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# Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?

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The bankruptcy courts' recent attempts to apply conflict of laws principles to spendthrift trusts seem to substantiate the old adage that bad facts produce bad law. Citing public policy concerns, the bankruptcy courts in two recent decisions in this area, *In re Portnoy*<sup>1</sup> and *In re Brooks*,<sup>2</sup> each applied the law of the forum state, rather than that designated under the trust instrument, in order to avoid finding that "applicable non-bankruptcy law" exempted a self-settled<sup>3</sup> spendthrift trust from the bankruptcy estate under Bankruptcy Code section 541(c)(2).<sup>4</sup>

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1. *Marine Midland Bank v. Portnoy (In re Portnoy)*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

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

3. A "self-settled" trust is one in which the settlor retains an interest as a beneficiary, even if it is only to receive distribution in the discretion of a trustee (other than the settlor).

4. See *In re Portnoy*, 201 B.R. at 698-701; *In re Brooks*, 217 B.R. at 102-04. Although neither court specifically discusses 11 U.S.C. § 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 non-bankruptcy law is enforceable in a case under this title," it follows from each court's reasoning that neither wanted to grant the debtor the relief afforded by that section through a finding that the foreign law recited in the trust as controlling was the "applicable non-bankruptcy law." Each court instead turned to the law of the forum to determine the trust's

Although each of the debtors in *Portnoy* and *Brooks* appeared to have created the trusts primarily to avoid creditors' claims,<sup>5</sup> neither the *Portnoy* court nor the *Brooks* court even attempted to distinguish the substantial authority providing that a settlor's designation of controlling law is generally to be respected by the courts.<sup>6</sup> Although the results in *Portnoy* and *Brooks* may have been appropriate to their immediate facts, the purported common rationale for their holdings nevertheless does a disservice to the generally thoughtful and considered body of law in this area. These decisions set an unfortunately biased precedent for future debtors who may be more deserving of relief.<sup>7</sup> This Article will attempt to elucidate that broader body of conflict of laws principles and to apply those principles to spendthrift trusts and the Bankruptcy Code section 541(c)(2) exemption in a more objective manner than may have been possible under the presumably egregious factual backgrounds of *Portnoy* and *Brooks*.<sup>8</sup>

*validity.* By finding the trust to be invalid, the courts avoided the issue of determining whether "applicable non-bankruptcy law" provided the spendthrift protection afforded under section 541(c)(2).

5. In its opening remarks, the *Portnoy* court stated that "[a]t the heart of [*Portnoy*] lies an irrevocable offshore trust into which [the debtor] placed virtually all of his assets at a time when he knew that his personal guarantee of his corporation's indebtedness was about to be called. The debtor . . . claims not only that his assets have been successfully insulated under the law of the Jersey Channel Islands . . . but that he is entitled as a matter of law to a discharge of all debts including the indebtedness which he guaranteed." *In re Portnoy*, 201 B.R. at 688.

Although the full factual background of *Brooks* is not set out in the court's opinion, it is nevertheless easily inferred from the fact that the court twice characterized the debtor's purported estate planning as a "scheme" that the court considered the debtor to have acted in bad faith for reasons other than the pure "estate planning" motives recited by the debtor. *In re Brooks*, 217 B.R. at 102, 103.

6. See generally *In re Portnoy*, 201 B.R. at 697-700; *In re Brooks*, 217 B.R. at 101-03.

7. Although the authors believe that the courts in both *Portnoy* and *Brooks* reached the correct result in denying the debtors their discharge, the same result could presumably have been achieved using either a fraudulent transfer or bad faith theory without resort to what the authors believe to be a novel (and result driven) interpretation of conflict of laws principles.

8. An even more recent bankruptcy case, *In re Stephan Jay Lawrence*, 227 B.R. 907 (S.D. Fla. 1998), which also deigned to apply the law of the forum state rather than the law designated by the trust settlor under the trust instrument, is not a focus of this Article since it does not consider the applicability of the spendthrift trust exemption of Bankruptcy Code section 541(c)(2) in light of the conflict between the law of the forum (Florida) and that designated under the trust instrument (Mauritius), but rather denied the debtor his discharge based upon his "unrelenting campaign to conceal crucial information," and his "web of deception." *Id.* at 911, 916.

## I. BACKGROUND

The conflict of laws issue in both *Portnoy* and *Brooks* seems to have turned on a single defining feature: the settlors' designation of the laws of "offshore" jurisdictions, specifically, Bermuda and the Jersey Channel Islands, in an effort to obtain spendthrift protections for the settlors' retained beneficial trust interests at a time when the settlors were apparently experiencing significant creditor problems.<sup>9</sup> The settlors' decision to go offshore was presumably driven by the fact that at the time the *Portnoy* and *Brooks* trusts were created, most domestic jurisdictions (including the respective forum states) did not permit a self-settled trust to effectively shield a settlor's retained beneficial interest from her creditors.<sup>10</sup> This is in contrast to the generally permissive state of domestic law permitting effective restraints on the alienation of non-settlor beneficiaries' trust interests. With respect to those interests, courts throughout the United States have for the past hundred and twenty years applied the maxim "*cujus est dare, ejus est disponere*," or "[w]hose it is to give, his it is to dispose."<sup>11</sup>

The *Portnoy* court chose the rule of the Restatement (Second) of Conflict of Laws section 270 to resolve the conflict between the law of the Jersey Channel Islands and the law of the respective forum state.<sup>12</sup> Section 270 provides that:

An inter vivos trust of interests in movables is valid if valid

(a) under the local law of the state designated by the settlor to govern the validity of the trust, provided . . . that the application of its law does not violate a *strong* public policy of the state with which, *as to the matter at issue*, the trust has its *most significant relationship* under the principles stated in [RESTATEMENT (SECOND) OF CONFLICT OF LAWS] § 6 . . .<sup>13</sup>

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9. *In re Portnoy*, 201 B.R. at 697-99; *In re Brooks*, 217 B.R. at 101-03. Although in *Brooks* it was actually the debtor's wife who settled the trust for the debtor's benefit, she had received the subject property from the debtor just prior to settlement and the court, therefore, held that she was, in fact, a mere nominee of the debtor. *In re Brooks*, 217 B.R. at 102-03.

10. See RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959). A notable, but seemingly little used, exception existed at that time under Missouri law. See MO. ANN. STAT. § 456.080 (West 1992). See also *Estate of Uhl v. Commr.*, 241 F.2d 867 (7th Cir. 1957); *Estate of German v. Commr.*, 7 Cl. Ct. 641 (1985), cases involving federal estate tax matters but holding that certain self-settled trust protections are afforded, respectively, under Indiana and Maryland law.

11. BLACK'S LAW DICTIONARY 378 (6th ed. 1990).

12. See *In re Portnoy*, 201 B.R. at 698.

13. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 270 (1971) (emphasis added).

The *Portnoy* court also cited New York law, and recognized that, under this law, "to render foreign law unenforceable as contrary to public policy, it must violate some fundamental principal of justice, some prevalent conception of good morals, or some deep-rooted tradition of the common weal."<sup>14</sup>

The *Portnoy* and *Brooks* courts then discussed precedent that held self-settled spendthrift trusts to be contrary to public policy under the law of their respective forum states.<sup>15</sup> Each court thus determined to decide whether the trust was valid using the subjective criteria set forth in section 6 of the Restatement (Second) of Conflict of Laws which provides that "[a] court, subject to constitutional restrictions, will follow a statutory directive of its own state on choice of law," or, if none, the court should determine choice of law based on

- (a) the needs of the interstate and international systems,
- (b) the relevant policies of the forum,
- (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue,
- (d) the protection of justified expectations,
- (e) the basic policies underlying the particular field of law,
- (f) certainty, predictability and uniformity of result, and
- (g) ease in the determination and application of the law to be applied.<sup>16</sup>

Under this analysis, the courts in both cases held that the domestic jurisdiction had a greater interest in the matter at issue than did the foreign jurisdiction.<sup>17</sup> The blanket rule that may be

14. *In re Portnoy*, 201 B.R. at 700 (citing 19 N.Y. Jur.2d, *Conflict of Laws* § 14, at 586-87 (1982)).

15. *In re Portnoy*, 201 B.R. at 700; *In re Brooks*, 217 B.R. at 103-04.

16. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6.

17. See *In re Portnoy*, 201 B.R. at 698; *In re Brooks*, 217 B.R. at 101. However, the *Brooks* court decided to apply the law of the forum state by simple reference to the Connecticut Superior Court's opinion in *Stetson v. Morgan Guaranty Trust Company of New York*, 164 A.2d 239 (1960) rather than pursuant to a true analysis under section 6 of the Restatement. *In re Brooks*, 217 B.R. at 101. Specifically, the *Brooks* court, citing *Stetson*, stated that, "Connecticut courts have held that ' . . . the legality of the trust of personalty [is determined] by the law of the settlor's domicil . . . ' " *Id.* The court, therefore, looked only to the settlor's Connecticut residency to hold that Connecticut law trumped the law of the Jersey Channel Islands. See *id.* at 103-04.

Interestingly, the full quote from the *Stetson* opinion provides a very different import than the one set forth by the *Brooks* court:

While in general the validity of a trust of realty has been determined by the law of the situs of the land and the legality of the trust of personalty by the law of the settlor's domicil, there are many opportunities for complications and variations. Among other considerations, the courts are influenced by the nature of the property involved and its location; the domicil of the settlor and the trustee; the situs of the trust administration and whether

distilled from these cases seems to be that, unlike with other spendthrift trusts, public policy acts as an absolute bar to an individual's right to create an effective *self-settled* spendthrift trust unless the law of the forum state permits such trusts.

## II. DISCUSSION

Putting aside the subjective consideration of public policy, the law is well established that a settlor's designation of controlling law governs the administration of a trust, including the efficacy of a trust's spendthrift provision:

If the settlor creates a trust to be administered in a state other than that of his domicil, the law of the state of the place of administration, rather than that of his domicil, ordinarily is applicable. Thus a settlor domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state. In that case the law of that state will be applicable as to the rights of creditors to reach the beneficiary's interest.

This permits a person who is domiciled in a state in which restraints on alienation are not permitted, to create an inter vivos trust in another state where they are permitted and thereby take advantage of the law of the latter state.<sup>18</sup>

In fact, in some jurisdictions a settlor's ability to designate the law of a particular jurisdiction as the governing law of the trust is expressly provided by statute. For example, section 7-1.10 of the New York Estates, Powers and Trusts Law provides that "[w]henever a person, not domiciled in this state, creates a trust which provides that it shall be governed by the laws of this state, such provision shall be given effect in determining the validity, effect and interpretation of the disposition in such trust . . ."<sup>19</sup> Interpreting a prior version of this statute, the New York Court of Appeals in *Hutchinson v. Ross* stated that "[t]he statute makes [a settlor's] express declaration of intention [of controlling law] conclusive . . ."<sup>20</sup> A New York court also noted that "[i]t cannot be doubted . . . that this state encourages the selection by

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the question is the legality of the act of trust creation or the rule governing trust administration. *There is a tendency to respect the expressed will of the settlor as to the controlling law.*

*Stetson*, 164 A.2d at 240 (emphasis added) (citing 1A Bogert, TRUSTS AND TRUSTEES § 211).

18. 5A ASTON W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 626, at 419 (4th ed. 1989).

19. N.Y. ESTATES, POWERS AND TRUSTS LAW § 7-1.10 (McKinney 1992).

20. *Hutchinson v. Ross*, 187 N.E. 65, 71 (N.Y. 1933).

residents of other states of New York as the situs of trusts."<sup>21</sup> Although the *prima facie* ability of a domiciliary settlor to create a valid trust governed by the laws of a foreign jurisdiction is not expressly conferred by statute, it is either set forth under existing case law or can be logically inferred.<sup>22</sup> A strong argument can also be made that principles of judicial comity require that a settlor's designation of controlling law be respected by the courts.<sup>23</sup>

The apparent conflict over the import of section 270 of the Restatement (Second) of Conflict of Laws, as set forth in *Portnoy* and *Brooks* and the foregoing authorities is a result of the fact that section 270 is specific to the *validity* of a trust rather than the efficacy of a purported restraint on alienation of beneficial trust interests. With regard to the conflict of laws issue on this latter matter, section 273 of the Restatement (Second) of Conflict of Laws is the applicable authority. Section 273 provides that:

Whether the interest of a beneficiary of [an inter-vivos] trust of movables is assignable by him and can be reached by his creditors is determined

. . .  
 . . . by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related.<sup>24</sup>

The express public policy caveat of section 270 is neither repeated in section 273 nor in the official comment.<sup>25</sup> The absence of such a caveat raises the question of whether public policy is an appropriate basis for effectively overturning a settlor's designation of controlling law when the issue is the alienation of spendthrift trust interests rather than the general validity of the

21. *In re Accounting of New York Trust Co.*, 87 N.Y.S.2d 787, 792 (N.Y. Sup. Ct. 1949). For other laws supporting a settlor's right to determine the law applicable to a trust see R.I. GEN. LAWS § 18-1-1 to 18-1-4 (1997); Convention on the Law Applicable to Trusts and on their Recognition, Oct. 8, 1984, art.6 reprinted in 23 I.L.M. 1389, 1389 (1984). ("A trust shall be governed by the law chosen by the settlor.")

22. See, e.g., *In re New York Trust Co.*, 87 N.Y.S.2d at 792 ("It is inconceivable that a state committed to [the policy of ESTATES, POWERS AND TRUSTS LAW § 7-1.10] would deny its own residents the corresponding right to establish trusts in other states. . . . [U]nder the law of this state, a New York resident may choose another state as the situs of a trust as freely as a non-resident may create a trust in New York.")

23. See generally 17 C.J.S. § 12(1).

24. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 273 (1971).

25. Compare *id.* § 270 (stating that the settlor's designation of the law governing the trust is only valid if not contrary to a "strong public policy" of the state whose laws would ordinarily govern the trust) with *id.* § 273 and cmt. d (stating that an *inter vivos* trust and whether it can be reached by creditors will be governed by the laws of the state designated by the settlor).

trust. Although it cannot be denied that public policy concerns underlie the application of all conflict of laws principles, the express public policy provision in section 270 makes its absence from section 273 conspicuous and suggestive of a relatively low importance vis à vis the application of conflict of laws principles to spendthrift trusts.

Indeed, even the *Portnoy* and *Brooks* courts acknowledged that a settlor may generally specify the trust's controlling law.<sup>26</sup> For this reason, each court most likely misconstrued the question before it as one of *validity* under section 270, rather than *administration* and efficacy of the spendthrift provision under section 273. Moreover, even under section 270, each court simply chose to assume the premise that it wished to prove; that is, the law of the forum should govern because it provides that self-settled trusts are void as to the settlor's creditors.<sup>27</sup> Such reasoning, however, constitutes an obvious nonsequitur. Although application of the foreign law may, *arguendo*, have violated a strong public policy of the forum, such a finding cannot deliver the courts' desired result unless it is also the case that "as to the matter at issue, the trust has its most significant relationship" to the forum.<sup>28</sup>

On this latter point, although the principles set forth in section 6 of the Restatement (Second) of Conflict of Laws, recited above, are quite general, it seems questionable whether, as to the matter at issue, the *Portnoy* and *Brooks* trusts would have their most significant relationship with the forum state. This issue would most likely turn on the location of the primary administration of the trust.<sup>29</sup> For example, a trust designates the law of the Jersey Channel Islands as controlling, and the trustee resides in the Jersey Channel Islands with the vast majority of trust transactions taking place in the Jersey Channel Islands, but the trust settlor is a resident somewhere in the United States. It would appear that a domestic creditor, with a cause of action against the trust settlor, would be hard pressed to argue that the United States has a more significant relationship with the trust as to that cause of action than the Jersey Channel Islands. Aside

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26. See *Marine Midland Bank v. Portnoy* (*In re Portnoy*), 201 B.R. 685, 697 (Bankr. S.D.N.Y. 1996); *Sattin v. Brooks* (*In re Brooks*), 217 B.R. 98, 101 (Bankr. D. Conn. 1998).

27. See *In re Portnoy*, 201 B.R. at 700; *In re Brooks*, 217 B.R. at 102.

28. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 270.

29. It is interesting to note that for federal tax purposes, whether a trust is deemed domestic (i.e., U.S.) or foreign turns upon whether a domestic court is able to exercise primary supervision over the administration of the trust and whether domestic trustees control all substantial decisions effecting the trust. See 26 U.S.C. § 7701(a)(30)(E)(i).



from the cases dealing with self-settled trusts, there seems to be no authority suggesting that a court cannot apply the law declared by the trust settlor simply because the debtor/beneficiary resides in the forum state.<sup>30</sup> Although the public policy concerns of the forum state may well differ when the trust is self-settled, focusing on self-settlement begs the applicable question: "as to the matter at issue," which state has the most significant relationship to the trust?

Moreover, in contrast to the implication of *Portnoy* and *Brooks*, the fact that the forum state does not permit self-settled spendthrift trusts to be created under its own law does not necessarily mean that it would violate a *strong* public policy of the forum state to recognize a self-settled spendthrift trust if it was validly created under the law of a foreign jurisdiction. In fact,

[i]t would seem that the policy of a state, whether it be to restrain alienation in order to protect the beneficiary, or to permit alienation in order to protect creditors and assignees, is not so strong as to preclude the application of the law to the contrary prevailing in another state.<sup>31</sup>

Although not dealing with the efficacy of a restraint on the alienation of a self-settled spendthrift trust interest, the Fifth Circuit has stated that:

Mere difference between the law of the forum and that of the foreign State does not of itself prevent enforcement of the foreign law or rights based thereon if such law is not against the public policy of the forum. The fact, therefore, that under Florida law the trust agreement is presumptively void does not prevent a Florida court from applying the law of Minnesota, where the agreement was made and under which law the agreement is presumptively valid. Such difference in the law of Florida and that of Minnesota does not of itself prevent enforcement in Florida of the Minnesota contract and the rights based thereon, since the difference is not contrary to the prohibitory law of that forum.<sup>32</sup>

In addition, in every case where the enforcement of the law of another jurisdiction appears contrary to the public policy of the

30. See, e.g., *Subranni v. Remington (In re Remington)*, 14 B.R. 496, 502 (Bankr. D.N.J. 1981) (stating that the validity of a trust's spendthrift protection is determined by the law of the trust's situs, rather than law of the bankrupt beneficiary's domicile); see also *Togut v. Hecht (In re Hecht)*, 54 B.R. 379 (Bankr. S.D.N.Y. 1985), *aff'd* 69 B.R. 290 (S.D.N.Y. 1987); *In re Accounting of New York Trust Co.*, 87 N.Y.S.2d 787 (N.Y. Sup. Ct. 1949).

31. SCOTT & FRATCHER, *supra* note 18, § 626, at 414.

32. *Warner v. Florida Bank and Trust Co.* 160 F.2d 766, 772 (5th Cir. 1947). See also *Surman v. Fitzgerald (In re Fitzgerald)*, 1 Ch. 573 (1904), *rev'g* 1 Ch. 933 (1903) (stating that although restraints on the alienation of beneficial trust interests are not permitted under English law, they are not so far contrary to public policy as to preclude the English courts from enforcing them in trusts validly created under Scottish law).

forum state, principles of judicial comity provide a counterbalancing public policy that the validity of the law of such other jurisdiction be enforced.<sup>33</sup>

There are also a number of cases that have applied conflicts of law principles to spendthrift trusts without resort to public policy. For example, though not considered in either the *Portnoy* or *Brooks* opinions, the bankruptcy court's decision in *Togut v. Hecht* seems to provide direct precedent for both cases.<sup>34</sup> At issue in *Togut* was "whether the laws of the State of Maryland or New York are applicable in determining the validity of the spendthrift trust provisions . . ."<sup>35</sup> In *Togut*, the debtor argued for the application of Maryland law, because it would preclude the bankruptcy trustee from claiming any portion of the spendthrift trust's undistributed income and principal as a part of the bankruptcy estate.<sup>36</sup> The bankruptcy trustee argued that the law of the forum state of New York should apply, because under the law of New York, the bankruptcy trustee would be entitled to ten percent of the trust's undistributed income as well as any portion of the remaining ninety percent of such income that might be in excess of the debtor's reasonable living requirements.<sup>37</sup> The bankruptcy court's determination that the law of Maryland was the "applicable non-bankruptcy law" for purposes of determining the Bankruptcy Code section 541(c)(2) exemption<sup>38</sup> was based solely upon the trust settlor's designation of Maryland law as the law governing "all questions pertaining to [the trust's] validity, construction and administration."<sup>39</sup> The court apparently did not consider the possibility that the application of the more broadly based Maryland spendthrift laws might offend the public policy concerns of the bankruptcy court's forum of New York. The bankruptcy court's decision in *Togut* is, therefore, difficult to reconcile with *Portnoy* and *Brooks*, as all three cases dealt with the application of conflict of laws principles to the spendthrift trust exemption under section 541(c)(2).<sup>40</sup> It is

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33. Comity is granted "not as a matter of obligation but out of deference and mutual respect." See, e.g., *Brown v. Babbitt Ford, Inc.*, 571 P.2d 689, 695 (Az. Ct. App. 1977). The extension of comity, therefore, anticipates a reciprocal grant.

34. See generally *Togut v. Hecht* (*In re Hecht*), 54 B.R. 379 (Bankr. S.D.N.Y. 1985).

35. *Id.* at 381.

36. *Id.*

37. See *id.*

38. See *id.* at 382.

39. *Id.* at 381.

40. See *Togut v. Hecht* (*In re Hecht*), 54 B.R. 379, 382; *Marine Midland Bank v. Portnoy* (*In re Portnoy*), 201 B.R. 685, 701 (Bankr. S.D.N.Y. 1996). Cf. *Sattin v. Brooks* (*In re Brooks*), 217 B.R. 98, 101-03 (Bankr. D. Conn. 1998). A

especially difficult to reconcile *Portnoy* and *Togut* since both cases were decided in a New York forum that presumably had the same public policy in *Portnoy* that it did a mere nine years earlier in *Togut*.

Of the cases outside the bankruptcy area concerning the application of conflict of laws principles to spendthrift trusts, many respect the settlor's express designation of controlling law, notwithstanding that such a result seems to frustrate public policy concerns at least as important as the protection of creditors' rights. Most telling, perhaps, are those cases that deal either with a spousal right of election or the rights of parties in marital contests, as both types of cases implicate a substantial public policy recognized in all states. For example, in *The National Shawmut Bank of Boston v. Cumming*,<sup>41</sup> the settlor, a domiciliary of Vermont, created a trust of "the greater part of his property," which trust the settlor designated to be "construed and the provisions thereof interpreted under and in accordance with the laws of the Commonwealth of Massachusetts."<sup>42</sup> As recognized by the lower court's opinion, the *Shawmut* settlor's clearly implied intent in designating Massachusetts law as controlling was to defeat his surviving spouse's significantly greater inheritance rights under Vermont law.<sup>43</sup> According to the *Shawmut* court:

[i]f the settlor had been domiciled in this Commonwealth and had transferred here personal property here to a trustee here for administration here, the transfer would have been valid even if his sole purpose had been to deprive his wife of any portion of it. The Vermont law we understand to be otherwise and to invalidate a transfer made there by one domiciled there of personal property there, if made with an actual, as distinguished from an implied, fraudulent intent to disinherit his spouse.<sup>44</sup>

In holding that Massachusetts law should apply, thereby depriving the surviving spouse of the greater part of her inheritance rights, the *Shawmut* court stated that "[t]he general tendency of authorities elsewhere is away from the adoption of the law of the settlor's domicile where the property, the domicile

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distinction between *Togut*, and *Portnoy* and *Brooks*, is that the *Togut* trust was not self-settled. *In re Hecht*, 54 B.R. at 381. However, if self-settlement is a valid ground for disregarding the settlor's declaration of governing law (as opposed to the public policy considerations applicable to the differing disabling restraints underlying that declaration), no court has yet proffered such a justification and, at best, it seems questionable whether such a distinction could be persuasively presented.

41. 91 N.E.2d 337 (Mass. 1950).
42. *Id.* at 339.
43. *See id.*
44. *Id.* at 340 (citations omitted).

and place of business of the trustee, and the place of administration intended by the settlor are in another State.<sup>745</sup>

If the courts, nevertheless, insist upon a general public policy review whenever a self-settled spendthrift trust comes within their purview, their natural impulse towards automatic reliance on precedent must be tempered by recognition that our society has changed significantly since the Restatement (Second) of Conflict of Laws took its snap-shot of the law more than forty years ago. It is a truism that notions of public policy are not static, but vary with time and place, and courts are obliged to revisit public policy if they choose to cite to it as a judicial check against otherwise permissible estate and asset protection planning opportunities. In this regard, it was not until the United States Supreme Court decided *Nichols v. Eaton*<sup>46</sup> in 1875 that the general validity of spendthrift trusts, which today we take for granted in this country, was first recognized throughout the United States. In *Nichols* the court broke with a long tradition of English common law on spendthrift trusts, which to this day invalidates spendthrift trust protections in that country:

We concede that there are limitations which public policy or general statutes impose upon all dispositions of property, such as those designed to prevent perpetuities and accumulations of real estate . . . .We also admit that there is a just and sound policy. . . to protect creditors against frauds upon their rights . . . . But the doctrine, that the owner of property . . . cannot so dispose of it, but that the object of his bounty . . . must hold it subject to the debts due his creditors . . . is one which we are not prepared to announce as the doctrine of this court.<sup>47</sup>

Another example of the vagaries of public policy over time is the recent spate of legislative negation of the Rule Against Perpetuities in this country. When *Nichols v. Eaton* was decided in 1875, the Rule Against Perpetuities was viewed as a necessary limitation on potential restraints on the alienability of property. Today, eight states have repealed the Rule Against Perpetuities and a number of additional states are considering such changes.<sup>48</sup> Therefore, while on the one hand it can be argued there has been an erosion of the protections offered by spendthrift trusts in this country,<sup>49</sup> on the

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45. *Id.* at 341.

46. 91 U.S. 716 (1875).

47. *Id.* at 725.

48. To date, Alaska, Arizona, Delaware, Idaho, Illinois, Maryland, South Dakota, and Wisconsin have repealed the Rule Against Perpetuities.

49. While certain classes of creditors have always been able to reach spendthrift trusts under state law (e.g., alimony and child support creditors and tax creditors), recently at least one tort creditor has also been able to do so. See *Sligh v. First Nat'l Bank*, 704 So.2d 1020 (Miss. 1997). The Mississippi legislature, however, promptly acted to negate a *Sligh*-like result in future cases

other hand it can be said that spendthrift trust protections are expanding.<sup>50</sup> In the aggregate, these developments simply evidence the public policy pendulum swinging in different directions in response to the social and economic needs of our changing society.

Bankruptcy courts, however, have failed to take judicial notice of the recent trend of domestic jurisdictions to validate self-settled spendthrift trusts, both legislatively and judicially, provided the circumstances surrounding settlement are not deemed inequitable.<sup>51</sup>

In addition, although it cannot be considered part of this recent trend since it was initially enacted in 1861, in line with the foregoing is Colorado Revised Statutes section 38-10-111, which provides that "[a]ll deeds of gift, all conveyances, and all transfers or assignments, verbal or written, of goods, chattels, or things in action, or real property, made in trust for the use of the person making the same shall be void as against the *creditors existing* of such person."<sup>52</sup> Caselaw has settled this statute's obvious logical interpretation that as to *future* creditors, a self-settled Colorado spendthrift trust will be effective to protect the settlor's retained beneficial interest.<sup>53</sup>

Even New York, where the *Portnoy* court found the notion of a self-settled spendthrift trust to be offensive, has taken a step towards the recognition of such trusts under the appropriate circumstances. In *Matter of Heller*, an apparent case of first impression, the New York Surrogate's Court permitted the severance of "an irrevocable inter-vivos trust into two trusts for the novel purpose of insulating the trust's substantial cash and securities from potential creditor's claims that could arise from the trust's real property."<sup>54</sup> The severance of the trust into two portions, in effect, caused the creation of a self-settled spendthrift trust vis à vis the existing trust. In allowing this self-settled

through the "Family Trust Preservation Act of 1998." MISS. CODE ANN. §§ 91-9-501, *et seq.*

50. For example, pension plans and other retirement plans enjoy creditor protection under ERISA and a majority of state statutes (notwithstanding the fact that they are analogous to self-settled trusts). See, e.g., Gideon Rothschild & Christopher Alliot, *Protecting Retirement Plans*, J. ASSET PROTECTION, March/April 1997, at 35. More recently some states have exempted trusts funded with structured settlements from the claims of creditors.

51. See, e.g., ALASKA STAT. § 34.40.110(a) (Lexis 1998) (effective Apr. 2, 1997); DEL. CODE ANN. tit. 12, §§ 3571-76 (Supp. 1998) (effective July 1, 1997). See also H.R. 1553, 76th Leg., (Tex.) (introduced Feb. 17, 1999), available in WESTLAW, TX-BILLS Database (which, if enacted, would permit self-settled spendthrift trusts in Texas).

52. COLO. REV. STAT. § 38-10-111 (1997) (emphasis added).

53. See, e.g., *Connolly v. Baum* (*In re Baum*), 22 F.3d 1014, 1017 (10th Cir. 1994).

54. *In re Application of Heller*, 613 N.Y.S.2d 809, 810 (N.Y. Sur. Ct. 1994).

spendthrift trust to be created, the *Heller* court rightfully acknowledged that

New York law recognizes the right of individuals to arrange their affairs so as to limit their liability to creditors, including the holding of assets in corporate form, making irrevocable transfers of their assets, outright or in trust, as long as such transfers are not in fraud of existing creditors, establishing spendthrift trusts to protect the assets from the beneficiary's creditors and renouncing property interests that otherwise would be subject to creditors claims.<sup>55</sup>

The *Heller* court was apparently unconcerned with the effect of its ruling on the trust's creditors since the "trustee expressly represent[ed] that there [were] no current claims and none threatened or reasonably anticipated."<sup>56</sup>

In the above-mentioned statutory schemes, as well as in *Heller*, an effective balance is struck between the right to create a self-settled spendthrift trust and the rights of existing creditors to reach into those trusts to satisfy their claims if the funding of the trusts constitutes a fraudulent conveyance.<sup>57</sup> As such, the public policy concerns of the courts of other jurisdictions adjudicating the validity thereof should not be implicated, and self-settled trusts should not be regarded any differently from spendthrift trusts that are not self-settled. In the form of fraudulent conveyance legislation, every jurisdiction already has a built-in protection against the evil perceived by the *Portnoy* and *Brooks* courts that negates the need for a blanket rule vitiating the efficacy of spendthrift trusts validly created under the law of other jurisdictions.<sup>58</sup> Therefore, public policy need not be offended by the legitimate use of self-settled spendthrift trusts in estate and/or asset protection planning, but should only be

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55. *Id.* (citations omitted).

56. *Id.* By analogy, the recent enactment in every state of limited liability company legislation evidences an individual's right to shelter herself from liability arising from her business activities. It is also common to find business entities segregating their asset holdings by forming subsidiary structures to protect themselves from unforeseen liabilities.

57. For example, an Alaska self-settled spendthrift trust is ineffective if the transfer to the trust is considered a fraudulent transfer under Alaska law or if at the time of the transfer the settlor is in default of making child support payments. See ALASKA STAT. § 34.40.110 (Lexis 1998). A Delaware self-settled spendthrift trust is ineffective as against an even broader class of creditors. DEL. CODE ANN. tit. 12, § 3573 (Supp. 1998).

58. See, e.g., N.Y. DEBTOR AND CREDITOR LAW § 270-81 (McKinney 1990). Of particular significance is the distinction between "present" and "future" creditors and the differing circumstances under which a conveyance of property will be deemed a fraudulent conveyance as to each such class of creditors. Compare *id.* § 278 (stating that creditors whose claims have matured can set aside fraudulent conveyances in any complicit purchase or purchase for less than fair value) with *id.* § 279 (stating that creditors without mature claims must seek relief from the court and the court may set aside a conveyance, or stop a disposition of property).

offended by its abuse as determined by violation of applicable fraudulent conveyance law.<sup>59</sup> In this respect, legislation permitting the creation of a self-settled spendthrift trust is no different from a host of other legitimate planning opportunities, such as the use of ERISA qualified plans, individual retirement accounts, or life insurance or annuity exemptions, to shelter assets from the reach of creditors, while at the same time retaining almost complete control over such assets as well as the sole benefit thereof.<sup>60</sup> Moreover, even when such planning opportunities are used for the sole purpose of shielding otherwise non-exempt assets from the claims of existing creditors, courts have generally recognized such planning as acceptable.<sup>61</sup>

That the law allows a person to limit her exposure to creditors should come as no surprise to anyone, and voluntary creditors, at least, should not be heard to complain since they are presumed to know the extent to which the law will permit them to enforce their claims.

It is believed that every State in the Union has passed statutes by which a part of the property of the debtor is exempt from seizure on execution or other process of the courts; in short, is not by law liable to the payment of his debts. . . . This has come to be considered in this country as a wise, as it certainly may be called a settled, policy in all the States. To property so exempted the creditor has no right to look, and does not look, as a means of payment when his debt is created; and while this court has steadily held, under the constitutional provision against impairing the obligations of contracts by State laws, that such exemption laws, when first enacted, were invalid as to debts then in existence, it

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59. For an overview of the unique estate planning benefit of Alaska (and by extension, Delaware and "offshore" self-settled spendthrift trusts), see Gideon Rothschild, *Coming in from the Cold—Estate Planning Using Alaska Trusts*, in 3 CCH FINANCIAL AND ESTATE PLANNING ¶ 31,831 (Sidney Kess & Bertil Westin eds. 1997); Douglas J. Blattmachr & Jonathan G. Blattmachr, *A New Direction in Estate Planning: North to Alaska*, TRUSTS & ESTATES, Sept. 1997, at 48.

60. See H.R. REP. NO. 95-595, at 361-62 (1978) for the legislative history underlying the enactment of the Bankruptcy Reform Act of 1978.

61. See, e.g., *In re Mart*, 88 B.R. 436, 438 (Bankr. S.D. Fla. 1988). The judge in *Mart* stated that:

I agree that [the] statutory exemption [for annuities], perhaps like all exemptions, invites abuse. I also agree that the debtor's relationship with the . . . trustee, her evident willingness to accept her father's proposals, and the fact that this is a completely private arrangement are grounds for careful scrutiny.

I reject the argument and the objections, however, because . . . I find no intent to defraud creditors in this debtor's conversion of his non-exempt assets to exempt assets through the establishment of this annuity contract.

*Id.* See also Rothschild & Alliotts, *supra* note 50, at 35.

has always held, that, as to contracts made thereafter, the exemptions were valid.<sup>62</sup>

Thus, the Supreme Court distinguished between existing and future creditors, based upon "sound and unanswerable reason," since the future creditor

is neither defrauded nor injured by the application of the law to his case, as he knows, when he parts with the consideration of his debt, that the property so exempt can never be made liable to its payment. Nothing is withdrawn from this liability which was ever subject to it, or to which he had a right to look for its discharge in payment.<sup>63</sup>

Therefore, if the public policy basis for voiding self-settled spendthrift trusts is based upon an equitable creditors' rights argument, the question must be asked whether the equities are not somewhat distorted by a creditor who chose, in the pursuit of profit, to extend credit based upon exempt assets. Therefore, if it is accurate to state that the real concern is that a debtor will be able to obtain unfair advantage over existing creditors through the use of a self-settled spendthrift trust, the appropriate remedy would be the imposition of sufficient sanctions, whether they be penal or merely pecuniary, to deter those who would otherwise engage in fraudulent conveyances through vehicles that negate the practical risk of transferee liability.

Finally, some consideration must also be afforded to our obvious public policy goal of keeping trust capital (and trust business) within the United States and subject to the jurisdiction of the U.S. judicial system and the Internal Revenue Service. In this respect, although the *Portnoy* and *Brooks* courts denied their respective debtors a discharge in bankruptcy, for all intents and purposes, the assets that had been transferred to offshore fiduciaries will most likely remain unavailable to the debtors' domestic creditors and the Internal Revenue Service. Therefore, a blanket conflict of laws rule that, in the guise of public policy, refuses to validate self-settled spendthrift trusts under the appropriate circumstances will serve only to ensure the continuing flight of trust capital to foreign jurisdictions where the determination of a domestic court will have no practical effect. In contrast, a rule respecting the vast majority of self-settled spendthrift trusts, which do not defraud the settlor's existing creditors, will put domestic jurisdictions such as Alaska, Colorado, Delaware, and Missouri on par with offshore jurisdictions for legitimate trust business.

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62. *Nichols v. Eaton*, 91 U.S. 716, 726 (1875).

63. *Id.*



## III. CONCLUSION

It is unfortunate, but perhaps not terribly surprising, that the first two reported cases to consider the application of conflict of laws principles to self-settled spendthrift trusts both involved "bad facts" from an asset protection planning standpoint. In this regard, the adage "bad facts produce bad law" is not a slight on the courts, but rather an acknowledgment of a court's primary duty to do substantial justice to the parties immediately before it. However, in an effort to do substantial justice to the parties immediately before them, the *Portnoy* and *Brooks* courts have forged what may well become the first two links in an overly stiff and unyielding chain of precedent upon which future courts will rely without due analysis of the conflict of laws issue.<sup>64</sup> We do not suggest that debtors are bereft of any moral obligation to creditors, nor that the courts should countenance fraudulent conveyances simply because they may be valid under the law of another jurisdiction. We suggest instead that there must be a balancing of interests recognizing that our society continues to evolve, and that our common law must do so as well. In summary, a self-settled spendthrift trust, if valid under the law of a sister state, or even the law of a foreign state, should be respected if created for legitimate estate or asset protection planning purposes but should provide no spendthrift protection if not.

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64. An example of which is *In re Lawrence*, wherein the entirety of the court's analysis as to the conflict of laws between the forum state of Florida and the trust's designated law of Mauritius is a statement that "[t]his Court is persuaded by the decisions of *Portnoy*, *Brooks* and *Cameron*. The Debtor's rights and obligations under the Mauritian Trust are governed by Florida and federal bankruptcy law, which have an overriding interest in the trust, and not the law of the Republic of Mauritius." *Goldberg v. Lawrence (In re Lawrence)*, 227 B.R. 907, 917 (Bankr. S.D. Fla. 1998).

It is curious, however, that the court was persuaded by the decision of *In re Cameron* as to the conflict of laws issue since (i) that case accepted the trust's designated law of New York as controlling, and since (ii) there could necessarily be no conflict of laws issue because neither the designated law nor the law of the forum state permitted self-settled spendthrift trusts. *Dzikowski v. Edmonds (In re Cameron)*, 223 B.R. 20, 22-25 (Bankr. S.D. Fla. 1998).