I. INTRODUCTION

A. Traditional Rule

A client may protect interests in a trust that he or she creates for others (“third-party trust”) from claims by the beneficiaries’ creditors by subjecting such interests to a spendthrift clause or by making them wholly discretionary. But, the Second Restatement of Trusts, the Third Restatement of Trusts, and the UTC do not extend creditor protection to a trust in which the trustor retains a beneficial interest (“self-settled trust”), even if the trust contains a spendthrift clause. For example, § 156(1) of the Second Restatement says that:

Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.

Nor do they give any protection to a trustor-beneficiary’s interest in a self-settled discretionary trust. Thus, § 156(2) of the Second Restatement provides as follows:

Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.


2 Restatement (Second) of Trusts §§ 152, 153(1), 157, id. § 157 cmts. a–e; Restatement (Third) of Trusts §§ 58(1), 59, id. § 58 cmt. a, id. § 59 cmts. a(1), a(2), b–d; Uniform Trust Code (“UTC”) §§ 502–503 (2005). The current text of the UTC and the jurisdictions that have adopted the UTC are available at www.utcproject.org (last visited Sept. 27, 2007).

3 Restatement (Second) of Trusts § 155(1), id. § 187, id. § 155 cmt. b, id. § 187 cmts. d–i; Restatement (Third) of Trusts §§ 50, 60, id. § 50 cmts. b, d, id. § 60 cmt. e; UTC §§ 504, 814(a) (2005).

4 Restatement (Second) of Trusts § 156(1); Restatement (Third) of Trusts § 58(2), id. cmt. e; UTC § 505(a)(2) (2005).

5 Restatement (Second) of Trusts § 156(1).

6 Restatement (Second) of Trusts § 156(2), id. cmt. e; Restatement (Third) of Trusts § 60 cmt. f; UTC § 505(a)(2) (2005).

7 Restatement (Second) of Trusts § 156(2).
Where a person creates for his own benefit a . . . a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.

The above rule applies even if creation of the trust was not a fraudulent transfer and even if the trustor did not intend to defraud creditors. The trustor’s interest may be reached by existing as well as by future creditors.

The 5th edition of the Scott treatise, which was issued in 2007, discusses the traditional rule as follows:

The controlling policy is clear. The settlor can properly create a trust under which someone else takes a beneficial interest, and the settlor’s creditors cannot reach this interest unless the creation of the trust amounted to a fraudulent conveyance. To the extent that the settlor retains a beneficial interest, however, that interest is subject to the claims of the settlor’s creditors, even in the absence of fraud. It is plainly against public policy to permit the owner of property to create for his or her own benefit an interest in the property that is beyond the reach of creditors.

As shown in Appendix A, a few state statutes provide that a transfer in trust for the use of the trustor is void against claims of existing or subsequent creditors, many state statutes, like the traditional rule, provide that creditors may only reach the trustor’s interest in a self-settled trust, and a few such statutes provide that a self-settled trust is valid even though creditors may reach the trustor’s retained interest.

In Delaware, the Court of Chancery held that the trustor of an irrevocable trust who retained a general power of appointment could revoke the trust because his creditors could reach its assets. More recently, the same court held that the trustor’s creditors could reach his interest in an irrevocable self-settled spendthrift trust that was created prior to the 1997 enactment of the legislation that is discussed in VII below.

B. Effect of Traditional Rule

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8 Id. cmt. a.
9 Id.
10 Scott and Ascher on Trusts §15.4 at 954–55 (footnotes omitted).
As just noted, a few state statutes provide that a self-settled trust is void as to claims of existing and subsequent creditors. In those states, creditors might be able to reach all of the assets of a self-settled trust, regardless of the interest or interests retained by the trustor. If, as usually is the case, the pertinent statute provides that creditors may only reach the trustor’s interest, however, the result is quite different.

Thus, if the trustor creates a spendthrift trust to pay the income to himself or herself for life, with remainder to his or her issue, creditors may only reach the retained income interest and not the principal of the trust. A recent case illustrates this point.

In *Menotte v. Brown*, the Eleventh Circuit held that the debtor’s retained interest in a 7% charitable-remainder unitrust (“CRUT”) was includable in her bankruptcy estate. The court described the impact of its holding as follows:

> When establishing the ICRUA, Appellee made an irrevocable charitable gift of the trust corpus. By including the right to receive income payments for life, Appellee retained a portion of the assets for herself. Whatever interest Appellee retained is her own property, subject to the claims of her creditors. Accordingly, Appellee’s right to an income stream is not exempt from her bankruptcy estate and may be reached by her creditors. The corpus of the trust, however, may not be reached by Appellee’s creditors.

C. **Domestic APT Option**

As society became increasingly litigious, Americans became interested in the asset-protection trust (“APT”)—a trust in which the trustor may retain some potential benefits that cannot be reached by creditors. Until 1997, this interest was satisfied only by trusts created in foreign jurisdictions. For many Americans, however, a foreign APT is not an attractive option for the reasons set forth in XIII, C, below (e.g., risk of fine or imprisonment, possible application of the foreign-trust rules for income-tax purposes, and financial risk if the jurisdiction experiences political change).

A client may now create a domestic APT, i.e., an irrevocable self-settled spendthrift trust that generally is effective against claims by creditors in Alaska, Delaware, Nevada, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. Although he or she also might be able to create such a trust in Colorado,

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13 Restatement (Second) of Trusts §156 cmt. a illus. 1; Restatement (Third) of Trusts §58 cmt. e.
15 *Id.*, at 1271.
Missouri, or Oklahoma, this discussion will not focus on those states because the statutes in question are flawed and/or not fully developed. Domestic APTs warrant consideration along with other strategies for protecting assets, particularly because the effectiveness of some long-standing asset-protection techniques has been called into question. For example, reversing decades of judicial precedent, the U.S. Supreme Court held in 2002 that a spouse’s interest in tenancy-by-the-entirety property was subject to the federal tax lien under §6321 of the Internal Revenue Code of 1986 (“IRC”). Moreover, 2005 federal legislation affects the bankruptcy-law treatment of a retirement plan, a homestead, an individual retirement account (“IRA”), and an APT. Furthermore, in recent cases, trustors of foreign APTs have been fined or jailed for failure to produce documents or repatriate assets when ordered to do so by U.S. courts.

The “best candidate” for a domestic APT is a client who has surplus assets after he or she performs a realistic assessment of his or her existing and foreseeable assets and liabilities. The “worst candidate” for such a trust is a client who has (or is about to incur) a large obligation and wants to hide assets to avoid paying it. Nevertheless, if a client must meet a specific debt or claim, he or she may fund a domestic APT with assets that are not needed to satisfy that obligation.

D. Reasons Against Recognizing Domestic APTs

Although the Scott treatise inveighs against domestic APTs, it simply states that they violate public policy and does not explain its opposition to them. Other commentators posit the following reasons for making domestic APTs ineffective against creditors’ claims.

1. One Should Pay One’s Debts

The principal objections to recognizing the effectiveness of domestic APTs are that, “[y]ou should keep your promises and pay your debts because it is the right thing to do” and that, “there is something disturbing about a country that would allow debtors to leave their debts unpaid and still enjoy an extravagant lifestyle.” It seems to us, however, that recognizing domestic APTs is not inconsistent with these principles, provided that the fraudulent-transfer rules that we summarize in III below continue to apply.

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18 See IV, I, below.
19 See XIII,C,5, below.
21 Id.
2. **Preserve Liability System**

Another objection to domestic APTs is that allowing debtors to use such trusts to shelter their assets from potential creditors threatens the system of civil enforcement of obligations by undercutting the deterrent effect of our liability system and that the better way to address the excesses of the tort system is through tort reform not by recognizing domestic APTs.\(^22\) Unfortunately, the pace of tort reform has been glacial, whereas it has been possible to enact APT legislation at home and abroad.

3. **Domestic APTs “Always” Are Fraudulent**

The Bogert treatise opposes domestic APTs because:\(^23\)

Creditors have a right that their debtor shall pay their claims before he makes provision for his own support or comfort. Both existing and future creditors may be misled into believing that their debtor’s financial situation is sound, because he continues to enjoy the benefits of his property, and perhaps is in actual possession of it, although that property has been conveyed by a secret trust instrument to be held for the debtor. Generally there will be actual fraud, but it may be difficult to prove, and so the law strikes down the transaction as presumed to be fraudulent.

In our experience, the Bogert treatise’s assertion that domestic APTs always are created with evil intent simply is not true. Certain legal and practical factors prevent domestic APTs from being fraudulent:\(^24\)

[T]rustees are obligated as fiduciaries to exercise their discretion independent of the wishes or demands of the settlor and after considering the competing desires and needs of the other trust beneficiaries. Contrary to a commonly held belief, the settlor of an APT cannot compel the trustee to distribute all amounts that the settlor may desire, and a trustee who acceded to a settlor’s unreasonable demands would be liable to the other trust beneficiaries. Thus, a settlor who establishes an APT gives up substantial control over the settlor’s assets. Moreover, as a practical matter,

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\(^23\) *Bogert on Trusts* §223 at 448–49 (footnotes omitted).

trustees—especially trustees of APTs—will act conservatively in making trust distributions.

These legal and practical protections might not be available for foreign APTs, however.

E. Reasons for Recognizing Domestic APTs

There are several reasons why domestic APTs should be recognized.

1. Authorities Do Not Support the Scott Treatise

A commentator reports that the cases that the Scott treatise cites in support of the view that domestic APTs should not be honored do not justify that position.25 The Scott treatise responds as follows:26

It has been argued that when the First Restatement and the first edition of this treatise appeared there was little, if any, precedent for this position. Whatever the truth of that observation, it is plain that substantial authority for the Restatement position now exists.

One wonders how much of that authority developed in misplaced reliance on the First Restatement and that edition of the treatise. In addition, the Scott treatise fails to note that, in the interim, several other self-settled vehicles that offer protection from creditors have emerged.27

2. U.S. Is Unique

One commentator reports that:28

America stands virtually alone in its rigid and virtually absolute adherence to the rule against self-settled trusts.

He amplifies this point as follows:29

[B]etween the traditional English common law protective trust, the related statutory short form, the English discretionary trust, and the contemporary APT statutes of many other common law nations,

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25 Id. at 294–306.
26 3 Scott and Ascher on Trusts §15.4.3 at 967 n.12 (citation omitted).
27 See I, E, 8, below.
29 Id. at 441.