob. Code § 15301(b).

[136]Conn. Gen. Stat. § 52-321 (2010).

[137]Conn. Gen. Stat. § 52-321.

[138]Ga. Code Ann. § 53-12-28 (2010).

- **Idaho**

Idaho's recognition of spendthrift trusts is similar to that of the Uniform Trust Code.[139] Idaho does not recognize restraints on alienation in self-settled trusts;[140] however, the self-settled trust is qualified to an extent. If the grantor is able to receive a disbursement of the trust assets to satisfy a tax debt arising out of the creation of the trust, it will not be considered a self-settled trust.[141] Nor is the trust or any portion of the trust considered self-settled when a beneficiary is appointed trustee of the spendthrift trust resulting from the exercise of "testamentary power of appointment."[142]

- **Illinois**

Illinois recognizes spendthrift trusts as valid against judgment creditors.[143] Spendthrift provisions are not a valid restraint, however, as to creditor claims arising out of the collection of support under:

> Section 4.1 of the "Non-Support of Spouse and Children Act", Section 22 of the Non-Support Punishment Act, and similar Sections of other Acts which provide for support of a child as follows:
>
> (1) income may be withheld if the beneficiary is entitled to a specified dollar amount or percentage of the income of the trust, or is the sole income beneficiary; and
>
> (2) principal may be withheld if the beneficiary has a right to withdraw principal, but not in excess of the amount subject to withdrawal under the instrument, or if the beneficiary is the only beneficiary to whom discretionary payments of principal may be made by the trustee.

- **Indiana**

Indiana recognizes the validity of spendthrift trust provisions, to the extent the trust is not self-settled.[144] However, if the trust is qualified under 26 U.S.C.A. § 401(a), the fact that the trust is self-settled does not destroy the spendthrift provision.[145]

- **Iowa**

To the extent a beneficiary's interest is not subject to a spend-

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[139]Idaho Code § 15-7-502 (2010).

[140]Idaho Code § 15-7-502(4).

[141]Idaho Code § 15-7-502(5).

[142]Idaho Code § 15-7-502(6)(b).

[143]735 Ill. Comp. Stat. 5/2-1403 (2010).

[144]Ind. Code Ann. § 30-4-3-2 (2010).

[145]Ind. Code Ann. § 30-4-3-2.

thrift provision, and subject to Sections 633A.2305 and 633A.2306, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by levy, attachment, or execution of present or future distributions to or for the benefit of the beneficiary or other means.[146]

- **Kentucky**

Kentucky recognizes spendthrift trusts as to trust income and principal with regard to voluntary and involuntary alienation. However, exceptions are made for necessary services, alimony and support obligations, certain taxes, and where the trust is self-settled.[147]

- **Louisiana**

Louisiana is one of only two states to have codified the Model Spendthrift Trust Act prepared by Dean Griswold.[148] Louisiana recognizes the validity of spendthrift trusts except to the extent the creditor is seeking payment on a debt arising from the (1) alimony, or maintenance of a person whom the beneficiary is obligated to support; or (2) necessary services rendered or necessary supplies furnished to the beneficiary or to a person whom the beneficiary is obligated to support.[149]

- **Mississippi**

Mississippi recognizes the validity of spendthrift trusts except for self-settled spendthrift trusts.[150]

- **New Jersey**

New Jersey recognizes the validity of spendthrift trust restraints on alienation[151] and the analysis under the law is consistent with the foregoing article.

- **New York**

New York recognizes the validity of spendthrift trust restraints on alienation.[152] Under New York law, "all express trusts are presumed to be spendthrift unless the settlor expressly provides

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[146]Iowa Code Ann. § 633A.2301 (2010).

[147]Ky. Rev. Stat. Ann. § 381.180 (2010).

[148]La. Rev. Stat. §§ 9:2002 to 9:2007 (West 2010); Model Spendthrift Trust Act prepared by Dean Griswold, The Law of Trusts and Trustees § 222 (2010).

[149]La. Rev. Stat. Ann. § 9:2004 (2010).

[150]Miss. Code Ann. § 91-9-503 (2010).

[151]N.J. Stat. Ann. 3B-9-11 (2010).

[152]N.Y. Est. Powers & Trusts Law § 7-1.5 (McKinney) (2010).

otherwise."[153] Further, there is a statutory presumption of a spendthrift trust for all assets held pursuant to section 408 or section 408A of the U.S. Internal Revenue Code of 1986, as amended, or a Keogh (HR-10), retirement or other plan established by a corporation, which is qualified under section 401 of the U.S. Internal Revenue Code of 1986.[154] New York recognizes some exceptions to restraint including support obligations of the beneficiary[155] and where the disbursement received by the beneficiary is in excess of the amount necessary for support of the beneficiary, whereupon judgment creditors may seek payment by petition to the court.[156]

- **Oklahoma**

Oklahoma is the other state to have adopted the Model Spendthrift Trusts act prepared by Dean Erwin Griswold.[157] The analysis and language of the statute is almost identical to that of Louisiana.[158]

- **South Dakota**

South Dakota recognizes as valid spendthrift trust restrains on alienation.[159] The code is identical to the Former California Code with regards to spendthrift trusts.[160]

- **Texas**

Texas recognizes as valid spendthrift trust restraints on alienation.[161] The analysis is similar to the analysis put forth in the foregoing and that of the Uniform Trust Code.

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[153] *Regan v. Ross*, 691 F.2d 81, 86 n.14, 9 Bankr. Ct. Dec. (CRR) 1059, 7 Collier Bankr. Cas. 2d (MB) 485, Bankr. L. Rep. (CCH) P 69025 (2d Cir. 1982). *See* N.Y. Est. Powers & Trusts Law § 7-1.5(a)(1) (2010).

[154] N.Y. Est. Powers & Trusts Law § 7-3.1(b)(2) (2010).

[155] N.Y. Est. Powers & Trusts Law § 7-1.6 (2010).

[156] N.Y. Est. Powers & Trusts Law § 7-3.4 (2010).

[157] Okla. Stat. Ann. tit. 60, § 175.25 (2010).

[158] See notes 148 and 149, supra.

[159] S.D. Codified Laws §§ 43-10-12 and 43-10-13 (2010).

[160] See S.D. Codified Laws §§ 43-10-12 (2010) (Credits); Cal. Prob. Code §§ 867 and 859 (prior law) (repealed 1986).

[161] Texas Prop. Code Ann. § 112.035 (2010).

- **Washington**

Washington has codified its recognition of spendthrift trust restraints on alienation,[162] and has no other exceptions by which the anti-alienation provision may be restricted.

- **West Virginia**

Similar to most of the referenced jurisdictions, West Virginia codified its recognition of spendthrift trusts.[163]

- **Wisconsin**

Wisconsin has established legislation by which it recognizes the validity of spendthrift trust restraints,[164] subject to claims arising from child, spousal[165] or public support.[166]

c. Common Law Jurisdictions

The remaining jurisdictions—Colorado, Hawaii, Maryland, Massachusetts, Michigan, and Minnesota[167]—recognize the validity of spendthrift trusts pursuant to the principles of common law. The framework of law and analysis under which these jurisdictions act are based on case law specific to each jurisdiction, but generally are in accord with principles espoused in the foregoing article.

CONCLUSION

When a bankruptcy practitioner is confronted with a prospective debtor client who has an interest in a spendthrift trust, the practitioner must consider: (1) whether the trust is a testamentary or inter-vivos trust; and (2) whether the spendthrift provision is enforceable under the law of the jurisdiction applicable to that trust, including analysis of both state and federal non-bankruptcy laws.

Further, other bankruptcy provisions may impact whether the spendthrift provision protects the interest of the debtor in that trust, such as Sections 541(a)(5)(A) and 548(e). When these provisions apply, an additional analysis under the respective frame-

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[162]Wash. Rev. Code § 11.96.150 (2010).

[163]W. Va. Code § 36-1-18 (2010).

[164]Wis. Stat. Ann. § 701.06 (2010).

[165]Wis. Stat. Ann. § 701.06(4).

[166]Wis. Stat. Ann. § 701.06(5).

[167]Minnesota has statutes with regard to spendthrift trust involving insurances policies, Minn. Stat. Ann. § 61A.04 and employee retirement trusts, § 501B.87 (2010).

works of these sections is undertaken, even though the spendthrift provision may have been validly created.