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Can a Bankruptcy Trustee Recover Assets Transferred to a Self-Settled Trust?

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Introduction

A "spendthrift trust" provides a fund for the *benefit of another,* secures it against the beneficiary's improvidence, and places it beyond the reach of the beneficiary's creditors.[1] A spendthrift trust has long been recognized as a useful vehicle for providing the beneficiary with the benefits of the trust while simultaneously preventing the beneficiary from voluntarily transferring his interest in the trust. This is particularly useful where the settlor wants to protect the transfer of wealth to a beneficiary.[2] For instance, if a parent makes a large gift to an irresponsible child, the child will likely squander the gift in the short term. Further, if a classic trust is set up for the irresponsible child, he may freely alienate his interest in future payments of the trust and essentially achieve the same short-term gain at the cost of a long-term promise.[3] However, a spendthrift trust solves these potential problems by allowing the parent to gift to the child while simultaneously protecting the payments from immediate alienation by the child

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[1] *In re* Brooks, 217 B.R. 98, 102 (Bankr. D. Conn. 1998) (citing *Greenwich Trust Co. v. Tyson*, 129 Conn. 211, 219 (1942)).
[2] Michael Sjuggerud, *Defeating the Self-Settled Spendthrift Trust in Bankruptcy*, 28 FLA. ST. U. L. REV. 977, 979 (2001).
[3] *Id*.

through a spendthrift clause.[4] The clause prohibits the beneficiary of the trust from voluntarily or involuntarily transferring her interest in the trust.[5]

"Self-settled spendthrift trusts" are a sub-class of spendthrift trusts.[6] Offering similar protection to the assets placed within the trust as a spendthrift trust, a self-settled spendthrift trust is created by the beneficiary of the trust. Self-settled spendthrift trusts are a popular tool for protecting one's assets from creditors. Specifically, the creator of the self-settled trust will protect the assets transferred from voluntary or involuntary alienation while simultaneously retaining the benefits of the assets for himself. However, most states do not recognize the validity of self-settled trusts because of numerous public policy concerns.[7] The basic belief is that a debtor may not protect or hide his assets away from legitimate creditors by placing the assets in a self-settled spendthrift trust.[8]

The weight of public policy concerns lie against allowing self-settled spendthrift trusts. The advantages of self-settled spendthrift trusts mostly benefit the creator/beneficiary. The creator of a self-settled trust will place the assets beyond the reach of present and future creditors while maintaining the benefits of the assets placed in trust with him.[9] Restraining alienation of assets preserves the status quo and is "inconsistent with an entrepreneurial, free market society."[10] Allowing debtors to place assets out of the reach of legitimate creditors without losing any of the benefits of owning the assets would lead to an unjust result. State legislatures and

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[4] *Id*.
[5] Anne S. Emanuel, *Spendthrift Trusts: It's Time to Codify the Compromise*, 72 NEB. L. REV. 179, 184 (1993).
[6] *In re Brooks*, 217 B.R. at 98 (using term "self-settled spendthrift trust" throughout).
[7] *See In re* Portnoy, 201 B.R. 685, 689 (Bankr. S.D.N.Y. 1996); Greenwich Trust Co. v. Tyson, 129 Conn. 211, 219, 27 A.2d 166, 171 (1942).
[8] *See Id*. at 103-104.
[9] *See In re Portnoy*, 201 B.R. at 700 (stating it "probably goes without saying that it would offend our policies to permit a debtor to shield from creditors all of his assets because ownership is technically held in a self-settled trust").
[10] Anne S. Emanuel, *supra* note 5 at 190.

courts are concerned that admitting the validity of such trusts "would open too wide an opportunity for a man to evade his just debts."[11]

Further, states are concerned that allowing this power will hurt in-state creditors who will then externalize the additional costs of lending that would result if self-settled trusts were permitted.[12] If lenders must bear additional costs associated with lending to a debtor who may or may not later protect his assets in a trust not recognized in local law, the cost of borrowing will be increased. As a result, the cost of borrowing will rise for all borrowers. As such, states have been reluctant to recognize the validity of self-settled spendthrift trusts.[13]

However, even where a court recognizes the validity of a self-settled spendthrift trust, the transfer of assets to that trust may not be protected. While a self-settled spendthrift trust moves the trust's assets beyond the reach of the beneficiary's creditors including bankruptcy trustees, protections are not guaranteed.[14] Self-settled trusts do provide a hurdle for which bankruptcy trustees must overcome, but it is not absolute.[15] In overcoming this hurdle, bankruptcy trustees may utilize bankruptcy law in order to avoid the transfers made to self-settled spendthrift trusts when the transfers are deemed to involve actual fraud.[16] If the transfers are avoided, the beneficiary's assets are then reachable by the bankruptcy trustee.[17] Further, the structure of self-settled trusts include several "badges of fraud" in which courts look to in inferring actual fraud.

This Article will analyze the various ways courts deal with self-settled spendthrift trusts. Part I will analyze how courts deal with self-settled trusts that contain choice-of-law provisions

[11] *Greenwich Trust Co. v. Tyson*, 129 Conn. 211, 219 (1942).
[12] *See In re Portnoy*, 201 B.R. at 689.
[13] *See Id*.
[14] *See Id*.
[15] *See In re* Zukerkorn, 484 B.R. 182, 186 (B.A.P. 9th Cir. 2012).
[16] 11 U.S.C. § 548(a)(1)(A) (2006).
[17] In re Huber, 493 B.R. 798, 811 (Bankr. W.D. Wash. 2013).

electing foreign laws in jurisdictions which have a public policy against upholding these trusts. Part II will analyze whether individuals should rely on self-settled trusts to protect their assets when the local jurisdiction does not recognize self-settled trusts. Part III will discuss how courts have utilized bankruptcy law in relation to self-settled trusts while Part IV will discuss what implications bankruptcy law has on determining whether to utilize a self-settled spendthrift trust to protect one's assets. Finally, the Article will conclude by analyzing whether individuals should rely on self-settled trusts to protect their assets in light of choice-of-law and bankruptcy law considerations.

I. Choice-of-Law Provisions in Self-Settled Spendthrift Trusts

Since a few states recognize the validity of self-settled spendthrift trusts, debtors have attempted to utilize choice-of-law provisions in creating trusts. A debtor in a state which does not recognize self-settled trusts will attempt to create the trust in a foreign jurisdiction that does. When the trust is being created, the settlor will insert a choice-of-law provision stating that the foreign state's law will be controlling. While an individual's choice-of-law provision will generally be upheld,[18] in instances where public policy outweighs the right to determine controlling law, a court will refuse to uphold a choice-of-law provision. When determining whether self-settled trusts are valid, courts have refused to honor choice of law provisions in self-settled trust documents when courts have found doing so would violate public policy.[19]

For instance, in *In re Brooks*, a husband and wife attempted to protect stock certificates in a trust created under Jersey law with a matching choice-of-law provision.[20] The husband transferred stock certificates to his wife who then subsequently traveled to Jersey in order to

[18] *See In re* Brooks, 217 B.R. at 101.
[19] *See Id*. at 104.
[20] *Id*. at 101.

create a trust which named her husband as the beneficiary.[21] Once this trust was established, the wife transferred the stock certificates to it.[22] When the couple later filed for bankruptcy in Connecticut, the chapter 11 trustee brought an adversary proceeding to recover the stock certificates held by the trust. The bankruptcy court held that the trust created under Jersey law was a self-settled trust and void as a matter of law in Connecticut.[23]

The *Brooks* court held the husband and wife were acting according to a scheme meant "to remove the stock certificates from the reach of [the husband's] creditors while providing him with any income from that property" and, therefore, the trust was self-settled.[24] This meant that while the wife established the trust for the benefit of the husband, it still constituted a self-settled spendthrift trust.[25] Once identified as a self-settled trust, the court did not honor the choice-of-law provision because "on the basis of public policy . . . the enforceability of the spendthrift provisions of the trusts is determined under Connecticut law."[26] Applying local law, the court held Connecticut does not permit self-settled trusts and thus the spendthrift provisions of the trust were not enforceable.[27] In particular, the court cautioned that "[t]o admit the validity of such trusts would open too wide an opportunity for a man to evade his just debts . . . is the reason why the overwhelming weight of authority holds [these trusts] ineffective."[28]

Other courts have relied on Restatement (Second) Conflict of Laws § 270 when refusing to apply a choice-of-law provision regarding a self-settled trust. When a trust contains a choice-of-law provision that designates a law of a foreign state that conflicts with the local state's law,

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[21] *Id*.
[22] *Id*.
[23] *Id*. at 103 (noting that "that virtually all other jurisdictions" do not recognize the validity of self-settled trusts).
[24] *Id*.
[25] *In re Brooks*, 217 B.R. at 103.
[26] *Id.* at 102.
[27] *Id*. at 104.
[28] *Id*. (citing *Tyson*, 129 Conn. at 219).

Restatement § 270 guides courts in determining which law to apply. Specifically, § 270 states that a choice-of-law provision in a trust should be honored by a court if the designated state has a substantial relation to the trust and the application of the designated state's laws would not violate the strong public policy of the state with which the trust has its most significant relationship.[29] Section 270 provides that a state has a substantial relation to a trust if at the time the trust is created: (1) the trustee or settlor is domiciled in the state; (2) the assets are located in the state; and (3) the beneficiaries are domiciled in the state.[30] However, even where there exists a substantial relation, a court may still apply local law if not doing so would violate strong public policy.[31]

For example, in *In re Huber*, the bankruptcy court in Washington held that prepetition transfers of the debtor's assets to a self-settled trust created under Alaska state law were void under Washington law.[32] There, a debtor who lived in Washington created a self-settled trust in an effort to shield his assets from his creditors.[33] Because Washington law does not recognize self-settled trusts, the debtor created the trust in Alaska under Alaska law, which permits self-settled trusts.[34] The trust agreement included a choice-of-law provision, which stated that Alaska state law would govern all legal disputes.[35]

After the trust was created, the debtor filed for bankruptcy.[36] The chapter 7 trustee brought an adversary proceeding seeking to recover assets that the debtor transferred to the self-

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[29] Restatement (Second) of Conflict of Laws § 270 (1971).
[30] *Id*.
[31] *Id*.
[32] *In re* Huber, 493 B.R. at 798.
[33] *Id*.
[34] Alaska Stat. Ann. § 34.40.110 (West).
[35] *Id*.
[36] *See id*. at 803.

settled trust.[37] In deciding whether to honor the choice-of-law provision, the court first determined that Alaska did not have a substantial relation to the trust[38] because the debtor was not domiciled in Alaska, his assets were not located in Alaska, and the trust's beneficiaries were not domiciled in Alaska.[39] Indeed, the court found that the only connections between Alaska and the trust were that the trust was to be administered in Alaska and one of the trustees was located in Alaska.[40] Next, the court determined that Washington had a strong public policy against allowing self-settled trusts.[41] Therefore, the court refused to honor the choice-of-law provision and instead applied Washington law, holding that transfers made to the self-settled trust were void as against the debtor's existing or future creditors.[42] As a result, the trustee was able to recover the assets.[43]

Similarly, in *In re Portnoy*, a bankruptcy court in New York the applied New York law over a trust's choice-of-law provision in determining whether a self-settled spendthrift trust created under Jersey law was void.[44] There, a New York resident attempted to shield assets in a self-settled spendthrift trust created under Jersey law.[45] Ultimately, the only connections to Jersey were that the trust was settled and administered in Jersey and the trustee was a Jersey resident.[46] Like the court in *Huber*, under a § 270 analysis, the *Portnoy* court found that New York held a stronger interest in applying local law because the trust, its beneficiaries, and the

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[37] *Id*. at 808. The trustee also sought to have the transfers avoided as fraudulent transfers . *Id*.
[38] *Id*. at 809 (finding state had strong public interest against self-settled trusts because state law did not recognize such trusts).
[39] *Id*. at 808.
[40] *Id*.
[41] *Id.* at 809 (stating "Washington State has a strong public policy against self-settled asset protection trusts").
[42] *Id*. (finding under local law "transfers made to self-settled trusts are void as against existing or future creditors").
[43] *See id*.
[44] *In re* Portnoy, 201 B.R. at 689.
[45] *Id*.
[46] *Id*. at 698.

ramifications to creditors have a more significant impact locally.[47] Thus, the court applied New York law and held the trust was void.[48]

In contrast, in *In re Zukerkorn*,[49] the Bankruptcy Appellate Panel for the Ninth Circuit decided to honor a choice-of-law provision contained in a spendthrift trust created under Hawaii law.[50] There, a self-settled spendthrift trust was created in Hawaii by Sally Zukerkorn in which she was the settlor, individual trustee, and beneficiary of the trust.[51] Upon her death, her son succeeded her as the trustee as well as the beneficiary of the trust.[52] Later, the son filed for bankruptcy in California while he was domiciled there. The bankruptcy trustee moved for turnover of principal and income from the self-settled trust, claiming the choice-of-law provision was invalid.[53] The BAP found the trust had a substantial relationship to Hawaii because the trustee and settlor were domiciled in Hawaii at the time of the trust's creation, the assets were located in Hawaii, and the debtor, a beneficiary of the trust, was domiciled in Hawaii and remained a citizen of Hawaii for over 70 years.[54] Thus, Hawaii had a substantial relationship to the trust.[55] The Hawaiian choice-of-law provision was honored because the court determined this was not a case of a California resident attempting to avail himself of the benefits of law in a foreign jurisdiction.[56] Thus, while courts will scrutinize choice-of-law provisions in self-settled

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[47] *See id*.
[48] *Id*.
[49] *In re* Zukerkorn, 484 B.R. at 182.
[50] *Id*. at 192.
[51] *Id*. at 186. Additionally, the trust contained a choice-of-law provision providing Hawaii state law would govern all legal disputes.
[52] *Id*.
[53] *Id*. at 187. In contrast to Hawaii state law, under California state law a bankruptcy trustee may seek up to twenty-five percent of a spendthrift trust. *Id.* at 189.
[54] *Id*. at 192.
[55] *Id*.
[56] *See id.*

spendthrift trusts, where the trust is substantially related to choice-of-law jurisdiction, the trust will be valid and the choice-of-law provision honored.

II. Can a Debtor Rely on a Choice-of-Law Provision?

Individuals that are domiciled in jurisdictions that do not recognize the validity of self-settled trusts should not attempt to utilize choice-of-law provisions in order to circumvent local law. Courts are concerned that choice-of-law provisions will be used by residents in attempts to avail themselves of the favorable laws in foreign jurisdictions and, thus, circumventing local laws. In most cases, a court will refuse to honor a choice-of-law provision due to the overwhelming public policy against self-settled trusts. Indeed, unless the individual is able to show a substantial relationship to the foreign state at the time of the trust's creation, the home state court will be unwilling to uphold the validity of the trust. *Zukerkorn* demonstrates just how high the bar is set. There, the trust was created in Hawaii, while the beneficiaries, settlor, and trustee were all domiciled there as well.

If an individual creates a self-settled trust in a foreign jurisdiction relying on a choice-of-law provision, the provision will only be honored over local laws when the individual's ties to the foreign jurisdiction are very significant. As such, individuals should not rely on choice-of-law provisions to avoid local prohibitions on self-settled trusts. It is unlikely an individual will be able to avail himself of a foreign jurisdiction's favorable self-settled spendthrift trust laws if the jurisdiction in which he resides does not allow for these. However, where an individual creates a valid self-settled spendthrift trust in a jurisdiction that he both resides and allows for this type of trust, *Zukerkorn* demonstrates that the trust will likely be upheld if the he later moves to a jurisdiction that prohibits self-settled trusts.

III. An Alternative Way of Avoiding Transfers to Self-Settled Trusts – Fraudulent Transfer Law

Even if a self-settled spendthrift trust is found to be valid, a bankruptcy trustee may still be able to avoid the transfer of assets to the self-settled trust a fraudulent transfers.[57] Section 548 allows a bankruptcy trustee to avoid a transaction as a fraudulent transfer if the transfer was made "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."[58] Under section 548(e), the statute of limitations for avoiding actually fraudulent transfers of assets to self-settled trusts is extended to 10 years preceding the filing of the bankruptcy petition.[59] In addition to section 548, under section 544(b), a trustee to avoid transfers under state law on behalf of an actual creditor.[60]

However, as a practical matter, it is unlikely any "smoking gun" evidence will be uncovered which clearly identifies the debtor's actual intent to hinder delay, or defraud his creditors when he made the transfer. As such, courts look to the circumstances surrounding transfers to determine the debtor's subjective intent. The evidence most pertinent to proving this subjective intent has become known as the "badges of fraud."[61] The non-exhaustive list of badges of fraud include:

> (1) Whether the transfer or obligation was to an insider;
> (2) Whether the debtor retained possession or control of the property transferred after the transfer;
> (3) Whether the transfer or obligation was disclosed or concealed;
> (4) Whether, before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
> (5) Whether the transfer was of substantially all of the debtor's assets;
> (6) Whether the debtor absconded;
> (7) Whether the debtor removed or concealed assets; or

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[57] 11 U.S.C. § 548(a)(1)(A) (2006).
[58] 11 U.S.C. § 548(a)(1)(A) (2006).
[59] 11 U.S.C. § 548(e) (2006).
[60] 11 U.S.C. § 544 (2006).
[61] *See In re Huber*, 493 B.R. at 811.

(8) Whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.[62]

While not all factors are relevant to analysis for self-settled trusts, it should be important to note that the first and second factors will likely be present in every transfer to a self-settled trust.[63] A self-settled trust by definition will have the creator of the trust be the same as the beneficiary.[64] Further, the debtor, as the beneficiary of the trust, will retain the benefits of the transferred assets. Therefore, if a debtor transfers his assets to a self-settled trust and subsequently files for bankruptcy, the bankruptcy court will likely hold such transfers are avoidable as actually fraudulent transfers, especially if there are other badges of fraud present.

For example, in *In re Huber*, the bankruptcy court held that the chapter 11 trustee could avoid the transfers of assets to the self-settled trust as actually fraudulent transfers whether or not the trust was void.[65] The *Huber* court noted that there were five badges of fraud present. The most notable was at the time of the creation of the trust and subsequent transfers, the debtor was suffering financial losses in most of his business ventures due to the downturn in the real estate market. [66] Further, another badge of fraud was present since, with the foreclosure of several of his properties already underway, pending litigation seemed certain.[67] Also, indisputably, the debtor held an insider relationship with the transferee because he was the beneficiary of the trust. These badges were enough for the court to find an inference of actual intent to hinder or delay

[62] *In re* Roca, 404 B.R. 531, 543 (Bankr. D. Ariz. 2009).
[63] *See In re Huber*, 493 B.R. at 814.
[64] *See Id*. at 813.
[65] *In re Huber*, 493 B.R. at 814.
[66] *Id*. at 813.
[67] *Id*. at 812.

Huber's creditors and held all transfers to the self-settled trust were recoverable whether or not the trust was void, which is was.[68]

IV. A Transfer of Assets to a Self-Settled Trust Will Likely be Avoidable as a Fraudulent Transfer

Even in a situation where a choice-of-law provision is honored by a court and a self-settled spendthrift trust is held valid, a debtor's assets are still not fully protected. Under the Bankruptcy Code, the trustee may avoid actually fraudulent transfers, which likely includes most transfers of assets by debtors to a self-settled trusts. As a result, the trustee will get a second bite of the apple for recovering the assets from the trust so long as the transfer of assets to the trust took place within the applicable statute of limitations (which is usually two, four or six years depending on which section that the trustee brings the action under).

Transfers made before an impending bankruptcy petition will likely be avoidable due to the badges of fraud associated with self-settled spendthrift trusts. A court can easily infer that a debtor transferred his asset to a self-settled trust with intent to hinder, delay, or defraud his from the very nature of a self-settled trust. Indeed, two badges of fraud will always be present in a situation in which a debtor has transferred his assets to a self-settled trust. Once an indicia of fraud is established, the burden falls on the transferee to prove a "legitimate supervening purpose" for the transfer.[69] Therefore, even if a debtor can convince a court that the self-settled trust is not void, the debtor will still face an up-hill battle if the trustee seeks to avoid the transfer of asset to the trust as an actually fraudulent transfer. These additional bankruptcy concerns further support the notion that individuals in jurisdictions that do not recognize self-settled trusts should not rely on these devices to protect their assets.

V. Conclusion

[68] *In re Huber*, 493 B.R. at 814.
[69] *See in re* Huber, 493 B.R. at 812.

Due to these challenges self-settled spendthrift trusts face regarding choice-of-law provisions and bankruptcy law, individuals who reside in jurisdictions that do not permit self-settled trusts should not attempt to avail themselves of these devices. If an individual attempts to rely on a choice-of-law provision to avoid local prohibitions on self-settled trusts, the provision will only be honored where there are substantial ties to the foreign jurisdiction. An individual simply looking to avail himself of favorable laws will not overcome the strong public policy concerns with self-settled spendthrift trusts. Moreover, even if the choice of law provision is honored, the individual will face the additional difficulties through bankruptcy law. The "badges of fraud" inherent in self-settled trusts raises the risk that even a valid trust will fail in its protection of an individual's assets. In jurisdictions that do not allow for self-settled trusts, individuals should look to other avenues when seeking to protect assets against creditors.