Delaware Asset Protection Trusts and Creditors' Rights

Settlor-beneficiaries who create Delaware asset protection trusts will have greater protection against the claims of bankruptcy and non-bankruptcy creditors than they otherwise would have had if they had not created such trusts.

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Trust settlors have had the ability to create a Delaware asset protection trust (DAPT) since 1997 under the Delaware Qualified Dispositions in Trust Act, 12 Del. C. §§ 3570 et al. (the "Act"). Under traditional common law, a spendthrift clause included in a trust instrument is inapplicable to the settlor-beneficiary of a self-settled trust and the settlor's creditors could obtain access to the assets of a self-settled trust.[1] However, the Act is a statutory override of this traditional common law rule. If a trust qualifies as a DAPT under the Act, then its spendthrift clause may apply to the settlor.

A discussion of the requirements for a trust to satisfy the provisions of the Act, and thus become a valid DAPT, has been addressed by numerous authors and is outside of the scope of this article. This article is intended to discuss the rights that creditors may have to access the assets of a DAPT once it is created. The first issue to be addressed is what happens when a creditor tries to access assets held in a DAPT in the context of the settlor's bankruptcy.

Bankruptcy protection of beneficial interests in a DAPT

Bankruptcy Code section 541(a)(1) provides that a debtor's bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case...." This provision has been interpreted very broadly. The breadth of section 541(a) has been expanded by section 541(c)(1)(A), which states that "an interest of the debtor in property becomes property of the [bankruptcy] estate ... notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—(A) that restricts or conditions transfer of such interest by the debtor...." However, section 541(c)(2) provides an exception to this rule for an interest in a trust that is subject to a valid spendthrift provision. Bankruptcy Code section 541(c)(2) states "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."

DAPT is essentially a trust that contains a spendthrift provision that applies to the settlor pursuant to the Act. A spendthrift provision is a provision in a trust instrument that generally prohibits or invalidates the voluntary or involuntary assignment, pledging, transfer, or anticipation of the beneficiary's interest in the trust.

By the express terms of section 3570(11)c of the Act, the spendthrift provision of a DAPT instrument is a restriction on the settlor's beneficial interest that is enforceable under applicable nonbankruptcy laws

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within the meaning of Bankruptcy Code section 541(c)(2).[2] Although a creditor may contend that the "applicable nonbankruptcy law" under section 541(c)(2) is the law of the debtor's domicile, which may not have adopted self-settled asset protection trust legislation, this argument should be unsuccessful with respect to a properly structured and administered DAPT.[3]

Discretionary trusts. If a settlor-beneficiary has the right to receive distributions of income or principal in the sole discretion of the trustee from a trust that is not a DAPT (or an asset protection trust under a law similar to the Act), the entire trust fund may be subject to the claims of the settlor's creditors.[4] If the trust is a DAPT, however, then generally the entire trust fund should be protected from the settlor's creditors. Only distributions actually made to the settlor would potentially be subject to the settlor's creditors.

Income, unitrust, or annuity trusts. If a debtor in bankruptcy is a beneficiary of a trust, and there is no spendthrift clause applicable to the debtor-beneficiary's interest, or there is a spendthrift clause but it is not valid, the debtor-beneficiary's interest in the trust will become property of the bankruptcy estate and may be distributed among the creditors of the debtor-beneficiary.[5] Thus, in the absence of a spendthrift provision, a debtor-beneficiary's right to receive income, annuity, or unitrust distributions over a period of time, or for the remainder of his or her lifetime, will become a part of the bankruptcy estate and, in the future, the debtor-beneficiary will no longer possess that interest.[6] However, numerous cases have held that under Bankruptcy Code section 541(c)(2), a debtor-beneficiary's interest in a trust that is subject to a valid spendthrift provision under applicable state law is not a part of the bankruptcy estate.[7]

Bankruptcy protection for DAPT distributions

Although a debtor-beneficiary's income, annuity, or unitrust interest in a DAPT, as well as the remainder interest of the trust, should not be includable in the bankruptcy estate, the distributions from the trust to the debtor-beneficiary will be included as a part of the debtor's bankruptcy estate to the extent that the distributed assets fall within the scope of Bankruptcy Code section 541(a). In such cases, the courts have generally held that distributions from a trust are includable in the bankruptcy estate under section 541(a)(5)(A), which states that the bankruptcy estate includes: "[a]ny interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date—(A) by bequest, devise, or inheritance...."[8]

The Bankruptcy Code does not define the terms, "bequest," "devise," or "inheritance." Nonetheless, courts have held that a distribution of income received by a beneficiary from a testamentary trust with a spendthrift clause is a "bequest, devise, or inheritance" within the meaning of section 541(a)(5)(A).[9] However, a majority of courts have not held the same for inter vivos trusts with a spendthrift clause. Although at least one court has expanded section 541(a)(5)(A)'s reach beyond testamentary trusts,[10] most courts have declined to extend this principal to apply to such inter vivos trusts.[11]

We are not aware of any bankruptcy cases involving income, annuity, or unitrust distributions received by a settlor of an asset protection

1 See *Restatement (Second) of Trusts*, section 156(1) (1959); Weymouth v. Delaware Trust Co., 45 A.2d 427 (Del. Ch., 1946); Wilmington Trust Co. v. Carpenter, 75 A.2d 815 (Del. Ch., 1950).

2 12 Del. C. § 3570(11)c.

3 See Scott and Fratcher, *The Law of Trusts*, § 626(3) (4th ed., 1989) ("What then is the law applicable in determining whether a beneficiary's interest is transferable or can be reached by his creditors [in bankruptcy]? We have seen that ordinarily the law of the state of the place of administration ... determines whether the interest of a beneficiary is assignable to him and whether it can be reached by his creditors. Hence it is the law of that state which determines whether it can be reached by his trustee in bankruptcy."); see also In re Hunter, 380 B.R. 753 (Bkrptcy. DC Ohio, 2008) ("In deciding whether a debtor's interest is an interest in a trust, courts look to the law governing the purported trust.").

4 See *Restatement (Second) of Trusts*, § 156(2) (1959).

5 See, e.g., In re Mack, 269 B.R. 392 (Bkrptcy. Minn., 2001). The court in that case stated that all of the debtor-beneficiary's interests in the trust, including the power to remove and appoint trustees, became the property of the bankruptcy estate.

6 If the debtor only possesses the right to receive income, annuity, or unitrust distributions, the remainder interest of the trust should not become a part of the bankruptcy estate.

7 See, e.g., In the Matter of Moody, 837 F.2d 719 (CA-5, 1988); In the Matter of Hecht, 54 B.R. 379 (Bkrptcy. DC N.Y., 1985); Matter of Newman, 903 F.2d 1150 (CA-7, 1990) ("While there is disagreement about what else it might cover, it is clear that the phrase 'applicable nonbankruptcy law' used in [section 541(c)(2)] was intended to be applied to state law concerning spendthrift trusts...."); In re Coumbe, 304 B.R. 378 (CA-9 B.A.P., 2003) ("Under § 541(c)(2), an anti-alienation provision in a valid spendthrift trust created under state law is an enforceable 'restriction on the transfer of a beneficial interest of the debtor,' thereby excluding the trust assets from the bankruptcy estate."); see also Patterson v. Shumate, 504 U.S. 753 (1992) (extending the reach of 541(c)(2) to exclude a debtor's interest in an ERISA-qualified plan).

8 11 U.S.C. section 541(a)(5)(A).

9 See, e.g., In re Kragness, 58 B.R. 939 (Bkrptcy. Ore., 1986); In re Hunter, 261 B.R. 789 (Bkrptcy. DC Fla., 2001); In the Matter of Hecht, 54 B.R. at 383 ("Once income is received by the beneficiary or the beneficiary is entitled to receive it under the terms of the trust, the income is no longer entitled to spendthrift protection.").

10 See, e.g., In the Matter of Moody, *supra* note 7 ("Such trust income payments would qualify as 'bequests' under 11 U.S.C. § 541(a)(5)(A)."). The court did not make clear whether the trust at issue was created as an inter vivos trust or as a testamentary trust. However, the court did indicate that the trust was created by W.L. Moody, Jr. on 12/26/1934. W.L. Moody, Jr. died on 7/21/1954.

trust. Consequently, it is not clear whether income distributions to the settlor of a DAPT would be includable in the bankruptcy estate under section 541(a)(5)(A) as a "bequest, devise, or inheritance" or whether such payments would be includable under some other provision of section 541(a). DAPTs, however, are inter vivos trusts and do not clearly fall within the meaning of a "bequest, devise, or inheritance." Additionally, such income distributions to the settlor of a DAPT may not be includable under section 541(a)(5)(A) because the settlor was the original transferor of the assets.

Another provision of section 541(a), which creditors may cite to include income distributed to the settlor of a DAPT in the bankruptcy estate, would be section 541(a)(1). It includes "all legal or equitable interests of the debtor in property *as of the commencement of the case*" (emphasis added). Under this provision, only the income distributions that the settlor received, or was entitled to receive, up to the time of the commencement of the bankruptcy proceeding would be includable in the bankruptcy estate, and any distributions made after the commencement of the proceeding (including distributions made within 180 days following the commencement of the proceeding) would not be includable.

For example, at least one court has specifically declined to use section 541(a)(1) to include income distributed during the 180-day period following the filing to a beneficiary who was not the settlor of an inter vivos trust.[12] Additionally, a debtor could argue that section 541(a)(1) specifically directs the reader to section 541(c)(2) which, as discussed above, supports enforcing a restriction on the transfer of a beneficial interest if such interest would be enforceable under applicable nonbankruptcy law.

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Thus, to be includable in the bankruptcy estate, a distribution from a DAPT must either:

1. Have been received by the settlor/beneficiary prior to the filing under section 541(a)(1).
2. Be received by the debtor-beneficiary within 180 days following the filing of the bankruptcy petition and result from a bequest, devise, or inheritance under section 541(a)(5)(A).

Regardless of which provision under section 541(a) may cause the income distributions of a DAPT to be includable in the bankruptcy estate, it appears that the broadest interpretation of any of these provisions would allow only income distributions received by the debtor-beneficiary within 180 days after the commencement of the proceeding to be includable. Income received by the debtor-beneficiary after the 180-day period following the filing of the bankruptcy petition would not be included in the bankruptcy estate.

Fraudulent conveyances to a DAPT

The Bankruptcy Code also includes a fraudulent conveyance provision that is specifically directed at self-settled trusts. Bankruptcy Code section 548(a) provides that a trustee in bankruptcy can avoid any transfer that was made or incurred within two years before the filing of the bankruptcy petition if there was an actual intent to hinder, delay, or defraud. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act) added a new section 548(e), which extends the two-year period to ten years for self-settled trusts if the transfer to the trust was a fraudulent transfer. Implicitly, section 548(e) validates the legitimacy of a DAPT.

The background to the enactment of Bankruptcy Code section 548(e), as a part of the 2005 Act, is both interesting and relevant to the discussion of the acceptability of DAPT's. Reportedly in response to a *New York Times* article criticizing domestic asset protection trusts,[13] Senator Charles Schumer of New York proposed an amend-

[11] See, e.g., Matter of Newman, 903 F.2d at 1154 ("Congress listed the specific interests to be included as property of the [bankruptcy] estate. Those interests do not include a category into which an *inter vivos* spendthrift trust may fit.... The decision of Congress to list certain interests without introducing them with the words 'includes' or 'including' creates a presumption that those are the sole interests covered.... [Such] [p]ayments [do not] qualify as interests 'by bequest, devise, or inheritance,' as specified in 11 U.S.C. § 541(a)(5)."); In re Coumbe, 304 B.R. at 385 (distinguishing Newman on the basis that the income distribution in Coumbe derived from a testamentary trust, where, in Newman, the income distributions came from an inter vivos trust); In re Schmitt, 215 B.R. 417 (CA-9 B.A.P., 1997) (stating that *inter vivos* trusts are not considered an interest obtained by "bequest, devise, or inheritance."); In re Crandall, 173 B.R. 836, 839 (Bkrptcy. DC Conn., 1994) ("The court is constrained to give a narrow construction to the words 'bequest, devise, and inheritance' and to conclude such words in their plain meaning do not encompass ... *inter vivos* trusts."); In re Roth, 289 B.R. 161 (Bkrptcy. DC Kan., 2003) ("[T]his Court cannot simply assume that Congress intended to include every vehicle for transferring property upon death in § 541(a)(5), since it clearly understood the concept of trusts in passing other federal statutes in the same time frame."); In re Spencer, 306 B.R. 328 (Bkrptcy. DC Calif., 2004) ("[T]his Court must ... conclude that section 541(a)(5) does not operate to include interest in property transferred to a debtor by way of inter vivos trust."); In re Eley, 331 B.R. 353 (Bkrptcy. DC Ohio, 2005) ("§ 541(a)(5)(A) does not allow postpetition distributions from an Ohio *inter vivos* spendthrift thrust to become property of the beneficiary's bankruptcy estate.").

[12] See Newman, 903 F.2d at 1154 ("Payments made to the debtor from the trusts during the 180 days following the filing of the bankruptcy action are not interests held by the debtor at the commencement of the case, as specified in 11 U.S.C. § 541(a)(1)....").

[13] See Morgenson, "Proposed Law On Bankruptcy Has Loophole," N.Y. Times, 3/2/2005.

ment to the 2005 Act legislation to pull all assets over $125,000 transferred to a self-settled trust into the bankruptcy estate.

The article asserted that the bankruptcy legislation then being debated in the Senate, which was intended to make it harder for people to walk away from credit card and other debts, is insufficient because it fails to close "an increasingly popular loophole that lets wealthy people protect substantial assets from creditors even after filing for bankruptcy." The loophole that the article criticized is the use of domestic asset protection trusts. The article cast a negative light on asset protection trusts and stated that such trusts should either be excluded from the bankruptcy law, which exempts assets held in trust that are governed by "applicable nonbankruptcy law" under Bankruptcy Code section 541(c)(2), or a dollar limit should be placed on the assets that may be used to fund an asset protection trust. The article stated that such trusts have become "increasingly popular in recent years among physicians, who fear large medical malpractice awards, and corporate executives, whose assets are at greater peril now because of new laws." According to the author, wealthy individuals can use asset protection trusts established in states like Delaware to shield their assets from creditors, calling such trusts an "abuse by rich people."

The proposed legislative change would have had a significantly deleterious effect on self-settled asset protection trusts in the bankruptcy context. Senator Schumer's proposed amendment was defeated in the Senate by a vote of 56 to 39. Subsequently, Senator Jim Talent of Missouri proposed an amendment that is currently found in Bankruptcy Code section 548(e). It passed by a vote of 73 to 26. This is very important background because it makes clear that Congress has expressly debated and considered the efficacy of domestic asset protection trusts and essentially approved of the use of asset protection trusts by a vote of 73 to 26 in adopting this 2005 amendment to the Bankruptcy Code.

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Under section 548(e), a trustee in bankruptcy "may avoid any transfer of an interest of the debtor in property that was made on or within ten years before the date of the filing of the petition if—(A) such transfer was made to a self-settled trust or similar device; (B) such transfer was by the debtor; (C) the debtor is a beneficiary of such trust or similar device; and (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted."

The effect of section 548(e) on a settlor-beneficiary of a DAPT is not fully apparent. Since the enactment of the 2005 Act, we are aware of only two Bankruptcy Court cases that have analyzed section 548(e). Despite the apparent legislative intent that section 548(e) should apply to self-settled asset protection trusts that include a valid spendthrift clause applicable to the settlor and provide the settlor with creditor protection, the two cases that we have identified do not even involve such trusts.

The first case, *In re Potter*,[14] is an unreported case from the Bankruptcy Court in the District of New Mexico that found that section 548(e) applied to transfers that a debtor made to a self-settled trust governed by California law. It is important to note that California does not authorize self-settled asset protection trusts. Rather, this court, under applicable California law, noted that "when the settlor is a beneficiary of the trust, any spendthrift provisions are invalid." Thus, the spendthrift provision of the trust was unenforceable with respect to the settlor and the bankruptcy trustee could reach the assets of the trust. This would also be the result in Delaware for self-settled trusts that do not comply with the requirements of the Act.

Nevertheless, the *Potter* court examined section 548(e) as a means for creditors to reach the self-settled assets of the trust. In the case, the debtor admitted to having a $600,000 judgment against him at the time he created, and transferred property to, the self-settled trust. The court found that the stated purpose of the trust was "to provide for the maintenance of Mr. Potter and fund his litigation, thus its intended effect could only be to shield his assets from creditors in order to allow Mr. Potter additional time to pursue and defend pending litigation."

The court held that the transfers to the trust, "as analyzed (under the state Uniform Fraudulent Transfer Act [UFTA]) ... were made with the intent to hinder or delay," and thus the trustee in bankruptcy could establish a claim under section 548(e). Although the court found that actual intent to defraud may be inferred under the UFTA from the facts and circumstances in the case, the court also

[14] 2008 WL 5157877 (Bkrptcy. DC N.M., 7/29/2008).

noted that since the UFTA requires an "intent to hinder, delay, *or* defraud, it is sufficient if the facts and circumstances show that the defendant merely intended to hinder or delay his or her creditors."

One other important note from *Potter* was that the court found that a debtor need not be the sole beneficiary of the self-settled trust for section 548(e) to be applicable. The debtor had argued that the trust was not self-settled because there were beneficiaries other than the debtor and because some of the transfers to the trust were made from two limited liability companies. The trust "was funded in part with shares of Summit Investment and Summit Valdes, two independent limited liability companies. [However, the debtor was] the sole member of Summit Investment, and Summit Investment, in turn, owned all the membership interest of Summit Valdes."

The court dismissed this claim, however, holding that for section 548(e) to apply, "the debtor need only to be 'a' beneficiary, not the sole beneficiary" of the trust.

The second case from the Bankruptcy Court for the District of Kansas, *In re Krause*,[15] involved several irrevocable trusts that the debtor created for the benefit of the debtor's children, and the debtor did not retain a beneficial interest. In other words, these trusts were neither asset protection trusts nor self-settled. Prior to marriage, the debtor entered into an antenuptial agreement that required the debtor to establish a spendthrift trust on the birth of his children. The debtor funded the trusts over a period of time with cash and life insurance policies. The bankruptcy trustee asserted that the assets of the trusts were subject to the ten-year look-back provisions of section 548(e). In a summary judgment motion, the debtor argued that the bankruptcy trustee had no section 548(e) claim because the trusts were not self-settled trusts and the debtor is not the beneficiary of the trust.

The court found the debtor's arguments "unpersuasive" and that section 548(e) "allows avoidance of transfers made to a self-settled trust *or similar device*." (Emphasis added.) The bankruptcy trustee argued that the trusts were "similar devices" and that the debtor was actually the trust beneficiary of the trusts. The court found that there were genuine issues of material fact, which precluded summary judgment. Ultimately, when these issues were decided by the Kansas Bankruptcy Court in April 2008, the court held that the trusts were deemed to be the debtor's "nominees" and the assets of the trusts were treated as the assets of the debtor himself, due to a substantial factual record of the debtor using and controlling the trusts for himself and engaging in a decades-long "scheme" of keeping assets out of his own name, while using them for his personal benefit and avoiding creditors. The issues involving the trusts were not ultimately decided under section 548(e), and the relevance of the Kansas court's analysis of the section is questionable in light of the facts and the ultimate disposition of the case.

It is still not clear how section 548(e) will be interpreted when a set of facts may present a closer call. At least three variations exist as to implications of this statute. As one initial interpretation, a United States bankruptcy judge from the District of Utah authored an article suggesting that a trustee in bankruptcy, to avoid a transfer under section 548(e), need not prove that a settlor intended such transfer to defraud a creditor, although that proof would be sufficient. Rather, Judge Glen Clark indicated that a trustee in bankruptcy might need to prove only that the debtor intended to hinder, or delay, future creditors as part of an asset protection strategy.[16]

In contrast, the Act requires, for a creditor whose claim arose after a transfer to a DAPT, proof that the transfer was made with an actual intent to defraud such creditor.[17] Consequently, such transfer could not be avoided in a Delaware state court action if the creditors could prove only that the settlor actually intended to hinder or delay a creditor whose claim arose after such transfer. Therefore, under this view, section 548(e) would substantively extend the ability of a trustee in bankruptcy to avoid a transfer made to a DAPT.

A moderate interpretation notes that because asset protection trust statutes already do not provide protection against fraudulent transfers, section 548(e) simply appears to extend the four-year limitation period, as provided for under the UFTA, to a period of ten years.[18] Delaware has adopted the UFTA, whose definition of fraudulent transfers is substantially identical to the language used in section 548(e).[19] Delaware's adoption of the UFTA is specifically referenced in the Act.[20] Thus, pursuant to this analysis, section 548(e) would not substantively expand the potential means of transfer avoidance that currently exist under the Act. Rather, it only broadens the procedural window through which a trustee in bankruptcy may avoid such a transfer by extending the four-year limitations period to ten years.

[15] 386 B.R. 785 (2008).

[16] See Clark, "Bankruptcy Muscle on Steroids—New Changes to Chapter 5 of the Code," 012606 ABI-CLE 350 (2005).

[17] See 12 Del. C. § 3572(a).

[18] See Shaftel and Bundy, "Impact of New Bankruptcy Provision on Domestic Asset Protection Trusts," 32 ETPL 28 (July 2005).

[19] See 6 Del. C. § § 1301-11. For a definition of fraudulent transfers under the Delaware Uniform Fraudulent Transfer Act, see 6 Del. C. § 1304(a)(1).

[20] See 12 Del. C. § 3572(b)(2).

Another interpretation put forward in a co-authored article by a United States bankruptcy judge from the Western District of Tennessee would be even more favorable to a settlor. Judge William Brown analyzed section 548(e) as to require that a trustee in bankruptcy prove not just that the settlor intended to hinder, delay, or defraud creditors *in general* when making the transfer, but rather the settlor intended to hinder, delay, or defraud a *specific* creditor at the time of the transfer.[21] A similar analysis was also offered by Judge Clark as an alternative to the first interpretation.[22] Under either of these latter two interpretations, as long as at the time of the initial transfer into a DAPT the settlor is solvent and does not make such transfer to defraud creditors, then such settlor would be able to defend successfully against any potential section 548(e) fraudulent transfer claims.

The existence of a DAPT presents a substantial impediment to a creditor.

The important point to be made about Bankruptcy Code section 548(e) is that it appears to establish clearly that a creditor should not have the ability to pull the corpus of a properly created DAPT into the debtor's bankruptcy estate, because section 548(e) requires the presence of a fraudulent transfer. A transfer to a DAPT should never be a fraudulent transfer, and practitioners and fiduciaries should (and do) take great care to ensure that transfers to a DAPT are not fraudulent transfers. A fraudulent transfer can be defeated under both the Act and the Bankruptcy Code, and it goes without saying that counsel should never assist a client with a fraudulent transfer.

General judgment creditors

Outside of the context of a bankruptcy proceeding, the extent to which a creditor could attack income, annuity, or unitrust distributions from an asset protection trust in a state court proceeding is unclear. It may be possible for a creditor who obtains a favorable judgment to have a judgment lien issued against the debtor's bank accounts or employ some other means of obtaining assets distributed from a DAPT following the judgment. A creditor might also try to obtain a judgment against the settlor in a state that does not recognize self-settled asset protection trusts and then come to Delaware and argue that such judgment is enforceable against the DAPT under the Full Faith and Credit Clause of the U.S. Constitution. Many articles have been written about the Full Faith and Credit Clause in this context, and a complete discussion of the Constitutional issues is outside the scope of this article. We note, however, that there are several important issues to be addressed here.

First, a court in another state must have jurisdiction, either in the form of *in rem* jurisdiction over the trust property or personal jurisdiction over the trustee. If a trustee holds and administers all trust assets exclusively in Delaware, the trustee could argue that another state would not have *in rem* jurisdiction over the trust corpus.[23] Thus, the creditor may be forced to seek personal jurisdiction over the trustee. Under the prevailing test, the creditor must satisfy two conditions:

1. That the trustee maintains certain minimum contacts with the forum state.
2. That asserting personal jurisdiction would not offend traditional notions of fair play and substantial justice.[24]

If the settlor uses only a Delaware trustee who maintains no office in the forum state and sends no representatives there, it is possible that a court will not be able to assert personal jurisdiction.[25] There are also arguments that the issue of jurisdiction over the trustee of the DAPT must be viewed from not the perspective of the trustee's contacts with the other jurisdiction in its corporate capacity, but rather whether the court has jurisdiction over the trustee, in its capacity as trustee of this particular trust.[26]

In the event that a creditor successfully argues that the trustee was subject to personal jurisdiction in a forum state, the court must decide whether to apply Delaware law or the law of the forum state. In determining which state's law governs the validity of a trust, a Delaware court considers the following factors:

1. The intention of the settlor of the trust.
2. The domicile of the trustee of the trust.
3. The place where the trust is administered.[27]

[21] See Brown, *Bankruptcy and Domestic Relations Manual* § 11:3.

[22] See Clark, *supra* note 16.

[23] See Walker v. W. Michigan Nat. Bank & Trust, 324 F. Supp. 2d 529 (DC Del., 2004), *aff'd* 145 Fed. Appx. 718 (CA-3, 2005).

[24] See International Shoe Co. v. Washington, 326 U.S. 310 (1945).

[25] See Hanson v. Denckla, 357 U.S. 235 (1958). Hanson involved a Delaware trust created by a Pennsylvania settlor who exercised a lifetime power of appointment and died in Florida. Although the Florida court ruled on the validity of the settlor's exercise of such power, the Supreme Court held that the Florida court assert personal jurisdiction over the trustee only if the trustee had "purposefully avail[ed] itself of the privilege of conducting activities within the forum State." Because the trustee had no contact with Florida, the court could not establish personal jurisdiction.

[26] See, e.g., Perrine v. Pennroad Corp., 168 A. 196 (Del. Ch. 1933).

[27] See Lewis v. Hanson, 128 A.2d 819 (Del., 1957), *aff'd sub nom.* Hanson v. Denckla, 357 U.S. 235, *reh'g den.* 358 U.S. 858 (1958); see also Wilmington Trust Co. v. Wilmington Trust Co., 24 A.2d 309 (Del., 1942); Wilmington Trust Co. v. Sloane, 54 A.2d 544 (Del. Ch., 1947).

This is generally consistent with traditional common law trust conflicts of laws analysis in most jurisdictions.

If the DAPT is properly structured and administered, the choice of Delaware law should satisfy the conflicts of laws rules in Delaware as well as the other jurisdiction, and Delaware law (including the Act) should apply to the DAPT (although there could potentially be an issue if the application of Delaware law violates strong public policy of the state that has the most significant relationship to the matter at issue).[28]

If a non-Delaware state court applied the law of a state other than Delaware, the Act creates an additional hurdle by providing that the trustee of a DAPT will cease to act as trustee in all respects and that a successor trustee must be appointed.[29] Alternatively, the trustee could bring an action in Delaware court to obtain a competing order holding that Delaware law applies. This was the conflict between the Florida and Delaware courts in the seminal Delaware case, *Lewis v. Hanson*,[30] which ended up being decided by the U.S. Supreme Court. Finally, even if the forum state court did assert personal jurisdiction and ruled that, under the law of the forum state, the property in the DAPT could be used to satisfy the judgment, the creditor still would need to persuade a Delaware court to enforce the out-of-state judgment. Overall, these hurdles create significant disincentives for a creditor to pursue property that is transferred to a DAPT.

From a practical standpoint, a creditor would likely first seek recovery from the debtor by looking to assets other than the debtor's beneficial interest in a DAPT. The existence of a DAPT presents a substantial impediment to a creditor and hurdles that a creditor will likely prefer to avoid. The jurisdictional and choice of law issues are complicated, and trust law issues will probably be unfamiliar to a plaintiff's lawyer seeking recovery for a creditor. Under the Act, if a DAPT is defeated under the Act because the transfer of assets to the DAPT was a fraudulent transfer, the DAPT would be defeated only to the extent necessary to pay that creditor's claim, together with such costs, including attorneys' fees, as the court may allow.[31]

The trustee of a DAPT may use trust assets to pay its costs of litigating the claim before satisfying the claim. Under section 3574(b)(1)(a) of the Act, unless a creditor proves by clear and convincing evidence that a trustee acted in bad faith in accepting and administering the trust, the trustee has a first and paramount lien against the assets of the DAPT in an amount equal to the entire cost, including attorneys' fees, properly incurred by the trustee in the defense of the action or proceedings to avoid the qualified disposition.[32] It is presumed that such trustee did not act in bad faith merely by accepting such property.[33] If a beneficiary has received distributions from a DAPT prior to the date the creditor commenced the action, the beneficiary may keep the distribution unless the creditor proves by clear and convincing evidence (or by a preponderance of evidence if the beneficiary is the transferor) that he or she acted in bad faith.[34]

Conclusion

It seems that in all events, a settlor who creates a trust in which he or she retains the right to receive income, unitrust, or annuity distributions will be better off creating the trust as a DAPT than as a trust in another jurisdiction that does not provide creditor protection to a settlor.

- In the best-case scenario, (1) the assets of the DAPT will be protected from the settlor's creditors, (2) the settlor's income, annuity, or unitrust interest will not be assignable and cannot be anticipated, and (3) creditors can only make a claim against actual distributions made prior to the filing of the bankruptcy petition.
- In the event of bankruptcy, it is possible, but unlikely, that income, unitrust, or annuity payments made within 180 days after filing would be included in the bankruptcy estate, and it appears that the corpus of a DAPT would be pulled into the bankruptcy estate only if the debtor made a fraudulent transfer within the previous ten years under Bankruptcy Code section 548(e).
- In the worst-case scenario, if the DAPT is invalidated, the settlor has created a situation in which many legal hurdles (and lengthy judicial proceedings) lie between the creditor and the assets of the DAPT, making the assets of the trust an unattractive target. If the assets of a DAPT were targeted by a creditor, the trustee would defend the validity of the trust in litigation, paying attorney's fees and other costs of defense as proper charges against the trust assets, resulting in the creditor's ultimate recovery from such litigation to be worth only a fraction of the total trust fund. ■

28 See Restatement (Second) of Conflict of Laws § 270 (1971).

29 See 12 Del. C. § 3572(g).

30 Lewis v. Hanson, 128 A.2d 819 (Del., 1957), *aff'd sub nom.* Hanson v. Denckla, 357 U.S. 235, *reh'g den.* 358 U.S. 858 (1958).

31 See 12 Del. C. § 3574(a).

32 See 12 Del. C. § 3574(b)(1)a.

33 See 12 Del. C. § 3574(b)(1)c.

34 See 12 Del. C. § 3574(c).