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ASSET PROTECTION TRUSTS: TRUST LAW'S RACE TO THE BOTTOM?

Stewart E. Sterk†

INTRODUCTION

Stephan Jay Lawrence had a problem. An MIT graduate, a successful options trader, and a major player on national securities exchanges, Lawrence faced financial ruin in early 1991 as a result of the margin deficit his firms had generated on Black Monday, October 19, 1987.¹ Although Lawrence's personal assets remained substantial, he had been mired for forty-two months in an arbitration proceeding over the size of his margin deficit.² His prospects in the arbitration apparently looked bleak, and an unfavorable award would wipe out his personal fortune.³

Lawrence addressed his problem by transferring, on January 8, 1991, between four and seven million dollars—ninety percent of his assets—to a trust in Jersey, Channel Islands,⁴ a jurisdiction whose trust law is known to be unfriendly to creditors.⁵ Less than a month later, Lawrence further amended the trust in order to transfer it to the even more debtor-friendly Mauritius, an island nation located on “the other side of the world.”⁶

On March 15, 1991, the firm Bear, Stearns & Co., Inc. (Bear, Stearns)—Lawrence's adversary in the arbitration proceeding—was awarded over twenty million dollars.⁷ Now Bear, Stearns had a prob-

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¹ See *Goldberg v. Lawrence* (*In re Lawrence*), 227 B.R. 907, 911 (Bankr. S.D. Fla. 1998).

² See *id.*

³ See *id.* at 912.

⁴ See *id.* at 912-14.

⁵ See *Marine Midland Bank v. Portnoy* (*In re Portnoy*), 201 B.R. 685, 699 (Bankr. S.D.N.Y. 1996) (detailing the history of Jersey trust law, and particularly the 1989 amendment which reversed the prior law that held that a gift into trust was fraudulent with respect to creditors if the settlor retained the power to dispose of the assets transferred into trust); PAUL MATTHEWS & TERRY SOWDEN, *THE JERSEY LAW OF TRUSTS* § 5.46, at 65 (3d ed. 1993).

⁶ *In re Lawrence*, 227 B.R. at 912 n.11 (noting that “Mauritian law appears to be even more ‘debtor-friendly’ than [the law of] the Jersey Channel Islands” and that “Mauritius has the added benefit of its location—the other side of the world”).

⁷ See *id.* at 911.

lem: How could it collect even part of its award when legal title to Lawrence's assets rested in the hands of a trustee with no connections to the United States and with offices on the other side of the world, in a country whose trust law imposes criminal penalties on any person, including the trustee, who discloses information about a Mauritius trust?⁸

Stephan Lawrence's efforts to avoid his creditors—euphemistically called “asset protection planning” by its practitioners—have become increasingly common in recent years.⁹ Although determining with any precision the value of assets that debtors have transferred offshore to avoid creditor claims is nearly impossible, conservative estimates exceed one trillion dollars.¹⁰ One lawyer, prominent in the asset protection business, represents that his firm alone has clients with more than three billion dollars in asset protection trusts.¹¹

Asset protection trusts have not been limited to major players in the financial world. Lawyers have marketed offshore trusts to physicians and other professionals as protection against malpractice judgments or divorce claims.¹² Furthermore, as a recent Ninth Circuit case illustrates, con men have used offshore trusts to stash their gains in entities beyond the reach of the investors they have defrauded.¹³ Entrepreneurial lawyers and professional trustees, like those who represented Stephan Jay Lawrence, have recognized that trusts need not be localized entities and that a settlor can avoid onerous regulations by locating the trust in a more favorable jurisdiction.¹⁴ To the extent

⁸ See *id.* at 912 n.11.

⁹ Indeed, the industry has spawned its own journal, the *Journal of Asset Protection*, which has published four volumes to date.

¹⁰ See Debra Baker, *Island Castaway*, A.B.A. J., Oct. 1998, at 54, 55 (“Experts estimate that \$1 trillion to \$5 trillion is currently being held offshore.”); David D. Beazer, *The Mystique of ‘Going Offshore,’* UTAH B.J., Dec. 1996, at 19, 19 (estimating that \$5 trillion pass through offshore financial centers).

¹¹ See *Asset Protection Trusts: What You Need to Know Now*, BCD News and Comment, Nov. 18, 1997, available in LEXIS, LEGNEWS Library, ALLNWS file (statement of David L. Lockwood, a principal in Engel, Reim & Lockwood PC).

¹² See, e.g., Deborah Grandinetti, *Protect Your Assets—Set Up a Trust*, MED. ECON., Apr. 26, 1999, at 80, 80; see also *Riechers v. Riechers*, 679 N.Y.S.2d 233, 235 (Sup. Ct. 1998) (describing how a physician created a Cook Islands trust, allegedly in response to malpractice lawsuits and later contending that the trust assets were unavailable to his wife in divorce proceedings). Indeed, a leading proponent suggests that asset protection planning is appropriate for individuals with a liquid net worth of \$1,000,000 or perhaps as little as \$500,000. See Roundtable Discussion, 32 VAND. J. TRANSNAT'L L. 779, 797 (1999) (statement of Barry S. Engel).

¹³ See *FTC v. Affordable Media, L.L.C.*, 179 F.3d 1228 (9th Cir. 1999). For an extended discussion of the landmark *Affordable Media* case, see *infra* Part III.A.4.

¹⁴ See, e.g., Pierce H. McDowell, III, *Trust Forum Shopping: The Next Generation*, TR. & EST., Aug. 1997, at 10, 14:

In today's shrinking world of high speed travel, wire transfers, video conferences, facsimiles, electronic mail and families spread across the globe, it has become apparent that it is not nearly so important to choose

trust assets, such as cash or securities, are intangible, only legal fictions enable us to assign a physical location to the assets. Moreover, even if the assets are tangible and fixed in a location, like real property is, no legal rule prevents a trust situated in one state from holding property located in another.

Entrepreneurial states have begun to take advantage of the mobility of trusts by creating legal regimes designed to attract trust settlers from other states.¹⁵ The leaders in the competition for trust business have been offshore jurisdictions, such as the Cook Islands, Belize, and the Bahamas.¹⁶ Recently, several American states have begun to compete aggressively: Delaware¹⁷ and Alaska¹⁸ enacted statutes that make it substantially easier for a trust settlor to shield assets from potential creditors. The competition, however, has extended beyond asset protection statutes. Several states, including Alaska and Delaware,¹⁹ have eliminated long-standing limitations on the duration of trusts, permitting the creation of "Dynasty Trusts" which can last forever.²⁰ Montana has enacted provisions that will permit foreign trust

the trust institution down the street as trustee. In fact, to do so may be negligent.

But see Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or, We Don't Have to Think of England Anymore*, 62 ALB. L. REV. 543, 558-59 (1998) (observing the "'invasion' of outsiders"—brokers and out-of-state institutions—into the world once dominated by local bankers).

¹⁵ The popular press has noted this competition. *See, e.g.*, Carolyn T. Geer, *Is Your Trust Well Placed?*, FORBES, June 16, 1997, at 190, 190 ("[C]ompetition is heating up among states eager to attract trust business.").

¹⁶ *See* James T. Lorenzetti, *The Offshore Trust: A Contemporary Asset Protection Scheme*, 102 COM. L.J. 138, 140-43 (1997) (listing Cook Islands, Cayman Islands, Bahamas, Gibraltar, Turks & Caicos Islands, Bermuda, Nevis, and Belize as popular offshore jurisdictions); Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating it Too*, 47 RUTGERS L. REV. 11, 62 (1994) (listing the "Bahamas, Belize, Cayman Islands, Cook Islands, Cyprus, Gibraltar, and the Turks and Caicos Islands" as popular offshore jurisdictions).

¹⁷ *See* DEL. CODE ANN. tit. 12, §§ 3570-3576 (Supp. 1998). The legislative history accompanying the 1998 amendment to Delaware's Qualified Dispositions in Trust Act includes the following statement:

The Act is intended to supplement the existing provisions of the Qualified Dispositions in Trust Act, 12 Del. C. § 3570 et seq., to enhance the dispositive and administrative options available to trust settlers and to trustees of existing trusts. These new features should make Delaware a more attractive jurisdiction for establishing trusts that are protected, under certain defined conditions, from claims of a settlor's creditors.

Qualified Dispositions in Trust Act, 1998 Del. Laws 843 (H.B. 747) (synopsis).

¹⁸ *See* ALASKA STAT. § 34.40.110 (Michie 1998) (restricting creditors' rights to satisfy their claims out of trust property).

¹⁹ *See id.* § 34.27.050(a)(B); DEL. CODE ANN. tit. 12, § 3535.

²⁰ *See* Donald Fink & Richard English, *Trusts That Last Forever*, N.J. L.J., May 26, 1997, at 27, 27 (listing South Dakota, Idaho, Wisconsin and Delaware as states allowing perpetual trusts); Al W. King III et al., *Dynasty Trusts: What the Future Holds for Today's Technique*, TR. & EST., Apr. 1996, at 28, 30 (listing South Dakota, Delaware, Idaho and Wisconsin as states that allow perpetual trusts); McDowell, *supra* note 14, at 10 (listing Alaska, Delaware, Idaho, Illinois, South Dakota, and Wisconsin as states that permit perpetual trusts). Ari-

settlers to obtain an extraordinary degree of privacy with respect to their transactions and will insulate trusts created under the statute from foreign judgments.²¹

Competition among the states for trust business through the creation of favorable legal environments is not a new phenomenon. States have long competed for corporate charters by offering attractive governance structures. The effects of this competition have generated voluminous commentary. William Cary started the debate by arguing that interstate competition for corporate charters was a "race for the bottom," with the various states—Delaware in particular—reducing the protection available to shareholders and others in order to attract corporate managers, who ultimately decide where to charter the corporation.²² Others disagreed, concluding that jurisdictional competition leads to rules that reduce transaction costs and ultimately increase shareholder value.²³ For these commentators, jurisdictional competition in corporate law results in a "race to the top," not to the bottom.

In recent decades, legal scholars have moved beyond corporate law to evaluate the effect of interjurisdictional competition in other areas of law, including banking law,²⁴ environmental law,²⁵ income

zona has recently joined the list. See ARIZ. REV. STAT. ANN. § 14-2901(A)(3) (West Supp. 1999).

²¹ See MONT. CODE ANN. §§ 32-8-101 to -603 (1999). For an exhaustive discussion of the statute, including the interplay between the statute and federal money laundering legislation, see David Aronofsky, *Montana's Foreign Capital Depository Act: A Financial Pie in the Rocky Mountain Sky or a Sensible New Assets Attraction Approach?*, 32 VAND. J. TRANSNAT'L L. 711 (1999).

²² William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 705 (1974); see also Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125, 1125 (1976) (building on Cary's view that the state chartering system has weaknesses and urging federal chartering at major corporations); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 971-74 (1990) (building on Cary's proposal for limited federal preemption of state corporate law).

²³ See Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-62 (1977); see also ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 14-24 (1993) (finding the empirical data more consistent with Winter's conclusions than with Cary's conclusions); cf. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 265-73 (1985) (finding that a change in domicile resulting from a reincorporation does not have a negative effect on the price of a company's stock).

²⁴ See, e.g., Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988); Helen A. Garten, *Devolution and Deregulation: The Paradox of Financial Reform*, 14 YALE L. & POL'Y REV. 65 (1996); Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1 (1977); Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133 (1990).

²⁵ See, e.g., Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992).

taxation,²⁶ local-government law,²⁷ bankruptcy,²⁸ and family law.²⁹ Broad claims that competition among jurisdictions leads to more efficient regulation have prompted closer examination of the premises necessary to sustain those claims.³⁰

Trust law presents an especially appropriate vehicle for the study of jurisdictional competition. Unlike competition in other areas, the competition among states for trust business has become visible and tangible.³¹ Moreover, unlike corporate law, the field of trust law remains wide open; no jurisdiction has yet obtained the dominant position and first mover advantages, which Delaware enjoys in the market for corporate charters.³²

This Article begins the study of jurisdictional competition in trust law. Its focus is on the development of so-called asset protection trusts, like the one used by Stephan Jay Lawrence, which permit the trust settlor to retain substantial control over, and derive significant benefit from, the trust property, while shielding that property from creditor claims. Part I explores the changes in the law of trusts that competition among jurisdictions has generated. Part II then identifies imperfections in the competitive process—externalities and agency costs—that undermine the claim that interstate competition will generate efficient trust law rules. Part III explores how the existing legal framework, including the broad power of bankruptcy courts, constrains competition among states with respect to asset protection trusts; existing constraints, such as choice-of-law rules and nationwide bankruptcy jurisdiction, should, in the long run, reduce the

²⁶ See, e.g., Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 458-61 (1996).

²⁷ See, e.g., Vicki Been, "Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine, 91 COLUM. L. REV. 473, 506-28 (1991); Richard Briffault, *Our Localism: Part II—Localism and Legal Theory*, 90 COLUM. L. REV. 346, 350-51 (1990); Robert C. Ellickson, *Suburban Growth Controls: An Economic and Legal Analysis*, 86 YALE L.J. 385, 402-03 (1977); Stewart E. Sterk, *Competition Among Municipalities as a Constraint on Land Use Exactions*, 45 VAND. L. REV. 831 *passim* (1992).

²⁸ See, e.g., David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994).

²⁹ See, e.g., Jennifer Gerarda Brown, *Competitive Federalism and the Legislative Incentives to Recognize Same-Sex Marriage*, 68 S. CAL. L. REV. 745 (1995).

³⁰ See William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401 (1994); William W. Bratton & Joseph A. McCahery, *The New Economies of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201 (1997); Thomas W. Merrill, *Chief Justice Rehnquist, Pluralist Theory, and the Interpretation of Statutes*, 25 RUTGERS L.J. 621, 640 (1994).

³¹ One commentator reported, for instance, that South Dakota's "governor is actively involved in promoting a legislative task force to enhance his state's prowess in the area of trust legislation". McDowell, *supra* note 14, at 14.

³² See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 720 (1998) (discussing how "Delaware's first mover advantage in corporate law" leaves other states with "weak incentives to develop corporate law innovations").

attractiveness of legislative competition, especially for American states.³³ Finally, Part IV examines what changes in the American legal regime would be necessary to diminish incentives for settlors like Stephan Jay Lawrence to transfer assets to offshore trusts. Ultimately, in a world in which assets are so easy to transfer, criminal penalties may be the only effective weapon available to the states, or Congress, to stem the growth of offshore trusts.³⁴

I

WHAT HAS JURISDICTIONAL COMPETITION WROUGHT?: ASSET PROTECTION TRUSTS

A. Background Law

1. *The Historical Development of Spendthrift Trusts*

The prominent role that trusts play in creditor avoidance should not be surprising. Born by accident,³⁵ the Anglo-American trust has endured because it has proven to be a powerful tool for accomplishing a wide range of objectives. Long recognized as a useful device for gratuitous transfers, particularly the transmission of wealth between

³³ As we shall see, Stephan Jay Lawrence's actions in creating and concealing his offshore trust resulted in the denial of a bankruptcy discharge. See *Goldberg v. Lawrence* (*In re Lawrence*), 227 B.R. 907, 915-18 (Bankr. S.D. Fla. 1998).

³⁴ Cf. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 3 (1996) ("In contemporary society, governments enforce law by essentially two mechanisms: incarceration and liability.").

³⁵ As Professors Hansmann and Mattei have recently emphasized, civil law countries never developed a precise analog to the trust, but continental European law has developed "various special purpose institutions that serve as substitutes for the trust in certain well-defined situations." Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 442 (1998).

The origins of the Anglo-American trust are closely tied to the development of the Court of Chancery and to the division of jurisdiction between law courts and courts of equity. The law courts had been unwilling to enforce trust-like obligations, leaving beneficiaries with little protection against dishonest trustees. See J.M.W. BEAN, *THE DECLINE OF ENGLISH FEUDALISM*, 1215-1540, at 156-58 (1968) (noting that legal enforcement of uses was very difficult to obtain and that easy enforcement would have removed the incentives for creating them because the law courts' recognition of the ownership interest of beneficiaries would have undermined the legal fiction that permitted evasion of feudal incidents and the prohibition on wills of land). But cf. R.H. Helmholz, *The Early Enforcement of Uses*, 79 COLUM. L. REV. 1503, 1504-11 (1979) (documenting ecclesiastical enforcement of uses in the period before the rise of the Court of Chancery). Ultimately, however, the chancellor became willing to enforce trust obligations for which no remedy was available in the law courts. See GEORGE T. BOGERT, *TRUSTS*, § 3, at 9-10 (6th ed. 1987). Hence, the interests of the trust beneficiary became known as equitable, rather than legal, interests. By increasing the security available to trust beneficiaries and trust settlors, the availability of equitable relief made the trust device considerably more popular. For a more extensive discussion of the growth of the trust, see 2 D.E.C. Yale, *Introduction to LORD NOTTINGHAM'S CHANCERY CASES* (D.E.C. Yale ed., Seldon Society 1961).

generations,³⁶ the trust has also become an important commercial instrument.³⁷ The trust's success has, in large measure, been attributable to its flexibility; because the essence of the trust is the separation of legal from beneficial ownership, no inherent limitations exist on the purposes for which a trust may be created. A trust settlor has little reason to create a trust unless some obstacle—often a legal obstacle—makes it less practical for the settlor to use some other device to accomplish his objectives. Thus, it should not be surprising that, since their conception, settlors have often used trusts to avoid otherwise applicable legal rules.

As early as the fourteenth century, landowners employed the "use"—the precursor to the modern trust—both as a tax avoidance device and as a way to escape English primogeniture rules at a time when the law did not yet recognize wills of land.³⁸ During the same era, some landowners employed uses to keep their lands "out of the clutches of creditors."³⁹

As trust settlors used trusts to avoid legal rules, new legal rules evolved to constrain trust settlors. Thus, in 1376 and 1377, the British Parliament enacted statutes that diminished the attractiveness of the use as a creditor-avoidance device.⁴⁰ The Statute of Uses,⁴¹ enacted in 1535, eliminated the use as a tax avoidance device and restored the king's power to collect feudal incidents.⁴² The give and take between

³⁶ See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 *YALE L.J.* 165, 165 (1997).

³⁷ See *id.* at 166 (noting that, in the United States, "most of the wealth that is held in trust . . . is placed there incident to business deals" and concluding that "over 90% of the money held in trust in the United States is in commercial trusts as opposed to personal trusts").

³⁸ See BEAN, *supra* note 35, at 132-33 (noting that the emergence of uses by the middle of the fourteenth century enabled landowners both to evade feudal incidents and to devise land as they wished).

Franciscan friars also employed uses to avoid the religious prohibition on property ownership. See F.W. Maitland, *The Origin of Uses*, 8 *HARV. L. REV.* 127, 130 (1894). Indeed, Maitland attributes the origins of the use to the needs of the Franciscan friars. See *id.* Bean, by contrast, argues that uses appeared in England before the Franciscans gained prominence. See BEAN, *supra* note 35, at 129.

³⁹ BEAN, *supra* note 35, at 137; see also *id.* at 135 (discussing reasons for the employment of uses by leading English landowners in the fourteenth century).

⁴⁰ See 1 *Rich. 2*, ch. 9 (1377) (Eng.) (invalidating enfeoffments made by landowners "to Lords and other great Men of the Realm" in order to dissuade adverse claimants from pursuing claims against the land); 50 *Edw. 3*, ch. 6 (1376) (Eng.) (giving creditors the right to execute on land and chattels of debtors who "give their Tenements and Chattels to their Friends, by Collusion thereof to have the Profits at their Will"). See generally BEAN, *supra* note 35, at 125-26 (discussing regulation of uses by the English Parliament in the late fourteenth century).

⁴¹ 27 *Hen 8*, ch. 10 (1535) (Eng.).

⁴² See *id.* By its terms, the Statute of Uses converted the beneficiary's equitable estate into a legal estate, making it impossible for the feudal tenant to evade the incidents of feudal tenure by employing the use device. See BEAN, *supra* note 35, at 287-88. See generally

property owners (represented by their lawyers) and the state has been an ongoing one: lawyers adapt trusts to serve their clients' goals, and the state reacts by imposing constraints. Sometimes, as with the Statute of Uses, the constraints have been statutorily imposed, while in other instances, as with the Rule Against Perpetuities, the constraints have developed through the common law process.⁴³

The process did not stop in the sixteenth century. Since the late nineteenth century, trust settlors have been creating spendthrift trusts, designed to prevent the beneficiary's creditors from attaching or garnishing the beneficiary's interest in the trust and to prevent the beneficiary from assigning his trust interest.⁴⁴ Courts and legislatures have responded to this device with constraints of varying severity,⁴⁵ but spendthrift trusts have nevertheless become widely accepted.

The rationale for enforcing spendthrift trusts has been that the trust property belongs not to the trust beneficiary, but to the trust settlor. Because the settlor has no obligation to transfer the property to the beneficiary, the settlor is entitled to transfer it to the beneficiary subject to conditions, including the condition that the property be shielded from the beneficiary's creditors.⁴⁶

W.S. Holdsworth, *The Political Causes Which Shaped the Statute of Uses*, 26 HARV. L. REV. 108 (1912) (describing the politics surrounding the passage of the Statute of Uses).

⁴³ See generally *Jee v. Audley*, 29 Eng. Rep. 1186 (M.R. 1787) (discussing the reasons for the Rule Against Perpetuities).

⁴⁴ A typical spendthrift provision might read: "The interests of my trust beneficiary, whether in trust income or trust principal, shall not be capable of assignment, anticipation, or seizure by legal process." JOEL C. DOBRIS & STEWART E. STERK, RITCHIE, ALFORD & EFFLAND'S ESTATES AND TRUSTS: CASES AND MATERIALS 518 (1998).

⁴⁵ Spendthrift provisions in trust instruments have had a controversial history. See DOBRIS & STERK, *supra* note 44, at 522. Enforcement of spendthrift provisions has aroused fierce objections from many commentators, most notably John Chipman Gray, who wrote:

The general introduction of spendthrift trusts would be to form a privileged class, who could indulge in every speculation, could practise every fraud, and, provided they kept on the safe side of the criminal law, could yet roll in wealth. They would be an aristocracy, though certainly the most contemptible aristocracy with which a country was ever cursed.

JOHN CHIPMAN GRAY, RESTRAINTS ON THE ALIENATION OF PROPERTY 174 (1883). For a modern attack, see Paul G. Haskell, *Teaching Moral Analysis in Law School*, 66 NOTRE DAME L. REV. 1025, 1047 (1991) ("Testator's use of the spendthrift provision, and the law which upholds it, are not morally defensible.").

Although the majority of American states enforce spendthrift provisions, see DOBRIS & STERK, *supra* note 44, at 522, most hold them invalid against particular classes of claimants, particularly children claiming support and spouses claiming alimony. See, e.g., *Bacardi v. White*, 463 So. 2d 218 (Fla. 1985); RESTATEMENT (SECOND) OF TRUSTS § 157 (1959). Moreover, a number of states refuse to protect from a money judgment any interest in a spendthrift trust exceeding the beneficiary's needs for education and support. See, e.g., CAL. PROB. CODE § 15307 (West 1991); N.Y. EST. POWERS & TRUSTS LAW § 7-3.4 (Consol. 1979). Until recently, states universally refused to enforce spendthrift provisions for the benefit of the settlor of the trust. See, e.g., *Ware v. Gulda*, 117 N.E.2d 137, 138-39 (Mass. 1954); RESTATEMENT (SECOND) OF TRUSTS § 156.

⁴⁶ Judicial enforcement of spendthrift trusts can be traced to two leading decisions: the United States Supreme Court's decision in *Nichols v. Eaton*, 91 U.S. 716 (1875), and the

2. Self-Settled Spendthrift Trusts

Despite vociferous opposition,⁴⁷ the spendthrift trust has become an entrenched feature of American trust law.⁴⁸ However, two barriers have until recently made trusts nearly useless for the settlor who seeks to insulate trust property from the claims of his own creditors. First, even more entrenched than spendthrift trust doctrine itself is the rule that a spendthrift provision for the settlor's own benefit is unenforceable.⁴⁹ Second, fraudulent transfer law protects creditors against a gratuitous transfer, whether to a trust or to another individual, if the transfer is made to delay, hinder, or defraud creditors.⁵⁰

The rule that a settlor may not create a spendthrift trust for his own benefit rests in part on the belief that property owners would otherwise use self-settled trusts to mislead creditors⁵¹ and in part on

decision of the Supreme Judicial Court of Massachusetts in *Broadway National Bank v. Adams*, 133 Mass. 170 (1882). In *Adams*, the court wrote:

The founder of this trust was the absolute owner of his property. He had the entire right to dispose of it, either by an absolute gift to his brother, or by a gift with such restrictions or limitations, not repugnant to the law, as he saw fit to impose. . . . His intentions ought to be carried out, unless they are against public policy.

... He [the settlor] has the entire *ius disponendi*, which imports that he may give it absolutely, or may impose any restriction or fetters not repugnant to the nature of the estate which he gives. Under our system, creditors may reach all the property of the debtor not exempted by law, but they cannot enlarge the gift of the founder of the trust, and take more than he has given.

Adams, 133 Mass. at 173-74.

⁴⁷ See GRAY, *supra* note 45, at 173-74.

⁴⁸ See RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. a (Tentative Draft No. 2, 1999). A few states continue to hold spendthrift provisions unenforceable. See, e.g., *Industrial Nat'l Bank v. Budlong*, 264 A.2d 18, 21 (R.I. 1970) (citing the English rule invalidating the spendthrift provisions of a trust).

Extending spendthrift trust doctrine even further than most other states, a New York provision makes all trusts spendthrift, unless an express provision authorizes assignment of beneficial interests. See N.Y. EST. POWERS & TRUSTS LAW § 7-1.5(a)(1).

⁴⁹ See RESTATEMENT (THIRD) OF TRUSTS § 58(2) (Tentative Draft No. 2, 1999) ("A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid."). For recent cases illustrating the rule, see *Speed v. Speed*, 430 S.E.2d 348, 348-49 (Ga. 1993) and *Coster v. Crookham*, 468 N.W.2d 802, 808-09 (Iowa 1991).

⁵⁰ The Statute of Elizabeth, 13 Eliz., ch. 5 (1570) (Eng.), which rendered invalid transfers made with the "[end,] purpose and intent to delay [] h[i]nder or defraud [] creditors," is often identified as the foundation for modern fraudulent transfer law. Today, most American jurisdictions have adopted either the UNIF. FRAUDULENT TRANSFER ACT, 7A-2 U.L.A. 266 (1999), promulgated in 1984 by the National Conference of Commissioners on Uniform State Laws, or its predecessor, the UNIF. FRAUDULENT CONVEYANCE ACT, 7A-2 U.L.A. 2, promulgated in 1918.

⁵¹ As Bogert notes in discussing the rule that spendthrift provisions in self-settled trusts are unenforceable,

To hold otherwise would be to give unexampled opportunity to unscrupulous persons to shelter their property before engaging in speculative business enterprises, to mislead creditors into thinking that the settlor still owned the property since he appeared to be receiving its income, and

the fact that the "image of benevolent paternalism is absent when the settlor of the trust is also the beneficiary."⁵² That is, although courts and legislatures have had some sympathy for property owners seeking to protect their imprudent or profligate children, the notion that property owners ought to be able to protect themselves against their own profligacy, at the expense of their creditors, has been much harder to swallow.⁵³ Moreover, under traditional principles, a trust settlor may not avoid the invalidity of spendthrift provisions in self-settled trusts by creating, instead, a discretionary trust; when a settlor creates a trust and gives the trustee discretion to make payments to the settlor, the settlor's creditors may reach the maximum amount the trustee would be entitled to pay to the settlor.⁵⁴

3. *Fraudulent Transfer Law*

Creditors may reach a settlor's beneficial interest in a trust even if the settlor did not intend to defraud creditors with her initial transfer into the trust. Suppose, however, the settlor creates a trust in which she disguises her beneficial interest. Imagine, for instance, an irrevocable trust in which the settlor declares herself trustee, retains discretion to make income payments among her three children, and reserves the power to appoint the principal from among her children at the time of her death. In this case, the legal limitations on self-settled trusts would not apply, because the settlor has not retained an enforceable beneficial interest in the trust. Moreover, the settlor's creditors would not be entitled to reach the children's interests. On the other hand, the settlor could use her power to allocate income and appoint the principal to assure that her children are attentive to her needs and desires.

Fraudulent transfer law, however, may enable the settlor's creditors to invalidate her transfer to the trust. Since 1570, Anglo-Ameri-

thereby to work a gross fraud on creditors who might place reliance on the former prosperity and financial stability of the debtor.

BOGERT, *supra* note 35, § 40, at 155-56.

⁵² *Pitrat v. Garlikov*, 947 F.2d 419, 424 (9th Cir. 1991).

⁵³ *But see* Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives*, 73 WASH. U. L.Q. 1, 83-84 (1995).

⁵⁴ *See* RESTATEMENT (THIRD) OF TRUSTS § 60 (Tentative Draft No. 2, 1999); *see also* *Greenwich Trust Co. v. Tyson*, 27 A.2d 166, 172-74 (Conn. 1942); *Dzikowski v. Edmonds (In re Cameron)*, 223 B.R. 20, 24 (Bankr. S.D. Fla. 1998); RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959). In *Vanderbilt Credit Corp. v. Chase Manhattan Bank, N.A.*, 473 N.Y.S.2d 242 (App. Div. 1984), the court noted:

It is irrelevant that in creating the discretionary trust for her benefit the settlor did not intend to defraud her creditors or was solvent at the time of the creation of the trust. It is against public policy to permit the settlor-beneficiary to tie up her own property in such a way that she can still enjoy it but can prevent her creditors from reaching it.

Id. at 246.

can jurisdictions have held invalid transfers made with “the End, Purpose, and Intent, to delay, hinder or defraud Creditors.”⁵⁵ However, proving the debtor-transferor’s state of mind has always been difficult. Thus, English courts quickly developed a sense for “the signs and marks of fraud,” which would serve as adequate proof of intent to defraud.⁵⁶ The Statute of Elizabeth, together with the “badges of fraud” identified in *Twyne’s Case*, remains the foundation of modern American fraudulent transfer law. Today, most American states have enacted some version of either the Uniform Fraudulent Conveyance Act⁵⁷ (UFCA) or the more modern Uniform Fraudulent Transfer Act⁵⁸ (UFTA).⁵⁹ Both statutes protect creditors against transfers designed to insulate debtor assets from creditor claims.⁶⁰

Section 4 of the UFTA, entitled “Transfers Fraudulent as to Present and Future Creditors,” provides that specified transfers are fraudulent towards a creditor “whether the creditor’s claim arose before or after the transfer was made or the obligation was incurred.”⁶¹ Thus, the statute clarifies that a transfer may be fraudulent as to a creditor with no claim outstanding against the transferor at the time of the transfer.⁶² Both the statutory language and history of the UFTA, sup-

⁵⁵ 13 Eliz., ch. 5 (1570) (Eng.). For a historical discussion of fraudulent conveyance law, see Peter A. Alces & Luther M. Doit, Jr., *A Critical Analysis of the New Uniform Fraudulent Transfer Act*, 1985 U. ILL. L. REV. 527, 529-37 (1985).

⁵⁶ *Twyne’s Case*, 76 Eng. Rep. 809, 812 (Star Chamber 1601).

⁵⁷ UNIF. FRAUDULENT CONVEYANCE ACT, 7A-2 U.L.A. 2 (1918).

⁵⁸ UNIF. FRAUDULENT TRANSFER ACT, 7A-2 U.L.A. 266 (1999).

⁵⁹ See *id.*; UNIF. FRAUDULENT CONVEYANCE ACT, 7A-2 U.L.A. 2.

⁶⁰ See UNIF. FRAUDULENT TRANSFER ACT prefatory note, 7A-2 U.L.A. 269 (“Both Acts declare a transfer made . . . with actual intent to hinder, delay, or defraud creditors to be fraudulent.”).

⁶¹ *Id.* § 4(a).

⁶² The UFTA defines a “creditor” as “a person who has a claim.” *Id.* § 1(4). The UFTA defines “claim” as “a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” *Id.* § 1(3).

The comment to section 1(4) of the statute establishes that the statutory definition was not intended to change prior law:

The definition of “creditor” in combination with the definition of “claim” has substantially the same effect as the definition of “creditor” under § 1 of the Uniform Fraudulent Conveyance Act. As under that Act, the holder of an unliquidated tort claim or a contingent claim may be a creditor protected by this Act.

Id. § 1 cmt. 4. Although the statute does not specify *when* a person must have a claim in order to qualify as a creditor within the meaning of the statute, only two plausible alternatives exist: the person has a claim either at the time or after she makes the allegedly fraudulent transfer. The statute expressly excludes the first alternative. See *id.* Hence, under the statute, a person apparently can qualify as a creditor even if she had no legal rights against the transferor at the time of the transfer.

For the contrary interpretation, see John E. Sullivan III, *Future Creditors and Fraudulent Transfers: When a Claimant Doesn’t Have a Claim, When a Transfer Isn’t a Transfer, When Fraud Doesn’t Stay Fraudulent, and Other Important Limits to Fraudulent Transfers Law for the Asset Protection Planner*, 22 DEL. J. CORP. L. 955, 975-88 (1997). Sullivan argues that “[u]nless the

port the view that a transfer can be fraudulent even if the transferor had no creditors at the time of the transfer. Therefore, so long as a creditor can prove that the settlor transferred property into trust with the intent to defraud some present or future creditor, any creditor—even one whose claim had not arisen, and was not anticipated, at the time of the transfer—may set aside the transfer.

The creditor still must prove, however, that the transfer is fraudulent within the meaning of the statute. Section 4(a)(1) defines as fraudulent with respect to creditors any transfer that a debtor makes “with actual intent to hinder, delay, or defraud any creditor of the

plaintiff has a legal ‘right,’ he does not hold a ‘claim’ and, therefore, is not a ‘creditor.’” *Id.* at 976. Similarly, he argues that the statute contemplates that only a debtor can make a fraudulent transfer and that if a transferor is not liable on a claim at the time of the transfer, “he is not a ‘debtor,’” and the UFTA is inapplicable. *Id.* at 977. Sullivan’s argument, however, begs the timing question; he implicitly assumes—without offering any analysis of the point—that when the statute refers to debtors and creditors, the statute means debtors and creditors at the time of the transfer. That assumption, however, is inconsistent with the text of section 4(a), which explicitly contemplates that a creditor’s claim may arise “before or after the transfer was made.” UNIF. FRAUDULENT TRANSFER ACT § 4(a) (emphasis added).

This construction of the UFTA is consistent with its predecessor, the UFCA, which remains the law in a number of states. *See* UNIF. FRAUDULENT CONVEYANCE ACT, 7A-2 U.L.A. 2 (listing six states). The UFCA explicitly declares that specified conveyances are “fraudulent as to both present and future creditors.” *Id.* § 6. The Prefatory Note to the UFTA makes it clear that the drafters of the new statute did not intend to change that aspect of the UFCA. *See* UNIF. FRAUDULENT TRANSFER ACT, 7A-2 U.L.A. 269 prefatory note. The Prefatory Note indicates that “[t]he basic structure and approach of the Uniform Fraudulent Conveyance Act are preserved in the Uniform Fraudulent Transfer Act.” *Id.* More specifically, the Prefatory Note provides more specifically that “[e]ither an existing or subsequent creditor may avoid a transfer or obligation for inadequate consideration when accompanied by the financial condition specified in § 4(a)(2)(i) or the mental state specified in § 4(a)(2)(ii).” *Id.*

The sparse case law generally supports the principle that a person who has no claim at the time of a transfer can later have a fraud claim against the transferor. *See* *United States v. Chapman*, 756 F.2d 1237, 1241 (5th Cir. 1985) (holding a transfer fraudulent under Texas law as to the U.S. government when made with the intent to avoid future tax claims, even though transferor had incurred no tax liability at the time of transfer); *Spanier v. United States Fidelity & Guar. Co.*, 623 P.2d 19, 24-25 (Ariz. Ct. App. 1980) (holding a conveyance that left a business with “unreasonably small capital” to be fraudulent as to a creditor who did not contract with transferor until after the transfer); *David v. Zilah*, 90 N.E.2d 343, 345 (Mass. 1950) (finding a conveyance to transferor’s son fraudulent with respect to a future creditor).

Courts certainly have asserted that a transfer may be fraudulent only as to persons who have claims at the time of the transfer. Those assertions, however, generally have been made in the dicta of cases involving claims that arose before the time of the transfer. *See, e.g.*, *United States v. Brickman*, 906 F. Supp. 1164, 1172 (N.D. Ill. 1995) (holding that the United States was a creditor of a transferor who made a transfer after incurring tax liability but before the Internal Revenue Service issued an assessment of that liability); *Dunham v. Dunham*, 910 P.2d 169, 171-72 (Idaho Ct. App. 1994) (suggesting, in dictum, that the Idaho UFTA applies only to claims that arise before the allegedly fraudulent transfer is made). The *Brickman* court stated that “[t]o set aside transfers as fraudulent conveyances, the United States must establish that its rights as a ‘creditor’ were impaired at the time the conveyances were made.” *Brickman*, 906 F. Supp. at 1172.

debtor."⁶³ Because proving actual intent is notoriously difficult, section 4(b) lists a number of factors—known as “badges of fraud”⁶⁴—which courts may consider in determining actual intent. Among those factors are whether “the debtor retained possession or control of the property transferred after the transfer,”⁶⁵ whether “the transfer was of substantially all of the debtor’s assets,”⁶⁶ whether “the debtor removed or concealed assets,”⁶⁷ and whether the debtor received consideration “reasonably equivalent to the value of the asset transferred.”⁶⁸

However, even if the creditor cannot prove actual fraud under section 4(a)(1) of the statute, the creditor may be able to set aside the transfer into the trust on the ground of constructive fraud. Section 4(a)(2) of the UFTA deems a transfer fraudulent as to a creditor if the debtor fails to receive consideration reasonably equivalent in value, so long as the debtor

(i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.⁶⁹

Thus, if a settlor transfers property into trust while engaging in a business in which liability claims are likely, such as malpractice claims against a physician or lawyer, the settlor’s future creditors may be able to set aside the transfers for constructive fraud, unless the settlor can establish that she has obtained adequate liability insurance.⁷⁰

B. The Advent of Offshore Asset Protection Trusts

Until the 1980s, the offshore trust industry was largely English. Centered in former British colonies, the industry used trust laws based on those of England and drew many clients from the United Kingdom and other Commonwealth countries.⁷¹ These offshore jurisdictions attracted trusts, in some measure, because they operated as tax havens

⁶³ UNIF. FRAUDULENT TRANSFER ACT, § 4(a)(1).

⁶⁴ *Id.* § 4(b) cmt. 5.

⁶⁵ *Id.* § 4(b)(2).

⁶⁶ *Id.* § 4(b)(5).

⁶⁷ *Id.* § 4(b)(7).

⁶⁸ *Id.* § 4(b)(8).

⁶⁹ *Id.* § 4(a)(2)(i)-(ii).

⁷⁰ See Sullivan, *supra* note 62, at 998-1001 (arguing that insurance generally negates fraudulent intent).

⁷¹ See Antony Duckworth, *The Offshore Trust in Transition*, in INTERNATIONAL ESTATE PLANNING: PRINCIPLES AND STRATEGIES 129, 132 (Donald D. Kozusko & Jeffrey A. Schoenblum eds., 1991).

for residents of England, Australia, and New Zealand.⁷² Most of the tax advantages for American settlers, however, disappeared with the enactment of the Tax Reform Act of 1976.⁷³ In an attempt to curtail the use of foreign trusts to avoid American income taxes, the Act provided that the IRS would treat for income tax purposes the assets of most foreign trusts settled by Americans as the settlor's assets.⁷⁴

Offshore trusts nevertheless remain popular with some American settlers, because financial institutions in these former British colonies retain the English tradition of bank secrecy.⁷⁵ As a result, offshore trusts continue to be useful to settlers committed to tax evasion rather than tax avoidance. If American auditors cannot trace transactions between offshore banks and their clients, the offshore trust becomes an attractive way to launder money to avoid American tax obligations.⁷⁶ Starting in the mid-1980s, however, several offshore jurisdictions identified a new source of trust business: clients seeking to avoid not taxing authorities, but creditors.

Consider the Cook Islands' International Trusts Act of 1984. By its terms, the statute applies only to international trusts, not to trusts established for the benefit of residents of the Cook Islands—a sure sign that the purpose of the statute was to attract foreign capital.⁷⁷ To that end, the statute includes numerous measures that make the Cook Islands a favorite trust situs for settlers seeking to avoid creditor claims. First, the statute makes self-settled spendthrift trusts fully enforceable.⁷⁸ Second, the statute provides that creditors may not reach

⁷² See *id.* at 136 (also explaining that tax authorities in England, Australia and New Zealand disapproved of these trusts and have closed them to the offshore trust industry).

⁷³ Pub. L. No. 94-455, 90 Stat. 1520 (1976).

⁷⁴ See 26 U.S.C. § 679 (1994). This provision was enacted as part of the Tax Reform Act of 1976, Pub. L. No. 94-455, § 679, 90 Stat. 1520. For a more extensive discussion of this provision, see Elena Marty-Nelson, *Taxing Offshore Asset Protection Trusts: Icing on the Cake?*, 15 VA. TAX REV. 399, 410-12 (1996).

⁷⁵ See Douglas J. Workman, *The Use of Offshore Tax Havens for the Purpose of Criminally Evading Income Taxes*, 73 J. CRIM. L. & CRIMINOLOGY 675, 679 (1982).

⁷⁶ See *id.* at 681-86 (relying on testimony at congressional hearings to illustrate the potential for using offshore tax havens to evade tax liability). An American company seeking to deduct fraudulent expenses might make payments to an offshore company for services allegedly rendered. See *id.* at 681-82. The offshore company, in turn, might be owned by an offshore trust whose beneficiaries are the owners of the American company. See *id.* at 683. No record of payments from the offshore company to the offshore trust would be available to American auditors, and the auditors would find it difficult to establish whether the offshore company performed any services for the payments it received. See *id.*

⁷⁷ See International Trusts Act (1984) § 2(1) (1996) (Cook Islands).

⁷⁸ Section 13(F), entitled "Spendthrift beneficiary," provides:

(1) For the purposes of this Act, and notwithstanding any rule of law or equity to the contrary, it shall be lawful for an instrument or disposition to provide that any estate or interest in any property given or to be given to any beneficiary shall not during the life of that beneficiary, or such lesser period as may be specified in the instrument or disposition, be alienated or pass by bankruptcy, insolvency or liquidation or be liable to be seized, sold,

the settlor's interest in an international trust even if the settlor retains a right to revoke the trust.⁷⁹ As a result, once a settlor's assets enter a Cook Islands international trust, the settlor's creditors may not attach the settlor-beneficiary's interest.

Third, although the law of the Cook Islands was founded on English law, including the Statute of Elizabeth's prohibition on fraudulent transfers,⁸⁰ the statute now virtually precludes creditors from attacking a transfer into a Cook Islands international trust as a fraudulent conveyance.⁸¹ Under the statute, even if a creditor proves that the settlor intended to defraud by transferring assets into a trust, the creditor may not reach the trust assets unless the settlor was insolvent at the time the creditor's claim arose.⁸² Moreover, even in the rare case in

attached, or taken in execution by process of law and where so provided such provision shall take effect accordingly.

(2) Where property is given subject to any of the restrictions contained in subsection (1), the right to derive income from such property by a beneficiary and any income derived therefrom shall not pass by bankruptcy, insolvency or liquidation or be liable to be seized attached or taken in execution by process of law.

Id. § 13(F).

⁷⁹ Section 13(C), entitled "Retention of control and benefits by settlor," provides:

An international trust and a registered instrument shall not be declared invalid or a disposition declared void or be affected in any way by reason of the fact that the settlor, and if more than one, any of them, either—

- (a) retains, possesses or acquires a power to revoke the trust or instrument;
- (b) retains, possesses or acquires a power of disposition over property of the trust or the subject of the instrument;
- (c) retains, possesses or acquires a power to amend the trust or instrument;
- (d) retains, possesses or acquires any benefit interest or property from the trust or any disposition or pursuant to the instrument;
- (e) retains, possesses or acquires the power to remove or appoint a trustee or protector;
- (f) retains, possess or acquires the power to direct a trustee or protector on any matter;
- (g) is a beneficiary, trustee or protector of the trust or instrument either solely or together with others.

Id. § 13(C).

⁸⁰ Indeed, the High Court of the Cook Islands has recently reiterated that the Statute of Elizabeth, 13 Eliz., ch. 5 (1570) (Eng.), remains in force with respect to domestic transactions in the Cook Islands. *See* 515 S. Orange Grove Owners Ass'n v. Orange Grove Partners, Plaintiff No. 208/94 (High Court of the Cook Islands 1995).

⁸¹ *See* International Trust Act (1984) § 13(B) (1996) (Cook Islands).

⁸² Section 13(B) deals with fraud. Although the statute as drafted includes a number of inconsistencies, the drafters made some points abundantly clear. First, subsection (1) makes an international trust subject to creditor claims only if the creditor can prove "beyond reasonable doubt" (a) that the settlor made a transfer "with principal intent to defraud the creditor" and (b) that the transfer rendered the settlor "insolvent or without property by which that creditor's claim (if successful) could have been satisfied." *Id.* § 13(B)(1). Subsection (2) goes on to provide that if, at the time the settlor made the transfer to the trust, the fair market value of the settlor's property (exclusive of property relating to the trust) "exceeded the value of the creditor's claim," then the transfer shall be

which a transfer to an international trust is deemed fraudulent, the Cook Islands statute imposes a short statute of limitations on creditor claims: the creditor must bring the action within one year from the date of the fraudulent transfer.⁸³ As a result, if the settlor of a Cook Islands trust is solvent when she transfers assets into the trust, the transfers will not, under Cook Islands law, be voidable at the behest of creditors. Finally, the statute expressly provides that no Cook Islands court shall enforce or recognize a foreign judgment against a Cook Islands trust, or a settlor, trustee, or beneficiary of the trust, if the judgment is based upon application of a law inconsistent with the statute.⁸⁴

Many offshore jurisdictions embrace to varying degrees these three features of the Cook Islands statute—authorization of self-settled trusts, evisceration of fraudulent transfer protection, and refusal to enforce foreign judgments.⁸⁵ Although a desire to launder money may, to some extent, explain the popularity of offshore trusts, these new asset protection provisions are undoubtedly responsible, at least

deemed not to have been made with intent to defraud the creditor. *Id.* § 13(B)(2). Moreover, subsection (4) provides that a transfer into an international trust shall be deemed not to have been made with intent to defraud a creditor if the “disposition of property took place before that creditor’s cause of action [against the settlor] accrued.” *Id.* § 13(B)(4). Subsection (4) would appear to make subsection (3) superfluous, because subsection (3) provides that a disposition to an international trust shall not be fraudulent as against a creditor if “the disposition takes place after the expiration of 2 years from the date that creditor’s cause of action accrued.” *Id.* § 13(B)(3).

⁸³ See *id.* § 13(B)(3)(b) (providing that a transfer shall not be fraudulent if the creditor fails to bring a cause of action “before the expiration of 1 year from the date such . . . disposition took place”).

⁸⁴ See *id.* § 13(D). The Cook Islands High Court, however, has not given to the statute the broad construction its drafters intended. In an important opinion, the court held that a California judgment entitled a creditor to prevent removal of assets from a Cook Islands trust. In a particularly disingenuous sentence, written after the court found some ambiguity in the statute, the court concluded: “It should not be lightly assumed that Parliament intended to defeat the claims of creditors by allowing international trusts to be used to perpetrate a fraud against a creditor.” 515 S. Orange Grove Owners Ass’n v. Orange Grove Partners, Plaintiff No. 208/94 (High Court of the Cook Islands 1995).

⁸⁵ One commentator reported that twelve offshore jurisdictions have enacted statutes designed to attract asset protection trusts. See Gideon Rothschild, *Establishing and Drafting Offshore Asset Protection Trusts*, 23 EST. PLAN. 65, 65 (1996). For a catalogue of protections available in a number of popular offshore jurisdictions, see Lorenzetti, *supra* note 16, at 140-43.

The consensus appears to be that, with the possible exception of Belize, the Cook Islands statute remains the most attractive to asset protection planners. One commentator has noted that while “[t]he Cook Islands adopted at least some version of fraudulent conveyance law [,] Belize (the former British Honduras) did not even try.” Thomas Moers Mayer, *Sheltering Assets in 1994*, in REAL ESTATE WORKOUTS AND BANKRUPTCIES 1994, at 375, 446 (PLI Real Estate Law & Practice Course Handbook Series No. N-402, 1994).

in part, for the one trillion dollars or more currently held in offshore trusts.⁸⁶

C. Delaware and Alaska Enter the Fray

Since 1997, two states—Alaska and Delaware—have begun to compete for asset protection trusts.⁸⁷ Neither state offers trust settlors the range of protection available in the Cook Islands and other offshore jurisdictions. Both states, however, offer the following advantages not available offshore: ease of access to the trust's assets, lower costs associated with trust creation, and greater political stability than some offshore locations.⁸⁸ Hence, less asset protection may be necessary to attract trusts into these states.

1. *The Alaska Statute*

In 1997, the Alaska legislature amended its trust law to permit a trust settlor to include an enforceable restriction on the power of creditors to reach the settlor's discretionary interest in the trust principal or income, provided the following four conditions are met: (1) the transfer into the trust was not fraudulent; (2) the settlor did not reserve a right to revoke; (3) the trust instrument does not require any distribution of the trust income or principal to the settlor; and (4) the settlor is not, at the time of transfer, in default by thirty or more days on payments due under a child support judgment or order.⁸⁹ Thus, if a settlor creates a discretionary trust, under which the trustee has ab-

⁸⁶ See Baker, *supra* note 10, at 55 (estimating that \$1 trillion to \$5 trillion currently are being held offshore trusts); Lorenzetti, *supra* note 16, at 140 (reporting estimates that \$1 trillion were held in offshore asset protection trusts in 1994).

⁸⁷ See Amy Lynn Wagenfeld, Note, *Law for Sale: Alaska and Delaware Compete for the Asset Protection Trust Market and the Wealth That Follows*, 32 VAND. J. TRANSNAT'L L. 831, 850 (1999); see also Mark L. Silow, *Is It Now Possible to Buy American Version of Asset Protection Trusts?*, LEGAL INTELLIGENCER, Sept. 9, 1997, at 7, 7 ("In apparent response to [the] loss of business opportunity, the states of Alaska and Delaware have each recently enacted legislation intended to make trusts established in those states more attractive for [asset protection] purposes.").

⁸⁸ See Douglas J. Blattnacher & Jonathan G. Blattnacher, *A New Direction in Estate Planning: North to Alaska*, TR. & EST., Sept. 1997, at 48, 54 (discussing advantages of Alaska trusts over offshore trusts). The Blattnachers also speculate that American courts might be less likely to treat the creation of an Alaska trust as an attempt to secrete assets than they would with respect to a foreign trust. See Eric Henzy, *Offshore and "Other" Shore Asset Protection Trusts*, 32 VAND. J. TRANSNAT'L L. 739, 740-41 (1999) (noting that Alaska or Delaware trusts might cost between \$6,000 and \$12,000 to create, as opposed to the estimated \$18,500 to create an offshore trust); Blattnacher & Blattnacher, *supra*, at 54.

⁸⁹ See ALASKA STAT. § 34.40.110(a)-(b) (1998). These sections provide:

(a) A person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. In this subsection,

(1) "property" includes real property, personal property, and interests in real or personal property;

solute discretion to distribute all or part of the income to the settlor, the settlor's creditors may not reach the trust principal unless the transfer into the trust was fraudulent. This provision represents a significant departure from the prevailing treatment of self-settled discretionary trusts.⁹⁰

Moreover, Alaska's fraudulent conveyance law is not creditor-friendly. Alaska has adopted neither the UFTA nor its predecessor, the UFCA.⁹¹ Alaska's fraudulent conveyance statute requires proof of actual fraud and includes no conception of constructive fraud.⁹² Also, it extinguishes any fraudulent transfer claim after four years from the time of the transfer, even if the creditor's claim did not arise until after the transfer;⁹³ thus, if the settlor creates a trust, anticipating and seeking to avoid possible future liability, the settlor will succeed so long as the liability does not arise—or the creditor does not sue—within four years after the settlor makes the transfer of property into the trust.

Finally, consider the ease with which a trust settlor can arrange to have Alaska law applied to the trust. Under the Alaska statute, a provision in the trust instrument selecting Alaska law "is valid, effective, and conclusive" if at least some of the assets are deposited in the State and administered by an Alaska resident or Alaska banking institution.⁹⁴ So long as one of the trustees is an Alaska resident or banking institution,

(2) "transfer" means any form of transfer, including deed, conveyance, or assignment.

(b) If a trust contains a transfer restriction allowed under (a) of this section, the transfer restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor, or another person from satisfying a claim out of the beneficiary's interest in the trust, unless the

(1) transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons under AS 34.40.010;

(2) trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; in this paragraph, "revoke or terminate" does not include a power to veto a distribution from the trust, a testamentary special power of appointment or similar power, or the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor;

(3) trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor; or

(4) at the time of the transfer, the settlor is in default by 30 or more days of making a payment due under a child support judgment or order.

Id.

⁹⁰ See *supra* note 54 and accompanying text.

⁹¹ See *Summers v. Hagen*, 852 P.2d 1165, 1169 n.5 (Alaska 1993).

⁹² See ALASKA STAT. § 34.40.010; see also *id.* § 34.40.090 (providing that fraudulent intent "is a question of fact, and not of law").

⁹³ See *id.* § 34.40.110(d).

⁹⁴ *Id.* § 13.36.035(c). This section provides:

a nonresident individual or a non-Alaska banking institution may serve as a co-trustee.⁹⁵

In 1998, Alaska amended the statute to make it even more attractive to trust settlors. First, the legislature enacted a provision that allows the settlor of an existing trust established in another state or foreign jurisdiction to change the trust's situs to Alaska.⁹⁶ At the same time, the legislature made it clear that a fraudulent transfer into an Alaska trust would not be set aside in toto, but "only to the extent necessary to satisfy the settlor's debt to the creditor or other person at whose instance the trust or property transfer is voided or set aside."⁹⁷

2. *The Delaware Statute*

In 1997—the same year Alaska's legislature enacted its asset protection statute—Delaware's legislature enacted the Qualified Dispositions in Trust Act.⁹⁸ This statute disallows any action brought "for an attachment or other provisional remedy against property that is the

A provision that the laws of this state govern the validity, construction, and administration of the trust and that the trust is subject to the jurisdiction of this state is valid, effective, and conclusive for the trust if

(1) some or all of the trust assets are deposited in this state and are being administered by a qualified person; in this paragraph, "deposited in this state" includes being held in a checking account, time deposit, certificate of deposit, brokerage account, trust company fiduciary account, or other similar account or deposit that is located in this state;

(2) a trustee is a qualified person who is designated as a trustee under the governing instrument or by a court having jurisdiction over the trust;

(3) the powers of the trustee identified under (2) of this subsection include or are limited to

(A) maintaining records for the trust on an exclusive basis or a nonexclusive basis; and

(B) preparing or arranging for the preparation of, on an exclusive basis or a nonexclusive basis, an income tax return that must be filed by the trust; and

(4) part or all of the administration occurs in this state, including physically maintaining trust records in this state.

Id. The statute goes on to define "qualified person" to mean:

(A) an individual who, except for brief intervals, military service, attendance at an educational or training institution, or for absences for good cause shown, resides in this state, whose true and permanent home is in this state, who does not have a present intention of moving from this state, and who has the intention of returning to this state when away;

(B) a trust company that is organized under AS 06.25 and that has its principal place of business in this state; or

(C) a bank that is organized under AS 06.05, or a national banking association that is organized under 12 U.S.C. 21—216d, if the bank or national banking association possesses and exercises trust powers and has its principal place of business in this state.

Id. § 13.36.390(1).

⁹⁵ See *id.* § 13.36.320(a).

⁹⁶ See ALASKA STAT. § 13.36.043.

⁹⁷ *Id.* § 13.36.310(b).

⁹⁸ DEL. CODE ANN. tit. 12, § 3570-3576 (Supp. 1998). The statute was enacted as part of 71 Del. Laws 159 (1997).

subject of a qualified disposition" in trust, subject only to Delaware's fraudulent conveyance statute.⁹⁹ The statute defines a transfer in trust as a "qualified disposition" even if the trustee or trustees retain discretion to make payments of income or principal to the trust settlor.¹⁰⁰ The Delaware statute permits nonresidents to act as trust advisers with authority to remove and appoint qualified trustees, or "to direct, consent to or disapprove distributions from the trust."¹⁰¹ In this respect, the Delaware statute is like the Alaska statute, and unlike the law of all other American jurisdictions.

On the other hand, if the trust settlor has an absolute right to receive trust principal, the statute implicitly suggests that the disposition would not be treated as a "qualified disposition," and creditors would be able to attach the trust property.¹⁰² In this respect, too, Delaware's statute resembles the Alaska statute. But in one important respect, the Delaware statute appears to be more protective of trust settlors than the Alaska statute: in Delaware, the settlor may retain an absolute right to income and still be able to shield trust assets from creditors.¹⁰³ In other words, the Delaware statute authorizes self-settled trusts that are spendthrift as to income. However, the Delaware

⁹⁹ *Id.* § 3572(a).

¹⁰⁰ *See id.* § 3570(6) (requiring only that the transfer be to a "qualified trustee . . . by means of a trust instrument"); *see also id.* § 3570(8) (stating that a qualified trustee is a person who (1) if a natural person, is a resident of Delaware or, if not a natural person, is an institution authorized by the state to act as a trustee, and (2) maintains custody of some of the property in the state, maintains records for the trust, "or otherwise materially participates in the administration of the trust").

¹⁰¹ *Id.* § 3570(8)(c). A "trust instrument" within the meaning of the statute must incorporate Delaware law, must be irrevocable, and must provide that the interest of the transferor or other beneficiary "may not be transferred, assigned, pledged or mortgaged." *Id.* § 3570(9). The statute does not explicitly define "irrevocable," but provides:

[A] trust instrument shall not be deemed revocable on account of its inclusion of [the following provision]:

4. The transferor's potential or actual receipt of principal if such potential or actual receipt of principal is either in the sole discretion of a qualified trustee or qualified trustees or is pursuant to an ascertainable standard contained in the trust instrument

See id. § 3570(9)(b). Therefore, the existence of trustee discretion to make payments of principal to the settlor does not make the trust revocable and does not remove the trust proceeds from the statutory protection against creditor claims.

¹⁰² *See id.* § 3570(9)(b). This section expressly provides that the trust shall not be treated as revocable merely because the trustee has discretion to make principal payments to the settlor. *See id.* § 3570(9)(b)(4). The failure of the drafters to list as exceptions trusts in which the trustee is *required* to make principal payments to the settlor creates the strong inference that, if the settlor retains an absolute right to the distribution of the trust principal, courts will treat the trust as revocable, rendering the transfer not a qualified disposition.

¹⁰³ *See id.* § 3570(9)(b) (providing that an instrument will not be deemed revocable "on account of . . . [t]he transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument"). Unlike paragraph (4) of § 3570(9)(b), paragraph (3) includes no language requiring that the transferor's right to income be within the discretion of the trustee. Ordinary principles of statutory construction, there-

statute includes an express exemption for claims for support or alimony in favor of a spouse or child, claims for distribution of property in favor of a spouse, and claims for "death, personal injury or property damage on or before the date of a qualified disposition."¹⁰⁴ The Alaska statute includes no comparable exemption.

Finally, the Delaware statute, like the Alaska statute, permits creditors to reach trust assets if the creditor can demonstrate that the transfer into trust was fraudulent.¹⁰⁵ Also, like the Alaska statute, the Delaware statute imposes a four-year limitation period on fraudulent transfer claims, measured from the time the settlor made the qualified distribution.¹⁰⁶ Unlike Alaska, however, Delaware has adopted the actual- and constructive-fraud provisions of the UFTA,¹⁰⁷ which may make it substantially easier for a creditor to prove fraud in Delaware than in Alaska.

II

DOES INTERSTATE COMPETITION ASSURE OPTIMAL TRUST LAWS?

The evidence this Article has presented so far establishes that a number of jurisdictions, both domestic and foreign, compete for trust business.¹⁰⁸ Is this an area in which a form of Gresham's law ap-

fore, lead to the conclusion that in Delaware, a settlor may insulate an income interest in trust from creditor claims even if the income interest is absolute rather than discretionary.

¹⁰⁴ *Id.* § 3573.

¹⁰⁵ *See id.* § 3572. Like the Alaska statute, the Delaware statute was amended in 1998. The 1998 amendments did not significantly change the protections created the previous year. *See* 71 Del. Laws 343 (1998).

¹⁰⁶ *See* DEL. CODE ANN. tit. 12, § 3572(b). If the claim arose before the qualified disposition was made, but the disposition could not reasonably have been discovered until later, the creditor has an additional one year "after the qualified disposition was or could reasonably have been discovered by the creditor." *Id.* § 3572(b)(1).

¹⁰⁷ *See id.* §§ 1304(a)(1)-(2) (1999).

¹⁰⁸ Although the focus here is on asset protection trusts, a number of states have also begun to compete for trust business by abolishing the Rule Against Perpetuities, thereby making it possible for a settlor to create a "dynasty" or "perpetual" trust that avoids estate taxation, as well as permitting a settlor to retain greater "dead hand" control of property. Idaho and Wisconsin, for example, have long disregarded the Rule Against Perpetuities. *See* IDAHO CODE § 55-111 (1994); WIS. STAT. ANN. § 700.16 (West 1999). The South Dakota legislature has taken the same path. *See* S.D. CODIFIED LAWS § 43-5-4 (Michie 1997). South Dakota's action was part of its aggressive campaign to attract trust and banking business to the state, a campaign which included the repeal of its interest rate ceiling on consumer credit cards, *see* Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 215-16 (1986), and its rejection of a state income tax, *see* Pierce H. McDowell, III, *The Dynasty Trust: Protective Armor for Generations to Come*, TR. & EST., Oct. 1993, at 47, 48. *See also* McDowell, *supra* note 14, at 14 (noting that South Dakota's governor was pushing a task force to expand legislative prowess in enacting trust legislation).

Alaska, Arizona, Delaware, and Illinois also have substantially watered down or abolished the Rule Against Perpetuities. *See* ALASKA STAT. § 34.27.050(a)(3) (Michie 1998); ARIZ. REV. STAT. ANN. § 14-2901 (West Supp. 1999); DEL. CODE ANN. tit. 25, § 503 (Supp. 1998); 765 ILL. COMP. STAT. ANN. 305/4 (West Supp. 1999). Other states may follow. In-

plies?¹⁰⁹ Will bad, inefficient, or unfair trust law drive out the good? Or does jurisdictional competition constrain inefficient trust law, assuring survival only of the "fittest" trust law? Or does the existence of competition provide little insight on the relative wisdom of various trust law regimes? This Part considers these questions.

A. Are States Rational Maximizers?

Within the private sector, competition among firms generates efficient production of goods when each firm continues to produce goods until its cost of producing an additional good equals the price a purchaser is willing to pay for the good. At that point, production of additional goods is no longer worth the firm's while. So long as firms are price takers, they all will make the same choice: produce goods until marginal cost equals price. As a result, a firm will produce a good if and only if a buyer is willing to pay the marginal cost of producing the good. The premise of this analysis, of course, is that each firm will act in its self-interest and maximize its revenue. If firms routinely failed to act in their own self-interest, competition could not generate efficient levels of production.¹¹⁰

Similarly, for competition among states to generate efficient trust law, a necessary, but not sufficient, condition is that the state (whether it be Alaska, Delaware, or the Cook Islands) act in its own self-interest when it considers what legal regime to adopt. However, the premise that states act rationally in their self-interest is more questionable than the premise that business firms do so.

The first problem is defining a state's self-interest. Like the business firm, the state is a collective entity, comprised of agents and principals. In a business firm, however, the principals and their interests are generally well-defined. The principals are the stockholders each of whose interests is the same: to maximize the return on their investments. From this particular premise we reasonably can move to the more general premise that a firm's self-interest is to maximize shareholders' return, subject only to agency-cost problems.¹¹¹ For states,

deed, Professor Joel Dobris has recently written that "[t]here is room to speculate that the rule is on its last legs in New York, too, as people are going to other states to create perpetual dynasty trusts." Dobris, *supra* note 14, at 571-72.

¹⁰⁹ Cf. Cary, *supra* note 22, at 672 (suggesting that Gresham's law explained the Delaware Supreme Court's corporate law decisions).

¹¹⁰ Economists need not assume that all firms act in rational self-interest. Some firms may not be profit maximizers, but through a Darwinian natural-selection process, those firms disappear from the market. See Edward Rubin, *Rational States?*, 83 VA. L. REV. 1433, 1438 (1997). If, however, no firms acted rationally, it would be difficult to assert that competition generates efficient levels of production.

¹¹¹ See *id.* at 1438-39 (discussing "agency" and "transmission" problems as independent constraints on a firm's efficiency, and defining transmission problems as errors that occur when managers transmit instructions to subordinates for implementation).

however, this analysis is more complicated. First, who the state's principals are is not clear; should they include only its current residents (citizens or voters), or should they encompass potential or future residents? Second, unlike the interests of profit-maximizing shareholders, the interests of the state's principals may be at odds with one another, regardless of how we define that class. Economist Kenneth Arrow's theorem suggests that no nontyrannical mechanism exists for aggregating individual preferences into a single and consistent social preference.¹¹²

The literature on interjurisdictional competition generally simplifies these problems by assuming that it is possible to identify a "representative [resident] consumer"—much like the shareholder in a business firm—whose interests the state should maximize.¹¹³ Alternatively, the literature assumes a welfare-maximizing state, presumably one that makes its decisions based on a Kaldor-Hicks, cost-benefit analysis that sums up costs and benefits to all of its residents.¹¹⁴

Defining a state's self-interest, however, is only a preliminary step. In order to claim that competition will generate efficient regulation, one must establish that state officials—the agents—act in the interests of state residents. Public choice theory, however, suggests that government officials lack the incentives to maximize the aggregate welfare of

¹¹² See I KENNETH J. ARROW, *A Difficulty in the Concept of Social Welfare*, in COLLECTED PAPERS OF KENNETH J. ARROW: SOCIAL CHOICE AND JUSTICE 1, 4-7 (1983).

¹¹³ Wallace E. Oates & Robert M. Schwab, *The Allocative and Distributive Implications of Local Fiscal Competition*, in COMPETITION AMONG STATES AND LOCAL GOVERNMENTS 127, 130 (Daphne A. Kenyon & John Kincaid eds., 1991) [hereinafter Oates & Schwab, *Allocative and Distributive Implications*] (assuming that local government's objective is to maximize the utility of a representative resident consumer); see also Wallace E. Oates & Robert M. Schwab, *Economic Competition Among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, 35 J. PUB. ECON. 333, 339-41 (1988) (analyzing the interests of a "representative consumer" by using a "media-voter" model).

Peter Enrich criticizes this view, arguing that "government's role is to provide those services that the citizenry deems valuable but that the market is ill-suited to value properly." Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 378, 403 (1996). So long as capital is mobile, however, government cannot, in a competitive environment, impose a tax on capital greater than the local benefit the capital generates, because the capital will simply move to another jurisdiction. Hence, as Oates and Schwab point out, "all local taxes become benefit taxes." Oates & Schwab, *Allocative and Distributive Implications*, *supra*, at 131.

The representative-resident model—although problematic because of the likely differences in preferences among residents—is somewhat more plausible for local governments if we assume that residents dissatisfied with the preferences of their neighbors will exit to other municipalities. See Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 419 (1956); see also *infra* text accompanying notes 116-39 (discussing how corporate charters steer firms).

¹¹⁴ Cf. Revesz, *supra* note 25, at 1220-21 (acknowledging that not all jurisdictions may pursue welfare-maximization, but nevertheless treating all jurisdictions as wealth-maximizing "[f]or simplicity").

the state's residents.¹¹⁵ If government officials are motivated in large measure by the desire to maintain and improve their political positions, they may seek to attract businesses favored by organized groups, even if the costs of such businesses, which may be spread throughout the entire population, exceed the benefits the supporting groups derive.¹¹⁶ Similarly, officials who believe they can directly capture the gains associated with entrance of a new business—for instance, through campaign contributions—may encourage entrance of the new business despite the significant costs it may generate. Moreover, even a relatively conscientious official might overestimate the value of a business due to the considerable publicity it would generate to bring or retain the business within the state.¹¹⁷

By contrast, the same official might underestimate the costs associated with bringing or retaining the business, which are often spread over time, because those costs would generate less public attention. Furthermore, the official may recognize that the public is unlikely to blame her for providing too much incentive because it cannot precisely ascertain how much incentive is necessary to lure a business into the state.¹¹⁸ On the other hand, if the official offers too little incentive, and the business is lost, the public is more likely to hold her responsible for this outcome.¹¹⁹ Hence, systematic bias may exist that leads state governments to provide too much incentive to attract new businesses into the state.

¹¹⁵ In particular, public choice theorists recognize the tendency of government officials to overvalue the interests of small but organized groups, while undervaluing the interests of consumer and taxpayer groups. The classic works remain JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962) and MANCUR OLSON, JR., *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GOODS* (1965).

¹¹⁶ See Bratton & McCahery, *supra* note 30, at 246 (discussing the assumption in some models of government action that officials will assure that "the controlling voting coalition . . . enjoys most of the public goods benefits while sharing the taxation burden with disenfranchised local citizens").

¹¹⁷ See Enrich, *supra* note 113, at 393-94. Enrich states: "By taking visible steps to encourage economic growth, [elected officials] can take credit for subsequent economic successes, whatever their actual causes, and avoid blame for any losses of jobs to other states that otherwise would have been attributed to them if they had failed to act." *Id.* at 394 (footnote omitted).

¹¹⁸ See Enrich, *supra* note 113, at 395 ("Forecasts both of the foregone revenues from business tax incentives and of their countervailing economic benefits . . . are notoriously open to debate . . ."); cf. Andrew Reschovsky, *How Closely Does State and Local Government Behavior Conform to a Perfectly Competitive Model?*, in *COMPETITION AMONG STATES AND LOCAL GOVERNMENTS*, *supra* note 113, at 147, 147-48 ("Governments tend to be particularly sensitive to the demands of businesses because they have no way of judging the credibility of threats to leave . . .").

¹¹⁹ See Nonna A. Noto, *Trying to Understand the Economic Development Official's Dilemma*, in *COMPETITION AMONG STATES AND LOCAL GOVERNMENTS*, *supra* note 113, at 251, 254 (noting that officials are subject to more criticism for denying a concession and losing a firm than for giving too generous a concession and wasting resources); see also Enrich, *supra* note 113, at 393-94 (describing the intense pressure on officials to attract business).

Some, but not all, of the agency problems associated with state action are ameliorated when government officials act by general legislation rather than individualized deal making. Arrow's theorem applies to all forms of government action: no neutral way exists to aggregate citizen preferences, regardless of context. The general aggregation problem does not, however, generate a particular systemic bias with respect to incentives for new businesses. Nonetheless, the practical political problems that lead officials to provide excessive incentives are far worse when officials engage in individualized deal making than when they use general legislative processes.¹²⁰ When a state offers incentives through general legislation, the capacity of individual enterprises to secure special benefits is significantly reduced.¹²¹ So long as enterprises must meet statutory requirements, state officials will earn less public credit, and take less public blame, for the migration of firms into and out of the state. At the same time, state officials will be less able to use the bargaining process to curry political favor with new enterprises.

Why, then, would state officials act by general legislation rather than through individualized negotiation? When a state seeks to attract many separate enterprises, each of which generates a relatively small benefit, the cost of negotiating with each enterprise might well exceed the value generated by the enterprise, even when officials take into account the personal benefit they might derive from a deal. In this situation, general legislation is a more attractive alternative: the legislature drafts one attractive statute, and then waits for the returns.

Corporation statutes furnish the most obvious example of general legislation designed to attract business into the state. Delaware and other states could have offered corporate charters to companies on individualized terms, as most states did until the late nineteenth century.¹²² But in light of current demand for corporate charters, and the limited advantage that states would derive from each charter, the costs of individual negotiation would likely swallow the advantages a

¹²⁰ State officials may well offer overly generous incentives even by general legislation. A possible example is state takeover legislation, which is general in form, but which a major local firm facing a hostile takeover bid often stimulates. See ROMANO, *supra* note 23, at 57. The point is a comparative one: the ability to tailor incentives to particular firms generates more rents for public officials to capture.

¹²¹ See generally Richard A. Epstein, *The Supreme Court, 1987 Term—Forward: Unconstitutional Conditions, State Power, and the Limits of Consent*, 102 HARV. L. REV. 4, 29-31 (1988) (arguing that reducing discretion in granting state charters reduces the "level of intrigue" and that selective incorporation gives political actors a greater opportunity to extract economic rents); Sterk, *supra* note 27, at 852 (concluding that government officials have more opportunity to discriminate in favor of particular developers when government acts through deal making rather than rule making).

¹²² For a discussion of the special chartering system and its demise, see Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129, 138-63 (1985).

state derives from incorporation.¹²³ Moreover, incorporating companies would have an incentive to avoid states that chose to follow the individualized negotiation model, with its attendant negotiation costs, in favor of states that opted for general legislation.¹²⁴

The recent wave of trust legislation appears to follow the same model. The benefit that Alaska or the Cook Islands derives from any single trust is small—perhaps even smaller than the benefit that Delaware derives from reincorporation of a single additional firm. By providing general legislation attractive to trust settlors, jurisdictions hope to persuade many trusts to relocate, thus generating significant aggregate benefits. The competition for trust business, however, differs from the competition for corporate charters in one significant respect: Filling the state government's coffers does not appear to be a major factor motivating trust-friendly jurisdictions. Delaware, of course, generates a significant percentage of state revenue from corporate charter fees.¹²⁵ Jurisdictions seeking to become trust havens, on the other hand, appear content to draw business to local financial institutions and lawyers, even without direct benefit to the public fisc.¹²⁶

The basic point is this: there is more reason to believe that state officials are acting in the interest of the state, and not merely in their private interest when they enact trust legislation of general application, than when they engage in individualized deal making. The con-

¹²³ Some dispute exists in the literature about the gains available to states from individualized corporate charters. Lawrence Friedman has contended that the process of individualized chartering took up more legislative time than it was worth to the legislators. See LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 172, 447 (1973). Henry Butler, however, criticized Friedman, contending that the gains remained significant until jurisdictional competition wiped them out. See Butler, *supra* note 122, at 134, 146-63.

¹²⁴ Butler traces the demise of special charters to interstate competition, first spawned by New Jersey's liberal general incorporation statute, which was enacted in 1875. See Butler, *supra* note 122, at 156-63.

¹²⁵ See ROMANO, *supra* note 23, at 6 (stating that "a substantial portion of the state's tax revenue—averaging more than 15 percent from 1960 to 1999—is derived from incorporation fees").

¹²⁶ Another plausible explanation for enactment of asset protection trust legislation focuses not on competition for new business but on regulatory capture: Organized interest groups, including the bar and trust companies, seek legislation that will enable them to generate more business, even at the expense of other local residents (particularly creditors). Regulatory capture has also been advanced as an explanation for corporate legislation favorable to corporate managers. See John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 762-64 (1987); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 485 (1987). So long as trust capital is mobile, however, competition would drive states to enact trust legislation favorable to trust settlors even without regulatory capture. If the legislation was not sufficiently favorable, settlors would move their trusts to other states, provided, of course, that those with fiduciary duties, particularly lawyers, advise their clients about the advantages of doing so.

cerns about official self-dealing that arise when officials act in a deal-making mode are significantly less pressing. Hence, the primary question for consideration is whether competition among the states aligns the interests of the individual states with the interests of the nation (or in a global context, the world), or whether competition among the states makes all of the states worse off than they would be under some form of multistate coordination.

B. The Effects of Competition

When William Cary examined the state of corporate law in 1974, he concluded that, in its quest to attract corporate charters, Delaware had developed a corporate law that was unduly tilted in favor of corporate managers and was inadequately protective of corporate shareholders.¹²⁷ Cary argued that other states had little choice but to follow Delaware's lead; if they did not offer similar benefits to corporate managers, local corporations would simply move to Delaware.¹²⁸ Thus, Cary reasoned that even if each state would prefer to impose more stringent regulations on corporate managers, competition for charters precluded the states from doing so.¹²⁹ In Cary's view, competition among states was a "race for the bottom" that made all shareholders worse off.¹³⁰ Cary's proposed cure was federal regulation—in the case of corporate law, a set of minimum federal standards to be superimposed on top of state corporate law.¹³¹

Over the succeeding quarter century, the academic literature has generally discredited Cary's argument. Ralph Winter observed that if Cary were correct, and Delaware law were unattractive to shareholders, the result should be lower earnings and share prices in Delaware corporations, reflecting reduced investor confidence in management.¹³² Because management has a strong incentive to keep earnings and share prices high, it would in turn seek to reincorporate in a state whose laws were more conducive to higher earnings and share prices. As a result, Winter argued, the competition for corporate charters would tend toward optimal corporate-law regimes.¹³³

The argument that interjurisdictional competition leads to more efficient government regulation did not begin with Winter. In a 1956 article, economist Charles Tiebout argued that competition among municipalities could generate optimal provision of public goods because potential residents would "shop" among municipalities for the

127 See Carey, *supra* note 22, at 666.

128 See *id.* at 666-67.

129 See *id.*

130 *Id.* at 705.

131 See *id.* at 700-03.

132 See Winter, *supra* note 23, at 256.

133 See *id.* at 290.

one that offered their preferred mix of public goods.¹³⁴ Each municipality would seek to attract new residents so long as additional residents generated more benefits than cost, allowing it to provide its bundle of services at the lowest average cost.¹³⁵

By adapting Tiebout's hypothesis to corporate law, Winter spawned an extensive literature on competition for corporate charters. Much of the literature identifies structural problems that prevent interstate competition from generating a race to the top,¹³⁶ but Winter's article has nevertheless shifted the debate. First, empirical studies that examine the effect of reincorporation on share prices mushroomed, testing Winter's hypothesis that corporations would typically reincorporate in states that offered laws more favorable to shareholders.¹³⁷ These studies generally confirm Winter's hypothesis.¹³⁸ Second, the literature on corporate federalism has caused advocates of federal regulation to accept the burden of demonstrating why corporate law should not be left to state regulation.¹³⁹

Tiebout's influence in the legal literature has extended well beyond the debate over corporate charters. Richard Revesz has argued that federal environmental law takes insufficient account of the advantages of competition among states.¹⁴⁰ Vicki Been has suggested that competition among municipalities will limit their ability to impose on developers exactions that would distort the housing market.¹⁴¹ Clay Gillette has argued that state competition for business facilitates "economic integration for the benefit of the nation as a whole," making federal intervention undesirable.¹⁴² In general, the argument in each

¹³⁴ See Tiebout, *supra* note 113, at 418-20.

¹³⁵ See *id.* at 419-20.

¹³⁶ See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 222-23 (1991) (concluding that, although interjurisdictional competition will not lead to a race to the top, state regulation of corporate law will be more efficient than federal regulation); ROMANO, *supra* note 23, at 52-59 (identifying agency problems that might lead corporate managers to support, and state legislators to enact, inefficient anti-takeover legislation); William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1876-1903 (1995) (framing the debate over charter competition and proposing "a modified description of the system").

¹³⁷ See ROMANO, *supra* note 23, at 225; Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980).

¹³⁸ See ROMANO, *supra* note 23, at 14-24 (summarizing empirical research).

¹³⁹ See, e.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

¹⁴⁰ See Richard L. Revesz, *Federalism and Interstate Environmental Externalities*, 144 U. PA. L. REV. 2341, 2342-44 (1996); Revesz, *supra* note 25, at 1210-12.

¹⁴¹ See Been, *supra* note 27, at 478.

¹⁴² Clayton P. Gillette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 MINN. L. REV. 447, 448 (1997).

area has been that, if state government decision makers make rational judgments about the costs and benefits of attracting new businesses, each state will compete "up to the point when the marginal benefits of additional industry no longer exceed the marginal costs."¹⁴³

Taken to its extreme, the argument suggests that competition among states will result in an efficient level of regulation in each state, making federal regulation counterproductive. The general claim that interjurisdictional competition will lead to efficient regulation, however, is a claim that requires heroic assumptions. Tiebout himself identified several of these assumptions: (1) that economic actors can costlessly move from one jurisdiction to another in pursuit of packages of public goods they find attractive;¹⁴⁴ (2) that actors have adequate information about government policies and practices;¹⁴⁵ and (3) that enough competing jurisdictions exist to ensure alternative jurisdictions offering precisely the same mix of public goods and services;¹⁴⁶ if a particular state offers a bundle of public goods and services that no other state duplicates, that state is in a position to extract economic rents from firms seeking that specific bundle.

Beyond the assumptions Tiebout identified, the claim that interjurisdictional competition generates efficient regulation also requires state officials to act as entrepreneurial decision makers, seeking to maximize the interests of state residents.¹⁴⁷ To the extent that state

¹⁴³ *Id.* at 489. As a result, communities would essentially act as price takers, unable to derive benefits from new businesses through redistributive taxation. See Oates & Schwab, *Allocative and Distributive Implications*, *supra* note 113, at 128.

¹⁴⁴ See Tiebout, *supra* note 113, at 419.

¹⁴⁵ See *id.* at 420.

¹⁴⁶ See *id.* at 421. For Tiebout-style competition to generate efficient regulation, the number of jurisdictions must be sufficiently high to permit an economic actor dissatisfied with an inefficient rule promulgated by one jurisdiction to move to another jurisdiction without giving up the kinds of benefits offered by the first jurisdiction. For most economic actors shopping among jurisdictions, however, a number of public goods, of which law is only one, will be relevant factors in making a choice. Each jurisdiction will offer a "bundle" of public goods from which the economic actor may choose. If the bundles offered are significantly different across jurisdictions, any individual state may be able to introduce an inefficient rule without risking the loss of existing firms or residents, because those firms or residents may prefer the other elements in the jurisdiction's bundle. To eliminate this potential for inefficiency, multiple jurisdictions that offer virtually the same bundle must exist. However, as the number of public goods in the bundle increases, the number of jurisdictions necessary to offer the efficient array of public goods quickly skyrockets and approaches the number of economic actors in the system. See DENNIS C. MUELLER, *PUBLIC CHOICE II* 157 (rev. ed. 1989); Bratton & McCahery, *supra* note 30, at 223-24.

¹⁴⁷ As Bratton and McCahery observe, nothing in the Tiebout model technically requires state officials to act as entrepreneurs; if they fail to do so, the state would theoretically lose its entire population to other jurisdictions whose officials produce public goods more efficiently. See Bratton & McCahery, *supra* note 30, at 235-37. To the extent, however, that imperfect mobility would prevent inefficiently run states from disappearing, any model suggesting that interjurisdictional competition will generate efficient regulation must assume entrepreneurial state officials seeking to maximize the economic welfare of existing residents. This conception of state officials, however, is problematic. See, e.g., Ju-

officials behave as imperfect agents of state residents, the potential for inefficiency remains.¹⁴⁸ Furthermore, as the corporate literature makes clear, the claim that jurisdictional competition promotes efficient regulation also assumes that the private actors choosing among jurisdictions themselves behave as perfect agents of their principals.¹⁴⁹ Finally, the claim that jurisdictional competition generates efficient regulation assumes that the regulatory decisions of a state have no effects that spill over into other states; if regulation generates externalities, state officials acting in the interests of their state have little reason to take them into account.¹⁵⁰

By now it should be evident that the conditions necessary to ensure that interjurisdictional competition generates efficient regulation will never hold true in practice. This does not mean, however, that regulation at the state level is inevitably inefficient. First, the question begs for a baseline: inefficient compared to what? Inefficiencies at the state level might be outmatched by inefficiencies generated by regulation at the national level. Second, the absence of the conditions necessary for competition to generate efficient regulation reveals nothing about the efficiency of a particular regulation. Tiebout's goal was to refute the conventional wisdom that assessing whether a government was providing an efficient level of public goods was impossible.¹⁵¹ If Tiebout's assumptions do not hold, we are back to educated gues-

lius Margolis, *Public Policies for Private Profits: Urban Government, in REDISTRIBUTION THROUGH PUBLIC CHOICE* 289, 289 (Harold M. Hochman & George E. Peterson eds., 1974) (arguing that economic models of government actors are "different" from those of market actors); Susan Rose-Ackerman, *Beyond Tiebout: Modeling the Political Economy of Local Government, in LOCAL PROVISION OF PUBLIC SERVICES: THE TIEBOUT MODEL AFTER TWENTY-FIVE YEARS* 55, 75 (George R. Zodrow ed., 1983) (concluding that "empirical work in this area has too uncritically accepted median voter models or monopoly models which assume the governments maximize 'economic welfare'").

Bratton and McCahery identify models that posit government decision makers as maximizers of real estate values or tax revenues, but they correctly note that such models do not generate an entrepreneurial state. See Bratton & McCahery, *supra* note 30, at 237-38 ("[O]ne cannot assume an entrepreneurial state.").

¹⁴⁸ See John E. Chubb, *How Relevant Is Competition to Government Policymaking?*, in *COMPETITION AMONG STATES AND LOCAL GOVERNMENTS*, *supra* note 113, at 57, 60-61 (noting the weakness of the "black boxes" model of state government); Rubin, *supra* note 110, at 1451 (recognizing the potential for inefficiency).

¹⁴⁹ Cary's critique of Delaware regulation rests on the premise that corporate managers seek to maximize their own interests, which might conflict with those of shareholders. Cary observed that "[m]anagements want freedom from bothersome stockholders." Cary, *supra* note 22, at 699. He concluded that "[m]anagement should not be omnipotent" and that "[c]orporate charters and bylaws should not be molded for its benefit." *Id.* at 698.

Winter, by contrast, concluded that the capital market, the product market, and the market for corporate control discipline managers to act in the interest of their principals, the shareholders. See Winter, *supra* note 23, at 289.

¹⁵⁰ See Bratton & McCahery, *supra* note 30, at 231-33; Revesz, *supra* note 140, at 2343.

¹⁵¹ Richard Abel Musgrave, *The Voluntary Exchange Theory of Public Economy*, 53 *Q.J. ECON.* 213 (1939); Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 *REV. ECON. & STAT.* 387 (1954).

ing—unverified by market forces—about the relative efficiency with which governments provide public goods, including laws.

Nonetheless, in this nonidealized world of imperfect market discipline, will the states generate more efficient regulation than a national government subject to fewer market constraints?¹⁵² The answer depends on the extent to which real world conditions diverge from the assumptions underlying Tiebout's model. If externalities are a serious problem, state regulation may generate perverse results. Similarly, if firms choosing among jurisdictions face considerable bundling problems, or if significant constraints on mobility exist, interjurisdictional competition is unlikely to provide a comparative advantage for state regulation. On the other hand, if the regulatory issues concern primarily a discrete group of well-informed economic actors, who enjoy considerable mobility and are concerned about a small set of regulatory issues, competition among states may generate better results than a nationally imposed regulatory scheme, at least when externalities are not of paramount importance.¹⁵³

C. Jurisdictional Competition and Trust Law

In some ways, trust law would appear ideally suited for regulatory competition. Trusts are extraordinarily immobile. For a California trust to relocate to Alaska, no individual has to change her domicile. A trust can relocate to Alaska without the use of bricks or mortar. Indeed, a trust qualifies as an Alaska trust so long as one of the trustees is an Alaska resident or trust company, some of the assets are deposited in Alaska, and trust records are maintained in Alaska.¹⁵⁴ Thus, a settlor can create an Alaska trust by creating a trust in California, naming herself as co-trustee with an Alaska trust company, opening a small account in an Alaska bank, and having the trust company maintain records. Few of the trust assets need to be moved to Alaska, and the

¹⁵² In a world economy, even the federal government is subject to some market constraints (e.g., the Cook Islands International Trusts Act). See *supra* text accompanying notes 75-84.

¹⁵³ Bratton and McCahery list factors to be considered in evaluating the claim that competition among jurisdictions generates relatively better results than centralized regulation:

A claim that competitive benefits redound from the vesting of regulatory authority at the junior level will be more plausible when: (1) the regulation is unbundled, (2) the regulation implicates no substantial interconnections with other jurisdictions or with later consumers, (3) all actors affected by the regulation are highly mobile, (4) all actors are well-informed, and (5) competitive pressures registered by all actors affected by the regulation determine its content. To the extent that one or more [of] these variables does not obtain, the case for competitive benefits weakens.

Bratton & McCahery, *supra* note 30, at 262-63.

¹⁵⁴ See ALASKA STAT. § 13.36.035(c) (1998).

arrangement would involve little more effort for the settlor than creating a trust with a local California trust company.

As with corporate charters, all that changes is the situs of the trust.¹⁵⁵ Moreover, trust settlors with significant assets are likely to be well informed by their lawyers about the relative advantages that competing jurisdictions afford. Because the trust may have little connection with the chosen state, the trust settlor is unlikely to be concerned about the more general package of public goods and services the state provides. The settlor's only real concern is with the trust's legal status—the laws governing the trust.¹⁵⁶ The jurisdiction's bundling of goods and services, therefore, is unlikely to be a significant impediment to regulatory competition.¹⁵⁷

Externalities, however, pose a significant difficulty for a regulatory-competition model of trust law. In particular, neither the state government nor the settlor has any incentive to represent the interests of out-of-state creditors—including out-of-state taxpayers—in devising the state's regulatory regime. As a result, there is good reason to believe that competition among the states for trust business will not generate efficient regulation. To illustrate the point, consider first an isolated jurisdiction which can attract no foreign trust funds and from which no potential trust monies can escape. Suppose this jurisdiction must choose between two rules, one permitting creditors to reach settlors' beneficial interests in their trusts and the other permitting settlors to insulate their beneficial interests from creditors' claims. Settlors are better off if they have the option to create self-settled

¹⁵⁵ For present purposes, we will assume that a settlor who creates an Alaska trust obtains all of the benefits of Alaska law with respect to all issues surrounding the trust. A similar assumption is often made with respect to corporations in that courts typically invoke the internal affairs doctrine to apply the law of the state of incorporation to issues involving a corporation's rights and liabilities. See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89-90 (1987); *RESTATEMENT (SECOND) OF CONFLICT OF LAWS* § 302(2) (1971); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 *DUKE L.J.* 1, 17-18 (noting the prevalence of application of the law of the state of incorporation even after the revolution in choice-of-law theory).

On the other hand, even in corporate law, the law of the state of incorporation may not apply. See *RESTATEMENT (SECOND) OF CONFLICT OF LAWS* § 302 cmt. g, illus. 1 (1971). And, as we shall see in Part III, *infra*, it is not at all clear that creating an Alaska trust will inevitably provoke the application of Alaska law.

¹⁵⁶ Cf. Bratton & McCahery, *supra* note 30, at 266-67 (noting that, when competition involves the sale of legal status like corporate charters, information, mobility, and bundling do not significantly inhibit regulatory competition). Bratton and McCahery conclude that provision of legal status "leads to a two-party transaction resembling a conventional sale of goods," thereby solving "the problem of the entrepreneurial government actor." *Id.* at 267.

¹⁵⁷ Of course, a jurisdiction might bundle a rule permitting creation of perpetual trusts with another rule limiting the settlor-beneficiary's protection against creditors, or vice versa, but if we assume a high number of potential competing jurisdictions compared to the number of trust rules important to settlors, bundling is unlikely to impede regulatory competition.

spendthrift trusts. On the other hand, creditors are as a class better off if settlors do not have that option.

Is choosing between the two possible rules a zero-sum game, an allocation of a fixed sum of monies between the two classes of participants, settlors and creditors? With respect to contract creditors, the answer may be yes, because the parties can reallocate rights between themselves when they enter into their contractual relationship.¹⁵⁸ With respect to tort creditors, however, the answer is no. Permitting trust settlors to insulate their assets from creditor claims promotes riskier settlor behavior, because settlors will be aware that they will not bear the full costs of their actions.¹⁵⁹

To illustrate, suppose the settlor is a physician deciding how many tests to run on a patient. If the physician runs insufficient tests and misdiagnoses the patient, she risks malpractice liability, which will either require payment out of pocket or an increase in malpractice insurance premiums. If, however, the physician can insulate her assets from patient claims, she can afford to run fewer tests, because she will not bear the full costs of malpractice liability.¹⁶⁰

Suppose this risky behavior generates a net cost to the state, perhaps in the form of lost productivity or additional resources devoted to medical care. How will the state account for that loss in deciding what legal treatment is appropriate for self-settled spendthrift trusts? Assume that enforcing spendthrift provisions in self-settled trusts in-

¹⁵⁸ For a discussion of the disparate positions of voluntary and involuntary creditors, and an argument that involuntary creditors generally should enjoy priority over secured creditors, who have had the opportunity to protect themselves by contract, see Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994).

¹⁵⁹ Corporate scholars have extensively discussed the incentive to reduce precautions in a regime of limited liability. See Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1882-83 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1584-85 (1991); S. Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 45-46 (1986). Even the prime defenders of limited liability do not dispute this incentive effect. Instead, they argue either that limited liability generates corresponding benefits, see, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 93-97 (1985), or that attempts to abandon limited liability would be practically impossible, see Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 390 (1992).

¹⁶⁰ One might argue that, especially in the medical malpractice context, the potential tort victim—the patient—can require the potential tortfeasor to insure or to take additional precautions with respect to diagnosis or treatment. See Leebron, *supra* note 159, at 1584 & n.65. If the tort victim can take the costs of the tortfeasor's behavior into account, the tortfeasor's avoidance of liability will produce efficiencies. See *id.* at 1584. The assumption that the potential victim can take into account the risks of tortious activity is, however, an heroic one, especially in the classic tort case in which the potential victim has no prior information regarding the risks she faces. See *id.* at 1584 n. 65. Even in malpractice cases, in which the potential victim has some relationship with the potential tortfeasor, the professional's greater expertise makes it unlikely that the victim could account for risk as well as the professional could.

creases the benefit of each trust dollar by one cent. Assume further that enforcing those provisions imposes a cost of two cents for each trust dollar—one cent reflecting the ex post loss to victims injured by the settlor's risky behavior (precisely balancing the one cent gain to trust settlors) and one cent reflecting the ex ante cost of increased risky behavior. If our isolated jurisdiction were simply assessing costs and benefits, it would presumably refuse to enforce spendthrift provisions in self-settled trusts, because aggregate costs exceed aggregate benefits.

Now abandon the assumption of an isolated jurisdiction, and assume instead that each state is free to lure trust business from other states. In considering trust legislation, a state concerned only with the interests of its own residents will not care about the distribution of resources between out-of-state creditors and out-of-state settlors, nor will it care about the potentially riskier behavior of out-of-state settlors, resulting from enforcement of spendthrift provisions in self-settled trusts. The state's principal concern will be the benefit its trust companies derive from additional trust business within the state.

Suppose the state concludes that by enforcing spendthrift provisions in self-settled trusts, it would attract additional trust dollars from both out-of-state settlors and local settlors. Suppose, in addition, the state assumes that three quarters of the total dollar volume will come from out of state. Furthermore, suppose the state estimates that it will derive one-half cent of benefit from each trust dollar settled within the state by an out-of-state settlor.¹⁶¹ Should the state, under these circumstances, enforce self-settled spendthrift trusts?

Note the calculations facing state officials: A rule enforcing spendthrift provisions will affect both trusts created by local residents and trusts created by out-of-state settlors. As we assumed in the isolated-jurisdiction scenario, with respect to local residents, enforcing spendthrift provisions generates a loss to the state of one-cent on each trust dollar. On the other hand, with respect to out-of-state settlors, enforcing spendthrift provisions generates a gain of one-half cent per trust dollar. However, since the number of trusts created by out-of-state settlors will be three times the number of trusts created by local

¹⁶¹ The marginal benefit that the state derives from each additional trust dollar need not be constant. The discussion assumes only that the average benefit derived from each trust dollar, at the stated quantity of trust dollars, is one-half cent per dollar. This one-half cent represents the increased revenue local banks and lawyers will generate as the result of additional trust business. The one-half cent figure is, of course, arbitrary. The amount could be larger or smaller, just as the percentage of trust volume from out of state could be greater or smaller than three quarters. The numbers are chosen merely to demonstrate the incentives that jurisdictional competition creates, not to predict whether the prospect of new trust business will induce any particular state to authorize self-settled spendthrift trusts.

residents, the state will still gain more than it loses by enforcing spendthrift provisions.

To illustrate, let x equal the total dollar volume of trust business that the state will generate if it enforces self-settled spendthrift trusts. The volume of trust business settled by local settlors is $.25x$; the volume settled by out-of-staters is $.75x$. On trusts settled by locals, the state will generate a total loss of $.0025x$ ($.01$ loss per trust dollar times $.25x$ local trust business). On trusts settled by out-of-staters, the state will generate a total gain of $.00375x$ ($.005$ loss per trust dollar times $.75x$ local trust business). The state would therefore generate a net gain of $.00125x$ by enforcing self-settled spendthrift trusts ($.00375x - .0025x$), because the cost of such a policy, measured by the riskier behavior of trust settlors, would largely fall out of state.¹⁶²

This analysis also explains why smaller states, like Alaska and Delaware, rather than larger commercial states, like California and New York, have taken the lead in developing asset protection trusts.¹⁶³ The larger the state, the higher the percentage of trusts created by local settlors, and, hence, the more likely local creditors will be harmed by enforcement of self-settled spendthrift trusts. In other words, smaller states are in a better position to export the costs associated with self-settled spendthrift trusts.

However, with perfect mobility of capital, large states will ultimately follow small states to embrace asset protection trusts.¹⁶⁴ Failure to follow will result in a loss of trust business to states enforcing

¹⁶² Professors Macey and Miller have argued that Cary's race-to-the-bottom characterization of Delaware corporate law rests on a similar assumption:

[Cary] implicitly posits that Delaware legislators have an incentive to enact statutes that are harmful to shareholder welfare when doing so will attract additional revenue from franchise taxes to the state. Although the costs of such a scheme are distributed over shareholders located throughout the country, the group that enjoys the benefits from these increased charter revenues—presumably lower state taxes and increased state services—consists exclusively of the Delaware legislators' constituents.

Macey & Miller, *supra* note 126, at 475 (footnote omitted).

¹⁶³ In the corporate literature, the conventional explanation for the role of small states in competing for trust business has been that small states, particularly Delaware, can generate a larger percentage of state revenue from corporate charters than large states with much larger budgets. Bratton and McCahery note:

The explanation prevailing for Delaware probably applies across the board. Corporate franchise fees comprise fifteen percent of Delaware's tax base; the same cash flow, however, would be a trivial percentage of the tax base of a large state. Given a limited market, competitive success has a larger percentage impact on the smaller budget of a small jurisdiction. Political and financial incentives to create (or enter) a legal product market arise when there is the possibility of a significant payoff.

Bratton & McCahery, *supra* note 30, at 267; see also Carney, *supra* note 32, at 718-19 (noting the importance of franchise fees to a small state like Delaware).

¹⁶⁴ See, e.g., Dobris, *supra* note 14, at 571-72 (noting that even New York might change its rule to permit perpetual trusts to avoid loss of business to other states).

self-settled spendthrift provisions, without accompanying deterrence of risky behavior by local trust settlors.¹⁶⁵ Even if both states would be better off if they both refused to enforce self-settled spendthrift trusts, neither would have an incentive—other than by binding compact—to depart from the enforcement of spendthrift provisions.

In game theory terms, the decision by all states to enforce spendthrift provisions constitutes a Nash equilibrium.¹⁶⁶ The following matrix illustrates the problem:

		LARGE STATE	
		Enforcement	No Enforcement
SMALL STATE	Enforcement	-1, -3	2, -6
	No Enforcement	-2, -2	0, 0

Define the situation in which neither state enforces spendthrift provisions as the baseline, represented by a payoff of 0 to each state. Assume that the increase in risky behavior generated by routine enforcement of spendthrift provisions would generate a loss of 1 to the smaller state and a loss of 3 to the larger state, reflecting the greater overall activity in the larger state. Thus, if both states enforce spendthrift provisions, the payoff to the states is (-1, -3) reflecting only the increase in risky behavior in each state.

Next, let us make assumptions about the effect on each state of migration of trust business from one state to the other. Assume that if the small state attracts all of the large state's trust business, the small state will generate a gain of 3 and impose a corresponding loss of 3 on the large state. Conversely, assume that if the large state attracts all of

¹⁶⁵ The same situation exists with respect to competition for corporate business. As Professor Black has noted:

[F]or any state, large or small, bucking the tide is pointless. If Delaware is liberal and New York restricts corporate freedom in any important way, companies will flee New York, New York will lose revenue, and New York's law will fail of its purpose for lack of companies to operate on.

Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. U. L. Rev. 542, 548 (1990).

¹⁶⁶ For a more extensive discussion of Nash equilibrium, see ERIC RASMUSEN, *GAMES AND INFORMATION* 32-35 (1989).

the small state's trust business, the large state will generate a gain of 1 (reflecting the smaller size of the small state's business) and impose a corresponding loss of 1 on the small state. If the small state chooses to enforce spendthrift provisions, but the large state does not, the small state receives a positive payoff of 2 (reflecting a gain of 3 from increased business, offset by a loss of 1 from increased risky activity within its borders). The large state suffers a loss of 6 (3 from the loss of trust business, and 3 from increased risky activity generated by the ability of trust settlors to insulate their assets from potential liability by creating trusts in the small state).

By contrast, if the large state chooses to enforce spendthrift provisions, but the small state refuses to do so, the large state generates a net loss of 2, because the increase in trust business (+1) is more than offset by the increase in risky activity (-3). At the same time, the payoff to the small state is reduced to -2 (a loss of 1 from increased risky activity plus a loss of 1 from migration of trusts out of the state). The matrix demonstrates that whatever position the large state takes, the small state is better off if it enforces spendthrift provisions. That is, enforcing spendthrift provisions is a weakly-dominant strategy for the small state.¹⁶⁷ If the small state chooses enforcement, the large state's better strategy is also to enforce, because by enforcing, its payoff is -3, rather than the -6 it would receive if it chose not to enforce. Once the large state chooses to enforce, however, the small state has no incentive to change its position. As a result, the set {enforcement, enforcement} is a Nash equilibrium. By contrast, although the set {no enforcement, no enforcement} generates higher combined payoffs, it is not an equilibrium, because the small state always has an incentive to change its rule to enforcement of spendthrift clauses.

Note this model assumes perfect mobility of trust capital. If not all California settlors would choose to create Alaska trusts—perhaps because California lawyers, not admitted in Alaska, are reluctant to recommend Alaska trusts¹⁶⁸—large states like California might not follow Alaska's lead.¹⁶⁹ The point, however, is not to predict the strategy of each state, but to understand the incentive each state has to ignore

¹⁶⁷ A dominant strategy "is a player's strictly best response to any strategies the other players might pick." *Id.* at 28 (emphasis omitted).

¹⁶⁸ The notion that lawyers might resist crossing jurisdictional boundaries when the result might be a loss of fees is not peculiar to this area of law. See STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS 158-59 (American Law Institute, Tentative Draft No. 1, 1963) (noting that forum shopping across state lines is a less serious problem than forum shopping across the courthouse square because an out-of-state lawyer would share fees if a lawyer chose to forum shop into another state).

¹⁶⁹ If mobility of capital were imperfect, and only one-half of trust settlors chose to cross state lines, the matrix for a large state might look like this:

the costs imposed on other states, which result in potentially perverse outcomes.

D. Implications of Jurisdictional Competition

Competition among jurisdictions will not inevitably lead to efficient regulation of trusts. Due to the externalities and agency costs associated with asset protection and perpetual trusts, state legislatures are unlikely to consider all the costs and benefits associated with trusts created in their states. Competition, however, does discriminate among rules. It will lead state legislatures to prefer rules that generate out-of-state costs. Rules permitting asset protection trusts fit this model.

		LARGE STATE	
		Enforcement	No Enforcement
SMALL STATE	Enforcement	-1, -3	.5, -3
	No Enforcement	-1, -2.5	0, 0

The {enforcement, enforcement} and {no enforcement, no enforcement} payoffs would be the same as the full mobility matrix, because settlors would have no reason to choose states based on their legal rules. If the small state enforces, and the large state does not, the small state will gain, and the large state will lose, 1.5 from the movement of trust business from large state to small. The small state will lose 1 from the increase in risky activity, and the large state will lose 1.5 from the increase in risky activity, because only one-half of its trust settlors will be in a position to take advantage of spendthrift provisions. Conversely, if the large state enforces and the small state does not, the large state will gain, and the small state will lose, .5 from the migration of trust business. The large state will lose 3 from the increase in risky activity, and the small state will lose .5, because only one-half of its settlors will benefit from enforceable spendthrift provisions.

In game-theory terms, this matrix produces an iterated dominant strategy equilibrium, with the small state enforcing spendthrift provisions and the large state not enforcing. That is, no matter what strategy the small state pursues, the large state is at least as well off by not enforcing; if the small state enforces, the large state is neither better off nor worse off by not enforcing, but if the small state does not enforce, the large state is better off by not enforcing. Therefore, for the large state, nonenforcement is a weakly dominant strategy. If the large state pursues that strategy, the small state's best response is to enforce because, by enforcing, the small state receives a payoff of one-half instead of zero. See generally RASMUSEN, *supra* note 165, at 30-32 (applying iterated dominant strategy equilibrium to war and economic strategy).

Thus, the hypothesis of imperfect mobility might explain a regime in which small states enforce spendthrift clauses but large states do not follow their lead.

Rules that generate external costs, however, are not inefficient per se. Any claim about the global inefficiency of a trust law rule is contingent on assumptions about the broader legal context in which the rule operates. Whatever inefficiencies a particular trust law rule might generate, it may perfectly compensate for other inefficiencies inherent in the background legal regime. Consider, for instance, the enforcement of spendthrift provisions in self-settled trusts. As we have seen, enforcement would create incentives for potential tortfeasors to engage in risky behavior. If the background tort law were perfectly calibrated to induce economic actors to take all efficient risks and to eschew inefficient ones, enforcing spendthrift provisions in self-settled trusts would upset that balance and result in net inefficiencies. If, on the other hand, background tort law overdeters risky behavior, enforcing spendthrift provisions might counterbalance that overdeterrence, perhaps leaving the system more efficient as a whole than if potential tortfeasors were unable to insulate their assets from victims' claims.¹⁷⁰ Unfortunately, proving that tort law as a whole, or a tort law rule in particular, overdeters risky behavior is difficult.¹⁷¹ Moreover, because evaluating all background legal rules that interact with trust law is nearly impossible, claims of global inefficiency are difficult to sustain.

Asset protection trusts do, nonetheless, undermine the impact of background legal rules by sheltering from liability tortfeasors who would otherwise be required to compensate their victims. If we start with the assumption that background legal rules generally represent broadly accepted policy judgments—often, but not always, incorporating efficiency concerns—then enforcement of asset protection trusts undercuts those judgments. Moreover, the very availability of these devices to avoid background law creates one significant loss: The settlor expends resources on liability avoidance, which generates no new wealth, when the settlor could instead be using the same resources in ways that would generate new wealth.

¹⁷⁰ The problem here is a "second best" problem. The classic work on the theory of the second best is R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956-1957). Lipsey and Lancaster established that "there is no *a priori* way to judge as between various situations in which some of the Paretian optimum conditions are fulfilled while others are not." *Id.* at 11-12. The legal literature has recently given more extensive treatment to the theory of the second best, thanks in large measure to Richard Markovits. See, e.g., Richard S. Markovits, *Monopoly and the Allocative Inefficiency of First-Best-Allocatively-Efficient Tort Law in Our Worse-Than-Second-Best World: The Whys and Some Therefores*, 46 CASE W. RES. L. REV. 313 (1996); Richard S. Markovits, *Second-Best Theory and Law & Economics: An Introduction*, 73 CHI.-KENT L. REV. 3 (1998).

¹⁷¹ Indeed, tort law may have little effect on behavior in many circumstances. See Stephen D. Sugarman, *Doing Away with Tort Law*, 73 CAL. L. REV. 555, 561-64 (1985) (arguing that, in light of other incentives to avoid risky behavior, tort law often has little impact on potential tortfeasors).

The basic conclusion is the following: Jurisdictional competition is likely to lead a number of jurisdictions to adopt trust law rules that those jurisdictions would not otherwise adopt—rules that, historically, those jurisdictions have long rejected. Those rules may undermine the policy of the enacting state without generating any compensating efficiency advantages and are likely to undermine other states' policies without generating compensating benefits. Because jurisdictional competition creates these problems, we must look to mechanisms other than competition for potential solutions.

III

MECHANISMS FOR CONTAINING THE IMPACT OF ASSET PROTECTION TRUSTS

Most asset protection legislation has been built on the assumption that the enacting jurisdiction can protect, through its laws, anyone who creates a trust within the jurisdiction. If that assumption proves incorrect, foreign trusts become less attractive to settlors: Why go to the trouble of creating a trust out of state or offshore, without the assurance that the trust will permit the settlor to avoid undesirable domestic law provisions? This Part examines the assumption that states may preclude other jurisdictions from interfering with their attempt to afford foreign trust settlors protections not available at home.

First, this Part demonstrates that courts in a creditor's home state are not generally bound to apply the asset protection trust rules offered by foreign or sister-state jurisdictions. Jurisdictional limitations, however, will often prevent these courts from adjudicating the creditor's right to trust assets. Second, this Part shows how federal bankruptcy courts may provide a more attractive forum for reaching asset protection trusts. Third, this Part explores how a race to the courthouse may determine the creditor's success at reaching trust property in Alaska and Delaware.

A. State Court Remedies

Suppose a creditor domiciled in a state with traditional fraudulent transfer and spendthrift trust principles seeks to reach assets that a local settlor has placed in a trust in the Cook Islands or in Alaska. If the creditor proceeds in a Cook Islands or Alaska court, that court will almost certainly apply its own law.¹⁷² Suppose, however, the creditor

¹⁷² The Cook Islands Legislature has made it crystal clear that if an action to set aside a Cook Islands international trust is brought in the courts of the Cook Islands, those courts are to apply Cook Islands law. See International Trust Act (1984) § 13(H) (1996) (Cook Islands). The Act expressly provided that no disposition of property to a Cook Islands international trust is "void, voidable, liable to be set aside or defective in any fashion . . . by

proceeds in her home state. Assuming the creditor can obtain jurisdiction in her home state, what law will the court apply? When will the home-state court have jurisdiction to adjudicate the dispute? This section considers these issues.

1. *Choice of Law*

When a settlor transfers funds into an asset protection trust, and a creditor later seeks to reach those funds, two choice-of-law issues may arise: First, whose law should be applied to determine whether the transfer is fraudulent? Second, assuming the transfer itself was not fraudulent, whose law should be applied to determine the enforceability of a spendthrift provision purporting to insulate the settlor from creditor claims?

a. *Fraudulent Transfers*

As we have seen, offshore jurisdictions often authorize transfers that would be fraudulent under the UFTA.¹⁷³ In particular, the Cook Islands' International Trusts Act precludes a fraudulent transfer challenge whenever the transfer "took place before [the] creditor's cause of action accrued."¹⁷⁴ No American state goes that far, but Alaska's fraudulent transfer law is particularly unfriendly to creditors, requiring proof of actual fraud, rather than permitting creditors to rely on constructive fraud.¹⁷⁵ Suppose then, that a settlor from a UFTA jurisdiction creates a trust in the Cook Islands, and a creditor from the same UFTA jurisdiction brings an action in the local courts to set aside the settlor's transfer as fraudulent. What law will the court apply to resolve this issue?

Although choice-of-law doctrine is muddled,¹⁷⁶ the result in virtually any American court would be clear: The law of the Cook Islands

reason that . . . the international trust or disposition avoids or defeats rights, claims or interests conferred by the law of a foreign jurisdiction upon any person." *Id.* § 13(I).

Alaska has also expressly provided that a trust provision selecting Alaska law will be enforced with respect to "the validity, construction, and administration" of a trust having the requisite connections to Alaska. *See* ALASKA STAT. §§ 13.36.035(c)-(d) (Michie 1998).

¹⁷³ *See supra* Part I.B.

¹⁷⁴ International Trusts Act, § 13(B)(4).

¹⁷⁵ *See supra* text accompanying note 92.

¹⁷⁶ American courts use a variety of different methods to resolve choice-of-law cases. One scholar who tracks choice-of-law methodology in American courts has assembled a table identifying seven different approaches to choice-of-law issues and listing the courts that have adopted each approach. *See* Symeon C. Symeonides, *Choice of Law in the American Courts in 1997*, 46 AM. J. COMP. L. 233, 266 tbl.1 (1998). Symeonides lists the following seven approaches to choice-of-law issues: Traditional, Significant Contacts, Restatement (Second), Interest Analysis, *Lex Fori*, Better Law, and Combined Modern. *See id.* These categories, however, are not airtight, as the "Combined Modern" label suggests. For instance, the RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 145, 188 (1971), heavily relies on a court's ability to identify which state has the most significant relationship to the par-

does *not* apply. Cook Islands' fraudulent conveyance law would frustrate the goals of the American tort system by permitting those with sufficient resources to create a foreign trust to avoid tort liability. In this situation, no choice-of-law principle is sufficiently compelling to cause a judge to ignore the forum's substantive law.¹⁷⁷ A court conducting "interest analysis" in resolving choice-of-law questions, can easily reach this result: the forum has an interest in protecting its tort victims, and that interest should prevail even if the Cook Islands has an interest in protecting trust beneficiaries.¹⁷⁸ Of course, whether the Cook Islands has any interest in protecting the trust beneficiaries who are, in all likelihood, residents of a UFTA state is not at all clear.¹⁷⁹

If a court, on the other hand, purports to resolve choice-of-law cases by reference to the "better rule of law,"¹⁸⁰ the result will be the

ties and the occurrence or transaction. Moreover, both the interest-analysis and the better-law approaches often lead to application of *lex fori*. Joseph W. Singer suggests:

In practice, it is quite clear that what courts ordinarily do in conflicts cases is to apply forum law. Whatever the scholars say about it, the judges seem to understand that the point of law is to do justice, and, to the extent they view themselves as the moral voice of their community, they are likely to understand forum interests as outweighing nonforum interests.

Joseph William Singer, *Real Conflicts*, 69 B.U. L. REV. 1, 59 (1989).

¹⁷⁷ See Stewart E. Sterk, *The Marginal Relevance of Choice of Law Theory*, 142 U. PA. L. REV. 949, 992-93 (1994) (arguing that, "[i]n the ordinary choice of law case, choice of law principles take a back seat to the substantive results that are generated by the competing rules").

¹⁷⁸ In a series of articles in the 1950s and 1960s, Brainerd Currie developed a governmental interest analysis for resolving choice-of-law problems. See Brainerd Currie, *Married Women's Contracts: A Study in Conflict-of-Laws Method*, 25 U. CHI. L. REV. 227, 254 (1958). Currie argued that when the forum's own policy would be advanced by application of its own law, a forum court should apply domestic law even if doing so would frustrate the policy of another jurisdiction:

The sensible and clearly constitutional thing for any court to do, confronted with a true conflict of interests, is to apply its own law. . . . It should apply its own law . . . simply because a court should never apply any other law except when there is a good reason for doing so.

Id. at 261.

¹⁷⁹ See *Marine Midland Bank v. Portnoy* (*In re Portnoy*), 201 B.R. 685, 700 (Bankr. S.D.N.Y. 1996) (stating that "it is not at all clear what the policy behind the [Jersey Channel Islands law] is except, perhaps, to augment business," and then concluding that New York's "deep-rooted policies" mandate the application of New York law to a Jersey Channel Islands trust created by a New York settlor). Currie emphasized the interests of states in protecting their own residents. See Currie, *supra* note 178, at 233-34 (discussing Massachusetts' interest in protecting its own married women). At times, Currie also recognized the states' interests in regulating behavior within their borders. See Brainerd Currie, *Recent Development, Comments on Babcock v. Jackson*, 63 COLUM. L. REV. 1233, 1237-41 (1963) (discussing intended impact of traffic regulations). However, he did not generally accord comparable attention to these interests.

¹⁸⁰ Robert Leflar popularized the notion that courts should consider which substantive legal rule is "better" in resolving choice-of-law cases. See Robert A. Leflar, *Conflicts Law: More on Choice-Influencing Considerations*, 54 CAL. L. REV. 1584, 1587-88 (1966). Leflar did not suggest that the better rule should always prevail, but rather that the question of which rule is better should be considered along with a set of other factors. See *id.* In a recent survey, Professor Symeonides identified five states that have endorsed Leflar's better law

same: application of the forum's law. Courts in UFTA jurisdictions are unlikely to conclude that the Cook Islands' fraudulent conveyance law is better than the laws almost universally adopted by American state legislatures, the UFTA or the UFCA.

The approach of the Restatement of Conflict of Laws¹⁸¹ (the "First Restatement") to fraudulent transfers focuses on the type of property transferred. If the settlor transfers land or tangible personal property into a trust, a court must determine whether the transfer is fraudulent as to third parties in accordance with the laws of the state in which the property is located at the time of transfer.¹⁸² The First Restatement has no provision explicitly dealing with fraudulent transfers of intangible property, but does provide that "[t]he validity of a conveyance of a document in which a right is embodied . . . [is] governed by the law of the state where the document is at the time of the conveyance."¹⁸³ This provision, however, apparently does not apply to transfers of shares of corporate stock, which the law of the state of incorporation governs.¹⁸⁴

These rules potentially can generate peculiar results. Consider, for instance, a New York physician who owns land in New Jersey, shares of stock in a Delaware corporation, negotiable bonds located in her safe deposit box in New York, and a bank account in a New York bank. If she executes a document creating a Cook Islands international trust and delivers to the trustee a deed to the land, the shares of stock, the bonds, and the cash in the bank account, New Jersey fraudulent transfer law would apply to the conveyance of land, Delaware law to the shares of stock, and New York law to the bonds and the cash—unless the bonds and cash were first brought to the Cook Is-

approach in the area of torts. See Symeonides, *supra* note 176, at 266 tbl.1 (identifying Arkansas, Minnesota, New Hampshire, Rhode Island, and Wisconsin).

¹⁸¹ RESTATEMENT OF CONFLICT OF LAWS (1934).

¹⁸² See *id.* § 218 ("Whether a conveyance of an interest in land, which is in due form and is made by a party who has capacity to convey it, is in other respects valid, is determined by the law of the state where the land is."). *Id.* Comment f to section 218 further provides: "Whether a conveyance valid between the parties to it, is either void or voidable with respect to third parties, as for instance, where it is in fraud of creditors . . . is determined by the law of the state in which the land is." *Id.* § 218 cmt. f. Section 257 is identical to section 218, except that section 257 substitutes the word "chattel" wherever "land" appears in section 218. See *id.* § 257. Comment b of section 257 parallels comment f of section 218. See *id.* § 257 cmt. b.

¹⁸³ *Id.* § 262(3).

¹⁸⁴ See *id.* § 262 cmt. b (referring to section 182, which embodies "the special considerations which apply to the conveyance of a share certificate"). Section 182 provides that "[w]hether a person is a shareholder or other member of a corporation is determined by the law of the state of incorporation." *Id.* § 182; see also 2 JOSEPH H. BEALE, A TREATISE ON THE CONFLICT OF LAWS 985 (1935) ("[S]ince the state of incorporation alone can determine a question of membership in the corporation, the law of the state of incorporation governs the title to the share.") (footnote omitted).

lands and then transferred to the trust, in which case transfers to the trust would be governed by Cook Islands law.

A court likely would not have reached this result even at the time the First Restatement was drafted.¹⁸⁵ Today, when the physical location of many intangibles is far more difficult to identify, it appears inconceivable that a court would hold that the validity of a transfer would depend on the physical location of the intangible at the moment of transfer. Particularly when a property owner brings an intangible to the Cook Islands for the clear purpose of making a transfer that would otherwise be fraudulent under the law of the property owner's own domicile, even a court sympathetic to the First Restatement's general approach would almost undoubtedly balk at the application of Cook Islands law.

The Restatement (Second) of Conflict of Laws¹⁸⁶ (the "Second Restatement"), known generally for its malleability,¹⁸⁷ makes it somewhat easier for a court to reject the Cook Islands fraudulent conveyance law. Like its predecessor, the Second Restatement provides that the effect of a transfer of property interests in documents should be determined in accordance with "the law that would be applied by the courts of the state where the document was at the time of the conveyance," which is "usually . . . local law."¹⁸⁸ Unlike its predecessor, however, the Second Restatement employs the adjective "usually," thereby allowing courts to escape application of the law of the document's location.¹⁸⁹ The Second Restatement's provision dealing with the identity of corporate shareholders includes a similar escape hatch: The law of the state of incorporation applies "except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship . . . to the person involved and the corporation."¹⁹⁰ These open-ended provisions make it easy for a court to apply the law of a creditor's domicile, or of the property owner's dom-

¹⁸⁵ Indeed, Professor Beale, the Reporter for the Restatement, hedged the Restatement position in his treatise, suggesting that "in the case of a group of securities . . . [t]he change of title is governed by the law of the place where the securities are aggregated." 2 BEALE, *supra* note 184, at 985. Beale cites *Hutchison v. Ross*, 187 N.E. 65 (N.Y. 1933), in which the New York Court of Appeals held that New York law governed the validity of a transfer into trust of a combination of cash and securities—including corporate stock—held by the New York branch of a Quebec bank. *See id.* at 71-72.

¹⁸⁶ RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1971).

¹⁸⁷ *See, e.g.*, Larry Kramer, *Choice of Law in the American Courts in 1990: Trends and Developments*, 39 AM. J. COMP. L. 465, 466 (1991) (concluding that the Second Restatement's "undirected, multifactor analysis invites post-hoc rationalizing of intuitions about the applicable law").

¹⁸⁸ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 249(2)(b).

¹⁸⁹ *Id.*

¹⁹⁰ *Id.* § 303.

icile, to determine whether a transfer to a Cook Islands trust was fraudulent as to the creditor.¹⁹¹

Because most American states have enacted either the UFTA or the UFCA, American courts have had few opportunities in domestic-law cases to engage in choice-of-law analysis in fraudulent transfer cases; courts understandably are reluctant to spend much time deciding which of two states' laws should apply when the laws are identical.¹⁹² When a creditor challenges a transfer of land as fraudulent, courts generally look to the law of the situs to determine the effect of the conveyance—often without exploring how the law of the situs differs from other possible alternatives.¹⁹³ The courts' failure in these cases to examine the competing legal rules suggests that the parties were unable to identify significant differences in the laws of the various jurisdictions.¹⁹⁴ When land is not involved, most courts suggest applying the law of the jurisdiction in which the transfer is likely to have the greatest impact—generally the state where most of the creditors are located.¹⁹⁵

¹⁹¹ Indeed, the comment to the shareholder provision expressly indicates that the law of the shareholder's domicile should apply to determine the marital property interests of shareholders. See *id.* § 303 cmt. e.

¹⁹² See *Zahn v. Yucaipa Capital Fund*, 218 B.R. 656, 667-72 (Bankr. D.R.I. 1998) (concluding that no conflict between California's version of the UFTA and Rhode Island's version of the UFTA exists); *Ferrari v. Barclays Bus. Credit (In re Morse Tool, Inc.)*, 108 B.R. 384, 388 (Bankr. D. Mass. 1989) (concluding that, when the conveyed property is located in UFCA states, courts can apply Massachusetts's UFCA law without concerns about frustrating the interests of other states).

¹⁹³ See *Lindsay v. Beneficial Reinsurance Co. (In re Lindsay)*, 59 F.3d 942, 948-49 (9th Cir. 1995) (holding that Texas law applied to determine whether foreclosure on Texas land constituted a fraudulent transfer, without discussing the content of California's fraudulent conveyance law, the law of the forum state); *Hartsfield v. Lescher*, 721 F. Supp. 1052, 1056 (E.D. Ark. 1989) (holding that Arkansas's fraudulent conveyance law applied to the transfer of Arkansas land without examining the law of Tennessee, the state in which the creditor and trust beneficiary were domiciled); *James v. Powell*, 225 N.E.2d 741, 745-46 (N.Y. 1967) (concluding that Puerto Rican law, not the forum state law, must apply to determine whether the conveyance of Puerto Rican land is fraudulent, and remanding for examination of Puerto Rican law).

¹⁹⁴ Cf. *Sterk*, *supra* note 177, at 998-99 (arguing that "[t]o persuade [a] judge to alter her initial conclusions" on choice-of-law grounds, a litigator "would have to demonstrate that application of the choice of law principle is necessary either to promote some . . . social policy or to vindicate some fundamental right").

¹⁹⁵ See *In re Consolidated Capital Equities Corp.*, 143 B.R. 80, 85 (Bankr. N.D. Tex. 1992) (applying California law to invalidate a fraudulent transfer because the debtor's headquarters and greatest concentration of creditors were in California); *Murphy v. Meritor Sav. Bank (In re the O'Day Corp.)*, 126 B.R. 370, 390-92 (Bankr. D. Mass. 1991) (holding that Massachusetts law applied because debtor's assets, manufacturing operations, and greatest concentration of creditors were located in Massachusetts); *RCA Corp. v. Tucker*, 696 F. Supp. 845, 853-55 (E.D.N.Y. 1988) (applying choice-of-law principles applicable to tort cases to hold that New York law, under which transfer to wife would be fraudulent, was applicable because the transfer was made after a New York domiciliary brought an action against the transferor in New York court); *Hassett v. Far West Fed. Sav. & Loan Ass'n (In re O.P.M. Leasing Servs., Inc.)*, 40 B.R. 380, 395 (Bankr. S.D.N.Y. 1984) (holding that New

By creating a Cook Islands trust, a resident of a UFTA jurisdiction is seeking protection, not from Cook Islands creditors, but from creditors at home. When neither the trust settlor nor his creditors reside in the Cook Islands, the case law almost conclusively establishes that no court in a UFTA jurisdiction would apply the Cook Islands fraudulent conveyance law.¹⁹⁶ Moreover, even if a court was inclined to apply the fraudulent conveyance law of the situs of the transferred property, the court would be unlikely to do so if the property were transferred in order to defraud creditors.

Chief Judge Fuld's opinion in *James v. Powell*¹⁹⁷ makes this point clear. Esther James had obtained a libel judgment against former Congresswoman Adam Clayton Powell.¹⁹⁸ Powell's wife, acting with her husband's power of attorney, then conveyed land in Puerto Rico to her aunt and uncle for allegedly inadequate consideration.¹⁹⁹ James then brought an action in New York, alleging that the Powells had made a fraudulent transfer.²⁰⁰ When the case reached the Court of Appeals, Chief Judge Fuld endorsed the "situs" rule for determining whether a conveyance of real property is fraudulent, holding that the parties and the courts below had mistakenly assumed that New York's fraudulent conveyance law would apply.²⁰¹ In remanding the case, however, Chief Judge Fuld expressly announced an exception to the situs rule:

[I]f, in exploring the law of Puerto Rico, [the situs,] it were to be found that it was specifically designed to thwart the public policy of other states—for example, by denying a remedy to all judgment creditors in the plaintiff's circumstances in order to attract foreign investment in its real estate—the courts of this State would be privileged to apply the law of New York rather than that of Puerto Rico.²⁰²

York's fraudulent conveyance law applied in part because a vast number of the transferor's creditors were located in New York), *aff'd* 44 B.R. 1023 (Bankr. S.D.N.Y. 1984).

For a general discussion of the issue and the suggestion that courts should apply to each creditor the law of the creditor's home state in determining whether a transfer is fraudulent with respect to that creditor, see Thomas H. Day, *Solution for Conflict of Laws Governing Fraudulent Transfers: Apply the Law That Was Enacted to Benefit the Creditors*, 48 BUS. LAW. 889 (1993).

¹⁹⁶ Cf. *In re Morse Tool*, 108 B.R. at 386-87 (concluding that, when a transaction's only relationship to Connecticut is that the transferee is incorporated and does business in that state, Connecticut fraudulent conveyance law should not apply).

¹⁹⁷ 225 N.E.2d 741 (N.Y. 1967).

¹⁹⁸ See *id.* at 743.

¹⁹⁹ See *id.*

²⁰⁰ See *id.*

²⁰¹ See *id.* at 745 (citing, inter alia, RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 218 (Tentative Draft No. 5, 1959)).

²⁰² *Id.* at 746 n.4.

Chief Judge Fuld's exception applies in full force to transfers to a Cook Islands trust, and removes any doubt that a court in a UFTA jurisdiction would ignore the Cook Islands fraudulent transfer law in considering the validity of such transfers.²⁰³

This analysis only slightly differs if the settlor has created an Alaska, rather than a Cook Islands, trust. Although Alaska's fraudulent transfer law is less radical than its Cook Islands counterpart, the choice-of-law issues are the same: in Chief Judge Fuld's words, Alaska, like the Cook Islands, would be "denying a remedy to all judgment creditors in the plaintiff's circumstances in order to attract foreign investment."²⁰⁴ If the creditor and the trust settlor are both domiciled in a UFTA jurisdiction, no substantial reason would exist for a court of that jurisdiction to defer to Alaska law.

b. *The Availability of Spendthrift Trust Protection in the Absence of Fraud*

If a creditor successfully challenges transfers to an asset protection trust as fraudulent, the provisions of the trust are largely irrelevant to the creditor. So long as the creditor can recapture the transferred assets, the creditor has no reason to worry about the settlor's rights in the trust instrument. Suppose, however, the creditor cannot invalidate the settlor's transfer as fraudulent. Perhaps the creditor cannot prove actual intent to defraud, even with the assistance of the "badges of fraud,"²⁰⁵ and cannot prove constructive fraud within the meaning of the UFTA.²⁰⁶ Alternatively, suppose the statute of limitations has run on any fraudulent transfer claim.²⁰⁷ Can creditors nevertheless reach the settlor-beneficiary's interest in an offshore trust? Until the enactment of the Alaska and Delaware statutes, the answer had long been clear as a matter of American trust law: trust settlors could not make themselves trust beneficiaries and then insert in the trust instrument provisions that insulated their beneficial interests from creditor claims.²⁰⁸

²⁰³ See, e.g., *Curiale v. Tiber Holding Corp.*, No. 95-5284, 1997 U.S. Dist. LEXIS 14563, at *38-40 (E.D. Pa. Sept. 17, 1997) (applying New York fraudulent conveyance law to transfers made by a Bermuda corporation because New York's interest outweighed Bermuda's interest).

²⁰⁴ *James*, 225 N.E.2d at 746 n.4.

²⁰⁵ UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1), (b), 7A U.L.A. 301-02 (1999).

²⁰⁶ See *id.* § 4(a)(2).

²⁰⁷ See *supra* text accompanying notes 83-84.

²⁰⁸ See RESTATEMENT (SECOND) OF TRUSTS § 156(1) (1959) ("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."). Sometimes, the prohibition is embodied in statute. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 7-3.1(a) (Consol. Supp. 2000). At other times, the prohibition has been recognized in the absence of a statute. See, e.g., *Robbins v. Webster* (*In re Robbins*), 826 F.2d 293, 294 (4th Cir. 1987) (applying Maryland law). Recently enacted statutes in Alaska and Delaware to some extent

From a choice-of-law perspective, however, the enforceability of a spendthrift provision, in the absence of proof of fraud, is a more complicated question. Respectable authority suggests that the validity of a trust should be determined by the law of the situs of trust property, not the law of the trust settlor's domicile. In the leading case of *Hutchison v. Ross*,²⁰⁹ Ross and his wife, domiciliaries of Quebec, had executed an antenuptial agreement under which Ross agreed to establish a modest trust fund for the benefit of his wife and children.²¹⁰ Under Quebec law, neither party to the antenuptial agreement could modify its terms after the marriage.²¹¹ Nevertheless, after receiving a substantial inheritance from his father, Ross created a \$1,000,000 trust in New York for the benefit of his wife.²¹² At the time of the trust's creation, Ross and his advisors were apparently unaware that the more generous trust was invalid under Quebec law, as a modification of the antenuptial agreement.²¹³ Later, when he consulted a Montreal bar-rister to draw up his will, Ross learned of the trust's invalidity.²¹⁴ By that time, Ross had dissipated most of his inheritance and was heavily in debt.²¹⁵ Acting on a promise to his creditors, Ross brought an action in a New York court to have the trust set aside.²¹⁶ The New York Court of Appeals upheld the validity of the trust, concluding "that the validity of a trust of personal property must be determined by the law of this state, when the property is situated here and the parties intended that it should be administered here in accordance with the laws of this state."²¹⁷ New York²¹⁸ and other courts have cited

break with the previously universal prohibition on self-settled spendthrift trusts. For more on those statutes, see *supra* text accompanying notes 89-107.

²⁰⁹ 187 N.E. 65 (N.Y. 1933).

²¹⁰ *See id.* at 67.

²¹¹ *See id.*

²¹² *See id.*

²¹³ *See id.*

²¹⁴ *See id.* at 68.

²¹⁵ *See id.*

²¹⁶ *See id.*

²¹⁷ *Id.* at 71.

²¹⁸ *See* Wyatt v. Fulrath, 211 N.E.2d 637, 639 (N.Y. 1965) (citing *Hutchison* as support for the law-of-situs rule's application to uphold a survivorship agreement with respect to a New York bank account against forced heirship claims by relatives of Spanish domiciliaries); *In re Bauer's Trust*, 200 N.E.2d 207, 211 (N.Y. 1964) (Fuld, J., dissenting) (citing, *inter alia*, *Hutchison* to support the majority's conclusion that New York law governed a trust indenture executed "against the background of New York law"); Chase Nat'l Bank v. Central Hanover Bank and Trust Co., 39 N.Y.S.2d 541, 548 (App. Div. 1943) (citing *Hutchison* for the proposition that "the intention of the settlor" as to the governing law should prevail).

On the other hand, in two subsequent cases involving testamentary trusts, the Court of Appeals held that the law of the settlor's domicile should govern the validity of a trust created to minimize the inheritance of settlor's spouse. *See* Clare v. Clark (*In re Estate of Clark*), 236 N.E.2d 152, 156-57 (N.Y. 1968) (applying Virginia law to Virginia domiciliaries, despite the fact that the settlor's estate consisted largely of securities on deposit at a New

Hutchison.²¹⁹

In *Hutchison*, the trust instrument itself said nothing about the applicable law.²²⁰ In its opinion, however, the court of appeals cited a New York statute providing that when a settlor creates a trust of personal property situated in New York and expressly selects New York law as the applicable law, then “the validity and effect” of the trust must be determined in accordance with New York law.²²¹ The rule that the New York statute embodies,²²² is more or less consistent with the Second Restatement, subject to some qualifications.²²³ The seeming premise for the rule, at least as interpreted in *Hutchison*, is that the settlor’s intention should be controlling: “Where a nonresident settlor establishes here a trust of personal property intending that the trust should be governed by the law of this jurisdiction, there is little reason

York bank); *Hemingway v. McGehee (In re Estate of Crichton)*, 228 N.E.2d 799, 805-08 (N.Y. 1967) (applying New York law to permit New York domiciliary’s estate to avoid community property claims with respect to Louisiana bank accounts, stocks, and bonds).

²¹⁹ See, e.g., *Harrison v. City Nat’l Bank*, 210 F. Supp. 362, 370 (S.D. Iowa 1962); *Equitable Trust Co. v. Ward*, 48 A.2d 519, 526 (Del. Ch. 1946); *Amerige v. Attorney Gen.*, 88 N.E.2d 126, 132 (Mass. 1949).

²²⁰ *Hutchison*, 187 N.E. at 71 (“Here there is no express declaration of intention . . .”).

²²¹ *Id.* (internal quotation marks omitted). The statute was enacted after Ross established the trust and would not have been applicable to the case in any event. See *id.* The court cited the statute as evidence that New York’s legislature would honor a settlor’s intent about applicable law. See *id.*

²²² The current New York statute provides:

Whenever 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 of:

(1) Any trust property situated in this state at the time the trust is created.

(2) Personal property, wherever situated, if the trustee of the trust is a person residing, incorporated or authorized to do business in this state or a national bank having an office in this state.

N.Y. EST. POWERS & TRUSTS LAW § 7-1.10(a) (Consol. 1979). Section 7-1.10 says nothing about the power of a trust settlor to create a New York trust and to choose, in the trust instrument, application of the law of another state. In *Shannon v. Irving Trust Co.*, 9 N.E.2d 792, 794 (N.Y. 1937), however, the court of appeals upheld a trust that would have violated New York’s prohibition against accumulation of trust income, because the trust instrument expressly provided that New Jersey law should govern.

²²³ See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 270 (1971). This section in part provides:

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

under the local law of the state designated by the settlor to govern the validity of the trust, provided that this state has a substantial relation to the trust and 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 § 6

Id.

why the courts should defeat his intention by applying the law of another jurisdiction."²²⁴

To focus on the settlor's intention clearly serves the goal of a settlor seeking to insulate his assets from creditor claims, through the creation of an asset protection trust. The settlor's intent to have the law of the foreign jurisdiction—whether Alaska, Delaware, or an offshore jurisdiction—is typically beyond dispute, because virtually all asset protection trust instruments expressly select the law of the favored jurisdiction. If intent is determinative, all courts would have to honor spendthrift provisions in an asset protection trust, even if the trust settlor is also the protected beneficiary.

However, despite occasional language to the contrary in judicial opinions,²²⁵ the settlor's intent is rarely determinative on the issue of a trust's validity, particularly when parties other than the settlor and the beneficiaries are involved.²²⁶ Moreover, courts do not invariably look to the law of the trust's situs to determine the trust's validity, especially when the law of the situs is significantly different from the law of the forum.²²⁷

In the vast majority of cases in which courts have applied the law of the trust situs, the situs coincided with the forum.²²⁸ Furthermore,

²²⁴ *Hutchison*, 187 N.E. at 70; see also *id.* at 71 ("The statute makes express declaration of intention conclusive, but a construction which would deny effect to intention appearing by implication would be unreasonable.").

²²⁵ See *Tate v. Hain*, 25 S.E.2d 321, 325-26 (Va. 1943) (emphasizing the intent of the settlor in holding that trustee in bankruptcy was not entitled to beneficiary interests in insurance trusts because the trusts were created in New York, which recognized spendthrift provisions, and not in Virginia, the beneficiary's domicile, which recognized spendthrift provision only if limited to beneficiary's support); *Shannon*, 9 N.E.2d at 794 ("The intent of the settlor . . . is expressly stated in the body of the trust instrument. . . . The instrument should be construed and a determination of its validity made according to the law chosen by the settlor unless so to do is contrary to the public policy of this state.").

²²⁶ As one court has put it, "a choice of law provision 'will not be regarded where it would operate to the detriment of strangers to the agreement, such as creditors or lienholders.'" *Marine Midland Bank v. Portnoy* (*In re Portnoy*), 201 B.R. 685, 701 (Bankr. S.D.N.Y. 1996) (citations omitted).

²²⁷ See *infra* notes 247-62 and accompanying text.

²²⁸ See *Neto v. Thorner*, 718 F. Supp. 1222, 1223-24 (S.D.N.Y. 1989) (applying New York law to a New York trust, created by a Brazilian domiciliary); *Equitable Trust Co. v. Ward*, 48 A.2d 519, 524-26 (Del. Ch. 1946) (applying Delaware law to uphold a trust whose "intended situs" was Delaware); *National Shawmut Bank v. Cumming*, 91 N.E.2d 337, 338-41 (Mass. 1950) (applying Massachusetts law to uphold a Massachusetts trust allegedly created in fraud of the rights, under Vermont law, of a Vermont widow); *Amerige v. Attorney Gen.*, 88 N.E.2d 126, 128 (Mass. 1949) (applying Massachusetts law to sustain a Massachusetts trust against the challenge that the trust was invalid under the perpetuities law of New York, the domicile of the donee who exercised the power of appointment); *Wyatt v. Fulrath*, 211 N.E.2d 637, 637-38 (N.Y. 1965) (applying New York law to funds in a New York account created by Spanish domiciliaries); *In re Bauer's Trust*, 200 N.E.2d 207, 208 (N.Y. 1964) (applying New York's rule against perpetuities to invalidate a power of appointment exercised by an English domiciliary with respect to a New York trust); *Hutchison*, 187 N.E. at 67-68 (applying New York law to a New York trust). *But see* *Cutts v. Najdrowski*, 198 A.

in some of these cases, the forum court simply ignored the competing policies of another state with close ties to the trust, perhaps because those competing policies made little sense to the court.²²⁹ Thus, the *Hutchison* court was never able to articulate a coherent policy for a Quebec rule that would invalidate a husband's effort to modify an antenuptial agreement by giving his wife more money than the agreement originally provided. Simply put, modern courts tend to depart from forum law only when one of the parties has given the court a good reason for doing so.²³⁰ If neither party has identified a reason to apply foreign law, the court will simply apply local law. In other words, if domestic trust law appears eminently sensible—not to mention familiar—to the court, a lawyer seeking to displace domestic law will have to demonstrate how some important objective will be thwarted by application of the forum's law.²³¹ In cases in which the forum court has relied on a situs rule to justify application of domestic law, the party seeking to avoid situs law, which is also forum law, has given the court inadequate reason to depart from that law.

Moreover, when the situs and the forum do not coincide and courts nevertheless apply the law of the situs, situs law sometimes differs from forum law only in form. The New Jersey case of *Cutts v. Najdrowski*²³² is illustrative. In that case, a New Jersey domiciliary created a bank account trust at a New York bank.²³³ Under New York law, the trust was enforceable.²³⁴ Under New Jersey law at the time, the trust was treated as testamentary, and therefore unenforceable.²³⁵ However, under New Jersey law the settlor could have made the trust enforceable by executing the trust document in accordance with testa-

885, 885-86 (N.J. 1938) (applying New York law to uphold a New York trust created by a New Jersey domiciliary).

²²⁹ See *Hutchison*, 187 N.E. at 70; see also *Wyatt*, 211 N.E.2d at 638-39 (appearing unsympathetic to the Spanish policy giving collateral blood relatives a property right in the assets of a decedent).

²³⁰ Brainerd Currie identified and endorsed this principle: "[A] court should never apply any . . . law [other than forum law] except when there is a good reason for doing so." Currie, *supra* note 178, at 261.

²³¹ See Sterk, *supra* note 177, at 998. In that article, I argued:

Choice of law cases are not, however, cases in which choice of law is the only issue; choice of law cases are primarily tort cases, contract cases, or estates cases. When the judge develops a sense of who should win, the substantive aspects of the case are likely to predominate—unless ignoring choice of law issues would offend the judge's sense of justice by, for instance, frustrating expectations on which a party relied or promoting forum-shopping.

Id.

²³² 198 A. 885 (N.J. 1938).

²³³ See *id.* at 885.

²³⁴ See *id.* at 886.

²³⁵ See *id.*

mentary formalities.²³⁶ Thus, when the New Jersey court applied New York law and held the trust enforceable,²³⁷ the court in effect held that when settlors execute documents in New York, they only need to comply with New York formalities.

By contrast, some courts have chosen to apply situs law to issues of trust validity without ever exploring the content of forum law.²³⁸ Nonetheless, when neither party apprises the court of the consequences of its choice-of-law decision, the decision is unlikely to have a significant impact on the outcome of the litigation.

Finally, courts have virtually never applied the law of the trust's situs or the law expressly chosen by the settlor when the settlor chose situs or the law to evade a strong public policy of the settlor's domicile. In various cases in which the court has applied situs law, the settlor was apparently unaware of any difference between the law of the settlor's domicile and the law of the situs. For instance, the *Hutchison* court emphasized the fact that the person who prepared the trust instrument was "a Scotchman learned in the law of Scotland, but perhaps not in the law of Quebec."²³⁹ In another leading case, *Wyatt v. Fulrath*,²⁴⁰ Spaniards concerned with local instability during the Spanish Civil War had "sent cash and securities to New York for safekeeping and investment," not to take advantage of New York inheritance laws.²⁴¹ Similarly, in other cases involving trusts challenged as violative of the Rule Against Perpetuities,²⁴² of a statutory prohibition on accumulation of trust income,²⁴³ or of a limitation on enforceability of Totten trusts,²⁴⁴ there was little reason to suggest that the settlor had chosen the trust situs or the law to govern the trust in order to avoid the otherwise applicable law. Nonetheless, modest modifications in the trust provisions would have insulated the trust from challenge in all relevant jurisdictions.

²³⁶ See *id.*

²³⁷ See *id.*

²³⁸ See *Harrison v. City Nat'l Bank*, 210 F. Supp. 362, 370 (S.D. Iowa 1962).

²³⁹ *Hutchison v. Ross*, 187 N.E. 65, 67 (N.Y. 1933).

²⁴⁰ 211 N.E.2d 637 (N.Y. 1965).

²⁴¹ *Id.* at 637-38.

²⁴² See *Amerige v. Attorney Gen.*, 88 N.E.2d 126, 130-31 (Mass. 1949) (applying Massachusetts's capture doctrine to determine the distribution of assets after the exercise of a power of appointment violated the Rule Against Perpetuities, even though the settlor could have, in either New York or Massachusetts, specified the consequences of invalidity with appropriate language in the trust instrument).

²⁴³ See *Equitable Trust Co. v. Ward*, 48 A.2d 519, 525-26 (Del. Ch. 1946) (applying Delaware law after noting that the only effect of applying the Pennsylvania accumulations statute would be to require payment of income after the expiration of the statutory period); *Shannon v. Irving Trust Co.*, 9 N.E.2d 792, 795 (N.Y. 1937) (noting the similarity between New York and New Jersey policies on accumulation, and noting that the "[d]ifference arises only as to the ending of the period during which such power to suspend alienation and to provide for accumulation of income may be permitted").

²⁴⁴ See *Cutts v. Najdrowski*, 198 A. 885, 886 (N.J. 1938).

Until the emergence of offshore trusts, little reason existed for settlors to choose a trust situs to avoid creditor claims. Because every American jurisdiction refused to enforce spendthrift provisions in self-settled trusts,²⁴⁵ no jurisdiction afforded settlors an opportunity to avoid creditor claims. The closest situations, in which settlors might have chosen a particular trust situs in order to evade an important policy of their domicile, involved elective-share provisions.²⁴⁶ Although virtually all states now recognize the importance of protecting a spouse against intentional disinheritance, that recognition manifests itself in different ways, and the law has developed in a variety of different patterns.²⁴⁷ As a result, choice-of-law issues arise when a person dies in one state with property in another. Sometimes, the decedent's will creates a trust which is voidable by the spouse in one jurisdiction, but not another. In this situation, New York courts have refused to look to the law of situs of the trust or the law chosen by the parties, holding instead that the law of the spouses' domicile should govern the validity of the trust.²⁴⁸

National Shawmut Bank v. Cumming,²⁴⁹ a case applying Massachusetts law to sustain a Massachusetts trust against a claim by a Vermont widow, reached the opposite result.²⁵⁰ However, in that case the Supreme Judicial Court of Massachusetts emphasized a finding by the trial judge that the trust had not been created with the intent to deprive the widow of her distributive share of the property.²⁵¹ In a sense, therefore, we might view the language in *Cumming* as mere dictum. Moreover, the Second Restatement of Conflict of Laws, completed long after the *Cumming* case was decided, makes it clear that elective-share rights reflect a strong public policy that provides a court a justification for ignoring the law of the situs or the law chosen by the

²⁴⁵ See *supra* Part I.A.

²⁴⁶ See *infra* notes 247-51.

²⁴⁷ Compare, e.g., N.Y. EST. POWERS & TRUSTS LAW § 5-1.1 (Consol. 1979) (elective share), with ARIZ. REV. STAT. ANN. § 14-3101 (West 1995).

²⁴⁸ See *Clare v. Clark* (*In re Estate of Clark*), 236 N.E.2d 152, 158 (N.Y. 1968) (applying Virginia law to determine a widow's share in the \$23 million estate of a Virginia domiciliary, even though the estate consisted largely of securities on deposit at a New York bank); *Hemingway v. McGehee* (*In re Estate of Crichton*), 228 N.E.2d 799, 804-05 (N.Y. 1967) (rejecting the claim of a surviving spouse that Louisiana's community property law should apply to property owned by decedent in Louisiana, noting that both spouses had been domiciled in New York during their marriage).

²⁴⁹ 91 N.E.2d 337 (Mass. 1950).

²⁵⁰ See *id.* at 341.

²⁵¹ See *id.* at 340 ("One answer to the defendant's contention is that, wholly apart from what may be the law of Vermont, it was not shown that the trust was created to defraud the wife of statutory rights in Vermont. The judge was not plainly wrong in not making such a finding."). In Vermont at the time, a surviving spouse could invalidate an inter vivos transfer as fraudulent if the spouse could show that the transfer was made with actual intent to disinherit. See *id.* Massachusetts law at the time included no similar rule.

parties.²⁵² In addition, even if the *Cumming* court frustrated Vermont's public policy, it is critical to remember that the forum in that case was Massachusetts, not Vermont. In other words, a court is far less likely to subordinate the strong policy of its own state than that of another state.

A review of the authorities thus reveals that whatever courts say about honoring the law that the parties choose or the law of the situs of the trust, courts have not permitted trust settlors to frustrate important forum policies with their choice of law or trust situs. From courts in jurisdictions that do not enforce self-settled spendthrift trusts one would expect the same response to creditor claims against a foreign, self-settled, asset protection trust created by a forum domiciliary.

A series of recent bankruptcy cases confirm this conclusion. In each case, the court refused to honor spendthrift provisions in self-settled offshore trusts. In *Marine Midland Bank v. Portnoy (In re Portnoy)*,²⁵³ the settlor, knowing that his personal guarantee of a corporate debt was about to be called, created a trust in the Jersey Channel Islands.²⁵⁴ The trust instrument gave the trustee broad discretion over trust distributions, including power to distribute principal to the settlor, but reserved for the settlor the power, "in his absolute discretion," to remove any or all of the trustees from office.²⁵⁵ As a result, the settlor effectively ensured control over the trustee's behavior: if the trustee ignored the settlor's instructions, the settlor could remove the trustee. When the settlor sought a bankruptcy discharge to avoid his debts, the bankruptcy court denied his summary judgment motion,²⁵⁶ noting that "Portnoy may not unilaterally remove the characterization of property as his simply by incorporating a favorable choice of law provision into a self-settled trust of which he is the primary beneficiary."²⁵⁷

²⁵² See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 270(a) (1971). This section provides that an inter vivos trust of interests in movables should be governed in accordance with the law of the state that the parties choose, "provided that this state has a substantial relation to the trust and 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." *Id.* Comment b to section 270 explicitly provides:

[W]here the settlor creates a revocable trust in a state other than that of his domicile, in order to avoid the application of the local law of his domicile giving his surviving spouse a forced share of his estate, it may be held that the local law of his domicile is applicable, even though he has designated as controlling the local law of the state in which the trust is created and administered.

Id. § 270 cmt. b.

²⁵³ 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

²⁵⁴ See *id.* at 688-89.

²⁵⁵ *Id.* at 689.

²⁵⁶ See *id.* at 703.

²⁵⁷ *Id.* at 701.

Two 1998 cases followed *Portnoy's* lead. In *Sattin v. Brooks (In re Brooks)*,²⁵⁸ the court ruled that assets held in Jersey and Bermuda trusts should be included in the Connecticut settlor's bankruptcy estate.²⁵⁹ The court held that Connecticut would not enforce self-settled spendthrift provisions in a trust created by a Connecticut domiciliary regardless of the choice-of-law provisions.²⁶⁰ Similarly, the trust instrument in *Goldberg v. Lawrence (In re Lawrence)*,²⁶¹ the court held that the rights of a Florida settlor of a Mauritian trust would be "governed by Florida and federal bankruptcy law, . . . and not the law of the Republic of Mauritius."²⁶²

These cases confirm that courts in states that are hostile to self-settled spendthrift trusts are unlikely to enforce the spendthrift provisions in self-settled asset protection trusts, regardless of the effect that those provisions might have under the law of the trust situs.²⁶³ The principal hope for the trust settlor in using an asset protection trust, therefore, is to avoid litigation in hostile local courts. We now turn to a discussion of that issue.

2. Personal Jurisdiction

Suppose a creditor is convinced that a court in her home state will apply forum law to determine her rights in the property of an offshore or Alaska trust created by a local settlor. The creditor must still obtain a forum state judgment that will be effective against either the trustee or the trust property. Once the settlor transfers property to the asset protection trust, a personal judgment against the settlor is of limited value,²⁶⁴ because the settlor no longer claims any legal interest in the property. The trustee, not the settlor, becomes the creditor's adversary in the dispute over legal ownership of the trust property.

²⁵⁸ 217 B.R. 98 (Bankr. D. Conn. 1998).

²⁵⁹ *See id.* at 101, 104.

²⁶⁰ *See id.* at 103-04.

²⁶¹ 227 B.R. 907 (Bankr. S.D. Fla. 1998).

²⁶² *Id.* at 917.

²⁶³ Proponents of asset protection trusts have argued that the courts in these cases mistakenly characterized the issue in dispute as one of trust validity, where the settlor has only limited power to choose applicable law, rather than as one of trust administration, where the settlor may have broader power to choose applicable law. *See, e.g.,* Gideon Rothschild et al., *Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?*, 32 VAND. J. TRANSNAT'L L. 763, 768-69 (1999). These proponents, however, have offered no reasons why courts *should* adopt their proposed characterization to permit evasion of forum policy against self-settled spendthrift trusts. The opinions themselves indicate that courts are unlikely to adopt the "administration" characterization.

²⁶⁴ A personal judgment against the settlor may, however, give the creditor some leverage if the creditor can preclude the settlor from obtaining a bankruptcy discharge. *See infra* text accompanying notes 362-406.

The creditor, however, has no apparent basis for obtaining personal jurisdiction over a foreign trustee, so long as the trustee has taken care not to solicit business outside the trustee's home jurisdiction. If the trustee is a corporate entity, it almost certainly does no business outside its home jurisdiction. In the unlikely event that the trustee is an individual, the individual may never have set foot in the creditor's state. In these circumstances, *Hanson v. Denckla*²⁶⁵ appears to preclude the assertion of personal jurisdiction over the trustee.

In *Hanson*, a Pennsylvania domiciliary executed a trust instrument in Delaware delivering securities (the trust corpus) to a Delaware trust company.²⁶⁶ Under the terms of the trust instrument, the settlor retained power to appoint the remainder of the trust corpus by will or by inter vivos instrument.²⁶⁷ The settlor later moved to Florida, where she exercised her power to appoint the trust corpus by inter vivos instrument, in part appointing a total of \$400,000 in favor of trusts benefiting the children of one of her daughters.²⁶⁸ On the same day, she executed her will, which named the same daughter as executor, and left the residue of her estate—more than \$1,000,000—to her other two children.²⁶⁹ After the settlor's death, the two residuary legatees challenged the validity of the inter vivos appointment of trust property to the children of their sister, the will's executor.²⁷⁰ They brought an action in Florida court for a declaratory judgment "concerning what property passes under the residuary clause of the will."²⁷¹ The Delaware trustee was also named as a defendant and was served by ordinary mail.²⁷² The executor and her children moved to dismiss, contending that Florida lacked jurisdiction over an indispensable party, the trustee.²⁷³

The United States Supreme Court held that Florida lacked jurisdiction.²⁷⁴ Although the Court conceded that the settlor's exercise of

²⁶⁵ 357 U.S. 235 (1958).

²⁶⁶ See *id.* at 238.

²⁶⁷ See *id.*

²⁶⁸ See *id.* at 239.

²⁶⁹ See *id.*

²⁷⁰ See *id.* at 239-40. There was some dispute in the case about whether the residuary legatees were challenging only the validity of the appointment or whether they were challenging the validity of the trust as well. See *id.* at 240. Chief Justice Warren's majority opinion argues that the Florida courts held that the trust itself, and therefore the power created in the trust, was invalid. See *id.* at 253 n.25. Justice Black's dissent, by contrast, concludes that the Florida courts decided only that the power of appointment had been ineffectively exercised because the settlor had it not executed in accordance with Florida's statute of wills. See *id.* at 256 n.1 (Black, J., dissenting).

²⁷¹ *Id.* at 240 (internal quotation marks omitted).

²⁷² See *id.* at 241.

²⁷³ See *id.* at 241-42.

²⁷⁴ See *id.* at 250. After the residuary legatees brought suit in Florida, the executor brought a declaratory judgment action in Delaware to determine ownership of trust assets held in that state. See *id.* at 242. The Florida trial court rendered the first decision, ruling

the power of appointment in Florida gave the state a sufficient connection with the case to justify application of Florida law, the court held that the settlor's unilateral activity could not operate to give Florida courts personal jurisdiction over the nonresident trustee.²⁷⁵ In the Court's words, "it is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State."²⁷⁶ More recently, in *World-Wide Volkswagen Corp. v. Woodson*,²⁷⁷ the Court reaffirmed this "purposeful availment" requirement for personal jurisdiction.²⁷⁸ Thus, with respect to an offshore trustee that conducts no business within the United States, the implications of *Hanson* and *World-Wide Volkswagen* seem clear: no personal jurisdiction is available.²⁷⁹

The principle articulated in *Hanson* and *World-Wide Volkswagen* drew wide criticism, both inside and outside the Court, as being inconsistent with the notion that fairness, not physical power, should serve as the foundation for personal jurisdiction.²⁸⁰ Professors von

that the court lacked jurisdiction as to the trustee, but that it had power to render a decision binding as to the remaining parties. *See id.* The court held that the inter vivos exercise of the power of appointment was invalid, and that the appointive property passed to the residuary beneficiaries. *See id.* The Delaware court then concluded that the power of appointment had been validly exercised under Delaware law. *See id.*

On appeal by the executor's children of the Florida judgment, the Florida Supreme Court upheld the trial court's conclusion that the power had been invalidly exercised, but also concluded that the Florida court had jurisdiction over the trustee because jurisdiction to construe the will permitted the court to exercise jurisdiction over the absent defendants. *See id.* at 242-43. The residuary legatees then moved, in the Delaware proceeding, to compel the Delaware courts to give full faith and credit to the Florida determination. *See id.* at 243. The Delaware Supreme Court held, however, that the Florida decree was not entitled to full faith and credit because the Florida court lacked personal jurisdiction over the trustee and lacked jurisdiction over the trust property. *See id.* On certiorari from both the Florida Supreme Court and the Delaware Supreme Court, the United States Supreme Court reversed the Florida determination and affirmed the judgment in the Delaware proceeding. *See id.* at 256.

²⁷⁵ *See id.* at 253.

²⁷⁶ *Id.*

²⁷⁷ 444 U.S. 286 (1980).

²⁷⁸ *See id.* at 297.

²⁷⁹ The assumption here is that the offshore trustee has not solicited American business. In *Hanson*, for instance, the Supreme Court was careful to distinguish the previous year's *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957), by emphasizing that in *McGee*, the insurance company had solicited California business, although it did not operate in California. *See Hanson*, 357 U.S. at 251-52.

²⁸⁰ *Hanson* was a 5-to-4 decision in which Justice Black argued in dissent that the majority opinion was too slow to depart from the jurisdictional principles of *Pennoyer v. Neff*, 95 U.S. 714 (1877), *overruled by Shaffer v. Heitner*, 433 U.S. 186 (1977). *See Hanson*, 357 U.S. at 259-60 (Black, J., dissenting). Justice Douglas, also dissenting, emphasized that fairness to the parties should be the critical factor in the jurisdictional determination. *See id.* at 263 (Douglas, J., dissenting). More than 20 years later, Justice Brennan, dissenting in *World-Wide Volkswagen*, argued that "constitutional concepts of fairness no longer require the extreme concern for defendants that was once necessary." *World-Wide Volkswagen*, 444 U.S. at 309 (Brennan, J., dissenting).

Mehren and Trautman have suggested that the traditional distinction between *in personam* jurisdiction and *in rem* jurisdiction makes little sense once fairness has displaced power as the essential requisite for jurisdiction.²⁸¹ They instead suggest distinguishing between general jurisdiction, whereby a defendant's contacts with the state are so extensive that they justify a court's assertion of jurisdiction even for activities unrelated to those contacts, and specific jurisdiction, whereby a defendant's contacts justify jurisdiction only over disputes that arise out of those contacts.²⁸² Within their analytical framework, which Justice Brennan shared, a defendant's contacts with the forum should not assume paramount importance when courts evaluate claims of specific jurisdiction. Instead, courts must assert jurisdiction in these cases if the plaintiff and the controversy have a close relationship to the forum.²⁸³ This framework might well suggest that a New York court should have specific jurisdiction to resolve a dispute between New York creditors and a Cook Islands trustee over the trustee's power to pay monies to the New York debtor or his designees.

The criticisms of the approach that the Court took in *Hanson* and *World-Wide Volkswagen* have not yet persuaded the Court to depart from the principle that a court may not assert personal jurisdiction

For criticism outside the Court, see, for example, Geoffrey C. Hazard, Jr., *A General Theory of State-Court Jurisdiction*, 1965 SUP. CT. REV. 241, 243-44 (criticizing *Hanson*); Martin H. Redish, *Due Process, Federalism, and Personal Jurisdiction: A Theoretical Evaluation*, 75 NW. U. L. REV. 111, 112-15 (1981) (criticizing *World-Wide Volkswagen* for overemphasizing a defendant's contacts with a state and underemphasizing fairness).

²⁸¹ See Arthur Taylor von Mehren, *Adjudicatory Jurisdiction: General Theories Compared and Evaluated*, 63 B.U. L. REV. 279, 287 (1983). Von Mehren noted:

The traditional terminology has no logical or psychological connection with a jurisdictional theory based on fairness. Indeed, use of the terminology supports intellectual biases—in particular, the central importance of power in jurisdictional thinking—that are inconsistent with a fairness theory. More importantly, traditional terminology sometimes obscures the policy issues that such a theory faces in connection with the assertion of adjudicatory jurisdiction.

Id.; cf. Arthur T. von Mehren & Donald T. Trautman, *Jurisdiction to Adjudicate: A Suggested Analysis*, 79 HARV. L. REV. 1121, 1135-36 (1966) (noting that the distinction between *in personam* and *in rem* jurisdiction "does not seem apt or particularly useful").

²⁸² See von Mehren, *supra* note 281, at 288; von Mehren & Trautman, *supra* note 281, at 1164-66. The Supreme Court itself differentiated between specific and general jurisdiction in *Helicopteros Nacionales de Colombia, S.A. v. Hall*, 466 U.S. 408, 414 nn.8-9 (1984). In this case, the Court held that the Texas courts did not have general jurisdiction over a Colombian corporation merely because the corporation had purchased helicopters and parts from a Texas company, and had sent personnel to Texas for training and technical consultation. See *id.* at 418-19. The claim in *Helicopteros* arose out of a Peruvian air crash. See *id.* at 410.

²⁸³ See *World-Wide Volkswagen Corp.*, 444 U.S. at 300 (Brennan, J., dissenting); *Shaffer*, 433 U.S. at 220 (Brennan, J., concurring in part and dissenting in part) (emphasizing the need for "minimum contacts among the parties, the contested transaction, and the forum state") (emphasis added); von Mehren, *supra* note 281, at 311-12 (emphasizing the importance of the plaintiff's or the controversy's close relationship to the forum, as well as other factors unrelated to defendant's activities within the forum).

over a defendant who has not engaged in purposeful activity within the state's borders.²⁸⁴ Moreover, whatever the principle's merits in purely domestic cases, it makes substantially more sense in the context of offshore trusts, where the jurisdictional issues have international, rather than merely interstate, implications. After all, if the Supreme Court had decreed in *Hanson* that Florida had power over the Delaware trustee, then the Full Faith and Credit Clause would have compelled Delaware to honor the Florida judgment. By contrast, even if the Court decreed that a New York court has power over a Cook Islands trustee, that decree would have little impact on the trustee, who would be free to ignore it with the knowledge that the courts of the Cook Islands would never enforce it.²⁸⁵ In this sense, at least, physical power remains an important force in shaping the law of personal jurisdiction. Courts serve no significant purpose and undermine their authority if they take jurisdiction over cases in which they would be powerless to afford a victorious plaintiff an effective remedy.²⁸⁶

Thus, if a trust settlor transfers assets to a Cook Islands or Alaska trustee, which in turn ensures that all assets are held in cash or liquid investments, the settlor may effectively insulate those assets from claims by American creditors. Many property owners, however, are unwilling to go so far to avoid claims by potential creditors. If the settlor's property consists of local real estate, a medical practice, or a closely held business, the settlor may seek to transfer these assets into an asset protection trust. With respect to trusts funded with these assets, the question is whether the property itself can serve as a basis for jurisdiction.

3. *Jurisdiction Over Trust Property*

Suppose, as is often the case, that the settlor of an asset protection trust purports to transfer property that remains at home into the trust. Can the property itself serve as a basis for jurisdiction to determine a creditor's claim that the transfer was fraudulent? Before *Shaffer v. Heitner*,²⁸⁷ it was clear that a state in which the property was located had jurisdiction to adjudicate claims against the owner of that

²⁸⁴ Indeed, the Court's reaffirmation in *Burnham v. Superior Court*, 495 U.S. 604, 628 (1990), of the principle that personal service within the state, without more, is sufficient to confer jurisdiction on the state's courts, provides substantial evidence that the power theory of jurisdiction is far from dead.

²⁸⁵ See International Trusts Act (1984) § 13(D) (1996) (Cook Islands). *But cf.* 515 S. Orange Grove Owners Ass'n v. Orange Grove Partners, Plaintiff No. 208/94 (High Court of the Cook Islands 1995) (giving narrow construction to statute).

²⁸⁶ *Cf.* von Mehren, *supra* note 281, at 288, 305 n.71 (concluding that, even under a fairness-based approach to jurisdiction, the court's power and the effectiveness of its exercise of jurisdiction remain important).

²⁸⁷ 433 U.S. 186 (1977).

property, even if the owner never had set foot in the state.²⁸⁸ Thus, if the trustee of an offshore trust owned property in New York, the New York courts had jurisdiction to adjudicate claims against the trustee, and had power to seize and apply the trustee's property if the trustee did not comply with the court's orders. Moreover, the New York courts enjoyed this power even if the trustee had no other contact with New York: the reasonableness of the jurisdiction was not a factor.

Shaffer did little to change the situation. If a creditor brings suit in a New York court to set aside as fraudulent a transfer of New York property from the trust settlor to an offshore trustee, *Shaffer* would not deprive the New York court of the jurisdiction it previously enjoyed.²⁸⁹ In a fraudulent conveyance action, the property the settlor conveys is the subject of the litigation between creditor and trustee. The creditor would allege that the trustee is not the owner of the property because the settlor never had power to convey title good as against the settlor's present or future creditors.²⁹⁰

In many ways, the dispute is akin to an action to quiet title, in which one party with a claim to property brings an action against another party with an adverse claim to the property.²⁹¹ Some scholars argue that, in the quiet title context, *Shaffer* does not deprive courts of jurisdiction to adjudicate claims against nonresident claimants with property in the forum.²⁹² In part, the justification for conferring jurisdiction on the situs of the property to determine claims against non-residents rests on the common sense notion that some procedure must be available for a state to determine who owns property within its

²⁸⁸ See *Harris v. Balk*, 198 U.S. 215, 224 (1905), overruled by *Shaffer*, 433 U.S. at 186. *Harris* represents a logical extension of *Pennoyer v. Neff*, 95 U.S. 714 (1877), overruled in part by *Shaffer*, 433 U.S. at 186, in which the Supreme Court sharply distinguished between two bases for jurisdiction: jurisdiction over persons and jurisdiction over property. See *id.* at 722. That distinction rested squarely on a power theory of personal jurisdiction: a court could enforce its orders by seizing or attaching defendant's property if that property was within the state's borders. See *id.* at 723.

²⁸⁹ *Shaffer*, 433 U.S. at 207 ("[W]hen claims to the property itself are the source of underlying controversy . . . it would be unusual for the State where the property is located not to have jurisdiction.").

²⁹⁰ Cf. Julie Sirota Kourchin & Juli J. Kempner, Note, *Fraudulent Conveyance Law as a Property Right*, 9 CARDOZO L. REV. 843, 848 (1987) (characterizing fraudulent conveyance right "as a 'property' or 'in rem' right").

²⁹¹ See, e.g., UTAH CODE ANN. § 78-40-1 (1996) ("An action may be brought by any person against another who claims an estate or interest in real property or an interest or claim to personal property adverse to him, for the purpose of determining such adverse claim."). Unlike Utah, most states limit quiet-title actions to real property. See John T. Soma et al., *The Use of Quiet Title and Declaratory Judgment Proceedings in Computer Software Ownership Disputes*, 71 DENV. U. L. REV. 543, 567 (1994).

²⁹² See Lea Brilmayer, *How Contacts Count: Due Process Limitations on State Court Jurisdiction*, 1980 SUP. CT. REV. 77, 97; Joseph J. Kalo, *The Meaning of Contact and Minimum National Contacts: Reflections on Admiralty In Rem and Quasi In Rem Jurisdiction*, 59 TUL. L. REV. 24, 45 (1984).

borders, a justification equally available when the issue is whether the creditor or the offshore trustee owns local property that the settlor attempted to convey to the offshore trust.²⁹³

If a creditor does not bring an action to set aside a transfer to the offshore trust as a fraudulent conveyance, but instead challenges the validity of a spendthrift provision in a self-settled trust, the debtor or the trustee has a somewhat more plausible, although ultimately unconvincing, argument that the court in which the trust property is located lacks *in rem* jurisdiction. If the creditor concedes that the initial conveyance was not fraudulent—perhaps because the statute of limitations has expired on a fraudulent conveyance claim—the debtor or the trustee can argue that the dispute is not over title to the trust property itself. In that case the creditor would have to concede that the debtor's conveyance to the trustee was valid, challenging only the terms of the trust instrument that defines the rights of settlor and trustee. The debtor or the trustee might argue, therefore, that the challenge to the spendthrift trust, unlike a fraudulent conveyance claim, is not a situation in which “claims to the property itself are the source of the underlying controversy between the plaintiff and the defendant.”²⁹⁴ Hence, the claim is not one over which *Shaffer* endorsed continued use of *in rem* or *quasi in rem* jurisdiction.

This argument, however, ultimately fails. First, the Court indicated that “the presence of property [in the state] may also favor jurisdiction in cases . . . where the defendant's ownership of the property is conceded but the cause of action is otherwise related to rights and duties growing out of that ownership.”²⁹⁵ A challenge to a self-settled spendthrift trust precisely presents this situation: the creditor concedes the trustee is the legal owner, but questions the trustee's right to make payments to the settlor-beneficiary.²⁹⁶ More importantly, how-

²⁹³ See *Shaffer*, 433 U.S. at 208. The power of a state to regulate common trust funds furnishes another analogy. See *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950). In holding that New York had jurisdiction to settle a trustee's account in a New York common trust fund, even if many of the beneficiaries of the fund were nonresidents of New York, Justice Jackson wrote:

It is sufficient to observe that, whatever the technical definition of its chosen procedure, the interest of each state in providing means to close trusts that exist by the grace of its laws and are administered under the supervision of its courts is so insistent and rooted in custom as to establish beyond doubt the right of its courts to determine the interests of all claimants, resident or nonresident, provided its procedure accords full opportunity to appear and be heard.

Id.

²⁹⁴ *Shaffer*, 433 U.S. at 207.

²⁹⁵ *Id.* at 208. The Court used the example of “suits for injury suffered on the land of an absentee owner,” *id.*, but a dispute over the effect of a spendthrift provision in a self-settled trust fits the Court's category equally well.

²⁹⁶ Moreover, some authority exists to support the proposition that when a trust settlor creates a spendthrift trust for his own benefit, the trust is invalid at its inception. See *supra*

ever, the *Shaffer* Court made it very clear that its opinion did not impair the ability of creditors to realize the obligations incurred by debtors.²⁹⁷ The Court acknowledged that the primary rationale for treating the presence of property as a basis for jurisdiction has been the desire to prevent a wrongdoer from placing his assets in a state that lacks personal jurisdiction over him.²⁹⁸

The need to protect creditors against fleeing debtors may no longer serve as a justification for *in rem* jurisdiction when the debtor hides his property in a state in which the creditor will be unable to obtain a personal judgment against him. Creditor protection remains important, however, when the debtor conveys the property to an off-shore trustee, who is not subject to personal jurisdiction in any of the fifty states. Indeed, the Court in *Shaffer* left open the possibility that the presence of property—even if unrelated to the claim—might be “a sufficient basis for jurisdiction when no other forum is available to the plaintiff.”²⁹⁹ In other words, the Court tried to ensure that its opinion would not be used to insulate wrongdoers from claims by their creditors—the very problem that arises in the context of off-shore trusts.³⁰⁰

note 49 and accompanying text. Thus, a challenge to a spendthrift provision becomes a challenge to the trust itself and for jurisdictional purposes, a challenge to the trust as a fraudulent conveyance.

²⁹⁷ See *Shaffer*, 433 U.S. at 210.

²⁹⁸ See *id.* In justifying its departure from traditional *in rem* rules, the Court emphasized that the Full Faith and Credit Clause protects against attempts by debtors to avoid their obligations. See *id.* So long as the creditor may obtain personal jurisdiction over the debtor somewhere, all other states are obligated to enforce judgments rendered by the state with personal jurisdiction. See *id.* The Court stated:

[W]e know of nothing to justify the assumption that a debtor can avoid paying his obligations by removing his property to a State in which his creditor cannot obtain personal jurisdiction over him. The Full Faith and Credit Clause, after all, makes the valid *in personam* judgment of one State enforceable in all other States.

Id. (footnotes omitted). As the court implicitly recognized, creditors have found it significantly easier to obtain personal jurisdiction over debtors with the expansion of bases for personal jurisdiction over the course of the twentieth century. Today, personal service within the state is no longer required. Jurisdiction can be based on the debtor's domicile. See *Milliken v. Meyer*, 311 U.S. 457, 462 (1940). It can also be based on other minimum contacts between the debtor and the state. See *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945). As a result, *Harris v. Balk*-type attachment jurisdiction is no longer necessary to provide creditors with an appropriate forum for recovery of debts.

²⁹⁹ *Shaffer*, 433 U.S. at 211 n.37.

³⁰⁰ See Ronan E. Degnan & Mary Kay Kane, *The Exercise of Jurisdiction Over and Enforcement of Judgments Against Alien Defendants*, 39 HASTINGS L.J. 799, 823 (1988) (noting that the Court in *Shaffer* reserved judgment on “whether the attachment of property alone was sufficient to provide jurisdiction if no other forum were available” and observing that *Shaffer's* conclusions “implicitly rested on the notion that it was not necessary to rely on territorial principles because the defendants properly might be sued in some state in which they had minimum contacts and any judgment reached there could be enforced through the full faith and credit clause”).

Moreover, the problem is similar when the trust settlor creates an asset protection trust in a rogue American jurisdiction; without *in rem* jurisdiction, no effective forum would be available to vindicate a claim against a debtor who has moved his assets to an accommodating state. Thus, because the premise on which *Shaffer* rests is that jurisdiction based on the presence of property is no longer necessary to protect creditors, *Shaffer* should not be read to constrict jurisdictional power when a creditor has no alternative forum for vindication of rights recognized under local law.

Nevertheless, a creditor who relies on the presence of property within a state as the basis for asserting jurisdiction still faces an important, and often fatal obstacle: establishing that the property is indeed present within the state. When tangible property, particularly real property, is involved, establishing the location of that property will generally be straightforward. However, when intangible property—partnership interests and corporate shares—is at stake, the creditor faces serious difficulties.

Many of these difficulties are codified in Revised Article 8 of the Uniform Commercial Code (UCC), which deals with investment securities. All corporate equities are securities within the scope of Article 8, and partnership interests are within the statute's scope if the partnership agreement so provides.³⁰¹ The drafters of Revised Article 8 recognized three separate systems for holding securities, applying significantly different legal regimes to them: (1) the traditional system of holding securities through physical certificates; (2) the uncertificated securities system, in which ownership is reflected in the records of the securities issuer, but no certificates are issued; and (3) the indirect holding system, which now accounts for the majority of shares of all publicly traded companies.³⁰² Although the traditional system prevails in most closely held companies, and the indirect system has become increasingly important with respect to publicly traded companies, the uncertificated securities system remains undeveloped for most categories of securities.³⁰³

³⁰¹ See U.C.C. § 8-103(a) (2000) ("A share or similar equity interest issued by a corporation, business trust, joint stock company, or similar entity is a security."); see also *id.* § 8-103(c) ("An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an investment company security [as defined in section 8-102(b)].").

³⁰² See generally *id.* art. 8 prefatory note I.A.-C (2000). At the time of the UCC revision, the drafters reported that one common depository "is listed as the shareholder of record of somewhere in the range of sixty to eighty per cent of the outstanding shares of all publicly traded companies." *Id.* at I.C.

³⁰³ See *id.* at I.B.

Section 8-112 of the UCC governs creditors' legal process against the interest of a debtor in a security.³⁰⁴ With respect to certificated securities, a debtor's interest "may be reached by a creditor only by actual seizure of the security certificate by the officer making the attachment or levy."³⁰⁵ That is, once a trust settlor transfers his shares to an out-of-state or foreign trustee, the settlor's creditors may not attach those shares in the settlor's home state because the officers of the home state's courts lack power to seize the out-of-state assets. With respect to securities held through the indirect holding system, which Article 8 calls "securities entitlements," the interest of the debtor "may be reached by a creditor only by legal process upon the securities intermediary with whom the debtor's securities account is maintained."³⁰⁶

Suppose, then, that a trust settlor orders his broker to transfer securities to an out-of-state securities intermediary who acts as broker for the trustee. Legal process against the settlor's broker will be fruitless. Section 8-115 of the UCC provides that once a securities intermediary has transferred a financial asset at its customer's direction, the securities intermediary is not liable to adverse claimants, unless the intermediary "took the action after it had been served with . . . legal process" enjoining the transfer, has "acted in collusion with the wrongdoer," or, in the case of stolen certificates, has "acted with notice of the adverse claim."³⁰⁷ Legal process against the trustee's broker will be fruitless: first, the creditor may be unable to obtain jurisdiction against the out-of-state broker; and second, the UCC treats the broker as a "purchaser for value."³⁰⁸

Hence, whether the settlor has transferred into the trust securities certificates or a securities entitlement, Article 8 of the UCC leaves the settlor's creditors unable to attach those assets within the settlor's jurisdiction, even if those securities are shares in a closely held corporation that does business only in the settlor's home state. Moreover, if the settlor chooses to do business in partnership form, the settlor can obtain the same protection from creditors by "opting in" to Article 8 through language in the partnership agreement.

³⁰⁴ See *id.* § 8-112.

³⁰⁵ *Id.* § 8-112(a). The statute includes two exceptions, neither of which is important for present purposes. If the certificate has been surrendered to the issuer, a creditor may reach the security "by legal process upon the issuer." *Id.* If the certificate is "in the possession of a secured party," the creditor may reach the security "by legal process upon the secured party." *Id.* § 8-112(d).

³⁰⁶ *Id.* § 8-112(c).

³⁰⁷ *Id.* § 8-115.

³⁰⁸ *Id.* § 8-116 (making the securities intermediary a "purchaser for value"). UCC § 8-303(b) provides that a purchaser who gives value, does not have notice of any adverse claim, and obtains control of the security acquires its interest in the security free of any adverse claim.

UCC Article 8 is not, and does not purport to be, a jurisdictional statute. The statute limits a state's power to attach assets, not the state's power to assert judicial jurisdiction over a claim to the assets. Attachment is not constitutionally necessary to establish judicial jurisdiction over property within the state.³⁰⁹ A number of states have jurisdictional statutes that give their courts "jurisdiction on any basis not inconsistent with the Constitution of this state or of the United States."³¹⁰ Especially in a state with such a statute, there is little reason to believe that a court would treat Article 8 as an implied limitation on judicial jurisdiction. Thus, if the settlor operates a local business owned in partnership form or as a closely held corporation, the local court would very likely assert jurisdiction over the settlor's interest in the business even if the settlor has conveyed his partnership interest or corporate stock to a foreign trustee.

Even if Article 8 would not prevent a court from asserting judicial jurisdiction, the statute does create enforcement problems for local courts. Once a creditor establishes that he, and not the trust, owns the partnership property or the corporate shares, the UCC appears to

³⁰⁹ Historically, courts thought attachment was essential to permit the assertion of jurisdiction *quasi in rem* if the property that served as the basis for jurisdiction was unrelated to the plaintiff's claim. As the Supreme Court pointed out in *Shaffer* in regard to *Pennoyer v. Neff*, 95 U.S. 714 (1877), *overruled in part by Shaffer v. Heitner*, 433 U.S. 186 (1977):

Attachment was considered essential to the state court's jurisdiction for two reasons. First, attachment combined with substituted service would provide greater assurance that the defendant would actually receive notice of the action than would publication alone. Second, since the court's jurisdiction depended on the defendant's ownership of property in the State and could be defeated if the defendant disposed of that property, attachment was necessary to assure that the court had jurisdiction when the proceedings began and continued to have jurisdiction when it entered judgment.

Shaffer, 433 U.S. at 198 n.16. Even before *Shaffer*, however, attachment was not necessary to support *quasi in rem* jurisdiction when the plaintiff sought to establish his interest in property against the claim of some other designated person. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS ch. 3, topic 2 introductory note (1971) (distinguishing between two forms of *quasi in rem* jurisdiction and mentioning attachment as a prerequisite only for "the second type" of *quasi in rem* proceeding—the type in which plaintiff seeks to apply unrelated property to satisfaction of his claim).

The *Shaffer* Court's opinion purports to change the law only in this "second type" of *quasi in rem* proceeding. See *Shaffer*, 433 U.S. at 208-09. That is, in cases in which attachment was not required before *Shaffer*, it appears not to be required after *Shaffer*. Moreover, the Court's analysis, with its focus on the relationship between the property and the cause of action asserted, makes it unlikely that attachment is currently necessary to support *quasi in rem* jurisdiction.

Indeed, the RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 421(2)(k) (1986), drafted after the decision in *Shaffer*, concludes that exercise of jurisdiction with respect to a thing is reasonable if the claim is reasonably related to the thing and the thing "is owned, possessed, or used in the state." *Id.* That is, use within the state is sufficient to serve as a basis for jurisdiction even if the property is not owned or possessed within the state.

³¹⁰ CAL. CIV. PROC. CODE § 410.10 (West 1973).

limit significantly the remedies available to the creditor.³¹¹ Matters may not, however, be so simple. Article 8 is not the only body of law that purports to govern creditor remedies with respect to personal property. State law often authorizes appointment of receivers to enable a creditor to enforce a judgment against the property of a debtor.³¹² When the judgment debtor's property is a partnership interest, both the Uniform Partnership Act³¹³ and the Uniform Limited Partnership Act³¹⁴ contemplate charging the interest of the debtor partner with payment of a judgment debt and appointing a receiver to collect money due the creditor with respect to the partnership.

Because section 8-112 of the UCC does not explicitly repeal state law provisions making broader remedies available to judgment creditors, courts may be tempted to conclude that other creditor remedies survive enactment of Article 8. If so, creditors may be able to reach partnerships or closely held businesses whose physical operations are located within the state and who are therefore subject to state judicial power, even if the partnership agreement or stock certificates have been transferred to an offshore trust. Nevertheless, the creditor's road will be a difficult one, and if the settlor has been willing to fund the trust with cash or with publicly traded securities, the creditor's road may be blocked entirely.

4. *Jurisdiction over the Trust Settlor: Civil Contempt Sanctions*

Suppose an American court cannot obtain personal jurisdiction over the trustee or *in rem* jurisdiction over the trust property. Can the court impose contempt sanctions on the trust settlor to induce the settlor to apply trust assets toward repayment of the settlor's obliga-

³¹¹ See U.C.C. § 8-112; *supra* text accompanying notes 277-78.

³¹² See, e.g., CAL. CIV. PROC. CODE § 708.620 (West 1987) ("The court may appoint a receiver to enforce the judgment where the judgment creditor shows that, considering the interests of both the judgment creditor and the judgment debtor, the appointment of a receiver is a reasonable method to obtain the fair and orderly satisfaction of the judgment."); N.Y. C.P.L.R. § 5106 (Consol. 1978) (authorizing a court to "appoint a receiver of property which is the subject of an action, to carry the judgment into effect or to dispose of the property according to its directions").

³¹³ See UNIF. PARTNERSHIP ACT (1994) § 504, 6 U.L.A. 70 (1995); UNIF. PARTNERSHIP ACT (1914) § 28(1), 6 U.L.A. 744 (1995). The two versions of the Uniform Partnership Act are in force in various jurisdictions. Section 28(1) of the original act and section 504 of the revised act each make provision for charging orders and the appointment of receivers.

³¹⁴ See UNIF. LIMITED PARTNERSHIP ACT (1976) § 703, 6A U.L.A. 235 (1995) (not expressly providing for the appointment of receivers, but suggesting in commentary that the statute was not intended to restrict a court's power to appoint receivers); UNIF. LIMITED PARTNERSHIP ACT (1916) § 22, 6A U.L.A. 401 (1995) (expressly providing for the appointment of receivers).

tions? In *Federal Trade Commission v. Affordable Media, LLC*,³¹⁵ the Ninth Circuit affirmed a district court order that did just that.³¹⁶

In July 1995, the Andersons, a married couple, created an irrevocable Cook Islands trust, naming themselves and a Cook Islands company as co-trustees, and naming themselves as “protectors” of the trust.³¹⁷ The trust instrument provided that upon the happening of “an event of duress” within the territory in which a trustee is resident, the trustee’s title to the property would be immediately divested in favor of the remaining trustees.³¹⁸ The trust defined the issuance of a court order “which in the opinion of the protector will or may . . . restrict or prevent the free disposal by a trustee of any . . . property which may from time to time be included in . . . this trust” to constitute an event of duress.³¹⁹

Two years after creating the trust, the Andersons embarked on a Ponzi scheme which allegedly defrauded thousands of investors.³²⁰ The Federal Trade Commission filed a complaint, and, on motion by the Commission, the federal district court issued a preliminary injunction prohibiting the Andersons from making false or misleading statements in connection with the marketing of investments.³²¹ The injunction also required the Andersons to repatriate all assets outside the United States.³²² When the Andersons faxed a letter instructing the Cook Islands trustee to repatriate the assets to the United States, the trustee notified them that the court order was an event of duress under the trust.³²³ As a result, the Cook Islands trustee removed the Andersons as trustees and refused to repatriate the assets.³²⁴ On the Commission’s motion, the district court held the Andersons in civil contempt.³²⁵ After continuing the hearing three times to permit the Andersons to purge themselves of contempt, the district court judge ultimately ordered the Andersons taken into custody.³²⁶ The Andersons appealed both the preliminary injunction and the contempt order.³²⁷

In affirming, the Ninth Circuit rejected the Andersons’ principal argument: that their inability to comply with the district court’s order

³¹⁵ 179 F.3d 1228 (9th Cir. 1999).

³¹⁶ *See id.* at 1243.

³¹⁷ *See id.* at 1242.

³¹⁸ *Id.* at 1232.

³¹⁹ *Id.* at 1239 n.9 (citing Anderson trust agreement).

³²⁰ *See id.* at 1231.

³²¹ *See id.* at 1232.

³²² *See id.*

³²³ *See id.*

³²⁴ *See id.*

³²⁵ *See id.* at 1233.

³²⁶ *See id.*

³²⁷ *See id.*

constituted a defense to the charge of civil contempt.³²⁸ The court observed that, in a civil contempt proceeding, the defendant bears the burden of proving impossibility of compliance: "In the asset protection trust context, . . . the burden on the party asserting an impossibility defense will be particularly high because of the likelihood that any attempted compliance with the court's orders will be merely a charade rather than a good faith effort to comply."³²⁹ Then, observing that the district court's determination that the Andersons remained in control of the trust was a finding of fact, the court affirmed the finding as "not clearly erroneous."³³⁰ The Ninth Circuit noted that the Andersons were not only trustees, but also protectors of their trust, positions they retained at the time of the district court order.³³¹ Because the trust instrument provided the protectors with discretion to determine whether an event of duress has occurred, the court concluded that the Andersons had not established that the district court had committed clear error in finding that they retained power to force repatriation of trust assets.³³²

Affordable Media undoubtedly will dampen the enthusiasm for offshore trusts among some potential settlors and their advisors. Indeed, a federal bankruptcy court recent followed *Affordable Media* and imposed civil contempt sanctions on another settlor of an offshore trust³³³—the infamous Stephan Jay Lawrence, whose saga we encountered in the Introduction of this Article.³³⁴ Using its common sense to conclude that Lawrence had power to repatriate the assets in his Mauritius trust, the court adjudged Lawrence in civil contempt.³³⁵

Civil contempt sanctions, however, do not appear to offer a stable long-term solution for the problems associated with asset protection trusts. First, when the Andersons created their Cook Islands trust, they retained broad powers over the trust funds as trust protectors.³³⁶ In particular, the trust instrument gave the protectors power to ap-

³²⁸ See *id.* at 1243.

³²⁹ *Id.* at 1241.

³³⁰ *Id.*

³³¹ See *id.* at 1242.

³³² See *id.*

³³³ *Goldberg v. Lawrence (In re Lawrence)*, 238 B.R. 498 (Bankr. S.D. Fla. 1999).

³³⁴ See *supra* text accompanying notes 1-8.

³³⁵ See *In re Lawrence*, 238 B.R. at 500-01. The court wrote:

[T]his Court's finding is based as well on the entirety of the record before the Court in this case and in the Adversary proceeding, and the Court's own common sense: it defies reason—it tortures reason—to accept and believe that this Debtor transferred over \$7,000,000 in 1991, an amount then constituting over ninety percent of his liquid net worth, to a trust in a far away place administered by a stranger—pursuant to an Alleged Trust which purports to allow the trustee of the Alleged Trust total discretion over the administration and distribution of the trust *res*.

Id. at 500.

³³⁶ See *id.*

point new trustees and to determine when an event of default had occurred.³³⁷ The Ninth Circuit seized upon these powers, which settlors typically do not include in offshore trusts, as evidence that the Andersons had power to arrange repatriation of trust assets.³³⁸ Moreover, the Andersons' trust instrument had initially named them not merely as trust protectors, but also as co-trustees.³³⁹ Although *In re Lawrence* suggests that these features may not be necessary to trigger use of the civil contempt sanction, it remains to be seen how often, and in what circumstances courts will be willing to impose contempt sanctions on settlors who retain fewer powers.

Second, *Affordable Media* fails to answer one critical question: For how long will a court be willing to incarcerate an offshore trust settlor for civil contempt?³⁴⁰ In *Affordable Media* itself, for instance, "the district court ordered the Andersons released from custody" before the Ninth Circuit heard oral argument on their appeal.³⁴¹ Penalties for civil contempt are designed to coerce the contemnor into compliance with the court's order. If incarceration will not induce compliance, the foundation for imprisonment collapses.³⁴² Moreover, a settlor's failure to purge his contempt after sitting in jail for months or even weeks may establish to a court's satisfaction that the settlor is indeed

³³⁷ See *id.*

³³⁸ See *id.* The court wrote:

A protector can be compelled to exercise control over a trust to repatriate assets if the protector's powers are not drafted solely as the negative powers to veto trustee decisions or if the protector's powers are not subject to the anti-duress provisions of the trust. The Andersons' trust gives them affirmative powers to appoint new trustees and makes the anti-duress provisions subject to the protectors' powers[;] therefore, they can force the foreign trustee to repatriate the trust assets to the United States.

Id. (citation omitted). Implicit in the court's distinction between affirmative and negative powers is the conclusion that, if the protector retains only negative powers, contempt sanctions might not be available for failure to repatriate assets.

³³⁹ See *id.*

³⁴⁰ A court also might impose criminal contempt sanctions on a settlor who disobeys a court order to repatriate offshore trust assets. Criminal contempt sanctions, however, create problems of their own. First, in order to impose a prison term of longer than six months, the court must first offer defendant due process protections, including a jury trial. See *Codispoti v. Pennsylvania*, 418 U.S. 506 (1974); *Bloom v. Illinois*, 391 U.S. 194 (1968). Second, although trial judges have broad discretion to employ the contempt sanction for disobedience of court orders in federal courts, see 18 U.S.C. § 401 (1994), many state legislatures have defined criminal contempt and severely limited the penalties courts may impose. See *Bloom*, 391 U.S. at 206 n.8 (presenting survey of state limitations on criminal contempt penalties). As a result, it is highly unlikely that any state or federal court would impose criminal contempt sanctions in excess of six months on a recalcitrant trust settlor.

³⁴¹ *Affordable Media*, 179 F.3d at 1233 n.3 (stating that upon release, the district court held that the Andersons remained in contempt of court).

³⁴² See, e.g., *United States v. Lippitt*, 180 F.3d 873, 877 (7th Cir. 1999) (noting that a civil contempt order could "lose its coercive force if there were simply no reasonable possibility that the contemnor would ever comply with the court's demands"), *cert. denied*, 120 S. Ct. 389 (1999).

unable to arrange repatriation of trust assets, establishing a defense to civil contempt. Finally, even if a court remains convinced that the settlor has the power to arrange repatriation and that enough incarceration might induce the settlor to repatriate, the court might simply believe that indefinite incarceration is inappropriate without express statutory sanction.

Affordable Media serves as a reminder that a court's power over the trust settlor's person may indirectly operate to induce repatriation of trust assets, even without the power to directly reach offshore trust assets. Moreover, judicial power to incarcerate the settlor, particularly if augmented by legislatively imposed criminal sanctions, may reduce the incidence of offshore trusts; imprisonment is a risk that potential trust settlors may be unwilling to take. Civil contempt sanctions alone, however, may not be adequate either to deter creation of offshore trusts or to induce compliance with court-ordered repatriation.

B. Bankruptcy Court as an Alternative

Federal bankruptcy courts are not subject to the same jurisdictional limitations as state courts.³⁴³ To what extent, then, does bankruptcy jurisdiction operate as a check on the power of states or foreign jurisdictions to export asset protection trust legislation?³⁴⁴ The bankruptcy courts have two powers that limit the usefulness of asset preservation trusts to potential settlors. First, unlike state courts, bankruptcy courts have the power to reach a debtor's assets throughout the United States.³⁴⁵ Second, bankruptcy courts have the power to deny a settlor a discharge.³⁴⁶ Nationwide jurisdiction makes involuntary bankruptcy petitions attractive to creditors. On the other hand, the power to deny a discharge makes a voluntary bankruptcy petition less attractive for many debtors.

1. *Involuntary Petitions*

Under § 303(b)(2) of the Bankruptcy Code, a single creditor with a claim of at least \$10,000 against a debtor may commence an involuntary bankruptcy proceeding if fewer than twelve creditors hold claims against the debtor.³⁴⁷ If more than twelve creditors hold claims that aggregate at least \$10,000, at least three of those creditors must join in filing the petition.³⁴⁸ If the court finds that "the debtor is gen-

³⁴³ See 28 U.S.C. § 1334.

³⁴⁴ Because dynasty trusts typically do not result in more creditor claims than other trusts, bankruptcy jurisdiction is unlikely to have any discernable impact on dynasty trusts.

³⁴⁵ See 28 U.S.C. § 1334(e).

³⁴⁶ See 11 U.S.C. §§ 727, 1328.

³⁴⁷ See *id.* § 303(b)(2).

³⁴⁸ See *id.* § 303(b)(1).

erally not paying such debtor's debts as such debts become due," the Code instructs the court to order relief against the debtor, "unless such debts are the subject of a bona fide dispute."³⁴⁹

Once the case has commenced and a bankruptcy trustee has been selected, § 544(b) of the Code gives the trustee the power to "avoid any transfer of an interest of the debtor . . . that is voidable under applicable law by a creditor holding an unsecured claim."³⁵⁰ The applicable law for this purpose is state law.³⁵¹ Thus, if a transfer from the settlor-debtor to a trust would be fraudulent under state law, the bankruptcy trustee is entitled to avoid that transfer. Moreover, if the transfer is not itself fraudulent, but, under state law, a creditor of a settlor-debtor could reach the settlor's interest in a self-settled spendthrift or discretionary trust, the bankruptcy trustee can also reach that interest.³⁵²

Furthermore, unlike state courts, bankruptcy courts enjoy nationwide jurisdiction. In bankruptcy cases, Congress conferred on the federal district courts exclusive jurisdiction "of all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate."³⁵³ The Bankruptcy Rules, promulgated pursuant to the Supreme Court's rulemaking power,³⁵⁴ provide for nationwide service of process.³⁵⁵ They also expressly provide that, when a party is served in accordance with the Rules, the court has personal jurisdiction over that party if jurisdiction is consistent with the Constitution and federal statutes,³⁵⁶ thereby eliminating any doubts about congressional intent. Jurisdiction will be consistent with

³⁴⁹ *Id.* § 303(h)(1).

³⁵⁰ *Id.* § 544(b).

³⁵¹ The Bankruptcy Code includes a separate provision giving the bankruptcy trustee power to avoid transfers defined as fraudulent in the Code itself. *See id.* § 548. Section 548, however, permits the trustee to avoid only those fraudulent transfers made within one year before the filing of the bankruptcy petition—a period shorter than the period available under most state statutes, and particularly the UFTA. *See* UNIF. FRAUDULENT TRANSFER ACT § 9, 7A-2 U.L.A. 359 (1999) (providing a four-year limitation for claims other than those arising under § 5(b) of the statute, which applies to insider claims). Hence, from a creditor's standpoint, § 544(b) is likely to prove more useful.

³⁵² *See* U.S.C. § 541(a) (providing that "all legal or equitable interests of the debtor in property" are included in the bankruptcy estate, except as provided in §§ 541(b) and 541(c)(2)). Section 541(c)(2) provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." *Id.* § 541(c)(2). Thus, to the extent that a spendthrift provision in a trust is enforceable under applicable state law, the spendthrift provision is enforceable in bankruptcy. Conversely, if a spendthrift provision would not be enforceable outside of bankruptcy, the debtor's interest in the trust becomes property of the bankruptcy estate.

³⁵³ 28 U.S.C. § 1334(e).

³⁵⁴ That power emanates from the Rules Enabling Act. *See id.* § 2072.

³⁵⁵ *See* FED. R. BANKR. P. 7004(d) ("The summons and complaint and all other process except a subpoena may be served anywhere in the United States.").

³⁵⁶ *See* FED. R. BANKR. P. 7004(f). This section provides:

the Constitution and federal statutes if the defendant has the requisite contacts with the United States as a whole, even if the defendant has no contacts with the state in which the bankruptcy court sits.³⁵⁷ The bankruptcy courts' nationwide jurisdiction does not enable creditors to reach assets in offshore trusts, except in the unlikely event that the offshore trustee can be subjected to personal jurisdiction in the United States. Nationwide jurisdiction, however, significantly diminishes the utility of Delaware and Alaska asset protection trusts.

As we have seen, § 544(b) gives the bankruptcy trustee the power to avoid transfers that would be voidable under applicable law.³⁵⁸ The applicable law is state law. The natural question, however, is *which* state law? Whether a bankruptcy court is bound to apply the choice-of-law rules of the state in which it sits remains an unresolved ques-

If the exercise of jurisdiction is consistent with the Constitution and laws of the United States, serving a summons or filing a waiver of service in accordance with this rule or the subdivisions of Rule 4 F.R. Civ. P. made applicable by these rules is effective to establish personal jurisdiction over the person of any defendant with respect to a case under the Code or a civil proceeding arising under the Code, or arising in or related to a case under the Code.

Id.

Rule 7004(f) was added in 1996 to make clear "that service or filing a waiver of service in accordance with this rule or the applicable subdivisions of F.R. Civ. P. 4 is sufficient to establish personal jurisdiction over the defendant." *Id.* at 7004(f) advisory committee's notes; *see also* Goodson v. Rowland (*In re Pintlar Corp.*), 133 F.3d 1141, 1144-47 (9th Cir. 1998) (discussing personal jurisdiction under Rule 7004(f)), *cert. denied*, 524 U.S. 933 (1998). Before the 1996 amendment, a few courts had suggested that the Bankruptcy Rules provided for nationwide service of process, but might still require minimum contacts with the forum state to provide a basis for personal jurisdiction. *See, e.g.,* Nordberg v. Granfinanciera, S.A. (*In re Chase & Sanborn Corp.*), 835 F.2d 1341 (11th Cir. 1988), *rev'd on other grounds*, 492 U.S. 33 (1989).

³⁵⁷ With the enactment of Rule 7004(f), it is now clear that the exercise of jurisdiction only requires contacts between the defendant and the United States. Congress certainly had the power either to localize all bankruptcy jurisdiction in a single federal court or to create bankruptcy courts that cross state lines. Had Congress done so, a court would have had the power to subject defendants to jurisdiction even if they had no contacts in the state in which the court was located. If these hypothetical bankruptcy courts lacked such power, some defendants would not be subject to bankruptcy jurisdiction anywhere. On the other hand, if these hypothetical courts do not raise due process concerns, it is hard to see how the nationwide bankruptcy jurisdiction explicitly conferred in Rule 7004(f) could raise constitutional concerns—at least with respect to defendants who have some connection with the United States. Thus, any remaining fairness concerns about subjecting out-of-state defendants to the bankruptcy jurisdiction involve questions of venue, not personal jurisdiction. *See* Hogue v. Milodon Eng'g, Inc., 736 F.2d 989 (4th Cir. 1984). The *Hogue* court noted:

The propriety of process issuing from federal courts sitting in cases arising under federal law is not tested by the same yardstick as is the constitutional limitation upon service of process issuing from state courts because the issues involved necessarily are often national in character. Rather, the defendant must look primarily to federal venue requirements for protection from onerous litigation.

Id. at 991 (citation omitted).

³⁵⁸ *See* 11 U.S.C. § 544(b) (1994).

tion.³⁵⁹ Ultimately, however, resolution of the question is unimportant, because no state, except perhaps Delaware or Alaska, would apply a choice-of-law rule that would permit local settlers to evade claims by local creditors simply by creating out-of-state trusts.³⁶⁰ In other words, choice-of-law analysis might lead a court to look to the law of the settlor's domicile or to the law of the state in which most of the creditors are situated. No choice-of-law analysis, however, would lead a court in any state that frowns on asset protection trusts to apply the law of a rogue jurisdiction that authorizes out-of-state settlers to create such trusts. As a result, if a creditor of the settlor of a Delaware or Alaska trust brings an involuntary bankruptcy proceeding against the settlor, the elaborate statutory protections designed by the Delaware and Alaska legislatures are unlikely to be of value to the settlor.

2. *Voluntary Petitions*

Involuntary bankruptcy petitions are not particularly helpful for creditors when the debtor's assets are tied up in offshore trusts. The bankruptcy court has no power to compel the holder of those assets to turn them over to the bankruptcy trustee.³⁶¹ On the other hand, the settlor of an offshore trust may bring a voluntary petition³⁶² to obtain one of the principal benefits of American bankruptcy law: the discharge of debts.

Section 727(a) of the Bankruptcy Code commands the bankruptcy court to give the debtor a discharge unless one of ten enumerated exceptions applies.³⁶³ The fact that the debtor has at some time

³⁵⁹ *Klaxon Co. v. Stentor Electric Manufacturing Co.*, 313 U.S. 487 (1941) established that, in diversity cases, a federal court must apply the choice-of-law rules of the state in which it sits, rather than developing independent federal choice-of-law rules. *See id.* at 497. Bankruptcy cases, however, are not diversity cases. As a result, the *Klaxon* doctrine does not directly apply. Nevertheless, a number of courts have suggested that, when the issue before a bankruptcy court is the scope of a state-created right, the bankruptcy court should look to the choice-of-law rules of the state in which the court sits. *See* *Koreag, Controle et Revision S.A. v. Refco F/X Assocs., Inc. (In re Koreag, Controle et Revision S.A.)*, 961 F.2d 341, 350-51 (2d Cir. 1992) (suggesting that state choice-of-law rules apply when the issue turns on state-created rights and should be displaced only if "important concerns implicating national bankruptcy policy" are implicated); *Compliance Marine, Inc. v. Campbell (In re Merritt Dredging Co.)*, 839 F.2d 203, 206 (4th Cir. 1988) ("[I]n the absence of a compelling federal interest which dictates otherwise, the *Klaxon* rule should prevail where a federal bankruptcy court seeks to determine the extent of a debtor's property interest.").

³⁶⁰ *See supra* Part III.A.1 (analyzing the choice-of-law processes that state courts are likely to follow).

³⁶¹ Section 542 of the Bankruptcy Code requires persons who are in control of property the bankruptcy trustee might "use, sell, or lease" to deliver that property to the bankruptcy trustee. 11 U.S.C. § 542(a) (1994). If, however, the court's process cannot reach the trustee of an offshore trust, the court has no direct means for enforcing a turnover order directed at the trustee of the offshore trust.

³⁶² *See id.* § 301 (providing for the filing of voluntary cases).

³⁶³ *See id.* § 727(a).

in the past made a fraudulent transfer is not a ground for denying discharge. Instead, the Bankruptcy Code deals with transfers that are fraudulent under state law by giving the bankruptcy trustee power to avoid them.³⁶⁴ With the aid of the bankruptcy court's nationwide jurisdiction, the trustee can exercise this avoidance power by bringing an action in bankruptcy court to recapture the fraudulently transferred property for the bankruptcy estate.³⁶⁵ The trustee's exercise of the avoidance power, however, provides little assistance to creditors if the assets are beyond the nationwide jurisdiction of the bankruptcy court.

Perhaps in recognition of this problem, and frustrated by the use of offshore trusts to frustrate local creditors, bankruptcy courts have begun to find that settlors of offshore trusts fall within one or more of the exceptions to the general rule entitling debtors to bankruptcy discharges. Three exceptions have proved popular so far. First, § 727(a)(2) precludes discharge when the debtor, within one year before filing the petition, transfers, removes, destroys, mutilates, or conceals property (or permits the property to be transferred, removed, destroyed, mutilated or concealed) "with intent to hinder, delay, or defraud a creditor."³⁶⁶ Second, § 727(a)(3) precludes discharge when "the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information . . . from which the debtor's financial condition or business transactions might be ascertained."³⁶⁷ Third, § 727(a)(4) provides that discharge is unavailable if "the debtor knowingly and fraudulently, in or in connection with the case . . . made a false oath" or "withheld from an officer of the estate . . . any recorded information . . . relating to the debtor's property or financial affairs."³⁶⁸

In *Marine Midland Bank v. Portnoy (In re Portnoy)*,³⁶⁹ the court invoked the "continuous concealment" doctrine to hold that a debtor who transferred assets to an offshore asset protection trust could be denied a bankruptcy discharge based on § 727(a)(2) of the Code, even if the initial transfer had occurred more than a year before the petition date.³⁷⁰ In 1989, Portnoy created a trust in Jersey, Channel Islands, and over the course of several months, transferred his assets to that trust.³⁷¹ He named himself as principal beneficiary of the trust

³⁶⁴ See *id.* § 544(b).

³⁶⁵ See generally 1 DAVID G. EPSTEIN ET AL., BANKRUPTCY § 6-2 (1992) (discussing who can avoid transfers in bankruptcy cases).

³⁶⁶ 11 U.S.C. § 727(a)(2).

³⁶⁷ *Id.* § 727(a)(3).

³⁶⁸ *Id.* § 727(a)(4).

³⁶⁹ 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

³⁷⁰ See *id.* at 692-701.

³⁷¹ See *id.* at 689.

and his two children as additional beneficiaries.³⁷² He also gave the Jersey trustees power to transfer all or part of the trust principal for the benefit of all or any one of the trust beneficiaries "as the Trustees shall in their absolute discretion think fit."³⁷³ In 1991, a creditor obtained a judgment against Portnoy for \$183,891, and in 1995, Portnoy filed a chapter 7 bankruptcy petition.³⁷⁴

The judgment creditor objected to the discharge, contending that, within one year of the date of the petition, Portnoy had continued to maintain unlimited control over the trust assets while concealing those assets from his creditors.³⁷⁵ Portnoy raised two arguments. First, he claimed that the court lacked jurisdiction to determine whether he had control over trust assets. Second, he asserted that Jersey law should be applied to determine his rights under the declaration of trust.³⁷⁶ The court rejected both contentions.³⁷⁷

The court held that it had jurisdiction to determine issues relevant to Portnoy's eligibility for discharge even if it had no jurisdiction over the trust itself.³⁷⁸ The court went on to hold that New York law, not Jersey law, should be applied to determine whether Portnoy retained an interest in the assets of the offshore trust for purposes of ascertaining his eligibility for a bankruptcy discharge.³⁷⁹ The court also observed that under New York law, the creditors of a settlor or beneficiary of a discretionary trust can reach the maximum amount that the trustee would be entitled, under the terms of the trust instrument, to pay out to the settlor-beneficiary, "even though the trustee in the exercise of his discretion wishes to pay the settlor/beneficiary nothing."³⁸⁰ The court determined that Portnoy's interest in the trust

³⁷² See *id.*

³⁷³ *Id.*

³⁷⁴ See *id.* at 691.

³⁷⁵ See *id.* at 695. The judgment creditor also objected to discharge on other grounds unrelated to the creation of the trust; the creditor contended that Portnoy had also concealed transfers of his paychecks to his wife. See *id.* at 692-95.

³⁷⁶ See *id.* at 696.

³⁷⁷ See *id.*

³⁷⁸ See *id.*

³⁷⁹ See *id.* at 700. The court relied on the strong and widely shared public policy that a debtor should not be able to retain control over trust assets while shielding those assets from creditors. See *id.* The court also rejected the notion that the creator of a trust ought to be able to select the law applicable to the trust for all purposes:

Whereas under normal circumstances parties are free to designate what state's or nation's law will govern their rights and duties, where another state or nation has a dominant interest in the transaction at issue, and the designated law offends a fundamental policy of that dominant state, the court may refuse to apply the foreign law.

Id. at 699.

The court also offered "a second basis upon which to apply New York law—a choice-of-law provision will not be regarded where it would operate to the detriment of strangers to the agreement, such as creditors." *Id.* at 701 (internal quotation marks omitted).

³⁸⁰ *Id.* at 701.

constituted property of the estate, and that Portnoy had not made that property available to creditors or to the trustee in bankruptcy. Thus, the court concluded that Portnoy had concealed, or permitted to be concealed, property of the debtor.³⁸¹ The only remaining question under § 727(a)(2) of the Code was the question of Portnoy's intent: Was the concealment accomplished "with the requisite intent to hinder, delay, or defraud" his creditor or an officer of the estate?³⁸² That question, in the court's view, presented "[c]lear issues of fact" to be resolved at trial.³⁸³

The *Portnoy* court also invoked § 727(a)(4) as a basis for denying Portnoy a discharge.³⁸⁴ That section provides for denial of a discharge if the debtor "knowingly and fraudulently" makes "a false oath or account" in connection with the bankruptcy case.³⁸⁵ Portnoy had not listed his interest in the offshore trust, especially his control powers, on his bankruptcy schedules.³⁸⁶ Once the court concluded that Portnoy did have control powers over the trust, the only question remaining was whether Portnoy's failure to list the assets had been knowing and fraudulent.³⁸⁷

Stephan Jay Lawrence met the same fate.³⁸⁸ Recall that *Goldberg v. Lawrence (In re Lawrence)*³⁸⁹ involved an options trader, Lawrence, who had transferred four to seven million dollars to a Jersey trust, just sixty-six days before an arbitrator awarded Bear, Stearns twenty million in its forty-two-month dispute with Lawrence.³⁹⁰ Apparently not satisfied that Jersey law provided adequate protection, Lawrence amended it within a month after creating the trust to include spendthrift language and to provide that the law of the Republic of Mauritius should govern its terms.³⁹¹ More than six years later, Lawrence filed a voluntary bankruptcy petition and sought discharge.³⁹²

The court held that Lawrence was not entitled to discharge.³⁹³ It relied upon Lawrence's unwillingness to acknowledge that he had established the Mauritius trust for protection against creditors and on

381 *See id.* at 695.

382 *Id.*

383 *Id.* at 701.

384 *See id.* at 701-02.

385 11 U.S.C. § 727(a)(4) (1994).

386 *See In re Portnoy*, 201 B.R. at 701-02.

387 *See id.* at 702.

388 *See supra* INTRODUCTION.

389 227 B.R. 907 (Bankr. S.D. Fla. 1998).

390 *See id.* at 912-13.

391 *See id.* at 912 n.10. The court observed that Mauritius provided two advantages for Lawrence: its debtor-friendly law and out-of-the-way location. *See id.* at 912 n.11. The court joked that "it appears the Debtor [Lawrence] would have set the trust up on Mars if he could have." *Id.*

392 *See id.* at 911.

393 *See id.* at 915.

his inability to advance any other plausible explanation for creating the trust.³⁹⁴ The court also relied upon a variety of inconsistencies in Lawrence's testimony and on his failure to provide satisfactory answers to interrogatories served on him by the bankruptcy trustee.³⁹⁵ In the court's view, the dereliction by Lawrence brought him within the terms of §§ 727(a)(2), (a)(3), (a)(4), and (a)(5) of the Bankruptcy Code, and therefore justified denial of the discharge Lawrence had requested.³⁹⁶ As we have also seen in a subsequent proceeding, the Florida court imposed civil contempt sanctions on Lawrence.³⁹⁷

The approach taken by the courts in the *Portnoy* and *Lawrence* cases mirrors the position other bankruptcy courts appear to have taken in recent cases involving slightly different issues. In *Sattin v. Brooks (In re Brooks)*,³⁹⁸ a Connecticut bankruptcy court held that assets transferred by the debtor to his wife, who subsequently transferred them to trusts in Bermuda and Jersey,³⁹⁹ were part of the debtor's bankruptcy estate.⁴⁰⁰ The court rejected the debtor's argument that the assets were outside of the estate because the spendthrift provisions were enforceable under the laws of Bermuda and Jersey.⁴⁰¹ Moreover, it held that the law of Connecticut was applicable to the trusts⁴⁰² and that, under Connecticut law, the spendthrift provisions were not enforceable.⁴⁰³

³⁹⁴ See *id.* at 914-15.

³⁹⁵ See *id.* at 909 n.1. For instance, when asked about the value of the trust property, Lawrence responded that he had no knowledge of the trust corpus as of the date of the interrogatory, and that the trustee of the trust had refused to provide the information. See *id.* When asked to set forth the disbursements he had received from the trustee, Lawrence responded that he did not know whether there were such dispositions, and that if there were any, they would have been deposited in accounts maintained by a former bookkeeper. See *id.*

³⁹⁶ See *id.* at 918. The *Lawrence* court did not carefully identify which of Lawrence's actions constituted a violation of each of the statutory provisions the court cited. See *id.* In general terms, the court concluded that Lawrence had failed to supply records that would provide creditors with adequate information to ascertain his financial condition and to track his financial dealings, noting that § 727(a)(3) imposes an affirmative duty to maintain and retain comprehensible records. See *id.* at 915-16. The court then appeared to rely on § 727(a)(2)'s prohibition of transfer or concealment of assets within one year of bankruptcy, but the court did not specify what acts constituted transfer or hiding within the prescribed period. See *id.* The court then moved to the "false oath or account" language of § 727(a)(4) and, finally, invoked § 727(a)(5), which prohibits discharge if debtor has failed to satisfactorily explain a loss of assets. See *id.*

³⁹⁷ See *In re Lawrence*, 238 B.R. 498 (Bankr. S.D. Fla. 1999).

³⁹⁸ 217 B.R. 98 (Bankr. D. Conn. 1998).

³⁹⁹ See *id.* at 101.

⁴⁰⁰ See *id.* at 104.

⁴⁰¹ See *id.* at 101-03.

⁴⁰² See *id.* at 101-02.

⁴⁰³ See *id.* at 104.

Another case, *Dzikowski v. Edmonds (In re Cameron)*,⁴⁰⁴ involved a domestic self-settled spendthrift trust. The court in that case, reiterated the general New York rule that "a debtor may not avoid his creditors, or future creditors, by placing his property in trust for his own benefit."⁴⁰⁵ The court went on to hold that, because the spendthrift provisions in the self-settled trust were unenforceable, the trust property was not excluded from the bankruptcy estate.⁴⁰⁶

Denial of the bankruptcy discharge, thus, provides some check against use of offshore trusts to avoid creditor claims. Debtors who might want to avail themselves of the discharge may find that asset protection trusts do not help them achieve their objectives. On the other hand, not all settlors will care about obtaining a bankruptcy discharge. If an offshore trust can provide generously for a settlor's relatives and, indirectly, for the settlor, the settlor may be willing to live indefinitely with a judgment debt hanging over his head—even if the settlor will consequently be unable to purchase and maintain tangible property within the United States.

C. Preemptive Strikes by the Trustee

We have explored the avenues that a creditor might pursue to reach the assets in an asset protection trust. But the creditor cannot expect that the trustee, acting in conjunction with the trust settlor, will always take a purely defensive posture, waiting passively for the creditor to challenge the trust's effectiveness as an asset protection device. Especially if the trust has been established in an American jurisdiction friendly to asset protection trusts, the trustee might strike first, either in a declaratory judgment action or in a bankruptcy proceeding, to preclude further litigation by settlors.

If the settlor has created a trust in Alaska, or Delaware, and later faces litigation in another state by a creditor seeking to reach the trust assets, the creditor's home state, as we have seen, is likely to be receptive to the creditor's position. Nonetheless, suppose the trustee first seeks a judgment in Alaska declaring that the trustee is not obligated to make payments from the trust to any of the settlor's creditors. If this action is brought in an Alaska court, the court would be obligated by statute to apply settlor-friendly Alaska law.⁴⁰⁷ Furthermore, if the judgment is binding in Alaska, the Constitution's Full Faith and

404 223 B.R. 20 (Bankr. S.D. Fla. 1998).

405 *Id.* at 24.

406 *See id.* at 27.

407 *See* ALASKA STAT. § 13.36.035(c) (Michie 1998).

Credit Clause would require other states to enforce the Alaska judgment, thereby precluding creditor claims.⁴⁰⁸

The trustee's principal difficulty in pursuing this course of action may be establishing the jurisdiction of the Alaska court. If the creditor has no connection with Alaska, the trustee will be unable to obtain personal jurisdiction over the creditor. Personal jurisdiction, however, is unnecessary if the Alaska court has jurisdiction over the trust property. Moreover if some or all of the assets are deposited in Alaska and are administered by an Alaska trustee, as Alaska law requires⁴⁰⁹ Alaska will likely have sufficient connection with the trust property to exercise jurisdiction.⁴¹⁰ So long as the creditor receives notice of the trustee's proceeding, the creditor will be bound by the Alaska judgment with respect to property in the Alaska trust.⁴¹¹ This possibility of a preemptive strike should lead creditors to act quickly, perhaps by bringing an involuntary bankruptcy petition, to foreclose litigation in the Alaska court.⁴¹²

⁴⁰⁸ See U.S. CONST. art. IV, § 1 ("Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State.").

⁴⁰⁹ See ALASKA STAT. § 13.36.035(c)(1)-(2) (requiring both that some or all assets be deposited in the state and that trustee be a "qualified person"); *id.* § 13.36.390 (defining "qualified person" to include Alaska residents, trust companies, and banks).

⁴¹⁰ See *Shaffer v. Heitner*, 433 U.S. 186, 207 (1977) (holding that "fair play and substantial justice" standard applies to *in rem* jurisdiction); *Hanson v. Denckla*, 357 U.S. 235, 247 nn.16 & 17 (1958) (sustaining Delaware court's exercise of jurisdiction in declaratory judgment action to determine ownership of trust assets deposited with Delaware trust company); *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950) ("[T]he vital interest of the State in bringing any issues as to its fiduciaries to a final settlement can be served only if interests or claims of individuals who are outside of the State can somehow be determined."); see also RESTATEMENT (SECOND) OF JUDGMENTS § 6 (1982) ("A state may exercise jurisdiction to determine interests in a thing if the relationship of the thing to the state is such that the exercise of jurisdiction is reasonable.").

⁴¹¹ A more problematic question would be the effect of a declaratory judgment, issued before any creditor claims have arisen, that purports to establish that the trustee holds trust assets free of all future creditor claims. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 103 (1971) (providing that the judgment of one state "need not be recognized or enforced in a sister State if . . . it would involve an improper interference with important interests of the sister State"); *cf.* *Elkind v. Byck*, 439 P.2d 316, 320 (Cal. 1968) (holding that California courts were not bound by a Georgia judgment that precluded further child support awards because Georgia "should not be permitted to determine the welfare of the child for all time and in all states"). *But cf.* *Yarborough v. Yarborough*, 290 U.S. 202, 212 (1933) (noting that a child's residence within a state does not give that state the power to impose additional duties on a nonresident father, who has complied with the judgment of a court in his domicile).

⁴¹² Commencement of an involuntary bankruptcy proceeding would not automatically stay litigation brought by the trustee to establish that a creditor has no rights in the trust proceeds, because the action would not be one brought against the debtor within the meaning of the Bankruptcy Code's automatic stay provision. See 11 U.S.C. § 362 (1994). Nevertheless, the bankruptcy court retains general equitable powers to issue orders or process necessary to carry out the provisions of the Bankruptcy Act. See *id.* § 105.

Note also that the settlor could not bring a voluntary bankruptcy proceeding in Alaska unless the settlor was a resident of Alaska or unless most of the settlor's assets were in Alaska. See 28 U.S.C. § 1408. Even if the settlor created an Alaska trust with most of his

The preemptive strike strategy, however, is not available to trustees of offshore trusts. Because the Full Faith and Credit Clause does not require American courts to enforce foreign judgments, a declaratory judgment by a Cook Islands court purporting to establish that a creditor has no rights to trust proceeds would not be binding and would not likely be persuasive in an American court. In this respect (although, as we have seen, not in many others) creditors are in a better position when the settlor has transferred assets offshore.

IV

SLOWING THE RACE: WHAT ROLE FOR LEGISLATION?

We have seen that if individual jurisdictions are free to compete for trust business by offering attractive packages of trust law provisions, many of them will have incentives to adopt inefficient, externality-generating trust law rules. Especially if relatively few local settlors make use of the trust law rules, few of the costs of the rules will be borne at home. Furthermore, if the trust law rules can be made available *only* to outsiders,⁴¹³ the jurisdiction has significant incentives to adopt rules that are attractive to outside settlors, whatever the costs those rules generate in the settlors' home jurisdictions. This race to capture trust business has been in progress offshore for at least a decade.⁴¹⁴ We are now seeing the start of the race within the United States itself.⁴¹⁵ Should the race trigger a legislative response?

Federal legislation to prohibit or restrict asset protection trusts is problematic. Congress has historically left the states free to choose which debtor assets should be exempt from creditor claims, and those exemptions survive even a federal bankruptcy proceeding.⁴¹⁶ Federal restraints on asset protection trusts would represent a significant break with that long-standing position. Moreover, if Congress were to restrict asset protection trusts, the appropriate shape of those restrictions would remain controversial. Finally, federal legislation on the

assets, the settlor would not be able to claim that most of his assets were in Alaska; the point of creating the trust was to establish that the assets were not, in fact, his assets. *See id.* As a result, venue in Alaska would be improper, and the settlor would not have the opportunity to argue that the federal bankruptcy court was bound, under *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941), to apply Alaska law. *Cf. supra* note 359.

⁴¹³ The Cook Islands' International Trusts Act, for instance, applies only to trusts whose "beneficiaries are at all times non-resident." International Trusts Act (1984) § 2 (1996) (Cook Islands) (defining "international trusts").

⁴¹⁴ *See supra* Part I.B.

⁴¹⁵ *See supra* Part I.C.

⁴¹⁶ *See* 11 U.S.C. § 522(b)(1) (providing for federal exemptions in bankruptcy, but permitting state law to disallow an exemption otherwise authorized); *id.* § 522(b)(2)(A) (exempting property that would be exempt under state law). More than two-thirds of the states disallow the use of federal exemptions. *See* Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. Rev. 235, 241 (1995).

substantive law of trusts would not reach many offshore trusts, simply because the United States as an entity lacks power to compel the foreign trustee to act in accordance with American law.

Moreover, with respect to domestic asset protection trusts, federal legislation may be largely unnecessary. If states sanction asset protection trusts primarily to attract the dollars of out-of-staters whose home states do not provide comparable protection, that market might well collapse as settlor-debtors realize that bankruptcy courts, armed with nationwide jurisdiction and power to apply the law of the settlor-debtor's home state, can reach the trust assets to satisfy creditor claims. Of course, some states might continue to authorize asset protection trusts to protect local settlor-debtors against their creditors, but that decision does not generate the same externalities and presents a less compelling case for federal intervention.

The bigger problem is with offshore trusts. With respect to these trusts, American courts have fewer tools to enable creditors to reach trust assets. As a result, offshore trusts remain attractive to some classes of debtor-settlers. The states, through the National Conference of Commissioners on Uniform State Laws, could collectively improve the lot of creditors by revising Article 8 of the UCC to make it possible for creditors to reach interests in closely held corporations or partnerships, without obtaining physical possession of the stock certificates or other indicia of ownership. These revisions, however, would make those interests less liquid, and the adverse impact that the revisions might have on commercial transactions could outweigh any benefits they would have with respect to tort claimants. A similar problem would accompany federal legislation that makes it easier for creditors to attach a debtor's interest in an American corporation or partnership.

Indirect sanctions against offshore trust settlors are somewhat more promising. As we have seen, courts have already imposed one such sanction on recalcitrant settlor-debtors: denial of the bankruptcy discharge. Another option is the modern-day equivalent of debtors' prison: criminal sanctions for persons who establish trusts in jurisdictions that enforce spendthrift provisions in self-settled trusts. Some commentators have argued that the legal framework is already in place for incarcerating settlors of offshore trusts and that courts currently have power to imprison uncooperative settlors for civil contempt, criminal contempt, or bankruptcy fraud.⁴¹⁷

⁴¹⁷ See Stacey K. Lee, *Piercing Offshore Asset Protection Trusts in the Cayman Islands: The Creditors' View*, 11 *TRANSNAT'L LAW.* 463, 497 (1998).

In *FTC v. Affordable Media*,⁴¹⁸ the Ninth Circuit affirmed civil contempt sanctions against the settlor of an offshore trust.⁴¹⁹ However, as we have seen, civil contempt remains problematic as a basis for incarceration.⁴²⁰ Because civil contempt is designed to induce compliance with a court order, it is inappropriate if the settlor-debtor can prove that compliance was impossible for lack of control over the trust assets.⁴²¹ Criminal contempt is a punishment meted out for willful violation of a court order. Again, if the settlor lacked power to comply, the basis for punishment would be undercut.⁴²² Moreover, bankruptcy fraud could be difficult to establish if, in connection with the bankruptcy proceeding, the settlor-debtor voluntarily disclosed all of the details surrounding his offshore trust.⁴²³

If criminal sanctions are appropriate, legislation that explicitly targets offshore trusts would be preferable. Moreover, the notion that criminal sanctions can effectively deter asset concealment is not novel. Congress has recently added criminal penalties to its strategy for preventing property owners from making transfers that would qualify them for Medicaid assistance.⁴²⁴ As in the Medicaid context, Congress or state legislatures could make the sanctions even more effective by imposing them on persons—including lawyers—who aid and abet a settlor who transfers assets to an offshore trust.⁴²⁵

⁴¹⁸ 179 F.3d 1228 (9th Cir. 1999).

⁴¹⁹ See *id.* at 1228.

⁴²⁰ See *supra* text accompanying notes 340-42.

⁴²¹ For discussion of the impossibility defense to civil contempt, see Linda S. Beres, *Civil Contempt and the Rational Contemnor*, 69 *IND. L.J.* 723, 727 (1994) and Michele Dickey, *Authority of the Trial Judge*, 86 *Geo. L.J.* 1659, 1669-72 (1998).

⁴²² For a discussion of the requirement that criminal contempt be willful, see Dickey, *supra* note 421, at 1674.

⁴²³ Two statutes govern bankruptcy fraud. The first, 18 U.S.C. § 152 (1994 & Supp. IV 1998), prohibits knowing concealment of assets in connection with a bankruptcy case. If the law of the offshore jurisdiction, together with the terms of the trust instrument, deprives the settlor-debtor of power to control trust assets, and if the debtor discloses the trust's terms to the bankruptcy court, it might be difficult to find that the debtor had "knowingly and fraudulently conceal[ed] . . . property belonging to the estate of the debtor." *Id.*

The second bankruptcy fraud statute, see *id.* § 157, makes it criminal for a debtor to file a bankruptcy petition "for the purpose of executing . . . a scheme" to defraud. *Id.* Again, if the debtor is entirely truthful before the bankruptcy court, it may be difficult to conclude that the petition was filed with the requisite intent to defraud.

⁴²⁴ The Health Insurance Portability and Accountability Act of 1996, 29 U.S.C. §§ 1181-1182 (Supp. III 1997), imposes criminal penalties on any person who "for a fee knowingly and willfully counsels or assists an individual to dispose of assets (including by any transfer in trust) in order for the individual to become eligible for medical assistance under a State plan under subchapter XIX." 42 U.S.C. § 1320a-7b(a)(6) (Supp. 1998).

⁴²⁵ See 42 U.S.C. § 1320a-7b(a)(6) (imposing aider and abetter liability). Not surprisingly, many lawyers object to the prospect of such liability. See, e.g., John M. Broderick, *To Transfer or Not to Transfer: Congress Failed to Stiffen Penalties for Medicaid Estate Planning, but Should the Practice Continue?*, 6 *ELDER L.J.* 257, 277-85 (1998).

We must also consider if prison is a sanction too draconian for creditor avoidance. As Lynn Lopucki has observed, “[i]n contemporary society, governments enforce law by essentially two mechanisms: incarceration and liability.”⁴²⁶ The efficacy of a liability system, however, requires either voluntary compliance by the judgment debtor or sovereign power over the debtor’s property. Indeed, so long as the state has sovereign power over the debtor’s property, voluntary compliance is likely, because a recalcitrant debtor would realize limited returns on his failure to comply. So long as most Americans regard moving assets outside the United States as too costly, either because of potential political or economic upheaval abroad or because of the time and expense involved in transferring assets to and from foreign jurisdictions, the liability system is generally effective.⁴²⁷ The growth of the offshore trust, however, suggests that the cost of exporting assets no longer seems so daunting to many people. If that trend expands, incarceration may well be the only available brake any individual government has on trust law’s international race for the bottom.

In one federal district court case, the judge issued a preliminary injunction, on First Amendment grounds, against enforcement of a statute’s imposition of criminal liability on aiders and abettors. *See* New York State Bar Ass’n v. Reno, 999 F. Supp. 710, 716 (N.D.N.Y. 1998).

Even without criminal penalties, the Model Rules of Professional Conduct restricts lawyers from counseling clients to engage in behavior “that the lawyer knows is criminal or fraudulent.” *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1999).

⁴²⁶ LoPucki, *supra* note 34, at 3.

⁴²⁷ LoPucki also catalogues a variety of other constraints on liability avoidance, many of which, in his view, are dissolving. *See id.* at 38-54.